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Housing markets, oil, China and the business cycle

Three important dimensions of the ongoing business cycle have been explored in depth by the Economics Department: housing markets, oil (or more broadly energy) markets and the increasingly prominent role of the Chinese economy. All three clearly have a structural component, implying they may matter for longer-run growth performance as well.

Housing and mortgage markets differ considerably across OECD countries. Some offer a much wider range of financing options than others, not least as regards the possibility to extract equity. OECD research documents how and to what extent market completeness so understood influences economy-wide outcomes, including resilience to adverse shocks. Besides, the sharp run-up in house prices witnessed since the late 1990s in many OECD countries raises the spectre of overvaluation. Our latest work suggests that any judgement on housing market "bubbles" or "froth" hinges on one's assessment of the level of long-term interest rates.

Oil prices have soared over the past two years, far exceeding markets' or economists' expectations. Unlike earlier oil price shocks, however, this one has been building up over time, driven by rising demand more than by disruptions in supply – even if there have been quite a few of the latter too. While the global economy is only about half as oil-intensive as in the 1970s, the impact of what look like durably higher energy prices is substantial, both cyclically and more fundamentally.

The Chinese take-off prompts admiration as much as angst. It benefits OECD consumers but worries some categories of OECD workers, contains global inflationary wage pressures but pushes oil prices up and exacerbates protectionist reflexes. Our first-ever Survey of the Chinese economy looks at it from within, and among other things presents new evidence on the size and dynamism of the private sector. It also sets out recommendations ranging from corporate sector and financial system to public finance reform, with a view to keep up the pace of China's economic catch-up.



Jean-Philippe Cotis
OECD Chief Economist

House prices and fundamentals

House prices have risen strongly in most OECD countries since the mid-1990s. Because of the influence of housing wealth on economic activity, these trends need to be monitored closely. Recent house price run-ups are unprecedented in terms of size, duration, disconnection with the business cycle and synchronisation across countries. While worries have been expressed about high housing prices, overvaluation appears to concern only a relatively small number of countries, at least up to the beginning of 2005, which is the cut-off date for recent OECD work on this topic. However, whether current price levels are sustainable hinges crucially on long-term real interest rates remaining close to their current low levels.

This house price boom is different

The current house price boom stands out in several respects. First, the size and duration of real price gains recorded in the recent episode have far exceeded those of previous upturns in many OECD countries, including Australia, Denmark, Ireland, the Netherlands, Norway, Sweden, the United Kingdom and the United States. Second, while house price and economic activity turning points roughly coincided from 1970 to 2000, the most recent price run-up is strikingly out of step with the business cycle. Finally, the current upswing is more generalised across OECD countries than in the past.

Are house prices in line with fundamentals?

Rapid house price increases do not necessarily denote overvaluation. To assess whether this is the case, prices need to be related to their underlying determinants. Looking at evidence from econometric models, recent studies uniformly point to overvaluation only in a few cases (Ireland, Spain, United Kingdom). Given the margin of uncertainty of such estimates, such evidence needs to be complemented by other indicators. One of these is the price-to-income ratio, a gauge of whether or not housing is within reach of the average buyer. For the vast majority of OECD countries, price-to-income ratios in 2005 exceed their long-term averages, sometimes by 40% or more. However, this indicator provides an incomplete measure of housing affordability. Taking into account the decline in financing costs brought about by lower mortgage interest rates, household debt service burdens have generally been relatively stable.

