

Outreach, Reform and the Economics of Climate Change



Meeting of the OECD Council at Ministerial Level 2008

Key Information



ORGANISATION FOR ECONOMIC
CO-OPERATION AND DEVELOPMENT

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Les questions clés

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Preface

Dear Minister,

The 2008 Ministerial Council Meeting (MCM) will be held under the chairmanship of Christine Lagarde, Minister of the Economy, Industry and Employment of France, with the overarching theme of “Outreach, Reform and the Economics of Climate Change”. Ms. Lagarde will be supported by Ms. Doris Leuthard (Switzerland) and Mr. Agustín Carstens (Mexico).

This year's MCM takes place against a challenging economic landscape. Financial turbulence is affecting growth in OECD countries and is starting to touch upon major emerging economies. Soaring commodities prices, led by a spectacular increase in the price of oil, are feeding into inflation at the broader level. These price increases have coincided with a number of other factors to drive up world food prices. Then, of course, there is the question of how to tackle a changing climate, one of the greatest challenges of our time and a potentially dangerous legacy for our children.

The information in this brochure provides a background for the main topics that ministers will address. These are: i) the current economic outlook including the current food prices situation; ii) OECD activities and strategic orientations; iii) the economics of climate change; iv) the political economy of reform; v) the multilateral trading system; and vi) sovereign wealth funds.

I am especially pleased to welcome this year, for the first time, ministers from Chile, Estonia, Israel, the Russian Federation and Slovenia (the five candidate countries for accession to the Organisation), and from Brazil, China, India, Indonesia and South Africa (the five candidates for Enhanced Engagement). Their participation is both a reflection of a highly interdependent global economy, where emerging countries are playing an increasingly important role, and of a more open and inclusive OECD, gradually consolidating as a hub of permanent dialogue on global issues.

Also for the first time, this year's MCM will be held in the new OECD Conference Centre, as will OECD Forum 2008. I would strongly encourage you to participate in this “multi-stakeholder” summit which brings together business and labour representatives, civil society personalities, government ministers and leaders of international organisations to discuss key aspects of the MCM agenda.

At the MCM and Forum, we do not come together to focus on problems, but on solutions. And these can be found only in the collaborative context of intergovernmental co-operation. I look forward to working closely with you during these annual meetings to agree on those solutions that will make our world better, for our generation, but especially for those who will one day benefit from our efforts, rather than suffer from our inaction.



Angel Gurría

World Economy

ECONOMIC SITUATION AND PROSPECTS

Financial turmoil endures

Financial market turbulence has lasted longer than initially expected. Pressures have spread to new markets and institutions, far beyond US subprime mortgages and derived products, leading to a generalised wariness and repricing of risks. Deleveraging is under way both in the non-financial corporate sector and among banks, some of which have started to raise capital domestically and abroad.

Three sets of factors are casting a shadow on growth prospects

In this context, near-term global growth prospects have weakened. Three sets of factors are at play – especially in the United States but also in a number of other OECD economies – whose effects are unlikely to fade soon:

- New issuances in various segments of the financial market have dried up, spreads have widened and lending standards have been tightened. The effects on demand are likely to be significant but are hard to gauge. Equity and housing price declines, particularly in the United States, are also holding back demand, with some lags.
- The housing cycle has turned in a number of OECD economies. In the United States, the direct effect of the residential investment slump has been subtracting around one percentage point from real GDP growth over the past two years and will continue to do so this year.
- Household real incomes are being squeezed by soaring energy and food prices, even if in the euro area and to a lesser extent in Japan, currency appreciation has provided some offset.

Growth is slowing

Against this backdrop, the US economy has slowed down sharply. Domestic demand weakness, however, is offset to some extent by slower imports and buoyant exports. In the euro area, the deceleration is less abrupt. Business confidence has held up better, as has export growth, despite euro appreciation. At the same time, unemployment has remained on a downward path. Even so, a spell of subpar growth lies ahead. In Japan, business sentiment is weakening and the pace of underlying growth seems to be softening somewhat.

Among large non-OECD emerging market economies, growth is easing somewhat in China and India, not least as a result of policy tightening in the face of overheating symptoms, but is projected to remain robust. Economic momentum is also set to be largely sustained in Russia and Brazil, supported by high commodity prices.

Inflation has risen

Turning to inflation, both headline and core measures exceed comfort levels in many economies and on some indicators inflation expectations have tended to move up. In the United States, however, the rapid widening of economic slack should help contain inflation going forward. In the euro area, core inflation measures continue to trend up and second-round effects are seen as a risk. Japan continues to stand out, with core inflation – excluding food and energy prices – still in negative territory.

Current account imbalances: some signs of adjustment

With slowing domestic demand and a pick-up in exports, the US current account deficit has shrunk substantially over the past couple of years, and would have adjusted faster still had it not been for soaring oil prices. At the same time, there are signs that the Chinese current account surplus may be stabilising as a share of GDP, as exports slow and domestic demand accelerates. Renminbi appreciation *vis-à-vis* the US dollar is helping, although faster appreciation in effective terms is called for, which would contribute to containing domestic inflation.

Risks and uncertainties

How macroeconomic policies should react to the slowdown is contingent on the outlook for activity and inflation beyond the near-term as well as on the balance of several interrelated risks:

- the extent of any further financial turbulence and the magnitude and duration of the restraint exerted on economic activity by banks' and investors' newfound prudence, and by their need to recapitalise, is unclear;
- oil and other commodity prices may remain high or even continue to rise for some time from their already high levels, despite slowing activity;
- higher energy prices and more restrictive credit conditions may drag down productivity and potential output growth going forward; and
- short-run trade-offs between inflation and output may have changed in recent years, casting some doubts on the exact extent to which subdued growth will moderate inflation pressures.

How much policy stimulus is needed?

In this light, the case for policy stimulus is stronger in the United States than in Europe or Japan. US policy makers have already acted with resolve and on a broad front, with aggressive policies that include interest rate cuts, a series of initiatives to provide liquidity in novel ways, direct intervention to contain the systemic repercussions of the collapse of a large investment bank, various measures to support housing and a sizeable, timely and targeted fiscal package. These measures have forcefully addressed the most urgent challenges arising from the current turmoil. In Europe, the monetary authorities have also taken measures to improve market liquidity but the near-term outlook for activity and inflation does not point to a need for stimulus and, insofar as output and prices will decelerate, automatic fiscal stabilisers will provide more support than in other regions. Japan has limited scope for responding to greater weakness.

RISING WORLD FOOD PRICES

Supply shortfalls and unexpectedly high demand have pushed food prices up

The prices of a number of staple foods have soared since last year, leading to social tensions, especially in non-OECD countries, and prompting various types of government intervention. These price increases reflect several factors. Weather-related supply shortfalls in a context of low cereal and oilseed stocks have pushed crop prices up. So has strong demand for food and feed from emerging economies in Asia as well as increased feedstock demand to satisfy growing biofuel production. High cereal prices trigger land use shifts from other crops into maize and wheat, raising prices for other crops (mostly oilseeds) as well. Recent speculative behaviour, in particular large hedge fund investments, has also affected commodity markets. The rise in international dairy prices mostly stems from temporary supply shortfalls in the European Union and Australia.

Systemic changes in demand will keep commodity prices high, even if they are set to gradually decline from their current levels

Assuming normal weather conditions, supply is expected to respond significantly and agricultural commodity prices are likely to resume their declining trend in real terms, though not immediately and more gradually than has been the case historically – and from a higher level. Strong demand from large emerging economies and biofuel producers, low cereal stocks, and resource constraints (land and water) will be offset by productivity gains and growing production and trade outside the OECD area. On average, over the next ten years, agricultural commodity prices are expected to be 20% to 80% higher in nominal terms (and up to 35% higher in real terms) than during the past decade. In addition, increased price variability can be foreseen, in particular for crops, insofar as stocks remain relatively low and as a growing share of total demand will come from industrial sources which are less sensitive to prices than traditional food and feed demand.

