Chapter 1

GENERAL ASSESSMENT
OF THE MACROECONOMIC SITUATION
The recovery continues, albeit at a slower pace in the near term

Overview

The global economy is continuing to recover, but progress has become more hesitant. Output and trade growth have softened since the early part of the year, as temporary growth drivers, including the boost from fiscal support measures, have faded and not yet been fully replaced by self-sustaining growth dynamics. With monetary policies remaining accommodative even as fiscal consolidation becomes widespread, the present soft patch in output growth is not projected to persist for long. Even so, in the OECD economies at least, near-term growth appears unlikely to gain the momentum seen in earlier cyclical upturns. With emerging economies also growing at a slightly lower, and more sustainable, pace than earlier in the recovery, global output growth is expected to be around 4¼ per cent in 2011 and 4½ per cent in 2012 (Table 1.1). On this basis, OECD unemployment would decline moderately, to around 7¼ per cent by the end of 2012, compared with the pre-crisis trough of just over 5½ per cent. Inflation should stabilise gradually at a low rate. Outside the OECD area, domestic demand is expected to be strong, with spare capacity diminishing and policy normalisation continuing.

Table 1.1. The global recovery will remain moderate
OECD area, unless noted otherwise

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<td>Per cent</td>
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<tr>
<td>Real GDP growth</td>
<td>2.7</td>
<td>0.3</td>
<td>-3.4</td>
<td>2.8</td>
<td>2.3</td>
<td>2.8</td>
<td>2.7</td>
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<td>-2.6</td>
<td>2.7</td>
<td>2.2</td>
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<td>1.7</td>
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<td>2.0</td>
<td>2.1</td>
</tr>
<tr>
<td>Japan</td>
<td>1.2</td>
<td>-1.2</td>
<td>-5.2</td>
<td>3.7</td>
<td>1.7</td>
<td>1.3</td>
<td>3.3</td>
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<tr>
<td>Output gap(^2)</td>
<td>0.3</td>
<td>0.0</td>
<td>-4.7</td>
<td>-3.5</td>
<td>-2.9</td>
<td>-2.1</td>
<td></td>
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<tr>
<td>Unemployment rate(^3)</td>
<td>6.4</td>
<td>6.0</td>
<td>8.1</td>
<td>8.3</td>
<td>8.1</td>
<td>7.5</td>
<td>8.3</td>
</tr>
<tr>
<td>Inflation(^4)</td>
<td>2.8</td>
<td>3.2</td>
<td>0.6</td>
<td>1.8</td>
<td>1.5</td>
<td>1.4</td>
<td>1.7</td>
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<tr>
<td>Fiscal balance(^5)</td>
<td>-2.0</td>
<td>-3.3</td>
<td>-7.9</td>
<td>-7.6</td>
<td>-6.1</td>
<td>-4.7</td>
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Memorandum Items

<table>
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<tr>
<th></th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
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<tr>
<td>World real trade growth</td>
<td>6.8</td>
<td>3.1</td>
<td>-11.1</td>
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<tr>
<td>World real GDP growth</td>
<td>3.8</td>
<td>2.6</td>
<td>-1.0</td>
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1. Year-on-year increase; last three columns show the increase over a year earlier.
2. Per cent of potential GDP.
3. Per cent of labour force.
4. Private consumption deflator. Year-on-year increase; last 3 columns show the increase over a year earlier.
5. Per cent of GDP.
6. Moving nominal GDP weights, using purchasing power parities.

Source: OECD Economic Outlook 88 database.

StatLink: http://dx.doi.org/10.1787/888932346610
But risks remain substantial...

... on the downside...

- A particular downside risk is that renewed declines in house prices in the United States and the United Kingdom would have a negative effect on household balance sheets, thereby slowing consumption and raising saving rates. Clear risks also remain from ongoing concerns about public debt sustainability in some OECD countries; if these were to strengthen, they could disrupt financial markets and confidence. Other areas of downside risk in financial markets relate to the possibilities of an abrupt reversal in government bond yields, lingering uncertainties about banks and the availability of credit during the recovery, the adverse effects of large capital inflows into many emerging economies and the tensions created by recently widespread currency interventions which could spill over into protectionist policy action.

... and the upside

- On the upside, there is the possibility of higher business investment on the back of elevated corporate profits and a stronger recovery in equity markets, with shares being priced at multiples of earnings below historical norms in some countries. An additional upside risk is that already-normalised aggregate financial conditions could provide greater delayed stimulus to the economy than projected, or even improve further.

Policy considerations remain closely interlinked

With the normalisation of monetary, fiscal, financial and crisis-related structural measures expected to gain momentum over the next two years, and take place in an increasingly large number of countries simultaneously, domestic policies in one domain will need to take into account policy settings in others and in other countries. International cooperation, including through the G20, will be essential to boost the credibility of this policy effort. In countries that have a choice, the extent and speed of fiscal consolidation will depend in part on the scope for monetary policy to offset the adverse near-term effects on demand from fiscal tightening by reducing or delaying increases in policy interest rates. Equally, the pace of reforms to financial regulations will affect monetary and fiscal policy settings. Structural policies, in addition to strengthening the economy in the longer term, can contribute to fiscal consolidation, create room for monetary policy to extend the period of accommodation by raising potential output and also help strengthen demand in the short term. In addition, certain structural reforms that are desirable on
domestic grounds alone can also contribute to narrowing international imbalances, both at the global level and inside the euro area.

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

- **Economic policy requirements are:** …

  - **to actively pursue fiscal consolidation…**
    - Budget consolidation to bring public finances onto a sound footing should be pursued actively from 2011 onwards in almost all OECD countries. The pace of withdrawal of fiscal stimulus should be commensurate with the state of the public finances, the ease at which government debt can be financed, the strength of the recovery and already-announced consolidation commitments. The automatic stabilisers should be allowed to operate around the planned consolidation path to offset any temporary weakness in activity, except in countries at acute risk of losing credibility. In countries with more comfortable fiscal positions, the underlying pace of consolidation could be softened if growth were to turn out weaker than projected. Overall, based on the current set of projections, the planned consolidation in most OECD countries is appropriate in both 2011 and 2012.

  - **to normalise policy rates at a pace contingent on the recovery…**
    - The challenge for most monetary authorities will be to exit from exceptional stimulus in a way consistent with macroeconomic developments, without exacerbating fragilities in financial markets. With still-wide output gaps and sizeable fiscal consolidation in prospect, the normalisation of policy interest rates in the United States and the euro area should begin in earnest only from the first half of 2012, with monetary policy remaining accommodative beyond the projection horizon. In Japan, against the backdrop of persistent deflation, policy rates should remain at their current low levels throughout 2011 and 2012, and significant quantitative easing should be implemented to give stimulus to the economy. If output growth were to turn out weaker than projected in the major OECD economies, the normalisation of policy interest rates should be delayed further, and, depending on the duration and extent of economic weakness, firmer actions might be needed to lower real interest rates further out in the maturity spectrum via additional quantitative easing and communications policies. In OECD and non-OECD countries alike, it remains important that exchange rate changes consistent with necessary international rebalancing are not resisted.

  - **to maintain momentum towards financial reforms…**
    - The momentum toward financial reform needs to be maintained to strengthen the stability of the global financial system. The implementation of the recently agreed global reform package for the banking sector will contribute to this end. The prolonged phasing-in of the reforms will help to achieve the transition in a way that does not imperil the recovery. Additional reforms, including steps to address distorted incentives for systemically-important financial institutions and tighten regulations on non-bank financial institutions, remain to be tackled.
... and implement structural reforms to overcome the legacy of the crisis and narrow global imbalances

- Structural reforms need to be implemented to raise potential output in the long term, thus facilitating fiscal consolidation, and to help tackle some of the specific legacies of the recession, not least weakness in labour markets that threatens to have durable negative consequences. Reforms to improve public-sector productivity, remove barriers to job creation, change the tax structure and implement pollution-pricing mechanisms would all help to protect growth and employment and facilitate fiscal consolidation. Structural reforms will also be instrumental in addressing the underlying determinants of global imbalances through their impact on saving and investment. A well-designed package of structural reforms to reduce product market regulations in sheltered sectors and improve social welfare systems in non-OECD countries, in conjunction with fiscal consolidation, would do much to narrow global imbalances in the years ahead.

Forces acting on the OECD economies

Global economic activity has softened more than previously expected since the early part of the year with the handover from temporary to self-sustaining growth drivers proving uneven. However, surveys of business confidence and order levels, which had eased in the summer, have now begun to turn up once again. On balance, the forces acting on OECD economies remain favourable, with the softening of growth likely to prove only temporary rather than a reflection of a stronger underlying weakness of private spending. Global developments and financial conditions remain supportive and good progress is being made in tackling pre-recession imbalances, although there are clear areas of weakness, most notably labour markets, where adjustments remain far from complete.

Global trade growth is now moderating; the annualised rate of trade growth in the third quarter is estimated to have been around 9%, compared to growth above 15% in both the first and second quarters of the year. The slowdown in trade growth reflects in part the normalisation that would be expected after a period in which trade and industrial production have rebounded rapidly from the trough of the recession. Recent monthly trade and global indicators suggest that trade growth could soften a little further to an annualised rate of 7¼ per cent by the year end. Even so, global trade volumes will have risen past their pre-crisis peak in the course of the second half of 2010. The gap between the rate of trade growth in the OECD and non-OECD economies has narrowed during 2010, reflecting some moderation in domestic demand and import growth in the non-OECD area, and a rise in the trade intensity of growth in the OECD countries, associated in part with a pick-up in fixed investment, a component of demand which is particularly trade intensive. After the near-term slowdown, global trade growth is expected to generally remain buoyant through 2011-12, continuing to grow at close to the pre-crisis (2004-2008) rate of 1.7 times world output growth (Figure 1.1).
1. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

The upturn in activity in the non-OECD economies has moderated since the spring, especially in industrial sectors closely integrated into global supply chains. Even so, final domestic demand remains robust, helping to support external demand in the OECD economies. In China, the economy lost some momentum earlier this year as policy normalisation got underway and excessive stock levels were reduced, although GDP growth picked up again in the third quarter, to an annualised rate estimated to be around 9½ per cent. Retail sales growth remains solid, and business sentiment, as reflected in the PMI, has now turned up once again. Output growth has also moderated a little this year in India, although domestic demand remains strong and business sentiment remains solid. Active steps towards monetary policy normalisation have begun amidst inflationary pressures. In Brazil, the output gap has closed rapidly in the aftermath of the recession, with robust domestic demand growth over the past year. Net trade has been a drag on growth, in part because of a sizable appreciation of the effective exchange rate due to heavy capital inflows. Macroeconomic policy normalisation has begun and signs of a slowing in activity growth have now emerged. Growth remains more sluggish in Russia and South Africa and comparatively dependent on external demand and higher international commodity prices.

Financial conditions, as summarised by the OECD financial conditions indices (FCIs), have remained broadly stable since early in the year, at close-to-normal levels in the main OECD areas (Figure 1.2). Given the lags involved, the earlier improvements in aggregate financial conditions will continue to support activity for some time. The recent

Note: The import volume figures include intra-region trade. Based on a trade in goods and services volume matrix in 2005, just over a half of global trade is within OECD countries, about a third between OECD and non-OECD countries and the rest between non-OECD countries. Source: OECD Economic Outlook 88 database.
stability of the aggregate FCIs masks disparate developments in their components – real interest rates, bond spreads, credit conditions, real exchange rates and household net wealth. In the United States, lower real interest rates, especially at the long end of the curve, and looser credit conditions have offset continued weakness in household net wealth. In the euro area, lending standards have tightened a little and the offset coming previously from a weaker exchange rate has faded. In Japan, the improvement in credit conditions and spreads has broadly offset the impact of the yen appreciation and equity price declines. Key factors helping to support financial conditions include:

- Low money market rates and government bond yields provide support to financial conditions at present, despite the renewed strains in financial markets from the concerns about public-debt sustainability in several euro area countries (discussed further below). The stress tests on the EU banking sector have helped to alleviate immediate market concerns, although lingering worries about counterparty risk remain visible in the cost of insuring bank bonds against default, which has remained high, especially in some smaller euro area
economies. Long-term benchmark government bond yields have fallen to exceptionally low levels in the United States and Germany, and also declined in Japan and many other European countries (see Box 1.4 below). In the emerging economies, financial conditions have also been buoyed by lower sovereign bond yields. Strong capital inflows have boosted asset prices in many of these countries, but have also put upward pressure on exchange rates.

Corporate bond markets have remained resilient, despite the European sovereign debt turmoil, providing companies, especially larger ones, with cheap financing prospects. Yields for investment-grade borrowers have eased to very low levels and also fallen back for riskier borrowers, after rising markedly at the height of concerns in sovereign debt markets earlier this year. Bond issuance by non-financial companies this year is below the 2009 record level, but remains above long-term averages, especially in the euro area, and private securitisation markets have begun to revive, albeit gently.  

Equity markets have experienced significant volatility in recent months, but are above their levels at the start of the year in most developed countries, although Japan is a notable exception. Prices appear moderate relative to estimates of trend earnings in some countries (Figure 1.3), suggesting that there is only a limited risk of further large declines in prices, with adverse effects on household net wealth. Stock markets in many emerging economies have been a little more buoyant than in the OECD during 2010, but generally remain closely linked to developments in the global economy.