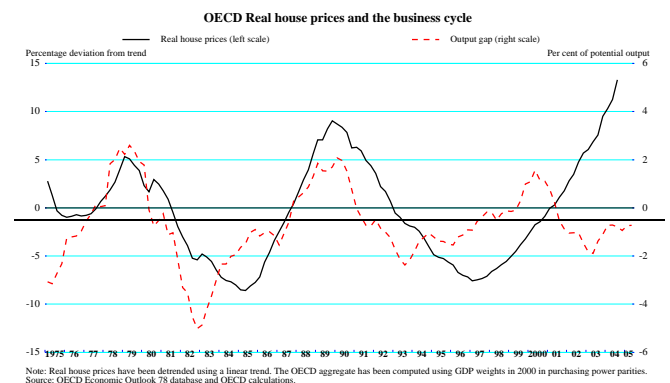
Price-to-rent ratios

Another measure to get an indication of over or undervaluation is the price-to-rent ratio, which can be interpreted as the cost of owning versus renting a house. When house prices are too high relative to rents, potential buyers find it more advantageous to rent, which in turn should exert downward pressure on prices. During the recent upswing, price-to-rent ratios have hit historical peaks in several OECD countries. Still, like affordability ratios, price-to-rent ratios should be assessed against the evolution of interest rates and,

more broadly, against the change in the user cost of home ownership. When proper account is made for the impact of low interest rates (and that of taxation) on price-to-rent ratios observed at the end of 2004, these appear to exceed their "fundamental" levels only in a few countries, including Australia, Ireland, the Netherlands, Spain and the United Kingdom. At the other end of the spectrum, some signs of undervaluation are found in Germany and Japan, possibly reflecting past building excesses.

Other influences on house prices

House prices can also be affected by other features that are specific to this market, such as supply conditions or demographic developments. For instance, legal restrictions on the availability of land for residential housing development make for a more rigid housing supply in Ireland, the Netherlands and the United Kingdom. In those same countries, the large relative size of cohorts of individuals in their thirties boosts housing demand. Still, these factors affect both prices and rents, thereby presumably leaving price-to-rent ratios unchanged. Other recent developments may have contributed to the joint rise in prices and price-to-rent ratios. In particular, financial deregulation in mortgage markets has significantly reduced borrowing constraints on households, with permanent positive effects on housing demand.



Further reading:

OECD Economic Outlook No. 78, December 2005.

Housing cycles and economic activity

Housing cycles affect economic activity mainly through residential construction and wealth effects. Where mortgage and housing markets are more flexible, housing wealth effects and the monetary policy transmission mechanism appear to be stronger. This is usually conducive to greater resilience of activity in the face of macroeconomic shocks. However, a number of distortions should be avoided in order to minimise risks of house price booms and busts and their adverse consequences for economic activity.

Housing cycles affect activity via two main channels

Over the past few years, house price developments across the OECD area have contributed to shape economic activity patterns. The main channels through which housing cycles affect activity are residential construction and wealth effects. The construction sector appears to be responsive to changes in the profitability of housing investment, which in turn depends on house prices. However, this transmission channel is less powerful when supply constraints, in the form of planning restrictions or the availability of land, are overly stringent.

Housing wealth effects

Another feed-through from house prices to activity occurs via housing wealth effects on private consumption. Such effects arise either from saving responses to households' perceived wealth or from collateral effects on household borrowing. In practice, this latter mechanism seems to be pivotal in explaining cross-country differences in the magnitude of housing wealth effects. Where financial markets provide easy access to mortgage financing and to financial products that facilitate house equity withdrawal (Australia, Canada, the Netherlands, the United Kingdom and the United States), changes in housing wealth are found to have a significant impact on consumption, exceeding the effect of changes in financial wealth. High rates of owner-occupation, low housing transaction costs and low capital gains taxes on housing wealth also contribute to strengthen the aggregate wealth effect.

Housing markets and economic resilience to shocks

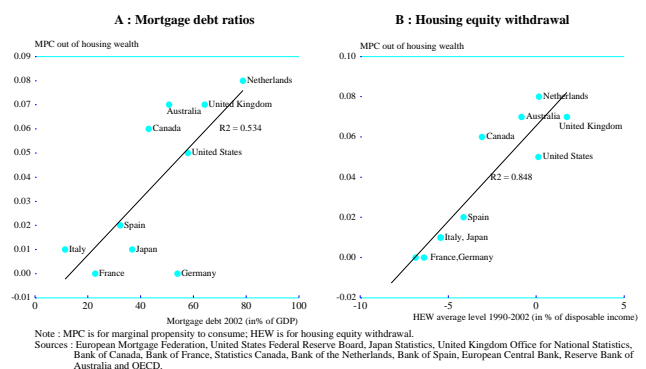
Implications for the transmission of monetary policy are of particular interest. The same mortgage-market mechanisms that determine the strength of housing wealth effects on spending seem to be associated with stronger and more rapid effects of interest rate changes on house prices. In general, having a strong transmission from interest rates to house prices and from housing wealth to spending will be conducive to greater resilience of activity in the face of macroeconomic shocks. For instance, interest rate declines have contributed to soften the 2001-02 downturn in those countries where transmission to house prices and housing demand has been strong.