Policies matter

This forecast assumes a return to normal growing conditions and unchanged agricultural and trade policies. The actual price path of agricultural commodities and, further down the chain, food, hinges importantly on future policy developments. Increased humanitarian aid would buffer the impact of high prices on the very poor, without any major impact on markets. On the other hand, maintaining or introducing trade-restricting policies would have undesirable impacts. Export taxes and embargos may, in the short-term, provide some relief to domestic consumers, but they impose a burden on domestic producers and limit their supply response, while contributing to global commodity market uncertainty. Policy support, as well as oil price developments, will strongly influence the evolution of demand for biofuel from agricultural commodity feedstocks. New technological breakthroughs accelerating the adoption of second generation feedstocks (thereby decreasing reliance on agricultural commodities) would also have a strong impact. Over the longer term, open borders and public and private investments to boost agricultural productivity, particularly in developing countries, would greatly improve supply prospects.

MEASURING THE PROGRESS OF SOCIETIES: A KEY OPPORTUNITY TO IMPROVE POLICIES

Recent years have seen a growing recognition that societies need to develop a more holistic view of societal progress rather than rely just on economic indicators like GDP per capita. Hundreds of initiatives are underway to develop broader measures of societal progress that cover the economic, social and environmental spheres. Now, political leaders and heads of international organisations are recognising that this is a key opportunity to improve policies and the functioning of democracy.

The Istanbul Declaration...

The OECD World Forum on “Measuring and Fostering the Progress of Societies”, held in Istanbul in June 2007, was attended by 1 200 participants from more than 130 countries. Thousands followed the event *via* Internet. At the end of the Forum, the OECD, the European Commission, the Organisation of the Islamic Conference, the United Nations and the United Nations Development Programme agreed on the “Istanbul Declaration”, subsequently signed by many others (UNESCO, UNICEF, etc.). The Declaration recognises the need to undertake the measurement of societal progress in every country going beyond conventional economic measures, and stresses how the availability of indicators and their dissemination to citizens can strengthen their capacity to influence the goals of the societies they live in and increase the accountability of public policies.

The Declaration calls for action to:

- encourage communities to consider for themselves what “progress” means in the 21st century;
- stimulate international debate on global issues of societal progress;
- share best practices on the measurement of societal progress and increase the awareness of the need to do so using sound and reliable methodologies;
- produce a broader, shared, public understanding of changing conditions, while highlighting areas of inadequate knowledge; and
- advocate appropriate investment in building statistical capacity especially in developing countries.

... and its implementation

The OECD proposed to launch a Global Project to transform these ideas into action and several organisations agreed to participate. The Project aims to encourage discussions around the world on what progress means for different societies, to identify best practices on how to measure progress and on how to ensure those statistical measures are used and understood by a wide audience. The Project is closely linked to the work on the political economy of reform.

National measuring progress initiatives are established in many countries (Australia, Canada, Ireland, United Kingdom, United States, etc.) and new projects are being launched in other OECD countries. Interest has reached the highest levels of government: in January 2008, France’s President Nicolas Sarkozy established a high-level commission to investigate “new measures of economic and societal progress”. Chaired by Joseph Stiglitz, the Commission has brought together a very impressive group of leading thinkers including several Nobel laureates. The OECD is represented by its Chief Statistician.

GLOBAL RELATIONS: ACCESSION AND ENHANCED ENGAGEMENT

Reflecting the evolving significance of the OECD as a hub of economic dialogue for globalisation, OECD ministers in May 2007 decided to open accession negotiations with Chile, Estonia, Israel, the Russian Federation and Slovenia, and to strengthen OECD co-operation with Brazil, the People's Republic of China, India, Indonesia and South Africa, through enhanced engagement programmes with a view to possible membership. Furthermore, Southeast Asia was identified as a region of strategic interest. At their meeting in June 2008, ministers will review progress in the implementation of these important mandates.

Accession

The Council, Committees and Directorates have responded quickly and effectively to the ministerial mandate, and all candidate countries are co-operating actively with the OECD.

The five “roadmaps” for Chile, Estonia, Israel, the Russian Federation, and Slovenia were approved at a special meeting of the Council on 30 November 2007, when the accession process was officially launched. Each “roadmap” describes the process of accession; lists the policy reviews to be undertaken, the Committees to be consulted and how they should proceed; stipulates the steps that each country should take; and indicates the costs, to be covered by the candidate country. Candidate countries have already paid the full amounts budgeted for 2008.

“Kick-off” missions, led by Deputy Secretary-General Thelma Askey, took place to all five candidate countries between mid-January and mid-February 2008. The Secretary-General has also made official visits to several of the countries. The missions were well received in every country and the authorities appeared strongly motivated to respond to the challenges of the accession process.

Candidate countries are making progress on their Initial Memorandum, the document where they are specifying their position in relation to the OECD Acts and other relevant instruments.

OECD Committees are currently finalising their arrangements for assessing the candidate countries' ability and willingness to assume the requirements of membership in their particular field of competence. The Council also invited OECD bodies to consider positively extending invitations to candidate countries to participate in their sessions or part of their sessions as observers on an *ad hoc* basis, to help them familiarise themselves with OECD methods and policy approaches. OECD bodies have made active use of this possibility.

The Council oversees all aspects of the accession process and is regularly updated by the Secretariat on progress.

Enhanced Engagement

Distinct from the process of accession, Enhanced Engagement (EE) is also quite distinct from OECD's regular global relations activities, in which all Enhanced Engagement partners (EE5) already participate to varying degrees. Enhanced Engagement aims at

building a more comprehensive, coherent and predictable set of relations with countries which are not seeking membership at this time, but are important for the fulfilment of the OECD's mandate to promote policy convergence and global economic development. Indeed, the EE5 together represent a significant share of global economic activity. They and the OECD economies have a great deal of impact on one-another, including in the areas of trade, investment, financial markets, environment and sustainable development, agriculture, governance, or human resource development. Enhanced Engagement aims to promote mutual understanding amongst the key economies driving global development and enable them to learn from each other, share experiences, support policy reform and pave the way for regulatory convergence in areas of mutual interest.

Enhanced Engagement will bring partners closer to the OECD and what it stands for by engaging them actively in OECD work processes, including importantly through their more active participation in OECD Committees. Such participation should provide a strong incentive to EE partners to engage: in addition to giving them access to the core of OECD experience, it will also allow them to contribute their own perspectives and approaches to various policy issues and thereby to exercise a degree of influence on OECD work.

This initiative will be developed in a spirit of true partnership that fully takes into account the interests, concerns and strategic objectives of each partner and those of OECD members. It will necessarily be differentiated with individual countries, given their distinct national interests and perspectives, and the varying degree of their existing involvement at the OECD.

The OECD Council, the External Relations Committee and its Reflection Groups, the Committees and the Secretariat have responded with enthusiasm to the 2007 Ministerial Mandate, and contacts are intensifying with all five EE partners, as well as with countries in Southeast Asia. Concrete measures are being discussed, in particular in the context of the preparation of the Programme of Work for 2009-10. The modalities and priority focus of the engagement, including in terms of selecting the substantive areas/committees in which to engage, are still under discussion, but preliminary indications of interest have been collected from several sources already.

The Ministerial Council Meeting in June 2008 will be an important milestone in the Enhanced Engagement initiative. The five EE partners will participate in all substantive sessions. A specific session will provide the opportunity to the ministers of Brazil, the People's Republic of China, India, Indonesia and South Africa to lead a discussion on key global issues of interest to them, notably the current developments and future changes in agricultural world markets and commodity prices which has been identified as a particularly timely subject of great concern to a number of EE5 ministers.

THE OECD INNOVATION STRATEGY

The overarching objective of the Innovation Strategy is to improve economic performance and social welfare. Innovation is recognised as a critical means for achieving these ends. What is needed is an improved understanding of how modern innovation systems work. The aim is to provide policy makers with effective strategies for harnessing the potential of innovation in achieving sustainable growth and development.

The way we innovate is changing

The way we innovate is changing from a linear progression to more complex and interactive processes driven by: i) the rise of knowledge-driven innovation; ii) the expansion and intensification of collaboration and knowledge-sharing; iii) the rapid improvement of connectivity and the acceleration of globalisation; iv) changes in markets, the nature of the competitive environment, and financial investment strategies; and v) the acceleration of technological change.

Adopting to the changing nature of innovation

The broadening of innovation, organisational change and new tools facilitate the shift towards more global and open innovation. A better understanding of the valuation of intellectual assets, the emergence of new research models and the Internet as a platform for innovation will improve knowledge of the processes of innovation systems.

Innovation has become a global activity in order to spread costs and risks and tap into new markets and cutting edge expertise. This raises challenges to policies that tend to be geographically bound. International innovation networks, ICT enabled offshoring and open models of innovation are part of the picture and work is underway to harness innovation to address global challenges.