Helped by very low funding costs, banks remained highly profitable in the first half of 2010. Bank lending surveys for the third quarter showed a continued gentle relaxation in lending standards in the United States, but a very small net tightening of credit standards in the euro area. With declining benchmark long-term interest rates, bank lending rates have generally eased for mortgages and consumer credit. Possibly as a reflection, signs of a modest pick-up in bank lending volumes to the private sector have emerged in the euro area through not yet in the United States (Figure 1.4). As the recovery matures, lending conditions may be relaxed, spurring a pick-up in lending to the private sector. However, as discussed further below, there remains some longer-term

1. The stress tests showed that the short-term risks, including from sovereign default, were much lower than many had feared. The tests did not consider losses on sovereign debt on banks’ banking books (where most of it is held) and, thus, did not assess associated longer-term risks but nonetheless provided information about these exposures (Blundell-Wignall and Slovik, 2010).

2. Examples of new deals include collateralised debt obligations (CDOs) of mortgage-backed securities and collateralised loan obligations (CLOs) of leveraged loans.
uncertainty about the impact of new regulatory requirements on banks’ balance sheets and on lending growth.

Going forward, aggregate financial conditions are likely to remain supportive, although moderating gently towards normal levels as the gradual move towards normalisation of policy rates begins and bond yields rise.
OECD-wide business investment remains well below the average intensity of the previous three decades, despite the upturn in investment volumes since the start of the year (Figure 1.5). This should limit the risk of any further downside adjustment in investment levels and provides ample scope for business investment to gain additional momentum as the recovery proceeds, especially in new equipment and software. Improvements in capital markets and in corporate profitability (Figure 1.6)
have eased financing conditions for businesses this year, even though bank borrowing remains subdued, and non-financial corporate balance sheets are in a healthy state in several countries. Capital-goods shipments and orders have continued to expand in the major OECD economies, although they have softened somewhat since mid-year, especially in the United States, suggesting that equipment investment growth in the latter part of this year may be a little weaker than earlier in the year. Further

Figure 1.5. **Business investment has started to pick up**

Percentage of nominal GDP

Source: OECD Economic Outlook 88 database.

StatLink http://dx.doi.org/10.1787/888932345052

Figure 1.6. **The profitability of non-financial corporations has improved**

Index 2007=100

1. Ratio of pre-tax profits to gross value-added of nonfinancial corporations.
2. Ratio of ordinary profits to sales reported by all incorporated businesses.
3. Ratio of gross operating surplus to gross value-added of nonfinancial corporations.

Source: BEA; Eurostat; and Datastream.

StatLink http://dx.doi.org/10.1787/888932345071
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ahead, normal cyclical forces and healthier financial conditions should lift investment levels over the projection period.

The upturn in the inventory cycle since mid-2009 is now moderating in several OECD economies. With few signs that inventories are presently at an excessive level in the major OECD economies, the likelihood both of temporary weakness in final demand being reinforced by a significant contraction in inventory levels, and of marked further growth in inventory levels appears limited. The contribution of inventories to quarterly output growth is assumed to be zero from the second quarter of 2011 onwards in the projections.

... and household balance-sheet adjustment is well underway

Household saving rates have remained elevated this year in most OECD countries relative to pre-crisis norms. Thus private consumption growth has remained comparatively subdued, held back by the need to repair household balance sheets and still fragile, but gradually easing, credit and labour-market conditions. The improvement in asset prices together with higher saving have helped to rebuild household balance sheets since the recovery began (Box 1.1). Wealth-to-income ratios remain

Box 1.1. Household balance sheets and the saving rate

Private consumption will play a crucial role for the overall recovery in OECD economies as temporary cyclical factors and fiscal support measures are fading. The ongoing repair in household balance sheets has pushed up household saving rates and depressed private consumption in all major OECD economies. An important question is how far balance-sheet adjustments have advanced and thus whether saving rates have already peaked or are expected to increase further over the projection period. This box looks at some key household balance sheet developments in major OECD areas (see Figure) and outlines possible implications for the saving rate.

Household balance sheets have recovered over the past year in the OECD area on the back of stabilising housing markets, gains in stock markets and continued deleveraging. However, household net wealth remains below immediate pre-crisis peaks in most countries and risks remain of a renewed weakening of housing markets in some OECD countries.

- In the United States, the ratio of net worth to disposable income in the second quarter of 2010 stood at around three quarters of its immediate pre-crisis peak and was still below its 5 and 10 year pre-crisis averages. The ratio of net financial assets to disposable income also stood 25% below its pre-crisis peak and remained below its 5 and 10 year pre-crisis average, despite stock market gains and a 10 percentage points decrease in the liabilities-to-income ratio since the onset of the crisis. While net financial assets are expected to have recovered in the third quarter from the temporary stock market weakness in the second quarter, the state of the housing market continues to be a drag on household balance sheets and represents a significant risk: a 10% fall in house prices would cancel more than a third of the increase in net worth from the trough in first quarter of 2009 to the first quarter of 2010.

- In Japan, the ratio of net financial assets to disposable income now stands at about 10% below its immediate pre-crisis peak but is above its 5 and 10 year pre-crisis averages. Little debt deleveraging has occurred since the onset of the crisis and housing wealth is likely to have further weakened as house prices continued to fall over the year to the second quarter of 2010.
Box 1.1. Household balance sheets and the saving rate (cont.)

- In the euro area, the ratio of net worth to disposable income in the second quarter of 2010 was around 5% below its immediate pre-crisis peak but above its 5 and 10 year pre-crisis averages. The ratio of net financial assets to disposable income has rebounded to the pre-crisis average, despite upward trending financial liabilities, but is still about 10% below the pre-crisis peak. Housing wealth, which is larger than financial assets in the euro area, started to increase moderately over the year to the second quarter of 2010.

- In the United Kingdom, the ratio of net worth to disposable income has also rebounded markedly and is now above the 5 and 10 year pre-crisis averages. However, it remains about 10% below its pre-crisis peak. Continuous deleveraging and stock market gains have been supporting forces behind the rebound in net financial assets. The ratio of net financial assets to disposable income is close to the 5 and 10 year pre-crisis averages.

**Wealth and saving**

<table>
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<th>% of disposable income</th>
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<td><strong>United States</strong></td>
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<td><strong>Japan</strong></td>
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<td><strong>Euro area¹</strong></td>
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<td><strong>United Kingdom²</strong></td>
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1. Uses data for all euro area member states for the level of financial assets and data for the EA-14 member states otherwise.
2. Gross disposable income and gross saving ratios.

Source: OECD Economic Outlook 88 database; Federal Reserve; Bank of Japan; and ECB.

Statlink: http://dx.doi.org/10.1787/888932345090
Box 1.1. Household balance sheets and the saving rate (cont.)

Analysis relating saving rates to longer-term fundamentals suggests that prior to the onset of the crisis in 2007 the saving rate in the United Kingdom was about 1 percentage point below its long-run equilibrium, conditional on household wealth (Hüfner and Koske, 2010). The saving rate was closer to the suggested long-run equilibrium values in the United States and the euro area. The losses in household net wealth since the beginning of the crisis have put pressure on the equilibrium saving rates. Simple back-of-the-envelope calculations based on long-run elasticities of consumption to net wealth can help shed some light on the magnitude of these necessary additional long-term adjustments in saving rates.

If allowance is made for separate housing wealth effects, which states and ½ a percentage point higher in the United Kingdom. These adjustments appear to have already taken place, with the saving rate having risen 4 percentage points since the beginning of the crisis in the United States and the United Kingdom and 1 percentage point in the euro area. Indeed, saving rates in the euro area and the United Kingdom may well have peaked in the middle of 2009.

Several near term risks exist, however, which might keep saving rates elevated for some time or even push them up further temporarily. The first risk relates to credit conditions, which play an important role for the future saving path, both directly and in interaction with house prices. First, favourable credit conditions may also affect the impact of housing wealth on household consumption and saving by affecting the extent to which housing wealth can be used as collateral for household borrowing (Aron et al., 2010; Kerdrain, 2010). In the near term, both of these factors imply that the impact of further declines in house prices on household consumption might be exacerbated if credit conditions tighten again, pushing the saving rate up further. A second risk to saving rates stems from ongoing deleveraging. Debt-to-income ratios have fallen substantially since the onset of the crisis in the United States and United Kingdom, and estimates of debt service ratios in the United States are back to longer-term historical averages (Deutsche Bank, 2010). However, the process of deleveraging is not yet finished: debt-to-income ratios remain well above longer-term historical averages in the United States and the United Kingdom; households may wish to hold debt-to-income ratios well below those seen immediately prior to the crisis for precautionary reasons; and tighter lending standards of banks may also require lower debt-to-income ratios. If households decide to reduce debt-to-income ratios as Japanese households did in the 1990s, saving rates might rise further (Glick and Lansing, 2009). Finally, unemployment rates are likely to remain elevated in many major OECD economies, suggesting that saving rates might remain at current high levels for some time. Similarly, government debt levels have risen sharply and are expected to rise even further in the near future. This may induce households to save more in anticipation of future tax increases, though, arguably, such adjustments might also have already taken place.

1. In what follows, the pre-crisis peak refers to the second quarter of 2007 for all countries and regions.
2. These calculations assume a representative long-run elasticity of consumption with respect to net financial wealth of 0.09 (with the elasticity of consumption with respect to income being 0.91). This implies ln(c/y)=0.09ln(w/y) where c, w and y are consumption, net financial wealth and income (omitting any constant). This is consistent with estimates presented for the euro area in OECD (2009), which were consistent with a marginal propensity to consume out of wealth of roughly 0.04. Similar figures have been estimated for a number of countries including those outside of the euro area, though there is substantial variability in these estimates (see for example Altissimo et al. 2005 and Mishkin 2007). With this specification and using the approximation that changes in the saving rate are equal to the opposite of changes in the log of the consumption to income ratio, ΔS=−0.09Δln(w/y) where S is the saving rate. Dale (2009) has noted that an approach like this may exaggerate the extent of the necessary adjustment. For example, it ignores that wealth including human capital (which depends on future labour earnings) is likely to have fallen less dramatically than financial wealth.
3. This calculation is based on assuming that ln(c/y)=0.04ln(hw/y)+0.08ln(fw/y) where hw and fw are net housing and net financial (net of home mortgages) wealth. The coefficients are based on estimates of the elasticities of consumption with respect of housing and stock prices for OECD countries in Ludwig and Slok (2002).
below their immediate pre-crisis levels in the major economies, but are now close to 5-10 year pre-crisis norms in the euro area, Japan and the United Kingdom, which suggests that the saving ratio may have either passed, or be close to, its peak, provided there is not renewed weakness in asset prices and labour markets. In the United States, comparatively more adjustment remains to be done, reflecting the ongoing weakness in the housing market and in household net worth, suggesting that the saving rate could remain at its current high level for a while and even rise further if credit conditions were to deteriorate. An updated comparison of actual and trend car sales, with the latter derived using information on income per capita, population growth and scrapping rates (Haugh et al., 2010), provides an additional indication of an underlying robustness in consumer demand at present. Car sales in the euro area, Japan, the United Kingdom and the United States all appear to be below trend in recent months (Figure 1.7). On this basis, in all of these economies, and the United States in particular, future downside risks for sales appear to be limited.

The recovery in housing markets broadened in the first half of 2010, but these markets remain fragile in some countries. Both investment volumes and real house prices were rising in a majority of countries in the second quarter (Figure 1.8). The ratio of housing investment to GDP is now close to, or even below, the level seen in past troughs in the majority of OECD economies, suggesting that the likelihood of any further sizable deterioration is small in most countries, and limiting the aggregate impact on GDP even if such an adjustment were to occur.

Going forward, OECD-wide housing investment is expected to rise gently relative to GDP from the fourth quarter of 2010 onwards, although its contribution to the overall recovery is likely to be much smaller than in the past (Box 1.2). However, house prices remain elevated relative to incomes and rents in many economies, with the exception of the largest three (Table 1.2), in part because of the present low interest rate environment. Thus, some downside risks remain for house prices, and hence housing investment and household balance sheets as monetary policy begins to normalise and bond yields increase. Housing markets remain comparatively weak in the United States (where a marked downturn has occurred since the expiration of the homebuyer tax credit at the end of April), the United Kingdom, Spain and Ireland. Non-residential construction spending now appears to be close to bottoming out in the United States, although commercial property prices continued to weaken through to August. Considerable excess capacity remains in this sector, which should damp business investment in structures. Worldwide, many countries also continue to report rising distressed commercial property sales.

Labour market conditions have begun to improve this year in most OECD countries. The OECD-wide unemployment rate, which peaked at 8½ per cent at the end of 2009, declined to an estimated 8¼ per cent by the
Figure 1.7. **Car sales are generally below trend levels**

Actual and trend car sales 1995-2012; number of cars, Millions

1. Euro 4 includes Germany, France, Italy and Spain.
2. For 2010 based on annualised sales in first nine months for Japan, and in first ten months for the United States, China, Germany, France, Italy, Spain and the United Kingdom.
3. Trend car sales are derived using a non-linear relationship between income per capita and car ownership, population growth and scrapping rates.

Source: Haugh et al. (2010); Datastream; China Association of Automobile Manufacturers; and OECD calculations.