Making the most of flexible mortgage and housing markets

Where mortgage and housing market rigidities remain pervasive, as in large continental European countries, greater flexibility would therefore help improve both economic efficiency and macroeconomic resilience. However, there have also been instances, particularly when the previous run-up had taken house prices to unsustainable levels and had been accompanied by a large rise in household indebtedness, where a protracted property market slump contributed to deepen and prolong a cyclical downturn (e.g. the United Kingdom and some Nordic countries in the early 1990s).

One general lesson from these and other experiences is that a number of distortions must be avoided for resilience to be strengthened and potential instability be reduced. In particular, two structural factors have been identified as potential sources of excessive house price variability: non-neutral housing tax structures, such as negative tax wedges resulting from the tax deductibility of mortgage interest; unnecessarily stringent zoning restrictions, which result in rigid housing supply. Finally, prudential controls should be in place to ensure the solidity of financial institutions faced with variations in house prices. This includes discouraging excessive risk-taking on the part of lenders and monitoring the possible emergence of financial fragilities in balance sheets in situations where asset prices may be subject to large corrections.

Marginal propensities to consume out of housing wealth and mortgage market indicators



Further reading:

OECD Economics Department Working Paper No. 394, "Housing Markets, Wealth and the business Cycle", by Pietro Catte, Nathalie Girouard, Robert Price and Christophe André (2004).

Oil shocks then and now

Oil prices have soared, scaling new peaks, in nominal but also in real terms. Their cumulative run-up over the past two years matches, in absolute terms, the large shocks observed in earlier decades. This time however, they are driven largely by strong demand. In the near term, how this shock is absorbed depends on economies' momentum, on their intrinsic resilience in the face of such adverse developments and on policy reactions. Supply and demand of oil are rather inelastic in the short run but will react over longer horizons.

Anatomy of the latest shock

Oil prices have risen relentlessly over the past two years, followed with more or less of a lag by natural gas and some of the other energy prices. In the process, they have reached new historical highs, be it in nominal terms or when deflated by export prices. In contrast to past oil price shocks, far futures prices have moved in line with the spot price, consistent with the perception that elevated prices are not an ephemeral spike but may be here to stay for some time. Against this backdrop, OPEC officially abandoned the notion of a \$22-28 price band, although without adopting a specific new target range.

What is keeping oil prices high?

One important reason underpinning the sentiment that oil prices are likely to remain high is that more than on past occasions the surge in prices was driven by unexpectedly buoyant demand, especially from Asia, notwithstanding the various disruptions witnessed this time as well on the supply side. In fact, Chinese demand alone represented almost one third of the worldwide increase in 2003-04, and going forward, China and India would account for one quarter of the extra global demand at the 2030 horizon. In addition, supply is set to stem more and more from countries where the investment climate has so far been rather inhospitable, with limits on foreign direct investment and unstable or unfavourable taxation regimes. As a result, technology transfer opportunities are under-exploited.