Fostering human capital for innovation

Human capital for innovation requires more than just scientific skills. New knowledge needs to be captured and adapted, and a culture conducive to skills upgrading and lifelong learning developed. The link between tertiary education and innovation will be examined.

Strengthening markets and systems of governance

The Competition Assessment Toolkit, country specific reviews and analysis of the impact of IPR will elucidate the role of framework conditions, as will analysis of the role of institutions, financing of local development and the role of tax policy as incentives to innovate.

Measuring innovation

Measurement gaps across the innovation system will be identified and new indicators developed, leading to a better understanding of the different facets of innovation, and the policies needed to bolster it.

Schedule of the work

- Phase I (January-June 2008): stocktaking and identification of critical knowledge gaps.
- Phase II (June 2008-June 2010): by the end of 2008, an outline of the synthesis report. Final report to the 2010 MCM.
- Phase III (July-December 2010): distillation and roll-out of recommendations.

ENCOURAGING EMPLOYMENT

In 2007, for the first time in two decades, the average unemployment rate in the OECD fell below 6%. This is welcome news, but no grounds for complacency. Labour market conditions remain difficult for some groups and downside risks in the global economy loom large with possible negative labour market consequences. Looking forward, policy reforms are required to strengthen further the adaptability of the labour market, remove barriers to higher employment and promote skill upgrading.

Making the most of technological advances and globalisation

Rapid technological change and globalisation pressures are creating new opportunities for workers, but also new challenges. To reap the benefits of technological progress and globalisation, policies should facilitate the reallocation of labour from declining firms and sectors to expanding ones, but also help workers in the adjustment process.

Promoting adaptability through activation policies

Well-designed social protection schemes, such as unemployment and related benefits, provide a necessary support for income security in dynamic labour markets. However, these benefit schemes need to be integrated with activation measures that include mutual obligations. The latter imply that benefit recipients, who are capable of working, are provided with the help they require finding a job, but they are also obligated to accept suitable offers; if they do not, they can face benefit sanctions. Recent experience suggests that activation measures, suitably adapted, can be applied to many recipients of other social protection benefits, such as those for lone parents or persons with partial disabilities.

Adjusting to population ageing

In many OECD countries, the workforce is now on the cusp of a period of rapid ageing. This could imply a slowdown in economic growth if employment rates and labour productivity do not improve significantly. Since, on average, more than one person in three of working age across the OECD area is not employed, there is considerable scope for raising labour supply. Promoting higher employment involves strengthening the rewards from work by reforming tax and benefit systems, while also using targeted interventions to help those with low skills or health problems to keep a foothold in employment. It also involves helping parents to reconcile work with family life through policies for quality child-care, maternity and child-care leave, and family-friendly practices at the workplace.

A better start for youths in the labour market

The transition from school to work is difficult for some youths, especially early school-leavers lacking basic qualifications. Special measures are required for this hard-to-place group, from early and sustained interventions to prevent academic failure to intensive remedial education and work-experience programmes. Regulatory reforms to reduce segmentation in the labour market are also required to promote upward mobility for youth from low-paid and temporary jobs to more stable career jobs.

PISA

Developed jointly by OECD countries, the Programme for International Student Assessment (PISA) assesses how far students approaching the end of compulsory education have acquired key knowledge and skills that are essential for full participation in the knowledge society. PISA provides education systems with crucial information to judge their areas of relative strength and weakness and to monitor progress. It informs national efforts to help students learn better, teachers teach better, and schools to become more effective. PISA is based on samples of between 3 500 and 50 000 15-year-old students that in most federal countries are also representative at regional levels.

The third PISA survey reveals wide differences among countries

In 2007, PISA published results from its third survey that examined student performance in 59 countries covering roughly 90% of the world economy. It also looked at a wider range of educational outcomes that include students' motivation to learn, their beliefs about themselves and their learning strategies. It also analysed some of the factors that influence the development of knowledge and skills at home and at school, how these factors interact and what the implications are for policy development.

PISA revealed wide differences in the extent to which countries succeed in fostering knowledge and skills in key subject areas, as well as effective learning strategies. For some countries, the results were disappointing, showing that their 15-year-olds' performance lagged considerably behind that of other countries, sometimes by the equivalent of several years of schooling and sometimes despite high investments in education. However, the strong science performance of countries such as Canada, Finland or Japan in PISA reveals that excellence in education is an attainable goal and shows that the challenge of achieving a high and socially equitable distribution of learning outcomes can be addressed.

Poland's capacity to raise the reading performance of its 15-year-olds by the equivalent of three-quarters of a school year within six years also shows that marked educational improvements can be achieved over reasonably short time spans. All of this has sparked an unprecedented research and policy debate in many countries as to the factors that drive successful educational performance.

Assessing adult skills

The OECD is currently extending the PISA approach to assess key competencies in adult populations. Through the OECD Programme for the International Assessment of Adult Competencies (PIAAC), the OECD seeks to: identify and measure differences between individuals and countries in competences believed to underlie both personal and societal success; assess the impact of these competences on social and economic outcomes at individual and aggregate levels; gauge the performance of education and training systems in generating required competences; and help to clarify the policy levers that could contribute to enhancing competences. A first survey is planned for 2011 covering the age group 25-64 year-olds.

Sustainable Development

ECONOMICS OF CLIMATE CHANGE

The long-term impacts of climate change include increased intensity and frequency of heat waves, droughts, storms and floods, which in turn will cause damage to key infrastructure and crops, and increase risks to human health and life. This will have social and economic consequences. The costs of inaction, though uncertain, are expected to be significant. At the same time, there will also be costs associated with the policies used to address climate change. OECD is working to help governments identify and implement least-cost policies to reduce greenhouse gas emissions and limit the impacts of climate change, as well as to integrate adaptation to climate change into all relevant policy areas.

Analysis in the new *OECD Environmental Outlook to 2030* indicates that ambitious climate change targets can be achieved at a cost that may seem relatively affordable, both when compared with expected economic growth and with the costs of inaction. However, this requires broad use of efficient policy instruments. In that context, the OECD work aims to support countries in putting the post-2012 climate policy architecture on a solid economic footing.

Market-based instruments need to feature prominently in a least-cost policy mix

A mix of policies will be needed to successfully address climate change. Market-based instruments, such as carbon taxes or emissions trading schemes, should feature prominently in the mix. By putting a “price” on greenhouse gas emissions, such instruments ensure that mitigation action takes place where it is cheapest, create incentives for R&D and clean technology adoption, and raise fiscal revenues that can be used to reduce taxes on capital and labour. Linking existing emissions trading schemes, and to some extent strengthening and scaling up the Clean Development Mechanism (CDM), can be concrete steps towards a global carbon market.

Other policies will also be needed

But market-based instruments will not be sufficient on their own. For instance, removing energy subsidies and trade barriers to climate-friendly goods would also contribute to a least-cost strategy. Other instruments – such as standards, information-based instruments or voluntary agreements – can be useful in addressing market and information barriers. Specific measures can also complement emission pricing to encourage the invention and the diffusion of low-carbon technologies. By contrast, only subsidising the “good” (emission cuts) can lock-in inefficient technologies or practices and is inherently more costly to taxpayers than pricing the “bad” (emissions). In particular, recent evidence on so-called first-generation biofuels is bringing into question their economic effectiveness, impact on food prices, and environmental performance.

Building political support for action is key to success

To make a post-2012 international climate policy framework effective, action will need to involve the main emitters in terms of both countries and sectors. The benefits and co-benefits of mitigation policies (*e.g.* avoided damages from climate change, lower local pollution and possibly improved energy security) will provide some incentives for large emitting countries to join an agreement to cut emissions.

But even with the right policy mix, there will be a cost to implementing ambitious policies aimed at reducing greenhouse gas emissions. Moreover, how this economic burden is shared both within and across countries will significantly affect incentives to take action. A wide range of international competitiveness, political and equity concerns – justified or not – will have to be dealt with. To this end, adequate arrangements can help build international and domestic political support for climate change policies. For instance, developing countries’ incentives to join in could be enhanced through tradable permit target setting and allocation rules, technology transfers (including through the CDM) or direct income transfers.

If only a few countries initially joined an agreement, reductions in their emissions could be partially offset by increases elsewhere in the world. In this case, measures could be considered to reduce such “carbon leakage” risk until other countries join in. Transitional arrangements might include a combination of region- and sector-wide agreements – covering energy-intensive, trade-exposed and/or transnational industries. On the other hand, countervailing tariffs on imports of carbon-intensive goods might be counterproductive and run into difficulties with WTO rules.