StatLink: [http://dx.doi.org/10.1787/888932345109](http://dx.doi.org/10.1787/888932345109)
Figure 1.8. **Housing markets continue to recover**

**Proportion of OECD countries with rising real house prices¹**
Based on quarter-on-quarter change

**Proportion of OECD countries with rising real housing investment**
Based on quarter-on-quarter change

1. House prices deflated by the private consumption deflator. Calculation based on 19 countries (18 available in 2010q1 and 16 available in 2010q2).

Source: OECD Economic Outlook 88 database; and various national sources, see table A.1 in Girouard et al. (2006).

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Box 1.2. **Housing market developments**

In most previous recessions, housing markets have supported the recovery process. In the United States, for example, housing investment contributed 0.6 percentage points to GDP growth in the year following the trough in GDP on average in previous recessions (see table), and house prices have on average increased by 4%, modestly supporting private consumption via wealth effects. In contrast, the growth contribution from residential investment in the latest recovery has been significantly smaller at 0.1 percentage point, reflecting both lower growth in investment as well as a smaller share of investment in GDP after the collapse in housing investment. House prices even continued to fall, which has likely contributed to weak private consumption growth.¹ While housing markets continued to recover in the majority of OECD countries in the first half of 2010 (see main text), some countries show continued or renewed weakness. Among them are, most notably, the United States, Spain, Ireland and, more recently, the United Kingdom.

- In the United States, home-builders’ business confidence remains low, and prices have edged down on some measures, with sales having plunged and permits having stalled after the expiration of the homebuyer tax credit earlier this year. Moreover the stock of unsold houses has edged up again since the spring, and the number of foreclosures started has remained elevated. These recent indicators, together with a slow recovery and a stubbornly high unemployment rate, suggest that the US housing market might remain weak for a prolonged period. A complicating factor, which however seems unlikely to change this conclusion, is the range of procedural problems at banks that may hold up foreclosures for some period.
Box 1.2. **Housing market developments** (cont.)

### Housing investment and house prices in previous recessions

<table>
<thead>
<tr>
<th>Trough in GDP</th>
<th>House price increase in the year following the trough in GDP in %</th>
<th>Contribution of housing investment to real GDP growth in the year following the trough in GDP in percentage points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mar-58</td>
<td>6.4</td>
<td>0.6</td>
</tr>
<tr>
<td>Dec-60</td>
<td>5.1</td>
<td>0.9</td>
</tr>
<tr>
<td>Mar-70</td>
<td>4.7</td>
<td>-0.2</td>
</tr>
<tr>
<td>Mar-75</td>
<td>2.8</td>
<td>0.5</td>
</tr>
<tr>
<td>Sep-80</td>
<td>2.4</td>
<td>0.7</td>
</tr>
<tr>
<td>Mar-82</td>
<td>2.8</td>
<td>0.5</td>
</tr>
<tr>
<td>Mar-91</td>
<td>4.3</td>
<td>0.6</td>
</tr>
<tr>
<td>Average of previous recessions</td>
<td>-5.0</td>
<td>0.1</td>
</tr>
</tbody>
</table>

*Source: OECD calculation.*

- In the United Kingdom, while real house prices increased in the year up to the second quarter of 2010, several recent signs point to renewed weaknesses in the housing market. Survey indicators of price expectations from the Royal Institute of Chartered Surveyors have slipped markedly in recent months, signs of increasing instructions to sell have emerged and several recent monthly house price indices point to falling house prices. Possibly underlying these renewed signs of weakness are expectations of slowing economic activity and income and thus housing demand.

- Ireland and Spain were among the countries experiencing the most pronounced housing boom-and-bust cycle and are still in the process of downward corrections. Real house prices, as well as ratios of house prices to rents and income continue to fall from historically high levels. Strong fiscal consolidation measures are likely to put a further drag on already weak income growth and thus housing demand. In Spain, housing permits continue to decline, and housing investment remains elevated relative to GDP compared to previous troughs, suggesting further likely downward adjustments. In Ireland, renewed financial market stress due to ongoing concerns about the health of the banking system may lead to a renewed tightening of credit conditions. In addition, recent signs of increased net outward migration from Ireland may weaken housing demand further.

One approach to gauge the eventual magnitude of the impact of possible further negative demand shocks on housing prices and new housing supply is to use estimated long-run supply and demand (semi-) elasticities. On the basis of the country-specific elasticities reported by Caldera Sánchez and Johansson (2010), holding all other factors constant (including housing supply), a negative income shock of about 1% would eventually decrease house prices by 3.5% in the United Kingdom. The impact would also be more than proportional in Spain (1.6%). In the United States and Ireland, prices would decrease slightly less than proportionally by 0.8% and 0.6% respectively. In contrast, a tightening of financial conditions would hit the Irish housing market particularly hard: a 2 percentage point increase in interest rates would eventually, all else equal, reduce prices by about 3% in Ireland, while the effect would be smaller in the United States (2%), Spain (1%) and the United Kingdom (0.5%).
Box 1.2. Housing market developments (cont.)

However, such price responses to demand shocks would trigger supply responses that would vary widely across countries (see figure). For example, a 6% decrease in real house prices (which roughly corresponds to the magnitude of price declines in the United States and Spain over the year to the second quarter of 2010), would, if long-lasting, be expected to translate into a 12% decline in housing investment in the United States. The same price decrease would trigger smaller investment declines of about 4%, 2.7% and 2.4% in Ireland, Spain and the United Kingdom, respectively. These calibrated effects suggest that if a further, long-lasting, negative demand shock in the housing market occurred, much of the adjustment required to bring demand and supply back into line could come from the supply side in the United States. In contrast, in the other countries discussed here, adjustments would have to come through larger price decreases stimulating housing demand, although this would be likely to have a negative impact on private consumption via adverse balance-sheet effects. It should be underlined, however, that the calibrations are based on observed past behaviour which may not be fully replicated in current housing market conditions with unusually low levels of housing investment.

Price responsiveness of housing supply: selected countries

Estimates of the long-run price-elasticity of new housing supply

1. Estimates of the long-run price elasticity of new housing supply where new supply is measured by residential investments (i.e. the coefficient on lagged prices in a long-run investment equation). All elasticities are significant at least at the 10% level. In the case of Spain, restricting the sample to the period 1995-2007, which would reflect recent developments in housing markets (such as the large stock of unsold houses resulting from the construction boom starting in 2000 and peaking in 2007-09), only slightly increases the estimate of the elasticity of housing supply from 0.45 to 0.58. Estimation period early 1980s to early/mid-2000s. See Caldera Sánchez and Johansson (2010) for details.

Source: OECD estimates.

StatLink http://dx.doi.org/10.1787/888932945147

1. A similar picture emerges for the aggregate of G7 countries with respect to housing investment and house prices when previous recessions are compared with the latest one.
2. Some evidence suggests that house prices may have not yet completely adjusted to values justified by longer-term fundamental house price determinants in Spain, the United States, the United Kingdom (see EC, 2010) and the euro area (Gattini and Hiebert, 2010). This would imply that prices would have to fall further than suggested by the simple simulations conducted here.
third quarter of 2010, and total employment has started to edge up. Labour market developments in Germany continue to be stronger than in most other countries, with unemployment continuing to decline, alongside job growth, thanks to labour market reforms over the past decade. Nonetheless, considerable slack remains in OECD-wide labour markets, with the unemployment rate in the third quarter over 2½ percentage points higher than at the onset of the crisis (Figure 1.9) and comparatively weak hiring intentions in business surveys.

With economic growth picking up only modestly, prospects for strong employment growth appear limited (Table 1.3), especially given the scope in many economies, notably Japan and some European economies, to meet increases in output by raising cyclically-low working hours and productivity. The OECD-wide unemployment rate is projected to decline

Table 1.2. Real house prices remain fragile in some countries

<table>
<thead>
<tr>
<th>Country</th>
<th>2001-2007</th>
<th>2008</th>
<th>2009</th>
<th>Latest quarter</th>
<th>Price-to-rent ratio</th>
<th>Price-to-income ratio</th>
<th>Latest available quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>-6.2</td>
<td>-4.1</td>
<td>-6.7</td>
<td>109</td>
<td>93</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>-2.0</td>
<td>-1.7</td>
<td>-2.0</td>
<td>64</td>
<td>66</td>
<td>Q1 2010</td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>-2.5</td>
<td>-0.7</td>
<td>-1.9</td>
<td>74</td>
<td>72</td>
<td>Q4 2009</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>-1.6</td>
<td>-6.7</td>
<td>4.7</td>
<td>138</td>
<td>131</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>-1.4</td>
<td>-3.5</td>
<td>-3.9</td>
<td>108</td>
<td>126</td>
<td>Q1 2010</td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>-3.9</td>
<td>-9.0</td>
<td>4.7</td>
<td>144</td>
<td>137</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>-2.8</td>
<td>4.0</td>
<td>7.9</td>
<td>156</td>
<td>131</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Australia</td>
<td>0.7</td>
<td>0.3</td>
<td>13.2</td>
<td>163</td>
<td>150</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Belgium</td>
<td>1.6</td>
<td>0.1</td>
<td>3.1</td>
<td>163</td>
<td>153</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Denmark</td>
<td>-7.4</td>
<td>-13.2</td>
<td>0.6</td>
<td>128</td>
<td>133</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Finland</td>
<td>-2.8</td>
<td>-0.8</td>
<td>9.1</td>
<td>139</td>
<td>109</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Ireland</td>
<td>-11.6</td>
<td>-10.0</td>
<td>-14.8</td>
<td>120</td>
<td>93</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Korea</td>
<td>-0.5</td>
<td>-2.3</td>
<td>0.8</td>
<td>110</td>
<td>67</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Netherlands</td>
<td>1.5</td>
<td>-2.7</td>
<td>-3.6</td>
<td>139</td>
<td>148</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Norway</td>
<td>-4.5</td>
<td>-0.6</td>
<td>7.7</td>
<td>157</td>
<td>131</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>New Zealand</td>
<td>-7.7</td>
<td>-4.0</td>
<td>2.3</td>
<td>156</td>
<td>159</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Spain</td>
<td>-3.2</td>
<td>-7.7</td>
<td>-5.6</td>
<td>138</td>
<td>126</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>0.4</td>
<td>-0.3</td>
<td>7.7</td>
<td>144</td>
<td>133</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Switzerland</td>
<td>0.0</td>
<td>5.5</td>
<td>4.0</td>
<td>90</td>
<td>93</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Euro area</td>
<td>-1.4</td>
<td>-3.9</td>
<td>-1.3</td>
<td>114</td>
<td>112</td>
<td>Q2 2010</td>
<td></td>
</tr>
<tr>
<td>Total of above countries</td>
<td>-3.6</td>
<td>-3.4</td>
<td>-2.3</td>
<td>107</td>
<td>98</td>
<td>Q2 2010</td>
<td></td>
</tr>
</tbody>
</table>

Note: House prices deflated by the private consumption deflator.
1. Average from 1980 (or earliest available date) on = 100, latest quarter available.
2. Average of available quarters where full year is not yet complete.
3. Increase over a year earlier to the latest available quarter.
4. Germany, France, Italy, Spain, Finland, Ireland and the Netherlands.
5. Using 2005 GDP weights, calculated using latest country data available.

Source: Girouard et al. (2006); and OECD.
to just above 7¼ per cent by the end of 2012, a rate which would still leave considerable labour market slack, damping wage pressures. A key policy challenge will be to minimise the transformation of cyclical into structural unemployment, especially in countries, such as the United States, where there has been an exceptionally large rise in unemployment in a context of a long-run downward trend in the outflow rate from unemployment.
1. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

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1.1. Growth prospects

Output growth was relatively subdued in the OECD economies in the third quarter, and growth was also weaker in the non-OECD economies than earlier in the recovery. Looking ahead, the soft patch in the global economy is expected to prove only temporary, with growth in the non-OECD economies and, more hesitantly, in the OECD economies gradually picking up from the start of next year (Figure 1.10), provided that policy stimulus is withdrawn in a gradual manner (Box 1.3), and that financial conditions remain favourable. Accommodative monetary policies should continue to support growth throughout the projection period but necessary fiscal consolidation and continued headwinds from the legacies of the recession, including ongoing balance-sheet adjustment and weak labour markets, will allow only a moderate upturn.

The key features of the economic outlook for major economies and world trade are as follows:

- Growth in the United States is expected to remain subdued until the end of 2010 before slowly gaining momentum through 2011-12, despite being damped by substantial fiscal consolidation over this period. Strong corporate profits, lagged effects from past improvements in aggregate financial conditions, and normal cyclical forces will all help equipment investment to remain robust, with housing and commercial property investment picking up more gradually once excess supply diminishes in property markets. Ongoing balance-sheet adjustment is...

Table 1.3. Labour market conditions will improve slowly

<table>
<thead>
<tr>
<th>Percentage change from previous period</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Employment</strong></td>
</tr>
<tr>
<td>United States</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Euro area</td>
</tr>
<tr>
<td>OECD</td>
</tr>
<tr>
<td><strong>Labour force</strong></td>
</tr>
<tr>
<td>United States</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Euro area</td>
</tr>
<tr>
<td>OECD</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Per cent of labour force</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Unemployment rate</strong></td>
</tr>
<tr>
<td>United States</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Euro area</td>
</tr>
<tr>
<td>OECD</td>
</tr>
</tbody>
</table>

Source: OECD Economic Outlook 88 database.