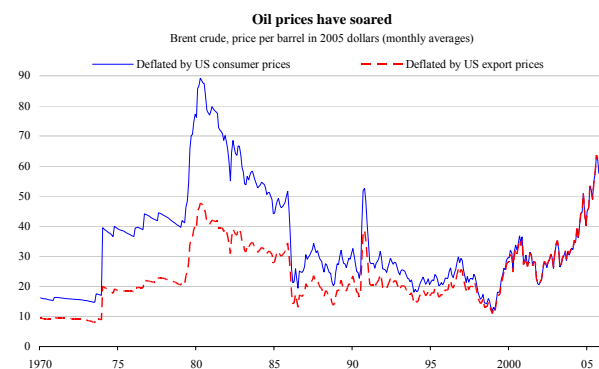
Short-run impacts

This oil price shock in slow motion has unpleasant macroeconomic effects, even if the negative impact on activity is offset to some extent by other factors, notably low interest rates and house price appreciation. Granted, the effects are probably smaller than those which would have been imparted by a similarly large shock in the 1970s, thanks to the lower oil-intensity of GDP and to improved monetary policy credibility and management, which has helped contain second-round effects on inflation. The reverberations are substantial nonetheless, all the more so as the adverse mechanical impact on activity of higher oil prices may be compounded by heightened uncertainty surrounding the evolution of energy prices

over the medium run. However, the exact magnitude of the net impact of higher oil prices also hinges on where, how quickly and how fully oil-producing countries spend their additional revenues.

Longer-run adjustments

Over the longer run, demand adjusts as energy-inefficient capital is being scrapped. At the same time, the supply of oil, which is also rather inelastic in the short run, does respond in due course, witness the increase in oil rig counts observed recently, if with a delay. As well, non-conventional oil and non-oil renewables become more attractive as the price of oil is perceived to remain high and as technical progress reduces their cost. For example, supply from plentiful non-conventional oil deposits, such as Canadian tar sands, has become less expensive over time and is on the rise. Indeed, the liquefaction of other fossil fuels, which are in plentiful supply, serves as a backstop technology. As such, it puts an implicit upper bound on the price of oil, although it is impossible to quantify this limit with any precision.



Source: OECD Economic Outlook 78 database.

Further reading:

OECD Economics Department Working Paper No. 412, "Oil price developments: drivers, economic consequences and policy responses", by Anne-Marie Brook, Robert Price, Douglas Sutherland, Niels Westerlund and Christophe André (2004).

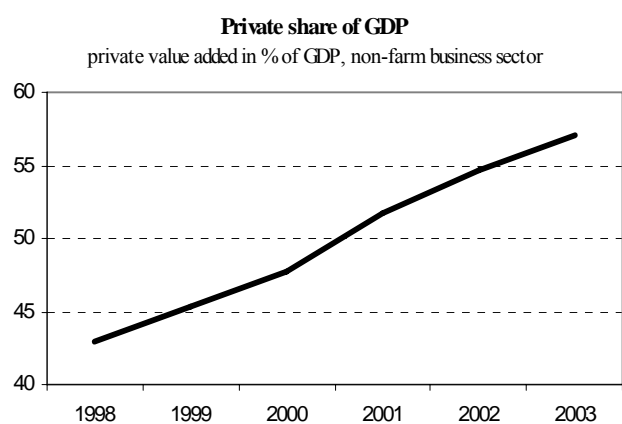
OECD Economic Outlook No. 78, December 2005.

The private sector increasingly drives China's growth

The first-ever *Economic Survey of China* examines the driving forces behind China's dynamic economic growth, and finds that the private sector is increasingly at the fore. Relying on a unique database of almost a million firm observations, it estimates the size and performance of the private sector, and shows that the economy is increasingly market-oriented, especially in its product markets. Rapid changes have taken place over the past five years, with the regulatory environment improving significantly. Nevertheless, important constraints remain, both in the regulatory area – where business expansion and exit is still problematic – and in factor markets, where the depth and flexibility of capital, land and labour markets leave much to be desired.

The private sector has emerged

China's private sector has become the main driver of productivity growth and job creation. Output by privately-controlled companies now exceeds half of value added (see figure), and dominates many industries. Private sector growth has been facilitated by an increasingly tolerant policy environment, and widespread structural reforms.



Source: OECD estimates.

Considerable uncertainty has surrounded previous estimates of the private sector in China due to the difficulty of determining which enterprises are controlled by private entities. Government estimates usually focus on a narrow definition of the private sector, restricted to domestic enterprises formally registered as private. In contrast, the detailed firm microdata analysed in the Survey (in co-operation with the China National Bureau of Statistics) allows the application of a definition of private enterprise more in keeping with modern theories of the firm. This definition determines who controls the "residual rights" of the firm by examining its shareholding structure. It fits with proposed criteria for economic ownership in the revised System of National Accounts.