Adaptation to climate change will be important

Developing countries are most vulnerable to the impacts of climate change, in part because their economies are more dependent on natural resource sectors (agriculture, forestry, fisheries), and because they often lack the infrastructure, financial resources and capacity to adapt to a changing climate. A recent OECD study shows that right now, nine out of ten of the port cities most vulnerable to rising sea levels (according to population exposure) are in developing countries.

Acknowledging this challenge, OECD is examining how countries can best adapt to unavoidable impacts of climate change, that is, those that are already locked-in because of past emissions. In particular, guidance is being developed on how best to integrate adaptation to climate change into development co-operation activities, to essentially “climate-proof” development aid.

OECD ENVIRONMENTAL OUTLOOK

Without new policies, we risk irreversibly damaging our environment within the next few decades

OECD countries have made significant progress in addressing many environmental challenges over the past few decades. However, remaining environmental challenges are increasingly complex or global, and their impacts may only become apparent over long timeframes. If no new policy actions are taken within the next few decades, we risk irreversibly altering the environmental basis for sustained economic prosperity. To avoid that, urgent actions are needed to address in particular, climate change, biodiversity loss, water scarcity, and health impacts of pollution and hazardous chemicals.

Cost of inaction is high but policy action is affordable

The economic and social costs of policy inaction or delaying action in these areas are significant. The greatest impacts of environmental loss will be felt by developing countries, which are less equipped to cope and to adapt. Policy inaction on the environment is already affecting economies – including in OECD countries – directly (*e.g.* through public health service costs) as well as indirectly (*e.g.* through reduced labour productivity). The costs of policy inaction for biodiversity loss (*e.g.* fisheries) and climate change could be considerable.

On the other hand, ambitious policy actions to address some of the most urgent environmental challenges are affordable, when compared with the expected economic growth of the next few decades and the expected costs of inaction. The *OECD Environmental Outlook to 2030* projects that world GDP will increase by almost 100% – or nearly double – from today's levels to 2030. The *Outlook* also estimates that it would cost around 1% of that accumulated growth in 2030 to implement a mix of policies to tackle several environmental problems simultaneously. This would include policies to reduce key air pollutants by about a third, and limit greenhouse gas emissions growth to 12% from today's levels instead of the 37% rise seen in the baseline scenario.

More ambitious policies are needed, especially in energy, transport and agriculture sectors

To keep the costs of action low, there must be a strong emphasis on the use of market-based instruments such as water pricing, emissions trading, taxes on pollutants, and waste charges. Removing environmentally harmful subsidies, especially for fossil fuels and agricultural production, would be a good start. It would shift the economy away from activities which pollute and over-use natural resources, save taxpayers and consumers a lot of money, and provide incentives for technological developments.

However, market-based instruments will need to be accompanied in the policy mix by other instruments, such as regulations and standards (*e.g.* energy efficiency standards for vehicles and buildings), investment in basic R&D, sectoral and voluntary approaches to harness industry initiatives, and eco-labelling and information approaches to enable consumers to use their market power to reward green producers.

NUCLEAR ENERGY AND CLIMATE CHANGE

Electricity generation is by far the largest contributor to anthropogenic CO₂ emissions, representing nearly 30% of the total, twice the next largest sector (road transport) and growing at more than double the rate. Electricity from nuclear power is nearly carbon-free, even on a full life cycle basis (i.e. including construction, uranium mining, etc.). Its carbon emissions are between one and two orders of magnitude below those of fossil-fuel chains. It contributes 16% of world electricity generation and in OECD countries this share reaches 25%. Its share could be much larger.

Nuclear energy, benefitting from several decades of industrial and commercial experience, is an established technology. Further, real accident data from full energy chains show that, contrary to the common perception, it is one of the safest forms of electricity generation. It provides a cost-effective and reliable option for reducing carbon emissions. The nuclear fuel – natural uranium – is plentiful and its geopolitical distribution ensures a high level of security of supply. The lifetime of known conventional uranium resources with current reactor technology is around 85 years (with limited exploration to date – it is believed that there is much more), as compared to 65 years for gas and 150 years for coal. Furthermore, advanced fast neutron reactor technology, under development and already demonstrated in several countries, can extend the lifetime of uranium resources to several millennia.

Research and development undertaken in many countries, and within international programmes, seeks to design and implement these advanced nuclear systems. These systems are also targeted at penetration into non-electrical applications such as hydrogen or desalinated water production.

Nuclear energy could increase steadily in the coming decades. However, high capital costs are a disincentive in liberalised electricity markets. Governments wishing to benefit from nuclear energy should ensure that national policies and regulatory frameworks provide investors with appropriate security for returns on long investment periods.

First, stable national energy policies with clear commitments on climate change and carbon emission reduction are a pre-requisite to providing incentives for such investment. The environmental cost of carbon emissions, supported by society until very recently, should be borne by producers and consumers of carbon emitting technologies and products. This will enhance the competitive margin of nuclear (and renewables) as compared with fossil-fuelled electricity.

Stable regulatory regimes are also essential in order to provide investors with guarantees that a nuclear project can be completed to a reasonable and predictable schedule. Governments have a major role to play in streamlining licensing processes for nuclear power plants and fuel cycle facilities while ensuring the health and environmental protection required for societal acceptability.

Nuclear energy's vast potential should also be recognised in any international arrangements for the diffusion of climate friendly technologies, particularly to developing economies with rapidly growing electricity demand.

BIOFUELS

Biofuel production is increasing rapidly, but remains a minor source of global fuel for transport

Between 2000 and 2007, global production of bioethanol doubled to more than 50 billion litres per year, while that of biodiesel increased eleven-fold to almost 11 billion litres. Even so, today biofuels account for less than 2% of global road transport fuel use. Assuming no change in government policies as in 2007, global production of ethanol and biodiesel is projected to double again by 2017, with much of that growth taking place in Brazil, the United States, and the European Union (EU).

In OECD countries, biofuel production is generally not viable without public support

Government policies have been instrumental in promoting the production and use of biofuels, with the estimated value of OECD country support to biofuels currently USD 13 to 15 billion per year. Policy instruments include budgetary measures, such as tax concessions, tax credits and direct payments to biofuel producers, mandatory minimum rates of biofuels use in the overall transport fuel mix, and import tariffs.

Increased biofuel production is one factor lifting current agricultural commodity prices

Growing feedstock demand for biofuels production is contributing to the current increase in prices for cereals and oilseeds. Although the contemporary increase in world grain prices is primarily explained by weather-related crop shortfalls in 2006 and 2007, the longer-term perspective in the latest *OECD-FAO Agricultural Outlook* suggests that growing demand in many developing countries, higher crude oil prices and further growth in biofuels production are important factors that will maintain commodity prices at higher average levels than seen in the past. By 2017, OECD projections indicate that about one-third of US coarse grain production, more than 60% of sugar cane production in Brazil, and more than 80% of vegetable oil use (both from domestic output and imports) in the EU, could be used to generate biofuels. On average, this will keep cereal and oilseed prices 40% to 60% higher and sugar prices more than 10% higher over the next decade, relative to the average prices of the previous ten years.

Biofuel policies matter

Although using biofuels to partly replace fossil fuels is widely assumed to deliver a number of energy security, environmental, and economic benefits, these are smaller than expected and unlikely to be delivered by current policies that focus on first generation technologies and agricultural feedstocks. Alternative policy approaches that encourage reduced energy demand and greenhouse gas emissions, provide for freer trade in biofuels, and accelerate introduction of “second generation” production technologies that do not rely upon current commodity feed stocks, offer potentially greater benefits without the unintended impact on food prices.

WIKIGENDER: INITIATING A BOTTOM-UP DIALOGUE ON GENDER EQUALITY

Earlier this year, on the occasion of International Women's Day, the OECD's Development Centre launched an innovative website to share and exchange information on gender equality: www.wikigender.org.

The website, which is designed to become the one-stop-resource on gender equality, already provides a rich base of sex-disaggregated data and statistics, including the political representation of women in national governments, the role of men in child upbringing, and the importance of women for African economic development. In addition, users have access to just over 280 articles and documents, including detailed country reports on gender equality from around the world, covering many OECD member and non-member countries. During its first month of operation, the site received more than 25 000 visits.