(Elsby et al., 2010). Structural labour market policies will have an important role to play in this regard, as discussed further below.

Growth prospects

Output growth was relatively subdued in the OECD economies in the third quarter, and growth was also weaker in the non-OECD economies than earlier in the recovery. Looking ahead, the soft patch in the global economy is expected to prove only temporary, with growth in the non-OECD economies and, more hesitantly, in the OECD economies gradually picking up from the start of next year (Figure 1.10), provided that policy stimulus is withdrawn in a gradual manner (Box 1.3), and that financial conditions remain favourable. Accommodative monetary policies should continue to support growth throughout the projection period but necessary fiscal consolidation and continued headwinds from the legacies of the recession, including ongoing balance-sheet adjustment and weak labour markets, will allow only a moderate upturn.

The key features of the economic outlook for major economies and world trade are as follows:

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likely to keep the household saving rate at or just above its current level, but private consumption growth should be helped by gradual improvements in labour market conditions. Despite a pick-up in employment growth, the unemployment rate is projected to remain elevated, declining only to around 8¼ per cent by the end of 2012, implying that marked economic slack will persist for some time.

... Japan...

Growth picked up in the third quarter in Japan, with private consumption brought forward to benefit from time-limited tax incentives. This will likely weaken consumption in the coming months. But the new fiscal packages announced in the autumn should help to support activity through to the first quarter of 2011. Thereafter, output growth is projected to be more modest, reflecting inter alia softer external demand, in part due to the appreciation of the real exchange rate. Continued improvements in labour market conditions and strong corporate profitability should help to support domestic demand, although public spending is likely to decline from mid-2011. The unemployment rate is expected to decline gently over the projection period, but will remain above its pre-crisis level.

... and the euro area...

In the euro area, domestic demand is expected to strengthen gradually over the projection period, helped by accommodative monetary policy, strong corporate profits and past improvements in financial conditions, but the pace of the upturn will be damped by fiscal consolidation and ongoing balance-sheet adjustments in the private sector. Area-wide government demand is expected to decline consistently from the start of 2011 onwards. Labour market conditions are likely to improve slowly, with ongoing employment growth and the unemployment rate edging
Box 1.3. Policy and other assumptions underlying the projections

Fiscal policy assumptions for 2011 are based as closely as possible on legislated tax and spending provisions. Where policy changes have been announced but not legislated, they are incorporated if it is deemed clear that they will be implemented in a shape close to that announced. Where government plans are available for 2012, fiscal projections follow the plans. Otherwise, in countries with impaired public finances, a tightening of the underlying primary balance of at least 1% of GDP in 2012 has been built into the projections. The tightening is assumed to be larger for countries in serious fiscal problems and facing market pressure, and smaller for countries in more comfortable positions. Where there is insufficient information to determine the allocation of budget cuts, the presumption is that they apply equally to the spending and revenue sides, and are spread proportionally across components. These conventions, which differ from the practice in previous OECD fiscal projections, allow for needed consolidation in countries where plans have not been announced at a sufficiently detailed level to be incorporated in the projections. Along this line, the following assumptions were adopted (with additional adjustments if OECD and government projections for economic activity differ):

- For the United States, fiscal policy follows the Administration’s proposed budget in the August 2010 Mid-Session Review.
- For Japan, the projections include the stimulus packages announced in September and October, with half of the outlays in the latter being spent in fiscal year 2010. Government expenditure in 2011-12 is limited in line with the Fiscal Management Plan announced in June 2010.
- For Germany, the government’s medium-term consolidation programme, announced in September 2010, as well as the phasing out of the temporary components of the fiscal stimulus packages has been built into the projections. For France, the projections incorporate the government’s medium-term consolidation programme. For Italy, the projections incorporate the measures announced in the 2011 budget legislation. For the United Kingdom, the projections are based on tax measures and spending paths set in the June 2010 budget.

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

- In the United States, the target federal funds rate is assumed to remain constant at ¼ per cent until mid-2011, as the economic recovery is relatively weak and inflationary pressure is likely to remain subdued. The programme of quantitative easing is assumed to be implemented as announced. Subsequently, and in order to re-establish the normal functioning of money markets and limit adverse effects of near-zero rates, the Federal Funds rate is raised, reaching 1% by the end of 2011. Once the recovery is projected to be more firmly established, around the middle of 2012, the policy rate is assumed to rise again so as to reach just over 2% by the fourth quarter of 2012.
- In the euro area, against the background of well anchored inflation expectations, the refinancing rate is assumed to remain at the current level until the first quarter of 2012, after which it rises to 2% by the end of the projection period.
- In Japan, the short-term policy interest rate is assumed to remain at 0 basis points for the entire projection horizon, as consumer prices continue to fall.

The projections assume unchanged exchange rates from those prevailing on 26 October 2010: $1 equals ¥81.39, €0.72 (or equivalently, €1 equals $1.39) and CNY6.66.

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

The cut-off date for information used in the projections is 12 November 2010. Details of assumptions for individual countries are provided in Chapter 2 and Chapter 3.
down over 2011-12 by just under 1 percentage point. This should help to support private consumption, which is likely to be further boosted by a moderation in the saving rate. The recovery is expected to remain uneven, with growth being more robust in the core economies than in those at the periphery, where sizable fiscal consolidation is needed, and, in some cases, is combined with a need for strong private-sector balance sheet repair.

And remain robust in the non-OECD area...

- In China, output growth is projected to remain robust, averaging 9¾ per cent over 2011-12. Domestic demand is expected to remain strong, with private consumption growth supported by tightening labour markets and a reorientation of public spending to meet social objectives, but net trade should be a drag on growth. In India, the recent moderation in activity is expected to prove only temporary. Helped both by strong investment and consumption, output growth is projected to reach its trend growth rate of around 8½ per cent from mid-2011. In Brazil, domestic demand is set to rebound by year-end. Solid economic growth is projected over the next couple of years, helped by large public infrastructure and energy development programmes, despite some modest drag from declines in net exports and ongoing policy normalisation. In Russia, activity growth is projected to rebound from the weather-affected third quarter this year, and remain at a pace slightly above potential through 2011 and 2012, even as policy normalisation gets underway.

... with solid global trade growth

- The moderation in trade volume growth in the latter half of this year has taken the rate down towards historical norms. With global activity projected to pick up from the start of 2011, trade growth is expected to remain solid, averaging just over 8% over 2011-12, remaining especially strong in many Asian economies and Brazil (Table 1.4).

Core inflation is continuing to moderate...

In recent months the annual rate of headline inflation has picked up somewhat in most major OECD economies, reflecting the firming in global commodity prices and, in some countries, price-level adjustment following indirect tax increases (Figure 1.11). Although oil prices remained broadly constant in the six months to late October, non-oil commodity prices rose by close to 20% during this period. But core inflation rates, abstracting from the direct effects of food and energy price inflation, and statistical measures of underlying inflation have generally continued to moderate, albeit relatively gently considering the considerable economic slack that remains in labour and product markets. The annual rate of core (private consumers’ expenditure, PCE) inflation has dropped to around 1¼ per cent in the United States this year, and, in the euro area the core inflation rate has been at or below 1% since the start of the year. In Japan, the annual rate of deflation continues to be close to an underlying rate of 1%. Higher-frequency estimates of core or underlying inflation point to continued
1. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

Disinflationary pressures in the United States and Japan, with the annualised rate of inflation over three and six-month periods being below annual rates. Labour-cost pressures presently remain minimal. Unit labour costs have fallen especially sharply in the United States and, more recently, in Japan and the euro area, helped by higher labour productivity growth and continued wage moderation. A moderate pick-

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

<table>
<thead>
<tr>
<th>Goods and services trade volume</th>
<th>Percentage change from previous period</th>
</tr>
</thead>
<tbody>
<tr>
<td>World trade¹</td>
<td></td>
</tr>
<tr>
<td>of which: OECD</td>
<td></td>
</tr>
<tr>
<td>OECD</td>
<td>1.2</td>
</tr>
<tr>
<td>OECD America</td>
<td>0.7</td>
</tr>
<tr>
<td>OECD Asia-Pacific</td>
<td>3.4</td>
</tr>
<tr>
<td>OECD Europe</td>
<td>1.0</td>
</tr>
<tr>
<td>China</td>
<td>6.5</td>
</tr>
<tr>
<td>Other industrialised Asia²</td>
<td>6.7</td>
</tr>
<tr>
<td>Russia</td>
<td>7.0</td>
</tr>
<tr>
<td>Brazil</td>
<td>8.4</td>
</tr>
<tr>
<td>Other oil producers</td>
<td>8.2</td>
</tr>
<tr>
<td>Rest of the world</td>
<td>7.4</td>
</tr>
<tr>
<td>OECD exports</td>
<td>2.0</td>
</tr>
<tr>
<td>OECD imports</td>
<td>0.5</td>
</tr>
<tr>
<td>Trade prices³</td>
<td></td>
</tr>
<tr>
<td>OECD exports</td>
<td>9.1</td>
</tr>
<tr>
<td>OECD imports</td>
<td>11.1</td>
</tr>
<tr>
<td>Non-OECD exports</td>
<td>14.9</td>
</tr>
<tr>
<td>Non-OECD imports</td>
<td>11.8</td>
</tr>
<tr>
<td>Current account balances</td>
<td>Per cent of GDP</td>
</tr>
<tr>
<td>United States</td>
<td>-4.7</td>
</tr>
<tr>
<td>Japan</td>
<td>3.3</td>
</tr>
<tr>
<td>Euro area</td>
<td>-0.8</td>
</tr>
<tr>
<td>OECD</td>
<td>-1.5</td>
</tr>
<tr>
<td>China</td>
<td>9.6</td>
</tr>
<tr>
<td>$ billion</td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>-669</td>
</tr>
<tr>
<td>Japan</td>
<td>157</td>
</tr>
<tr>
<td>Euro area</td>
<td>-100</td>
</tr>
<tr>
<td>OECD</td>
<td>-671</td>
</tr>
<tr>
<td>China</td>
<td>436</td>
</tr>
<tr>
<td>Other industrialised Asia²</td>
<td>95</td>
</tr>
<tr>
<td>Russia</td>
<td>102</td>
</tr>
<tr>
<td>Brazil</td>
<td>-28</td>
</tr>
<tr>
<td>Other oil producers</td>
<td>-497</td>
</tr>
<tr>
<td>Rest of the world</td>
<td>-194</td>
</tr>
<tr>
<td>Non-OECD</td>
<td>907</td>
</tr>
<tr>
<td>World</td>
<td>237</td>
</tr>
</tbody>
</table>

Note: Regional aggregates include intra-regional trade.
1. Growth rates of the arithmetic average of import volumes and export volumes.
2. Chinese Taipei; Hong Kong, China; Malaysia; Philippines; Singapore; Vietnam; Thailand; India and Indonesia.
3. Average unit values in dollars.
Source: OECD Economic Outlook 88 database.

StatLink http://dx.doi.org/10.1787/888932346667
Figure 1.11. Underlying inflation is set to remain subdued
12-month percentage change

United States

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

Source: OECD Economic Outlook 88 database.
up in private sector wage inflation in the euro area is projected to occur from 2011, but with ongoing productivity growth and public sector wage restraint in several countries, economy-wide unit labour cost growth should be minimal. Outside the OECD area, rising food prices, and the increasing extent to which many economies are now operating close to full capacity, have generated some inflationary pressures in India, China and Brazil.

Ongoing economic slack, although difficult to measure precisely, is expected to diminish only slowly through the projection period and is likely to continue to bear down on inflation for some time to come, even if the effect of persistent large output gaps appears to diminish as inflation eases (Meier, 2010).3 In the United States, the annual rate of core inflation is projected to drift down to average just below 1% over the projection period. Deflation is expected to persist in Japan, although at a slowly diminishing pace over the projection period. In the euro area, core inflation is expected to edge up towards 1¼ per cent in 2011-12, due largely to higher profit margins. A gradual reversal of past cost inflation patterns is expected within the euro area; economy-wide unit labour costs in Ireland, Spain, Portugal and Greece are projected to decline, both in absolute terms and relative to the euro area average over the next two years. Price inflation in Spain and Ireland is also projected to be at or below the euro area average over 2011-12. In contrast, in Greece and Portugal, price inflation is expected to remain more elevated, in part because of higher indirect taxes.

Ultimately, the likelihood of widespread deflationary pressures building up throughout the OECD area should be contained if longer-term inflation expectations remain well anchored. At present, inflation expectations remain relatively close to explicit or implicit inflation objectives of monetary authorities in most economies, suggesting that weak, but positive, inflation remains the most likely outcome over the next two years. Measures of longer-term inflation expectations derived from yield differences between nominal and indexed bonds have slipped back somewhat in recent months, but that could partly reflect a mis-measurement due to a flight to more liquid nominal bonds during the sovereign debt turmoil. Survey-based expectations measures have generally been somewhat more stable.