It is generating more sustainable growth...

The shift of resources to the private sector has improved economic performance, as private firms are much more efficient than state-controlled companies. Labour productivity in the private industrial sector is nearly the same as in the state sector, even though it uses only half as much capital per worker. Even after further factors such as the choice of location or industry, types of inputs and production processes are taken into

account, private-controlled firms remain twice as productive as those controlled by the state. Moreover:

- Annual productivity growth is five percentage points greater in the private sector, compared with the state sector. Thus, the growing share of private output should continue to enhance total factor productivity growth.
- Profitability is high among private firms: their rates of return on physical assets, before interest payments, have doubled to 15% in the past five years, exceeding that of the typical OECD listed company.
- The structure of production appears to be improving as well, with increasing regional specialisation and no significant decline in the marginal product of capital.

...yet it is still limited by regulatory weaknesses

The growing importance of the private sector in supporting the economy makes it all the more important to further modernise the legal framework for business. While much headway has been made in recent years, legislation is vital in three important areas: bankruptcy law, company law and the implementation of the constitutional amendment on property rights. Beyond the content of the law, though, there is a more substantial problem of giving force to economic laws.

Broadening financial markets is a further crucial aspect of supporting private sector development. At present, capital markets still play a limited role (especially for private companies) and this generates a greater concentration of financial risk in the banking sector than in most OECD economies. While there have been recent moves to make more government-owned shares tradable in the equity market, the market value of negotiable shares represented just 9% of GDP in 2004. Corporate bonds amounted to only 1% of GDP.

More generally, the creation of regional and national labour markets would also yield considerable gains. This requires reforms in a number of areas, including strengthening rural land rights, which would enable more rural workers to permanently move off of the land. At the same time, fiscal systems need to be reformed so that public services – especially education – can be provided more easily in the cities migrant workers move to – and this will also require greater attention to the environmental consequences.

Further reading:

OECD Economic Surveys: China – September 2005.

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M. Jorgensen

[One money, one cycle? Making Monetary Union a smoother ride](#)

In recent years the euro area has shown less resilience to the negative and largely OECD-wide common shocks than the English-speaking countries, but most of the smaller euro area countries have fared better than the large ones. What is important to foster a speedy adjustment to shocks? The small countries are well placed to adjust swiftly to asymmetric shocks because they are well integrated with the rest of the area. An activist fiscal policy is not needed and also not powerful enough to smooth the cycle. However, asset bubbles are a cause of concern as their limited weight means that the common monetary policy is more likely to be out of line with their cyclical position. Large countries are less well placed to cope with shocks and sluggish adjustment can be expected. Reforms should focus on enhancing trade linkages via the completion of the single market, on improving wage and price flexibility and on making their housing markets more responsive to changes in monetary policy. In principle, a more activist fiscal policy could help in the large countries, but so far the institutional framework has not ensured an anti-cyclical stance over the cycle.

P. Hoeller, C. Giorno, and C. de la Maisonnette (September 2004), "One money, one cycle, Making Monetary Union a smoother ride", No. 401

[Accounting for Russia's post-crisis growth](#)

Russia's recent growth has been driven by the oil sector - particularly privately-owned oil companies - much more than generally recognised. The oil sector's contribution to growth has hitherto been severely underestimated because official data do not account for transfer pricing, thus failing to reflect fully the importance of the hydrocarbon sector in the Russian economy. Prudent post-crisis fiscal policy has also been essential for creating a macro-economic environment conducive to strong growth. Looking forward, Russia is bound to remain a heavily resource-dependent economy for some time to come. This reality largely defines the challenges facing Russian policymakers as they seek to create a framework for sustained growth, with respect to both managing a resource-based economy successfully and facilitating economic diversification over time.