Ensuring quality content

Wikigender follows a two-layer approach which clearly distinguishes it from other websites based on "wiki" technology, such as the online encyclopaedia Wikipedia. Content from official sources (*e.g.* the OECD) is highlighted and protected. New information which is posted in the open Wikigender layer is subject to review from the nearly 300 specialists that have become registered users, authorised to suggest changes to the content as well as to create or upload new articles and documents. The site is therefore screened from potentially unreliable content, so ensuring highest levels of quality.

In addition to improving knowledge on the situation of men and women around the world, the initiative is also helping to raise awareness of the nature and extent of gender discrimination; an important prerequisite to tackle the prejudice and distrust that underpin inequalities.

Wikigender is providing the OECD with an effective means of reaching out to civil society and engaging in a bottom-up dialogue. It is facilitating mutual learning among groups such as workers' unions, business associations and teachers who can build pressure for needed reforms, as well as garner wider public support and dispel inevitable fears of change among citizens.

Advancing the OECD's ICT strategy

The Wikigender site, the OECD's first wiki, has been conceived to advance the Organisation's new ICT strategy which recommends the increased use of web 2.0 technologies. The results are being monitored closely as it serves as an efficient test for the feasibility of a wider "Wikiprogress" platform that could support the work programme of the proposed Global Project on "Measuring the Progress of Societies".

In its attempt to broaden the institutional foundations of the project, the Wikigender project recently concluded a partnership with the World Bank's International Finance Corporation. Other partnerships are in the course of negotiation. These will strengthen the organisational capacity to manage the site and increase the range of available topics and the depth of their coverage.

WOMEN ENTREPRENEURS IN SMES

In OECD member and non-member countries, women entrepreneurs constitute a growing share of small and medium-sized enterprises' (SME) owners and are creating new niches for entrepreneurial activity. Through this entrepreneurial activity, women entrepreneurs are making an important contribution to employment but as yet, the size of that contribution cannot be easily measured.

Barriers faced by women entrepreneurs

Women can face specific barriers to business creation and development. Overcoming those barriers and ensuring a good environment for the start-up and expansion of women-owned businesses is important for the overall development of the economy and society.

This is particularly true for the Middle East and North Africa (MENA) region, where the scope for women to realise their potential as entrepreneurs can depend on their status and role in society. Other barriers women face here, as in all countries, include educational background, competing demands on their time due to family responsibilities, and limited access to finance. Since entrepreneurship by women can lead to different and innovative approaches to management and organisation issues as well as business expansion, there is a need for policy makers in the MENA region, as well as in other countries, to address these issues so that the economic potential of women can be fully utilised.

The MENA-OECD Ministerial Declaration on Fostering Women's Entrepreneurship in the MENA region stressed the importance of removing gender-related obstacles to entrepreneurship through the elimination of barriers to enterprise creation and growth and removing impediments to the right to hold property or to sign contracts, where such impediments exist. As elsewhere, it is also important to foster the ability of women to participate in the labour force by ensuring the availability of family-friendly policies such as affordable child care, parental leave arrangements and other child-related issues, as well as equal treatment in the workplace.

Women entrepreneurs in emerging economies

In emerging economies, where women actively participate in economic activities, women entrepreneurs are also, however, subject to a number of constraints, including underdeveloped and affordable advisory services, particularly the provision of management capacity-building in rural areas which continues to be poorly provided.

Enhancement of existing policies and programmes in support of women's enterprise development in OECD member and non-member countries will therefore help to augment the economic empowerment of women and their involvement in innovative activities. In 2009-2010, the OECD will examine more closely the link between women entrepreneurship and innovation and the related policy implications.

It is essential to improve the factual and analytical underpinnings of our understanding of the role of women entrepreneurs in the economy in order to evaluate the impacts of the measures taken and to decide the direction to follow. This will require strengthening the statistical basis for carrying out gender-related cross-country comparative analyses.

SPACE APPLICATIONS: MONITORING CLIMATE CHANGE

Space applications are playing an increasingly critical role in monitoring changes in the world's climate and environment. Whether they be Earth observation or meteorological satellites, space communications or global positioning systems, they have become an indispensable tool in the international effort to track and better understand our atmosphere, oceans, forests and fresh water resources.

Current space capabilities

Some 30 countries now have dedicated space programmes, and there are more than 950 satellites operating in orbit, the bulk of which are for communications and Earth observation. The investment costs of this space-based infrastructure are estimated at around USD 180-230 billion (*The Space Economy at a Glance, OECD, 2007*). This is relatively small compared with other large terrestrial infrastructures, but the social, scientific and economic benefits they generate – though not always easily quantifiable – are considerable. For example:

- **Monitoring the climate** – over half the Essential Climate Variables (atmospheric, oceanic, terrestrial, etc.) identified by the United Nations Framework Convention on Climate Change depend on satellite information. Climatologists and glaciologists rely more than ever on continuous satellite observations of the Arctic and Antarctic to study, in almost real-time, climate change processes. Similarly, significant improvements achieved in weather predictions are due in large part to new meteorological satellites in polar orbits, bringing about substantial gains in agricultural and energy management.
- **Keeping track of the world's water supplies** – satellites contribute to the understanding of the global water cycle and to improved fresh water management. Clouds, water vapours, precipitation and sea-levels are all measured from space, in co-ordination with in-situ systems. Already in many OECD countries, satellite data are used to monitor daily the quality of water bodies, detecting in particular natural and man-made pollutants (e.g. harmful algal blooms, oil spills).

Building a sustainable space infrastructure

As the challenges posed by a changing climate grow, so too will the need to strengthen and improve the space-based infrastructure. The existing network of satellites will not only need continual renewal, it will also need to be extended to provide greatly enhanced coverage of the Earth's climate systems and to increase the number of re-visits to secure real-time information flows. Equally, further improvements in the resolution quality of optical imagery will be required, as well as wider coverage of the spectral band to improve monitoring of, for example, ocean salinity and temperature. Moreover, a sustainable regulatory and financial framework will become increasingly important. This can be done by supporting larger public use of existing space applications nationally and internationally. Private sector participation will also require encouragement through a supportive legal and regulatory environment for commercial activities and the reinforcement of private provision of space goods and services.

Good Governance

FINANCIAL MARKET INSTABILITY

Financial market stress has endured for almost a year now and remains acute, threatening economic growth in the United States and in Europe, with the possibility of knock-on effects to Asia. A near-term recession is a risk in some countries, though the ultimate economic impact will depend on the ability of policy makers to deal with the “credit crunch” effects operating through the balance sheets of financial intermediaries.

Contributing factors behind the current turmoil

Excessive leverage has been the key characteristic of the situation, particularly with respect to subprime mortgages and the securities based on them. Four causal factors may be identified. First, excess liquidity resulted in asset bubbles, particularly in housing and mortgage-based securities. Asset bubbles provide encouragement for speculators to borrow, while the (rising) asset value for collateral “comforts” lenders. Second, there were clear regulatory and accounting standard gaps in the treatment of off-balance sheet vehicles and lending standards. Third, rating agencies played a key role in the securitisation process. Normally banks assess credit and retain it as private information. To sell these credits into the capital markets requires external ratings. The transformation of typically BBB securities into notes for investors with prime and AAA ratings greatly smoothed the process for the boom in structured products (like collateralised debt obligations and asset-backed commercial paper conduits). Fourth, notwithstanding all of this, there were notable failures in the corporate governance of financial intermediaries. Some banks stayed clear of these high-risk products, and some managed to reduce their exposures significantly prior to the crisis, while others rushed headlong into major exposures, encouraged by short-term profits and fees. Had any of these four factors been absent, the current turmoil would have been much less.

Policy makers have limited room for manoeuvre

The immediate situation leaves policy makers little choice. Attempts to unwind holdings of illiquid mortgage-backed securities has led to price collapses, and with mark-to-market accounting, this has forced massive write-offs and insolvency risk, as the Bear Stearns episode well underlined. Central banks have had to step in with liquidity operations, extending the definition and timeframe for collateral they will accept in their dealings with banks. The aim here is to keep markets functioning, as banks refuse loans to each other due to uncertainty about which firms are at risk. However, at its core the problem is one of **insolvency** – the insolvency of home-owners who took on mortgages in the expectation of capital gains that did not materialise, and the insolvency of institutions that managed their risk concentration poorly, or were too reliant on business models that depend upon short-term wholesale funding of their balance sheets. Banks are highly-levered institutions, with large funding liabilities and asset portfolios, and a thin sliver of capital in-between. It does not take much to wipe out this capital if funding declines or asset write-offs occur, forcing banks (in the absence of new capital injections) to de-lever in order to meet capital rules or, in extreme cases, forcing bankruptcy. Restrained balance sheets of banks can shut down financial intermediation, with strong direct impacts on GDP. Consequently, policies that facilitate the re-building of capital are most important for addressing the solvency problems.