3. Recent estimates for the United States suggest that the projected gap between the unemployment rate and its minimum value over the previous three years might reduce core inflation by at least 0.5 percentage point, and possibly up to 1 percentage point between mid-2010 and mid-2011 (Stock and Watson, 2010), which would result in an extremely low, but still positive, inflation rate.
The early stages of the recovery have seen measured global imbalances begin to widen once more, with an increase in underlying deficits and surpluses. Imbalances are projected to remain wide and in some cases increase through the course of 2011 and 2012 (Figure 1.12). The US current account deficit rose by ½ percentage point of GDP over the year to mid-2010 and could increase by a ¼ percentage point over the next two years. Whilst the sizable current account surplus of Japan is projected to remain stable in 2011 and 2012, that of Germany is projected to rise, helped by the relative exposure of domestic exporters to fast-growing Asian markets. Most traditional euro-area deficit countries are set to experience improvements in their external account that exceed those in traditional surplus countries. External surpluses of the major non-OECD oil-producing economies, already bolstered by the firmness of oil prices in 2010, are also set to increase in the coming years. By contrast, the Chinese current account surplus, which was already lower in the first half of 2010 than in 2009, is expected to show a further slight decline over the next two years, helped by buoyant domestic demand growth.

Figure 1.12. **Global imbalances will remain pronounced**

Current account balance, in per cent of GDP

Source: OECD Economic Outlook 88 database.

The short-term risks around the projection remain considerable. It remains possible that the underlying momentum of the recovery in the OECD economy could pick up more markedly than thought after the current soft patch, but the risks are deeper on the downside. Such risks are largely associated with the possibility of interactions between particular events and existing fragilities that could prompt a new period of sustained weakness in private-sector activity. Many of the fragilities that

4. Underlying (cyclically-adjusted) trade balances in the major OECD economies (Cheung et al., 2010) are estimated to have widened somewhat this year, with an increase in the surplus in Japan and the euro area and a slight rise in the US structural deficit.
remain stem from the continued legacies of the recession and the boom that preceded it. At present, key risks include:

- An adverse feedback loop between the government and financial sectors could materialise if intensified concerns about sovereign debt in fiscally weak countries led to new losses for banks. Even if the European sovereign debt turmoil abated with the establishment of temporary support facilities, interest rate spreads have widened more recently in Greece, Ireland and Portugal, though without unsettling interbank and foreign exchange markets. However, a risk remains of sovereign-debt stress becoming more widespread and having more systemic consequences. More generally, a loss of confidence in the ability of governments to arrest unsustainable fiscal positions would give rise to corresponding losses in financial institutions as bond yields increase. Such a development could have further international ramifications and could destabilise the global financial system if a large country was involved and its banks reacted by repatriating funds from their foreign subsidiaries.

- A broader risk relates to the very low levels of long-term interest rates in major OECD economies. The current levels of long-term rates are difficult to reconcile with the projection of a mild but sustained recovery (see Box 1.4). The present set of projections reflects an assumption that long-term interest rates revert gradually to historical norms over the medium term. However, historical experience suggests that the adjustment could occur more abruptly. A rapid unanticipated increase in long-term interest rates could weaken the recovery through its direct effects on investment. As a possible order of magnitude, simulations on the OECD Global Model (Hervé et al., 2010) indicate that the impact of a simultaneous 100 basis points increase in bond yields in all countries could be to reduce output growth by around ½ percentage point in both the first and second years of the increase. An abrupt backup in yields could also threaten the recovery indirectly, via its effects on the financial sector, because the associated declines in bond prices would confront banks and other investors with a new wave of losses.

- Specific risks continue to emanate from banks. A number of fiscally weak euro area countries have banking sectors that are still highly dependent on liquidity support from the ECB (Figure 1.13). If these banks cannot regain market confidence in the coming quarters, they may experience funding difficulties when, as expected, the ECB stops its exceptional liquidity facilities because they become inappropriate for the needs of the euro area financial sector as a whole. Another risk coming from the banking sector is the possibility that, instead of adapting gradually to the new capital standards with few adverse effects on economic growth (see below and Box 1.6), banks engage in a race to reach the new standards by either compressing balance sheets, and thereby credit, or by issuing shares, pushing up the cost of equity for the broader economy.
Box 1.4. **Risks associated with current low bond yields**

Government bond yields have fallen to very low levels in major OECD economies, stoking fears of a bubble that could burst with serious consequences for financial stability, government finances and the economy more generally (see first figure). In Germany, long-term interest rates have fallen to their lowest level in more than fifty years. In the United States, they are very close to their historical lows of December 2008-January 2009. This fall has occurred even for the euro area benchmark bond, where the decrease in German, French and Dutch long-term interest rates since the beginning of the year has more than offset the increase in credit spreads in fiscally-weaker members of the currency union.

**Yields on long-term government bonds**

*Last observation: 12 November 2010*

Source: Datastream.

![Yields on long-term government bonds](http://dx.doi.org/10.1787/888932345242)

Yields on long-term government bonds issued by the major OECD economies are well below the average assumed level of short-term interest rates over the next ten years underpinning the OECD projection and its long-term extension (see Chapter 4 and second figure). Prima facie, this configuration goes against the normal pricing of long-term bonds, which should remunerate investors above expected average short-term rates so as to compensate them for their exposure to interest rate risk. Indeed, the outlook for public debt could be expected to raise bond yields given the need to fund very large government deficits and the increase in the credit risk of sovereign issuers.

One factor behind the discrepancy might be that markets anticipate a lower path of short-term interest rates over the next ten years than that assumed in the projections. Interest rate swaps, which value market expectations of average money-market rates, point in this direction, as they lie well below the average of assumed short-term rates underpinning the projections (see second figure). This difference could reflect expectations in financial markets of much weaker inherent growth dynamics than in the OECD short and longer-term projections, thus justifying persistent low policy interest rates to achieve convergence of output to potential and return inflation to objectives. However, it is also conceivable that market expectations reflect anticipation that pre-crisis interest-rate setting behaviour will continue, including the severe downward deviation in the past decade by some major OECD central banks from the levels of interest rates prescribed by simple rules. In contrast, the present projection is based on the assumption that past deviations, which contributed to the credit bubble, will not be repeated.
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Box 1.4. Risks associated with current low bond yields (cont.)

Government bond yields vs. future short rates

Source: Datastream, OECD Economic Outlook 88 database and OECD calculations.

http://dx.doi.org/10.1787/888932345261

The sovereign debt crisis that has hit a number of euro area countries is also likely to have contributed to the reduction of interest rates in the main countries as investors sought to rebalance their portfolio in favour of government bonds seen as having lower credit and liquidity risk. Resolution of sovereign-debt problems, or just anticipation thereof, should lead to a diminution of this effect.

Quantitative easing is another possible driving force behind the current low levels of interest rates. The Federal Reserve and the Bank of England have purchased large amounts of bonds issued or guaranteed by the government with the aim of reducing yields and easing financial conditions. There are large differences in the estimated effect of these policies. Work conducted at the US Federal Reserve and the Bank of England suggests that the impact has been large, in the 30-100bp range in the United States and close to 100bp in the United Kingdom (Doh, 2010; Gagnon et al., 2010; Joyce et al., 2010). Academic research, on the other hand, has found insignificant or small effects (Hamilton and Wu, 2010; Stroebel and Taylor, 2010).

Overall, it appears likely that the current levels of long-term interest rates are largely the result of expectations, in part shaped by quantitative easing, that the major central banks will keep short-term rates very low for an exceptionally long period of time. The present set of projections assumes that, as the recovery takes hold, these expectations will gradually adjust to reflect the likely subsequent normalisation of policy-controlled interest rates so that long-term interest rates will progressively become closer to the projected average of future short-term rates. The possibility of an abrupt adjustment, however, cannot be entirely excluded and represents a downside risk to the projection.

1. Beyond the projection period, short-term interest rates are assumed to converge gradually to their equilibrium level.
2. Even if interest rate swap rates are by design very tightly linked to expected future money market rates, they are also connected to government bond yields as any significant deviation between the two opens arbitrage opportunities.
3. See for instance Ahrend et al. (2009) and Taylor (2009) for a discussion of the link between market excess and downward deviations of policy-controlled interest rates from simple rules.

... net capital inflows to emerging markets and associated exchange rate tensions...

- Capital flows have risen sharply this year from countries with weak activity and accommodating monetary policies towards countries with more buoyant activity and less accommodating monetary policy, including emerging markets, especially in Asia and Latin America.
Associated changes in real exchange rates or attempts to resist them may, however, trigger political tension. Given the potentially adverse growth effects from exchange rate movements in trading partners (Table 1.5), currency intervention, if seen to be motivated largely by aims of maintaining or strengthening competitiveness, may trigger retaliatory actions, including protectionist measures, with serious consequences for the world economy.

Table 1.5. The activity effects of exchange rate depreciations
Difference from baseline, percentage points

<table>
<thead>
<tr>
<th></th>
<th>US dollar depreciation¹</th>
<th>Euro depreciation²</th>
<th>Yen depreciation³</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Year 1</td>
<td>Year 2</td>
<td>Year 1</td>
</tr>
<tr>
<td>United States</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP growth</td>
<td>0.5</td>
<td>0.5</td>
<td>-0.1</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP growth</td>
<td>0.0</td>
<td>-0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Euro area</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP growth</td>
<td>-0.2</td>
<td>-0.2</td>
<td>0.7</td>
</tr>
</tbody>
</table>

1. The US dollar falls by 10% against all currencies.
2. The euro falls by 10% against all currencies.
3. The yen falls by 10% against all currencies.

Source: Hervé et al., (2010).
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... and renewed house-price declines

- As mentioned above, renewed declines in nominal and real house prices cannot be excluded in some countries and have become a more acute risk in the United States and the United Kingdom due to weak sales and high inventories. Lower house prices would have a negative effect on household wealth and result in private consumption slowing further. Simulations on the OECD Global Model suggest that a 10% decline in US house prices would reduce US output growth by about 0.2% in 2011 and 0.4% in 2012, under the assumption of unchanged macroeconomic policies, with negative, though small, spillover effects onto other countries. An OECD-wide decline of 10% in house prices would have larger effects, reducing OECD GDP by 0.8% after two years, and consumer price inflation by around ¼ percentage point in both 2011 and 2012. The risk of stronger negative feedback loops between house prices, private-sector demand and financial sector weakness cannot be excluded, although they are not considered in the model simulations.

But there are also upside risks from business investment...

- On the upside, business investment could recover more strongly than projected from its current depressed level if high profits and improved cash-flow were to have the same impact on capital spending as in the past (Martinez-Carrascal and Ferrando, 2008). And, given its exceptional compression in the downturn, residential construction might also be stronger than anticipated, provided house prices do not weaken, though this would have only modest effects on GDP, given the historically low share of residential investment in most OECD economies.

... and from financial markets

- The financial sector is also a source of upside risk. For example, shares are priced at multiples of earnings that are below historical averages in some countries, implying a possibility of upward adjustment. Such a development would facilitate the balance-sheet adjustment of the private sector, possibly leading to a lower saving rate than in the current set of projections.

Policy responses and requirements

With the present soft patch in growth projected to be only temporary, policy decisions over the next years need to reflect two main challenges – the need for widespread normalisation of crisis-related policies and the need for reforms to strengthen future growth and employment prospects and the durability of the recovery. At the same time, policy needs to stand ready to react if risks such as those discussed above materialise. This comprises action on fiscal and monetary policies as well as financial and other structural reform.

Fiscal Policy

Following record highs in 2009, the OECD area-wide fiscal deficit is expected to fall to around 6% of GDP in 2011 (Table 1.6), with reductions in almost all OECD countries. Announced consolidation measures are the...
main driver of deficit reductions, but cyclical factors are also projected to contribute, more than offsetting rising interest payments. Public finances will continue to improve in 2012 on the basis of government announced plans and OECD assumptions about consolidation in that year (see below and Box 1.3) and the strengthening of cyclical positions. Nonetheless, though estimates are subject to considerable uncertainty, more than three-quarters of deficits are likely to be structural in 2012. The emergence of these large structural deficits reflects mainly the disappearance of the extraordinary revenue buoyancy prior to the crisis, the remaining parts of crisis-related stimulus measures, the impact of the crisis-induced reduction in the level of potential output, and the run-up in debt service payments. In the OECD as a whole, the ratio of gross government debt to GDP is set to continue rising, exceeding 100% by 2011 (Figure 1.14).