R. Ahrend (September 2004), "Accounting for Russia's post-crisis growth", No. 404

[Structural policy reforms and external imbalances](#)

It has been argued that one way to reduce global current account imbalances would be for countries with current account surpluses to push ahead with structural reforms. This would raise their potential growth, which is assumed to put downward pressure on the current account position. This line of reasoning is revisited by taking a closer look at how structural reforms in labour markets, product markets, and financial markets could be expected to affect current accounts. Empirical tests are carried out to this end, using pooled time-series techniques and controlling for the influence of relative cyclical positions, government fiscal balances and the real exchange rate. Indicators of structural reforms are found to have a significant relationship with the current account but their contribution to explain current account positions is quite limited.

M. Kennedy and T. Sløk (January 2005), "Structural policy reforms and external imbalances", No. 415

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M. Maher and M. Wise

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J. Høj and S. Toly

Getting the most out of public sector decentralisation in Japan

Revamping fiscal relations across levels of government is key to support fiscal consolidation and public sector effectiveness in Japan. A number of problems need to be addressed, including regulations limiting local governments' ability to innovate and respond to local citizens' preferences, an inefficient system of intergovernmental grants, a complex structure of local taxes and fiscal rules which are too lenient to secure public finance discipline. The grant system should be reformed to promote local governments' incentives to introduce innovations so as to better respond to needs at lower cost. Barriers to the effective use of sub-national governments' taxing powers should be removed while efforts should be made for the tax system to be as simple and neutral as possible. Existing fiscal rules and market instruments should be hardened. This would require that the central government state clearly that it will not intervene as a lender of last resort to local governments and ensure that adequate information on local governments' explicit and implicit liabilities is available.

I. Joumard and T. Yokoyama (January 2005), "Getting the most out of public sector decentralisation in Japan", No. 416

Fiscal gimmickry in Europe: One-off measures and creative accounting

Accounting conventions usually leave some room for judgment, which governments may be tempted to take advantage of, especially when fiscal rules bite or threaten to do so. The European experience over the past decade illustrates that fiscal gimmicks come in many different guises, but also that some are less mischievous than others. Logit regression analysis confirms that when deficit rules or, to a lesser extent, debt thresholds tend to become more binding, recourse to gimmicks is more likely. It also suggests that more centralised budget systems are less prone to such gimmickry. The policy implications are clear as to the virtues of transparent and consistent accounting practices, but more ambiguous regarding the merits or otherwise of one-off measures.

V. Koen. and P. van den Noord (February 2005), "Fiscal gimmickry in Europe: One-off measures and creative accounting", No. 417

Product market regulation in OECD countries: 1998 to 2003

How has product market regulation (PMR) evolved between 1998 and 2003 in OECD countries? Summary PMR indicators are presented measuring the degree to which policies promote or inhibit competition. They suggest that regulatory impediments to competition have declined in all OECD countries in recent years. Regulation has also become more homogenous across the OECD as countries with relatively restrictive policies have, in some areas, moved towards the regulatory environment of the more liberalised ones. Within some countries, product market policies have become more consistent across different regulatory provisions, although relatively restrictive countries still tend to have a more heterogeneous approach to competition. In general, domestic barriers to competition tend to be higher in countries with higher barriers to foreign trade and investment. Likewise, high levels of state control and barriers to competition tend to be associated with cumbersome administrative procedures and policies that reduce the adaptability of labour markets. Notwithstanding recent progress in product market reform, a "hard core" of regulations still impedes competition in virtually all countries.

P. Conway, V. Janod and G. Nicoletti (February 2004), "Product market regulation in OECD countries: 1998 to 2003", No. 419



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Netherlands	-	Public finance, labour market, product market competition, innovation
Slovak Republic	-	Preparing euro accession, labour markets, innovation, public sector reform
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- Business cycle dynamics in OECD countries: evidence, causes and policy implications, Sydney, July 2005
- Interim press briefing on the economic outlook, Paris, September 2005
- Launch of the OECD Survey of the United States, Washington DC, October 2005
- The Transatlantic Relationship (US & EU), Washington DC, October 2005
- Press conference on the OECD Economic Outlook No. 78, Paris, November 2005



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No. 40, 2005/1

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