The OECD has increased its estimate of the ultimate mortgage-related losses from USD 300 billion last autumn to a range of USD 350 billion to USD 420 billion now, based on a proper credit default model and depending on (alternative) assumed recovery rates in mortgage collateral. About USD 90 billion of the likely ultimate losses are directly associated with US banks that play a key role in the intermediation process. Left to itself, this could result in substantial deleveraging, as happened in the early 1990s.

The Federal Reserve's aggressive interest rate cuts since September 2007 have helped bank earnings, as have the calls for lower dividend payout rates (so that earnings are more fully retained). It would take banks 6 to 12 months to recapitalise through earnings, depending on the extent of these cuts. To expand their balance sheets to support economic growth requires not only offsetting losses, but also building capital to support the normal growth in their businesses. To speed the process, capital injections from sovereign wealth funds and hedge funds – groups that are prepared to take more risk at times when others are not – would be very helpful. Banks have already been quite successful in raising some of the capital they need, but the environment remains challenging and more will be required. A final line of defence, when systemic risk looms large, is the recourse to public money. As this risk fuels moral hazard in banking for the future, it is a last resort – as with the case of Bear Stearns – to avoid a wholesale financial collapse and its deleterious economy-wide repercussions.

European institutions are also exposed

These issues are not confined to the United States, since European institutions too bought a substantial share of the subprime securities and, on average, European banks are less well capitalised than their US counterparts. Equity derivative products are also more widespread in Europe, as is exposure to foreign currency loans in some countries. It also needs to be borne in mind that while on average corporate balance sheets are in good shape, there is a “fat tail” of corporate over-borrowing related to mergers and acquisitions. A pressing worry is that the deleveraging that will accompany the losses on subprime mortgages and related securities, if not handled well, could spill into other asset classes, such as corporate bonds, equity derivatives and the like.

FREEDOM OF INVESTMENT AND SOVEREIGN WEALTH FUNDS

The mandate to the OECD

In recent years, major changes in the environment for national security and the international economy have caused some governments to reassess their investment policies. One important element in the changing global economy is the growing prominence of Sovereign Wealth Funds (SWFs) from a wide range of home countries.

The OECD has been asked by the G7 finance ministers and the other OECD members to develop guidance for recipient countries' policies toward investments from SWFs. The OECD has addressed this request as part of the Investment Committee's project on Freedom of Investment and National Security, which was launched to help governments counter rising investment protectionism and maintain open markets. The guidance which the Committee released in April is the result of the work of the 30 OECD countries, the 10 non-member countries adhering to the OECD investment instruments, 4 other non-members participating in the project, and the European Commission. The project also benefitted from consultations with SWFs and the OECD's business and social partners.

SWFs bring benefits to both home and host countries

SWFs have much to offer. SWFs' recent injections of capital into several OECD financial institutions were stabilising because they came at a critical time when risk-taking capital was scarce and market sentiment was pessimistic. They help to recycle savings internationally and generally have a good track record as long-term investors. They contribute to the economic development of their home countries. As one of the world's main proponents of an open investment system, the OECD welcomes these benefits for home and host countries.

Existing OECD principles call for fair treatment of SWFs

But, as is often the case, when new actors emerge on the international financial scene, the players need to become better acquainted. The growing role of SWFs raises issues regarding the smooth functioning of financial markets as well as investment policy questions, including legitimate concerns in recipient countries about protecting national security.

The OECD's existing investment instruments already contain fundamental principles for recipient country policies that can underpin the required guidance. Through their adherence to the OECD investment instruments, OECD and other adhering governments have committed to the principles of transparency, non-discrimination and liberalisation.

National security is a legitimate concern but should not be a cover for protectionist policies

The OECD investment instruments recognise the right of adhering countries to take actions they consider necessary to protect national security. Investments controlled by foreign governments, such as those by SWFs, can raise concerns based on uncertainty regarding the objectives of the investor and whether they are commercially based or driven by political or foreign policy considerations.

However, adhering countries have agreed that the national security clause of the OECD investment instruments should be applied with restraint and should not be a general escape clause from their commitments to open investment policies.

Security-related investment safeguards should be made as open as possible

OECD members and other countries participating in the project have agreed on a number of key principles which should guide governments when they design and implement investment measures to address national security concerns while preserving and extending the open international investment system. These principles are the following:

- **Non-discrimination** – in general, governments should rely on measures of general application which treat similarly situated investors in a similar fashion. Where such measures are deemed inadequate to protect national security, specific measures taken with respect to individual investments should be based on the specific circumstances of the individual investment which pose a risk to national security.
- **Transparency/predictability** – while it is in investors' and governments' interests to maintain confidentiality of sensitive information, regulatory objectives and practices should be made as transparent as possible so as to increase the predictability of outcomes.
- **Regulatory proportionality** – restrictions on investment, or conditions on transaction, should not be greater than needed to protect national security and they should be avoided when other existing measures are adequate and appropriate to address a national security concern.
- **Accountability** – to ensure accountability of the implementing authorities, procedures for parliamentary oversight, judicial review, periodic regulatory impact assessments, and requirements that decisions to block an investment be taken at high government levels, should be considered.

Investors and home countries can ease concerns through transparency

Observance of high standards by SWFs and their provision of adequate and timely information will facilitate recipient countries' efforts to implement their OECD commitments and its recommendations for preserving open markets while safeguarding national security. Therefore the OECD also supports the work underway at the IMF on best practices for sovereign wealth funds.

Next steps

The work programme will include: further clarification of best practices regarding the implementation of the guiding principles, especially "accountability"; a special session on government-controlled investors; and any additional work which may seem appropriate in light of the results of the IMF's work. A final report on the Freedom of Investment project – bringing together all of the findings of the discussions – will be completed in the second quarter of 2009. Its recommendations may also contain suggestions for appropriate revisions/clarifications to existing OECD instruments.

The project includes a process of regular peer monitoring within which countries report measures in place or under consideration. As part of its on-going work, the Committee will continue to monitor developments in this regard in light of the principles of transparency/predictability, proportionality and accountability and of adhering countries' commitments under the OECD investment instruments.

The spirit of co-operation that has characterised these discussions to date will continue through consultation and dialogue between home and recipient countries, and between the IMF and the OECD.

GLOBALISATION AND REGIONAL ECONOMIES

Globalisation helps firms become more competitive by enabling them to reach new, larger markets and to access knowledge and technology easily. But this represents a challenge both for firms and for public policy. In the context of strategies to promote growth and adjustment, governments are increasingly realising that the regional dimension is crucial. This realisation is now shared among ministries of economy and finance; science, technology and industry; and regional development. The challenge for government is to provide a framework in which firms can exploit region-specific advantages. However, national policies often struggle to take the regional dimension into account. In turn, regions have little experience in developing policies that are market-driven and effective in key policy fields such as innovation.

The growing importance of regional policy

Why has the regional level become so important? In part, the answer lies in the way firms are responding to globalisation. Firms are under pressure to develop innovative products and assimilate new technologies rapidly. Given that even large firms cannot do this effectively in isolation, the system of innovation is becoming less vertical and more open. This means that there are new opportunities for suppliers to access new customers, with greater incentives for firms to innovate. Open innovation is becoming an important tool for large and small firms alike as they look for new ways to share risk and develop complex products and processes. In theory, it is now possible for firms to access the inputs and knowledge that they need from anywhere across the globe. Yet, many of the leading firms in “new economy” industries still cluster together. Recent work by OECD on regional innovation and clusters shows that region-specific advantages – embedded in specialised firms, skilled labour and dynamic universities – remain a significant source of productivity gain for firms, even for the largest multinational enterprises.

Competitive cities

Large metropolitan regions combine the knowledge infrastructure and labour skills that global firms are looking for. Groundbreaking OECD work on cities has shown that they are not all equally successful in making use of their assets – clear strategy and strong leadership, high quality public services, investment in innovation infrastructure and a functional approach to governance can all make a crucial difference in whether the city is able to compete effectively with other similar urban centres. OECD provides a forum for central government policy makers and mayors of major cities to discuss how public authorities at both national and city level can co-ordinate investment in a constructive way to meet these challenges.