Table 1.6. Fiscal positions will improve in coming years
Per cent of GDP / Potential GDP

<table>
<thead>
<tr>
<th>United States</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual balance</td>
<td>-6.3</td>
<td>-11.3</td>
<td>-10.5</td>
<td>-8.8</td>
<td>-6.8</td>
</tr>
<tr>
<td>Underlying balance</td>
<td>-5.9</td>
<td>-8.8</td>
<td>-7.6</td>
<td>-7.6</td>
<td>-6.0</td>
</tr>
<tr>
<td>Underlying primary balance</td>
<td>-4.2</td>
<td>-7.4</td>
<td>-7.0</td>
<td>-5.8</td>
<td>-3.9</td>
</tr>
<tr>
<td>Gross financial liabilities</td>
<td>71.1</td>
<td>84.4</td>
<td>92.8</td>
<td>98.5</td>
<td>101.4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Japan</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual balance</td>
<td>-2.1</td>
<td>-7.1</td>
<td>-7.7</td>
<td>-7.5</td>
<td>-7.3</td>
</tr>
<tr>
<td>Underlying balance</td>
<td>-3.5</td>
<td>-5.7</td>
<td>-6.7</td>
<td>-6.4</td>
<td>-6.3</td>
</tr>
<tr>
<td>Underlying primary balance</td>
<td>-2.6</td>
<td>-4.7</td>
<td>-5.5</td>
<td>-5.3</td>
<td>-4.7</td>
</tr>
<tr>
<td>Gross financial liabilities</td>
<td>173.9</td>
<td>192.8</td>
<td>198.4</td>
<td>204.2</td>
<td>210.2</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Euro area</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual balance</td>
<td>-2.0</td>
<td>-6.2</td>
<td>-6.3</td>
<td>-4.6</td>
<td>-3.5</td>
</tr>
<tr>
<td>Underlying balance</td>
<td>-2.1</td>
<td>-4.1</td>
<td>-3.9</td>
<td>-2.8</td>
<td>-2.2</td>
</tr>
<tr>
<td>Underlying primary balance</td>
<td>0.6</td>
<td>-1.7</td>
<td>-1.4</td>
<td>-0.3</td>
<td>0.5</td>
</tr>
<tr>
<td>Gross financial liabilities</td>
<td>76.0</td>
<td>86.3</td>
<td>91.6</td>
<td>94.8</td>
<td>96.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>OECD1</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual balance</td>
<td>-3.3</td>
<td>-7.9</td>
<td>-7.6</td>
<td>-6.1</td>
<td>-4.7</td>
</tr>
<tr>
<td>Underlying balance</td>
<td>-3.7</td>
<td>-6.2</td>
<td>-6.1</td>
<td>-5.2</td>
<td>-4.2</td>
</tr>
<tr>
<td>Underlying primary balance</td>
<td>-2.0</td>
<td>-4.7</td>
<td>-4.4</td>
<td>-3.3</td>
<td>-2.1</td>
</tr>
<tr>
<td>Gross financial liabilities</td>
<td>79.1</td>
<td>90.6</td>
<td>96.9</td>
<td>100.7</td>
<td>102.8</td>
</tr>
</tbody>
</table>

Note: Actual balances and liabilities are in per cent of nominal GDP. Underlying balances are in per cent of potential GDP. The underlying primary balance is the underlying balance excluding the impact of the net debt interest payments.
1. Total OECD excludes Mexico and Turkey.
2. Fiscal balances adjusted for the cycle and for one-offs.
Source: OECD Economic Outlook 88 database.

StatLink © http://dx.doi.org/10.1787/888932346705

5. The decomposition of fiscal balances into underlying and cyclical components is based on potential output and output gap estimates along the lines described in OECD Economic Outlook, No. 85. Given the uncertainties about the impact of the crisis on potential output levels and growth in the recent past and the near future, estimates of structural and cyclical components of budget balances are particularly uncertain at present.
Consolidation needs are large in most countries

Calculations by the OECD indicate that, based on plausible assumptions about medium-term growth and interest rates, the mere stabilisation of the debt-to-GDP ratio before 2025 would call for a tightening of underlying primary balances after 2010 of over 8% of GDP in Japan and the United States, which belong to the countries with the largest primary deficits (see Chapter 4). Moreover, for many countries...
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Stabilisation of the debt ratio would occur at high levels. This would raise the vulnerability of government finances to financial market volatility and reduce the scope and effectiveness of fiscal policy measures to counteract future economic downturns. Bringing debt ratios back to pre-crisis levels or to more comfortable levels of some 60% of GDP would require substantially greater consolidation than for debt stabilisation (see Chapter 4).

International cooperation will enhance the credibility of consolidation

Fiscal consolidation will have short-term negative effects on demand, particularly so with a large number of countries pursuing consolidation simultaneously. Such effects will, however, be minimised when consolidation is embedded in credible long-term consolidation programmes that may help reinforce confidence and accelerate the recovery of self-sustained growth. Although country-specific aspects can influence the consolidation path, the credibility of consolidation can be enhanced further if sustained by stronger international cooperation, including through the G20 framework for strong, sustainable and balanced growth. As shown in OECD Economic Outlook No. 87, a coordinated implementation of macroeconomic, exchange rate and structural policies would strengthen growth, accelerate fiscal consolidation and narrow global imbalances.

The speed of consolidation should depend on...

... the state of the public finances...

- The state of public finances. The greater the overall consolidation required to stabilise debt at reasonable levels, the more intensive consolidation will need to be in the short term.

... the ease of funding public debt...

- The ease at which government debt can be funded. Fiscal consolidation should be more rapid if government debt has become increasingly difficult to finance and if delays of consolidation policies would excessively undermine future GDP through higher long-term interest rates. The fact that spreads between benchmark sovereign bond yields in Germany and the countries affected by the European debt crisis still stand at record levels is witness to the difficulties of restoring market confidence in sound government finances once it has been lost (Figure 1.15).

... the strength of the recovery...

- The strength of the recovery. Countries enjoying a robust recovery can afford to reduce budget deficits faster than countries with more fragile recoveries. Also, if growth were to turn out markedly weaker than projected, the pace of consolidation could be moderated in those countries with reasonably sound public finances and credible medium-term consolidation strategies. More generally, in such circumstances, the automatic stabilisers could also be allowed to operate around the planned consolidation path in countries that have not lost the confidence of financial markets. Countries in poor fiscal shape and
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with little credibility could, however, be forced to react procyclically to weaker activity – which illustrates the importance of preserving credibility.

... the scope for monetary policy to provide stimulus...

- The scope for monetary policy to offset demand-restraining effects of fiscal contraction. At present, with policy interest rates close to zero in most OECD areas, monetary authorities are constrained in providing additional stimulus. However, if needed, the future pace of the normalisation of interest rates could be adjusted to offset economic weakness as a result of budget improvements. Hence, future consolidation should be more rapid where there is scope to delay interest-rate normalisation and moderate its pace.

... and existing commitments

- Existing commitments. Governments need to honour existing commitments for consolidation or risk undermining their credibility.

Planned consolidation in 2011 is appropriate in most countries...

Against the background of these criteria, the planned strengthening of structural budget positions in 2011 in most OECD countries appears to be appropriate:

- In the United States, taking into account projected state-level consolidation, the Administration’s budget proposal implies general government consolidation of around 1¼ percentage points of GDP, striking a balance between the need to arrest unsustainable debt dynamics and the need to avoid withdrawing stimulus too quickly. The underlying deficit nonetheless remains very high by historical standards, with the gross debt-to-GDP ratio increasing further to 98½ per cent.
In Japan, consolidation measures to be implemented in 2011 are likely to improve the underlying budget balance by around ¼ percentage point of GDP, after taking into account stimulus measures contained in the recent supplementary budget for the current fiscal year. While this limited consolidation would be consistent with the government’s medium-term strategy, its implementation is subject to unusually high political uncertainty. The debt ratio is expected to increase to nearly 205%. In the light of the extraordinarily high debt levels, stronger consolidation than currently planned would be warranted.

In the euro area, unwinding of stimulus measures and fiscal restraint are likely to improve underlying balances by 1 percentage point of GDP on average. Forceful consolidation is projected for most countries that are or have been exposed to market pressure, notably Greece, Ireland, Portugal and Spain, with improvements in underlying balances projected to total between 2 and 4¾ percentage points of GDP. In Ireland, extraordinary budgetary costs, related to the recapitalisation of the banking system, led to a steep increase in the headline fiscal balance in 2010, but such measures should not affect public finances in 2011. In France, the reduction in the underlying deficit by 1% of GDP is needed in view of the high debt and deficit levels. By contrast, in several other euro area countries, including Germany and Italy, consolidation gains are likely to be more modest, in the order of ½-1 percentage points of GDP, which is appropriate given their comparatively low underlying budget deficits and economic slack. In a few European countries, near-term improvements in structural budget balances are to be achieved partly by one-off measures and accounting changes (such as extraordinary receipts in exchange for assuming pension liabilities of private companies and the recording of contributions to second-pillar pensions as government revenues) that will not durably strengthen public finances. Box 1.5 reviews recent initiatives to strengthen the coordination and surveillance of fiscal policy in the euro area.

In the United Kingdom, the authorities’ consolidation plan is expected to improve the underlying balance by 1¼ per cent of GDP in 2011, as a further stage in the process to avoid unsustainable debt accumulation.

Further significant steps towards sustainable fiscal positions are necessary in 2012. Where government plans are available for 2012, the fiscal projections in this Economic Outlook follow those plans. Where this is not the case, consolidation has been assumed to proceed along the lines set out in Box 1.3.

In the United States, with the upswing projected to gain strength, a high underlying deficit and rising debt call for significant consolidation efforts. The projected reduction in the underlying deficit by about 1 percentage point of GDP, consistent with the Administration’s aim as reported in the August Mid-Session Review, appears to be appropriate.
Box 1.5. Fiscal rules and arrangements in the euro area

High levels of debt and large fiscal deficits in some euro area countries have led to concerns about fiscal sustainability, which has created turbulence for the area as a whole in recent months. This has drawn attention to weaknesses in the performance and design of euro area fiscal arrangements. In consequence, the fiscal governance of the euro area needs to be strengthened. This can be pursued through a combination of stronger institutions and more intense market discipline.

Strengthening the institutional framework

To achieve the necessary fiscal discipline, the European Commission announced in September 2010 a package of legislative proposals that seek to strengthen coordination and surveillance of fiscal policies in individual member countries and to ensure adherence to the Stability and Growth Pact. Many of these proposals were included in the report of the EU Taskforce, published on 21 October and endorsed by the European Council on 29 October. Major elements of the overall package are:

- Better ex ante coordination of national budgets through a “European Semester” in the early part of the year, with the ECOFIN issuing country-specific recommendations that can be taken into account in setting national budgets. The establishment of this mechanism had already been agreed before the presentation of the legislative package.

- Earlier and wider ranging enforcement of the Stability and Growth Pact (SGP). In case of non-compliance with the preventive arm, an interest-bearing deposit could be levied. Under the Pact’s “corrective arm”, a non-interest-bearing deposit would be levied as soon as an Excessive Deficit Procedure is engaged, which could be converted into a fine if a country did not follow through on its commitment to rectify its deficit.

- Increased focus on public debt and fiscal sustainability in the implementation of the Stability and Growth Pact, with clear debt-reduction benchmarks set for each member country with debt ratios above the SGP reference value of 60% of GDP.

- Stronger national fiscal frameworks by establishing minimum quality standards, such as legally-enshrined national fiscal rules reflecting EU obligations, multi-annual budgetary plans and better forecasting systems.

Overall, these proposals aim to enforce fiscal discipline by moving towards more ex ante sanctions that can influence behaviour before a country gets into a very weak fiscal position. To counter the unwillingness of the ECOFIN Council to sanction its own members in some cases, it is envisaged that the new sanctions would be adopted on a recommendation from the Commission by default, unless the Council decides against it by qualified majority within ten days. The quasi-automatic nature of sanctions could help to improve compliance, as in the current setting an explicit majority decision needs to be taken to apply disciplinary procedures. However, these proposals are still being discussed by member countries.

In addition to reducing the risk of crises, it is well recognised that an institutional framework is required to resolve crises that may occur. Towards this end and consistent with an approach based on ex ante surveillance, an arrangement along the lines of the three-year European Financial Stability Facility (EFSF) could be made a permanent feature of the euro area financial architecture thereby filling an important gap in terms of providing short-term liquidity insurance for countries facing difficulties in raising finance. However, such mechanisms create the risk of moral hazard and undermine efforts to improve fiscal discipline if they are viewed as providing bailouts for countries that pursue poor policies without strict conditionality. Countries with solvency problems should not have access to the EFSF and this practice could be extended to those with a record of non-compliance with the SGP. More generally, providing individual euro member countries with financial rewards for sound public finances could strengthen fiscal governance in the area as a whole. One option would be to entitle countries with a track record of fiscal soundness, based on clear objective criteria, but facing problems due to contagion to borrow from a common facility (like the EFSF) without conditionality (as in the IMF Flexible Credit Line (FCL) facility) or with minimal conditions attached. This would encourage countries to pursue policies to qualify for the insurance associated with such arrangements.
As market pressures are unlikely to be an imminent concern, automatic stabilisers should be allowed to operate around the projected consolidation path and some temporary support could be provided if activity were to be much weaker than anticipated.

- Based on the government’s medium-term spending plan, and with no allowance for changes in tax policy, the Japanese underlying balance is projected to remain unchanged. With the upswing projected to strengthen and given the serious persistent fiscal imbalance in Japan, more ambitious consolidation would seem to be required.
Also, there is no alternative to continued implementation of stringent consolidation policies in European countries whose public finances were particularly hard hit by the financial crisis or the subsequent sovereign debt crisis. The deficit reductions in Greece, Portugal and Spain embedded in government programmes of between ½ and 1 percentage point of GDP will be less than in the initial phase of their consolidation process, while in Iceland the underlying balance is projected to continue to improve at a rapid pace, by 2½ percentage points of GDP. For Ireland, the projected reduction in the underlying balance is 1½ percentage points of GDP, assuming that the government will implement its plan announced in early November 2010.

In France and Italy, underlying balances are projected to tighten by 1 and ½ percentage points of GDP, respectively, assuming that sufficient measures are introduced to meet the governments' consolidation targets. In both countries it is important that measures be implemented to meet the plans, given the substantial consolidation effort required to bring public debt to the 60% of GDP reference value stipulated in the EU Stability and Growth Pact (see Chapter 4), though automatic stabilisers should be allowed to operate were activity to turn out different from projections.