The role of rural regions

But globalisation does not only affect the major cities. Rural regions can also mobilise their assets in new ways to adapt and seize opportunities offered by globalisation. Too often rural regions have been seen as synonymous with decline and rural policy too closely tied to agricultural subsidies. Now, a new rural policy paradigm emphasises better use of the economic, social and cultural assets of rural regions. OECD reviews of rural development policy in both OECD and non-OECD countries show that this paradigm is becoming more accepted, with the potential to radically change the way public policies are framed for rural regions.

STEPPING UP THE FIGHT AGAINST INTERNATIONAL TAX FRAUD

International tax evasion threatens the financial health of countries and public confidence in the fairness of tax systems. The United States Senate estimates that the fraudulent use of offshore banking results in USD 40 to 70 billion in lost revenues. The recent scandal in Liechtenstein has reminded the international community of the urgent need to step up the fight against international tax evasion. The OECD is already heavily committed to the fight against harmful tax practices and plays a key role in preventing fraudulent behaviour by improving the transparency of international transactions.

Promoting transparency and exchange of information

There are many opportunities for evasion in a globalised financial environment. Therefore, the OECD has developed a series of standards aimed at securing greater transparency and effective exchange of information between States. These standards have been developed in association with jurisdictions that were considered tax havens in 2000 but have since committed to improving transparency and exchange of information. While progress has been made, particularly through the signing of numerous agreements on exchange of information, much work remains to be done. This is underlined by the recent affair involving Liechtenstein, one of the three jurisdictions which have refused to subscribe to the OECD's principles and therefore considered "unco-operative tax havens". This work will need to be intensified to ensure implementation of formal commitments on transparency and exchange of information.

Developing legal instruments to combat evasion

The OECD has developed several instruments that help both member and non-member countries implement tax legislation and eliminate both double taxation and double non-taxation. Over the past few years, new provisions have been added to the OECD Model Tax Convention to extend the exchange of information provisions, including cases where information is held by banks, and to allow for assistance in tax collection. A specific instrument has been developed for the effective exchange of information with tax havens (Model Agreement on Exchange of Information on Tax Matters). These principles will soon to be adopted by the United Nations. The OECD has also developed, with the Council of Europe, the Multilateral Convention on the Mutual Administrative Assistance in Tax Matters, now in force in 13 States and which offers numerous possibilities including the performance of simultaneous audits in several States. It is now time to make full use of these instruments and give tax authorities the means to implement tax legislation, thereby reducing the scope for concealment.

Ensuring a better understanding of suspicious tax behaviour

Understanding the workings of tax evasion and identifying new tax evasion schemes is crucial for tax authorities. The OECD is pioneering the pooling of intelligence on evasion schemes in this area, particularly those involving taxpayers with very high income or assets, as well as those involving tax havens. Efforts should also be made to strengthen relationships between different tax administrations and to facilitate links between tax authorities and those tasked with combating money-laundering.

FUTURE OF THE INTERNET ECONOMY

In the past decade, the Internet has become widespread thanks to the liberalisation of telecommunications markets and the development of user-friendly applications and services. In 2008, the Internet has become a fundamental part of our economies and societies.

Three key trends are influencing the policy environment for the Internet economy:

- **convergence** – the demands being placed on the Internet are increasing as it becomes the platform for voice, video, data and computing and begins to connect not just people, but also objects, things, and sensor networks;
- **creativity** – the Internet is becoming a truly global platform for all manner of social interaction and economic exchange, and a platform for innovation; and
- **confidence** – malicious attacks on systems and users via the Internet are increasing in severity and sophistication.

Each of these factors represents a significant shift in the use and functionality of the Internet. Collectively, they represent a major transition in the evolution of the Internet and the economic system that has developed around it. Therefore, it has become increasingly necessary that policies supporting the Internet economy be carefully crafted and coordinated across policy domains, borders and various stakeholder communities. Moreover, with the emergence of new players in global markets, such as India and China, policy discussions need to draw out common principles to help address opportunities and challenges at the international level.

The OECD promotes sustainable economic growth by developing policies and practices that:

- **Facilitate the convergence of digital networks, devices, applications and services.** The OECD analyses issues such as how best to stimulate a competitive environment as technologies and markets evolve to ensure that the Internet can continue to meet growing expectations, especially as high speed wireless and fibre networks develop.
- **Foster creativity in the development, use and application of the Internet.** OECD work aims at building a better appreciation of the role of ICTs as both an innovative sector in its own right and a catalyst for innovation across the economy and society. It seeks to better understand how ICTs and increased connectivity to the Internet contribute to innovation. The Internet, and the connectivity it provides, will be a key element of an OECD Innovation Strategy.
- **Strengthen confidence and security.** OECD work aims at improving international co-operation for privacy, security and consumer protection. It seeks to establish a common analytical base from which a framework for digital identity protection and management can be developed.

Ministers and stakeholders meeting at the 2008 OECD Ministerial on the “Future of the Internet economy” on 17-18 June in Seoul will further strengthen work and global dialogue on policies and practices to form an enabling environment for the Internet economy.

POLITICAL ECONOMY OF REFORM

Promoting growth and prosperity through the adoption of good public policies is at the heart of the OECD's mission. In all aspects of its work, the OECD seeks to identify areas where reform is desirable.

The identification and design of appropriate reforms is a challenge in itself, but even when reforms are well identified, they are often difficult to translate into action. The political economy of reform (PER) – the way in which political and institutional factors influence the design, decision-making process, approval and implementation of reforms – is a critical determinant in the success or failure of reforms in democratic societies. Public support is important for the adoption and implementation of reforms and for their ultimate success in achieving stated objectives.

A number of questions arise in the context of the reform process: How can reforms be timed and sequenced to minimise resistance while maximising their impact? How can governments educate groups directly affected by reforms and convince them of the benefits of reform? How can they build and maintain the trust of their citizens needed to carry out and follow through with reforms over time? How can dialogue and communications be harnessed as a tool for reform? OECD work on PER seeks to address these and other questions.

Helping policy makers implement reform

The OECD has long dealt with PER through its contributions to the policy debate in member countries. Following discussions at the 2006 Ministerial Council Meeting, the OECD is engaged in an ambitious project on the political economy of reform. The aim is to increase the effectiveness and relevance of OECD policy analysis and recommendations by supporting governments throughout the reform process and taking account of political economy concerns in a more systematic way. This **mainstreaming** of PER is often about policy coherence and the whole-of-government approaches to reform, and it requires due consideration of the context in which reforms are taking place.

The OECD's role in the political economy of reform

Enriched by the experiences of its members, the OECD is a powerful ally for promoting and increasing the public acceptance of reform in countries. The OECD is increasingly asked by members to contribute to the policy debate on reform by providing expertise on the costs and consequences of policy action, and inaction, for example through public presentations, analytical publications or high-level political dialogue. These services, which are demand-driven, are being strengthened to increase their policy impact.

As part of this horizontal effort, new analysis is underway to derive lessons for policy makers about strategies for advancing structural reforms. Using a common framework, case study research is examining the decisive political economy factors that affected the outcome of reform attempts in ten countries, beginning with the content of the reform and why it was endeavoured, and considering the policy processes for adoption and implementation. Future analysis will be extended to reform in different sectors. The aim is to help governments learn from other countries' experiences with reform and avoid possible pitfalls in the reform process.

Trade and Development

FUTURE CHALLENGES FOR THE MULTILATERAL TRADING SYSTEM

The beginning of this year marked the 60th anniversary of the multilateral trading system. The system has much to celebrate. Six decades of multilateral co-operation on trade matters under the aegis of the GATT and, since 1995, the WTO saw industrial tariffs in developed countries fall from an average of 40% in 1950 to less than 4% in 2006. Although the pace of agricultural trade reform has been slower, real progress has occurred in recent years. In the 20 plus years since the OECD started monitoring them, nominal rates of agricultural price protection in developed countries have more than halved. Partly as a result of these achievements, the volume of world merchandise trade is today 27 times what it was in 1950, a period during which the value of world output increased by a factor of 8. Since 1950, there was more than a four-fold increase, from 7% to 28%, in the ratio of world exports to global production. These changes have resulted in significant growth in economic prosperity and reductions in global poverty.