In the United Kingdom, a high underlying deficit and unsustainable debt dynamics warrant a continued consolidation of just above 1 percentage point of GDP, as implied by the government's programme. The automatic stabilisers should be allowed to operate to provide support for the economy if necessary. Even if the economy showed signs of turning out weaker than projected, planned structural fiscal adjustments should continue, though some temporary support could be provided in the event of a significant slowdown.

For most other countries, with relatively low debt and less impaired fiscal positions, consolidation is projected to proceed on a more moderate path. In particular, for the Nordic countries, Austria, Germany and Switzerland underlying balances are projected to improve by around ½ per cent of GDP. Automatic stabilisers should be allowed to operate in these countries and the pace of consolidation could be further moderated if needed.

Consolidation needs vary widely across emerging markets and in some countries are much less pressing than within the OECD area. Indeed, in the case of China borrowing levels should be maintained with government spending continuing to be reoriented to meet social objectives. In contrast, in India, where government deficit and debt levels are comparatively high, a steadfast commitment to timely fiscal consolidation will be important for ensuring balanced growth ahead. In several emerging markets, including Russia, fiscal consolidation should
be pursued via reducing subsidies, some of which were extended in the context of anti-crisis measures.

Looking further ahead, most OECD countries have announced medium-term consolidation programmes. However, in some cases, these may not suffice to halt adverse debt dynamics (Figure 1.16). Also, several programmes provide little specific information on what spending and revenue measures are to be used to meet consolidation targets and on how action should be phased.

Figure 1.16. Gross debt ratios under announced government consolidation plans

Percentage of GDP

United States¹

Japan²

Germany³

Note: Up to 2012, growth, interest rate and fiscal projections are taken from Economic Outlook No. 88. Thereafter, growth rates and gross asset ratios are based on the long-term scenario, while fiscal projections are derived using the assumptions explained below.

1. The debt path is consistent with the intention to balance the primary balance of the federal government by fiscal year 2015. After 2015, the primary balance is assumed to be constant. The general government balance is assumed to evolve in line with the federal government balance.

2. The debt path is consistent with the intention to halve the primary balance of the central and local governments between 2010 and 2015 and then to balance it by 2020.

3. The debt path is consistent with the constitutional fiscal rule requiring that the cyclically adjusted budget deficit of the federal government must not exceed 0.35% of GDP by 2016 and that the cyclically adjusted budgets for the Länder must be balanced by 2020.

Source: OECD Economic Outlook 88 database; and OECD calculations.

StatLink http://dx.doi.org/10.1787/888932345337
In the United States, the Administration aims to eliminate the federal primary fiscal deficit by 2015. If GDP growth and interest rates evolve as assumed in the long-run scenario presented in this Economic Outlook, this would stabilise the general government debt-to-GDP ratio in the second half of the decade. However, concrete measures are yet to be specified. Also, in view of future spending pressures, it would be desirable for the United States to introduce consolidation objectives, such as declining debt-to-GDP ratios, for the period after 2015.

The Japanese government, notwithstanding recent stimulus measures, aims to halve the primary deficit of the central and local governments from fiscal year (FY) 2010 to FY 2015 and achieve a primary surplus by FY 2020. To meet these targets government spending, net of interest payments, over the period FY 2011-2013 will not be allowed to increase from the FY 2010 level. Under the growth and interest rate assumptions of the Economic Outlook, this plan would not stabilise the debt-to-GDP ratio within this decade. As achieving medium-term consolidation targets will likely be challenging due to ageing-related fiscal pressures, credible consolidation measures, possibly involving tax increases, to meet the targets need to be announced.

In Germany, the constitutional deficit targets are likely to put the debt ratio on a downward trend, following further increases over the next three years. The government has presented a medium-term consolidation programme, providing targets for major revenue and spending items while leaving a significant part of envisaged budgetary improvements unspecified.

More detail on what measures can be used to fulfil current consolidation requirements in OECD countries, taking into account the scope for each instrument to generate budget improvements and its impact on growth and equity, is given in Chapter 4.

**Monetary Policy**

Against the backdrop of generally-resilient financial markets and the gradual global economic recovery, exceptional crisis-related measures have begun to be withdrawn in some countries. However, central banks in other countries have paused or even taken further steps to boost activity, reflecting continued disinflationary pressures and indications of subdued growth.

The Federal Reserve closed down access to all its special liquidity provision facilities by the end of June and terminated net purchases of securities. However, the subsequent decision in August to keep the size of the securities portfolio constant (instead of allowing it to fall with the maturing and prepayment of agency debt and mortgage-backed securities) put on hold the exit from extraordinary long-term asset holdings. More recently, in view of the weak recovery and low inflation, the Federal Reserve has announced an additional quantitative easing...
programme worth $600 billion. This is to take the form of regular small purchases of longer-term Treasury securities up to mid-2011, expanding the Federal Reserve balance sheet by a further one-quarter. The pace and eventual size of additional asset purchases are to be adjusted according to economic developments. Much of the impact of the announcement seems likely to have been priced into financial markets beforehand, but if markets expect further significant asset purchases above those already announced, real bond yields could fall further. However, given the exceptionally low yields at present (Box 1.4), there are limits to how much further nominal yields can fall, though other asset prices may be affected. Separately, the Federal Reserve has also engaged in discussion of greater acceptance of future inflation overshooting. To the extent this increases inflation expectations, it could be seen as helpful in current circumstances. However, the risk would seem to be non-negligible that such an approach could un-anchor long-term inflation expectations, with adverse consequences for the credibility of the monetary authorities. By contrast, the recent clarification of the medium-term goal for inflation may be useful to strengthen the credibility of the authorities’ price stability objective.

... Japan...

- After closing most of the temporary facilities and asset-purchase programmes that were introduced at the height of the crisis, the Bank of Japan has in recent months introduced new measures to respond to the deterioration of the economic outlook, expanding its credit facilities for financial institutions in August,6 and, acting as an agent for the Treasury, intervening in foreign exchange markets to curb the appreciation of the yen. In October, the Bank of Japan reduced its target for the main policy rate from 0.1% to a 0-0.1% band, committed to maintain this policy until the medium-to-long-term inflation outlook becomes positive and created a new facility (worth 1% of GDP) to purchase government and corporate bonds as well as commercial paper and real-estate investment trusts.

... and the euro area...

- While the European Central Bank has completed, as planned, the purchase of covered bonds, tensions in financial markets in Europe in May led the Bank to reschedule its exit from emergency liquidity measures. This involved extending the application of full-allocation procedures for some time, as well as enacting a new programme of outright purchases of government and private securities (the Securities Markets Programme).

... and a pause in the United Kingdom...

- The Bank of England has committed for now to keep the stock of securities unchanged at £200 billion, after the already completed implementation of its asset purchase programme.

6. The three-month credit line to financial institutions (up to 20 trillion yen) introduced last December was expanded in August by adding a six-month facility, up to 10 trillion yen.
... while other countries have started to tighten policy...

In OECD countries where the economic recovery has been more solid, such as Australia, Canada, Israel, Korea, Norway and Sweden, central banks have gone further and have already started to increase policy interest rates.

... especially outside the OECD area

The move to normalise monetary policy stances is even more evident in non-OECD economies, where economic recovery generally has gained momentum and raised concerns about inflation and asset price increases, with Brazil having increased policy rates, India continuing to increase policy rates and China also having taken a number of tightening steps, including increases in bank reserve requirements and interest rates.

Monetary policy should remain supportive...

The current and future stance of monetary policy should reflect the prospects for inflation and economic activity, including the effects from fiscal consolidation. With recent announcements suggesting more significant fiscal consolidation than previously expected in coming years, and given the sluggish nature of the recovery in many OECD countries, inflationary pressures are likely to be well contained into the foreseeable future and there is even a non-negligible risk of deflationary tendencies. In principle, the aim of monetary authorities should be to bring policy rates to their neutral levels by the time economic slack is eliminated. However, assessing the level of slack is fraught with difficulties following the deep recession. This has reduced the level of potential output to an extent that is difficult to pin down with normal margins of error. Exceptional uncertainty about the degree of slack renders it preferable for policy to rely on more directly observable gauges of where demand is situated relative to capacity (Pain and Koske, 2008). Hence, central banks may need to give more weight to survey measures of resource utilisation and inflation expectations and to whether price inflation is accelerating or declining. Acting only when there is a clear acceleration in underlying inflation would be a risky strategy in normal conditions because core inflation is a delayed indicator and monetary policy acts with long and variable lags. But in the current environment, with still low resource utilisation in many countries, low inflation and inflationary expectations close to the objectives of the monetary authorities, there are limited risks from monetary policy remaining supportive and moving decisively towards neutral rates only once underlying inflation seems set to turn up.

... but financial stability would benefit from small, yet positive interest rates

However, abundant liquidity provision at near-zero funding costs could keep alive insolvent banks, allowing them to roll over the debt of unviable businesses. In addition, extremely low interest rates may discourage activities in money markets, which could hinder the

7. To the extent that there is greater confidence in estimates of the growth rate of potential output, as compared with its level, there would also be useful information from the difference between actual and potential growth rates.
normalisation process in the future. Also, prolonged near-zero interest rates could lead to intensified search for yield, compressing spreads and distorting the pricing of risk, ultimately resulting in investment going to the wrong projects, or a build-up of financial fragilities, or more likely a combination of both. Zero rates in larger advanced countries could spill over into asset price inflation in emerging countries, triggering further distortive policy responses in these countries. Thus, conditional on the recovery being solid, and deflation risks having evaporated, there is a case for central banks to move policy-controlled interest rates to levels that are still very low, to support sluggish demand, but are clearly above zero so as to reduce the risks associated with free money.

Central banks should follow a two-step approach... Against that background, central banks should move away from close-to-zero rates relatively early, once recovery looks firm and deflation risks fade, but then wait until signs of incipient inflation increases begin to emerge before starting to normalise in earnest:

... in the United States... ● In the United States, the economic recovery has softened more than expected, and, as a result, inflationary pressure is likely to remain very subdued in the foreseeable future, even with the new round of additional quantitative easing. As a result, the creation of a buffer above zero rates should wait until mid-2011. Once the recovery is more firmly established, around the middle of 2012, the Federal Reserve should start to raise interest rates so as to make policy gradually less accommodative, although the pace of tightening should be moderated by the marked fiscal consolidation planned in 2012 and the following years.

... in the euro area... ● In the euro area, the ECB should keep its main refinancing rate steady at 1% and maintain its policy of full allotment for a while. As the functioning of the money market improves,8 the overnight rate should stay close to the main refinancing rates. Once the recovery gathers momentum, the normalisation of the policy rate can commence in 2012, though at a measured pace, particularly because, in the area as a whole, large fiscal consolidation is planned in the years ahead, weighing on economic activity.

... and the United Kingdom ● In the United Kingdom, against the backdrop of the recent slowdown in the global economy and stronger fiscal consolidation, the Bank of England should keep the current policy stance until the middle of 2011. It could then increase the buffer above the zero bound from ½ to 1 per cent

8. In the current situation, as a precaution, stressed banks are borrowing more liquidity than the required minimum from the Eurosystem, at 1%, and then parking it at the deposit facility at ¼ per cent or lending it in the overnight market at rates that have been averaging below ½ per cent until recently. As funding conditions have improved, banks have become increasingly reluctant to pay a ½ to ¾ per cent spread on their excess reserves. The resulting shrinkage of excess reserves has led the overnight rate to converge towards the ECB main refinancing rate.
1. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

in the second half of 2011. Further moves toward normalisation should not begin before the economic recovery is judged to be further advanced, which is projected to be around the second quarter of 2012.

Rates can be raised earlier in Canada...
- In Canada, normalisation should continue as the recovery gains momentum, with the pace of policy rate increases strengthening in the second half of 2011.

... but much later in Japan
- In Japan, persistent deflation suggests that interest rate hikes should wait until inflation is firmly positive, likely beyond 2012. The priority for the monetary authority is to counteract entrenched deflationary tendencies. Recent decisions by the Bank of Japan to expand its provision of credit and offer banks opportunities to refinance their lending in growth-enhancing areas are aimed at achieving this end. However, the authorities need to continue exploring further means to boost the economy. Purchasing long-term government bonds on a far larger scale than currently planned would be particularly urgent if the recent appreciation of the yen and muted domestic spending threaten the economic recovery and add to deflationary pressure.

In China the current stance can be maintained for some time
- In China, past policy actions appear to have been effective in slowing credit and money growth and in taming increases in real estate prices. The recent moderation in the economic expansion and a weaker near-term global economic outlook suggest that there is no need for the monetary authorities to further tighten policy settings, at least for some time, despite some recent increase in inflation. In the medium term, the decision in June to allow exchange rates to fluctuate within a wider band should be accompanied by a greater focus on achieving an appreciation against a basket of currencies.

Further tightening should occur in Brazil and India
- In Brazil, monetary tightening has paused in recent months, in part due to marked exchange rate appreciation and the recent moderation in headline inflation. But with labour markets being tight, and capacity utilisation above long-run average levels, further moves to normalise monetary policy settings should resume soon. In India, monetary policy normalisation has continued in recent months, even though the upward pressures on headline inflation from rising food prices have moderated. With domestic demand continuing to grow strongly, and only limited spare capacity, additional policy tightening remains warranted.