Resistance to further trade liberalisation is on the rise

Despite this progress, the conditions for undertaking further liberalisation and associated structural reforms appear more difficult today than they were ten years ago. Following a long period of buoyant economic growth, reform complacency seems to have emerged in many countries. There is dissatisfaction with previous reforms in parts of the developing world and various special interest groups are actively promoting anti-liberalisation ideas.

Potential gains from further liberalisation are high

Despite these challenges, the opportunities for further liberalisation remain high. Substantial gains from international specialisation remain untapped. An OECD study estimates potential welfare gains in developing countries from full liberalisation of just tariffs in the range of 2% of per capita gross domestic product per annum. This estimate includes neither the positive impacts of liberalising trade in services, nor the benefits that relatively more open markets tend to generate through stimulating dynamism in the economy via increases in innovation and competitive spirit. Stalled reforms threaten to deprive millions of people of a better life. Against this backdrop, the following challenges lie ahead.

Multilateral negotiations at the WTO can solidify progress to date, including in the context of the current round of trade talks, and begin to address future issues that may call for new co-operative efforts. One major challenge for all WTO members is to manage the fuller integration of developing countries into the trading system in a manner that brings genuine benefits to these countries. The system has to accommodate demands for dissimilar speeds of liberalisation by different countries, non-reciprocal preferential access to other countries' markets, and elaborate development-friendly trade rules in a manner that promotes development and growth. Reaching agreement across these issues is not easy; much work remains to be done to make the trading system more responsive to the aspirations of all its members.

Reform of agricultural trade policies is one area where progress has been slow and where more is expected. During this current period of historically high prices for many agricultural commodities, there is a unique opportunity to cut trade distorting farm support, to open agricultural markets, and to free up the productive capacity of the sector in developed and in developing countries. The benefits of doing so for competitive suppliers in many countries would be substantial. They would be even greater and more widespread if markets in the much larger non-agricultural sectors were also further liberalised.

Another challenge is the risk to the non-discrimination cornerstone of the WTO posed by the spread of preferential trade agreements (PTAs). Over the last decade, the number of PTAs has grown rapidly. As of 1 July 2007, 205 PTAs had been notified to the WTO and were in force, covering between one-third and one-half of world trade. PTAs have also increasingly broadened in scope, covering a wide range of trade-related areas in addition to tariffs. PTAs can be a positive development if they create trade and are open-ended and non-exclusive; but they can also fragment the trading system and become punitive to outsiders.

Pursuit of reform in services – by far the largest and fastest growing part of the world economy – is no easy task. Reforms require balancing the need for regulation to offset market failures with the need to increase competition by allowing firms to enter the market. Reforms are also complicated by the legitimate role that exists for government to achieve non-economic objectives, such as the universal provision of education or healthcare services. The WTO has confronted services liberalisation by adding the General Agreement on Trade in Services to its arsenal of agreements. This is a good example of the creativity and adaptability of the system.

Trade, by encouraging a more efficient use of resources, can also contribute to improved environmental outcomes. Trade in goods and services related to environmental protection, as well as pollution control and prevention, has helped to spread new technologies and techniques to rapidly industrialising countries. Looking ahead, technologies that can immediately help mitigate emissions of greenhouse gases that contribute to climate change might be of particular interest. At the same time, it will be important to ensure that environmental regulations do not become unnecessary barriers to trade.

Trade as a major contributor to growth, stability and prosperity

The story of 60 years of multilateral trade diplomacy is a positive one. By stabilising trade relations and promoting trade liberalisation, the GATT/WTO system has made a valuable contribution to post-war economic growth, stability and prosperity. The system has also managed to build a culture of permanent, incremental reforms, one that adapts flexibly to changing global conditions. It has faced and weathered many challenges in the past, and it continues to offer the way forward – but success is not automatic.

A renewed commitment to the rules-based multilateral trading system, founded on the principle of non-discrimination, would ensure that these challenges are met and that the opportunities offered by globalisation are widely shared. On its part, the OECD will continue to provide support to the multilateral trading system and promote the benefits of trade liberalisation through its analytical work and consensus-building process. Indeed all the issues identified above are currently the subject of intensive discussions at the OECD.

AID EFFECTIVENESS

Preparations are well underway for the Third High Level Forum on Aid Effectiveness (HLF3) in Accra, Ghana, 2-4 September 2008. The Accra HLF3 is one of the most important political events in 2008. It will take place just after the UN Development Co-operation Forum (in July) and just before the Financing for Development conference in Doha (in December). Accra and Doha are two sides of the same coin – scaling up to reach the MDGs will not succeed without action to enhance aid effectiveness.

The Paris principles and the Accra process

The 2005 Paris Declaration was supported by well over 100 donor and developing countries and addressed many of the reasons why aid has not always effectively promoted development. These lessons have to do with the way both the givers and the receivers of aid do business. Based on the five fundamental principles of ownership, alignment, harmonisation, managing for results and mutual accountability, the Paris Declaration sets clear indicators of success and establishes targets to be reached by 2010.

The HLF3 in Accra marks a mid-way point in the timeline of the Paris Declaration. Its unique monitoring process has generated key reports for Accra that will provide up-to-date information to guide decision-making.

Civil society organisations (CSOs) are actively engaged in the preparations for the HLF3. Their participation will help to generate ownership of aid effectiveness at all levels of society. A CSO event in Accra scheduled immediately before the HLF3 is expected to bring in about 300 participants. Emerging donors and global programmes are other important actors that are engaging in the Accra Process.

New ways of doing business

A successful conference in Accra will mean taking decisive and determined action to change the way we do business. The most important actions for improving aid effectiveness in the short and medium term – decided through wide participation of donor and developing countries – will be agreed on in the Accra Agenda for Action (AAA).

Partner country consultations in all the world's major geographical regions are offering opportunities to fine-tune ideas for the AAA and to discuss and negotiate its contents. Meanwhile, the OECD Development Assistance Committee is using its regular meetings to identify practical donor contributions that will move implementation forward.

The road to Accra is a tight timeline. All parties are being kept informed of key negotiating events so that in Accra, ministers and multilateral agencies will be prepared to agree on the actions that will lead to fulfilling, by 2010, the targets of the Paris Declaration. In doing so, they will be contributing to a true scaling up of aid, and to notable improvements in the lives – and the futures – of the poorest people in the world.

ADDRESSING THE MEDICAL BRAIN DRAIN

In recent years, concerns about growing shortages of health professionals, in particular doctors and nurses, have emerged in OECD countries. These shortages may increase over the next 20 years unless countermeasures are taken. One route to partially meeting such shortages is via international migration of health workers, an option which is already being utilised but raises concerns in both sending and receiving countries. This emphasises the need for adequate and co-ordinated policy responses.

Is there a risk of medical brain drain?

On average, 11% of employed nurses and 18% of employed doctors in the OECD circa 2000 were foreign-born. About half of foreign-born doctors or nurses working in OECD countries are located in the United States, almost 40% in Europe and the remainder in Australia and Canada. Over the past five years, significant upward shifts in the immigration trends of health professionals have occurred in several OECD countries.

Caribbean countries and a number of African countries have particularly high emigration rates of doctors. For some of them, this is combined with very low density of doctors in the home country, highlighting a very worrying situation for the health sector in these countries. On the other hand, for large origin countries such as China or India, the large numbers of their health professionals working overseas do not seem to have particularly affected domestic density, at least at an aggregated level.

However, the needs for health workers in developing countries, as estimated by the WHO, largely outstrip the numbers of immigrant health workers in the OECD. Thus, international migration is neither the main cause nor would its reduction be the solution to the worldwide health human resources crisis, although it exacerbates the acuteness of the problems in some countries.

Addressing the global health workforce shortage

To respond to health workforce shortages, many OECD countries have significantly increased intakes to medical schools during the past decade because of the long time it takes to train a doctor. However, the upswing has only recently become identifiable in higher graduation rates in a few countries.

A combination of health workforce management policies should be considered to deal with the shortages including: i) improving retention; ii) enhancing integration in the health workforce; iii) developing more efficient skill mix; iv) improving productivity; and v) having recourse to migration. Different countries are likely to choose different mixes of these policies.

Origin countries also need to act to strengthen their health systems and develop services that respond to the needs of their population. OECD countries can support developing countries' initiatives for the management of the health workforce. In particular, the current efforts devoted to increase official development assistance to health needs to be maintained.

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