A new downturn would require additional stimulus
While concerns about a double-dip have abated since summer, monetary authorities need to pay due attention to risks that the current soft patch turns out to be more protracted and deeper than appears likely at present and should be ready to provide further stimulus to the economy, if needed. Given that room for further reduction of policy rates is now very limited, even if mildly negative interest rates are considered a possibility, further stimulus could also come from additional quantitative
1. GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

Easing (over and above that already announced) via the purchase of government bonds. Decisions about extensive further quantitative easing need to take into account the risk that large holdings of private and public assets may keep the cost of finance artificially low, leading to a misallocation of resources and a reduction in potential output. Finally, central banks can also strengthen their commitments to keep policy rates close to zero for an extended period.

Strong capital inflows and upward pressure on currencies have recently prompted several countries (including Japan, Israel, Korea, Switzerland, Brazil and South Africa) to intervene in currency markets or change regulations on capital movements. In the case of emerging market countries, large inflows and currency appreciation are consistent with their relatively good economic prospects and will help global balancing. However, the pressures on some of these countries with relatively open capital accounts and floating exchange rates have arguably been exacerbated by other large emerging countries restraining capital and currency movements. Moreover, weaknesses in domestic financial regulation can lead to concerns about the robustness of financial institutions should capital flows reverse, which in some cases may constitute an argument for measures to restrict volatile inflows, though the efficiency of such measures is open to doubt. Instead, first-best approaches may focus on micro and macro-prudential policies. In general, countries should refrain from interventions in foreign exchange markets for the purpose of competitive devaluation of currencies. Foreign exchange interventions are effective mainly when not sterilised, so that they change the stance of monetary policy. Moreover, as discussed above, they raise a strong risk of mutually offsetting interventions that could ultimately result in protectionist measures with adverse consequences for not only the recovery but also long-term prosperity.

**Financial and macro-prudential policy**

Individual countries and jurisdictions have taken initiatives to reform financial regulation to tackle the failures that led to the financial crisis. Measures to strengthen framework conditions in financial markets have nevertheless proceeded at different speeds across countries, advancing especially rapidly in the United States. In particular:

- In the United States, the financial reform legislation enacted in July establishes a consumer financial protection entity, creates a systemic risk regulator (the Financial Stability Oversight Council), gives regulatory bodies the authority to determine which derivatives should be cleared through centralised clearing houses, creates a banking liquidation authority and establishes a size-related levy on banks (to accumulate in a liquidation fund). It also bans banks from using regulatory capital to finance some categories of risky investments (Volcker rule), and, in particular, requests that banks spin off part of their
proprietary trading desks. Most provisions are expected to be implemented within the next two years.

**The European Union is putting in place several oversight bodies**

- At the level of the European Union, the authorities have decided to establish a macro-prudential oversight body (the European Systemic Risk Board) and new European supervisory authorities to regulate banking, securities and insurance. The new bodies will set common technical standards that are binding, though only in some areas, and should make some progress in the direction of harmonising financial supervision across national borders within the union. The authorities have also made advances towards harmonising and simplifying deposit guarantee schemes (increasing the overall level of protection), as their heterogeneity proved disruptive for financial stability during the crisis. They also intend to put in place a banking crisis management mechanism to deal effectively with the failure of European banks, which could include a levy to pre-fund resolution costs. As well, the European Commission has launched a consultation document to harmonise rules and tools relating to short selling across member states.

**Some EU countries have taken specific national measures**

- At the national level, some EU countries have taken, or are planning, measures on their own. In the United Kingdom, the authorities intend to give responsibility for oversight of prudential regulation to the Bank of England. The new UK regulatory system is not expected to be completed before 2012, to give time for the financial sector to adjust. Moreover, an independent commission has been given one year to report to the UK authorities on the issue of separating retail and investment banking and the need to break up large banks. Sweden and the United Kingdom have introduced a levy on banks to ensure fair burden sharing and to discourage risky funding. Germany imposed a ban on naked short-selling of some kinds of securities.

**Regulators have agreed on new bank capital requirements**

An international effort to achieve financial reforms, led by the Financial Stability Board, is also being taken under the auspices of the G20. Regulators have recently agreed on key elements of a global reform package for the banking sector, namely the definition and the minimum required levels of bank capital (see Box 1.6). Experimentation mechanisms

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9. The intention is that the European Systemic Risk Board and the three new supervisory bodies be operational from January 2011. The new supervisory bodies will oversee mandatory supervisory colleges for cross-border institutions.

10. The proposed levy in the United Kingdom will be set at 0.07 per cent of total liabilities excluding Tier 1 capital and deposits and will apply to financial institutions with £20 billion or more in assets. The rate will be lower (0.04 per cent) for 2011, and there will also be a reduced rate for longer-maturity funding.

11. In addition, a bank-restructuring measure is currently being discussed in parliament in Germany and should be implemented by end-year. It envisages setting up a fund for troubled banks (paid for by a bank levy), with the intention of simplifying bank restructuring.
Box 1.6. Estimating the macroeconomic impact of Basel III capital requirements

The higher standards decided by the Basel Committee on Banking Supervision (BCBS) in September 2010 raise banks' minimum capital ratios for common equity and aggregate Tier I capital between 2011 and 2015 (see first table). Gradually, over the course of the following four years, these two ratios as well as the total capital ratio will be augmented by a further 2½ percentage point “conservation” buffer, within which banks will not be considered insolvent but will face restrictions on dividend payments and share buybacks. The Basel III framework also involves liquidity and other requirements, which are not examined in this box.

Bank capital: current and future requirements

<table>
<thead>
<tr>
<th>Common equity Tier I capital</th>
<th>Current requirement</th>
<th>Requirement in 2015</th>
<th>Requirement in 2019 (incl. conservation buffer)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier I capital</td>
<td>2</td>
<td>4.5</td>
<td>7</td>
</tr>
<tr>
<td>Total capital</td>
<td>8</td>
<td>8</td>
<td>10.5</td>
</tr>
</tbody>
</table>

Source: BCBS (2010).

The degree of effort that will be required to meet Basel III capital standards can be gauged by comparing bank capitalisation in 2006 and 2009. It appears likely that in 2006, at the top of the credit boom, banks held as little discretionary capital as possible above the regulatory minimum. After the crisis broke out, however, market pressure and the anticipation of reform led them to build up precautionary buffers. The Tier 1 ratio rose by close to 1½ percentage points in the United States, the euro area and Japan between 2006 and the end of 2009 (see second table). The tangible common equity ratio (TCE ratio), a more restrictive definition of capital which is comparable to common equity Tier I, also increased during the same period, although to a lesser extent in Japan. Insofar as the accumulation of capital between 2006 and 2009 occurred in anticipation of the new standard, banks can be expected to use this part of their discretionary buffers to meet the requirements up to 2019. It seems unlikely that they would go beyond that and reduce their discretionary capital buffers below their 2006 levels in the aftermath of what has been a major banking crisis. Against this background, it is assumed here that banks will increase their capital ratios by an amount equal to the increase in capital requirements between 2010 and 2019 minus the buffers they built up between 2006 and 2009 (see third table). Consistent with the objective of improving the quality of capital, it appears that the binding requirement will be the one concerning common equity (rather than full Tier I) and that it will be greatest in Japan where banks currently have comparatively low amounts of core capital.

Pre-crisis and current levels of bank capital

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tier 1</td>
<td>9.8</td>
<td>9.4</td>
<td>9.7</td>
<td>11.4</td>
<td>1.6</td>
</tr>
<tr>
<td>TCE</td>
<td>8.6</td>
<td>8.6</td>
<td>8.4</td>
<td>10.5</td>
<td>1.9</td>
</tr>
<tr>
<td>Euro area</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tier 1</td>
<td>8.0</td>
<td>7.7</td>
<td>8.6</td>
<td>9.4</td>
<td>1.4</td>
</tr>
<tr>
<td>TCE</td>
<td>6.8</td>
<td>6.6</td>
<td>7.3</td>
<td>8.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tier 1</td>
<td>5.4</td>
<td>5.6</td>
<td>5.6</td>
<td>6.9</td>
<td>1.5</td>
</tr>
<tr>
<td>TCE</td>
<td>3.3</td>
<td>3.3</td>
<td>3.3</td>
<td>4.1</td>
<td>0.8</td>
</tr>
</tbody>
</table>

Source: IIF (2010) and OECD calculations.
Box 1.6. **Estimating the macroeconomic impact of Basel III capital requirements** (cont.)

**Required increase in bank capital ratios to attain Basel III standards**

<table>
<thead>
<tr>
<th>Country</th>
<th>Tier 1</th>
<th>Achieved in 2006-09</th>
<th>Remaining</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>4.5</td>
<td>1.6</td>
<td>2.9</td>
</tr>
<tr>
<td>TCE</td>
<td>5.0</td>
<td>1.9</td>
<td>3.1</td>
</tr>
<tr>
<td>Euro area</td>
<td>4.5</td>
<td>1.4</td>
<td>3.1</td>
</tr>
<tr>
<td>TCE</td>
<td>5.0</td>
<td>1.2</td>
<td>3.8</td>
</tr>
<tr>
<td>Japan</td>
<td>4.5</td>
<td>1.5</td>
<td>3.0</td>
</tr>
<tr>
<td>TCE</td>
<td>5.0</td>
<td>0.8</td>
<td>4.2</td>
</tr>
</tbody>
</table>

**Source:** OECD calculations.

If, despite the higher capital requirements, banks maintain the same return on equity as before the crisis by hiking their lending rates, more expensive bank credit will have a damping impact on activity. The magnitude of the effect can be gauged using results from a wide range of models developed under the aegis of the Macroeconomic Assessment Group (MAG) of the Financial Stability Board (FSB) and the BCBS. Using the headline estimate in the MAG report and the evaluation of the remaining effort shown in the third table, the Basel III requirements could have the effect of reducing annual output growth by 0.07 percentage points in the United States and 0.1 percentage point in Japan through 2011-2018 (see the fourth table). If quantitative credit-supply constraints become binding in addition to higher lending spreads, based on the main results for this situation in the MAG study, the effects would be larger, from 0.12 percentage points per annum through 2011-2018 in the United States to 0.17 percentage points in Japan. All the effects mentioned assume no response from monetary policy but, to the extent that it becomes free from the zero lower bound, it could be used to reduce the size of the impact. It should be noted that the main results from the MAG study are surrounded by substantial uncertainty. Looking for instance at the case of Japan, if the headline results reported in the MAG report are replaced with model simulations prepared by the Bank of Japan and also reported in the MAG report, the corresponding impact estimate on GDP growth rises from 0.17 to almost 0.6 percentage points per annum in models with quantitative credit constraints. Although quantitative restrictions are a possibility in Japan, where low bank profitability reduces the scope for meeting the requirements by accumulating retained earnings, the long phase-in period for the new requirements greatly reduces the risk that they may become binding.

**Impact estimates on average annual GDP growth rates in 2011–2018**

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage points</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>-0.07 -0.12</td>
</tr>
<tr>
<td>Euro area</td>
<td>-0.09 -0.15</td>
</tr>
<tr>
<td>Japan</td>
<td>-0.10 -0.17</td>
</tr>
</tbody>
</table>

**Source:** MAG (2010) and OECD calculations.
Box 1.6. **Estimating the macroeconomic impact of Basel III capital requirements** (cont.)

Nevertheless, if banks decide to attain the new capital levels in advance, the costs will tend to come up front rather than in the longer term and in a period when monetary policy has very little room to offset the impact. Moreover, as the bank regulatory reform proposals include a change in the definition of capital, differences in capital composition across countries might result in additional cross-country variation in macroeconomic impacts. In countries where tangible common equity as a share of Tier 1 is currently relatively high, like in the United States and the euro area, the impact can be expected to be comparatively mild. By contrast, the impact on GDP is likely to be higher in Japan, where the banking sector might need to raise substantial amounts of common equity, and where low bank profitability makes it difficult to increase the capital base through retained earnings.

If the new regulations lead to permanent change in the financial sector, they can have an effect on the equilibrium level of output in the long-term. Indeed, the new regulations can result in permanently higher lending spreads if banks prove capable of maintaining their return on equity at pre-crisis levels. MAG results suggest that a one percentage point increase in core capital requirements can raise banking lending spreads by 16 basis points. If higher spreads translate one-for-one into higher lending rates which in turn raise capital costs in proportion with the share of bank lending in the external financing of non-financial businesses, estimates in Cournède (2010) suggest an impact on potential output of the order of 0.2% in the United States and 0.6% in the euro area. These calculations, however, omit the reasons behind the new capital framework, which are to reduce the likelihood and cost of financial crises and to improve the quality of capital allocation in the economy. These effects have been estimated to more than offset any gross costs of the new regulations, by a wide margin (BCBS, 2010).

Overall, the gross economic costs of Basel III capital requirements are likely to be small. Although in theory credit-supply effects could result in a more noticeable impact, in practice the very long phase-in period means that such effects are unlikely to materialise, especially in countries where banks have already accumulated large discretionary capital buffers above regulatory minima. In the long term, higher capital requirements could be associated with some widening of lending spreads and a small reduction in the equilibrium capital stock. However, this negative effect is likely to be far more than offset by the benefits of sounder banking in terms of reducing the frequency and cost of future financial crises.

1. Alternative estimates using the OECD Global Model and OECD financial conditions indices yield very similar results (Slovik and Cournède, 2010).

The cost of reform is likely to be limited

have been decided for the introduction of a leverage ratio and liquidity standards. Consultations are on-going on forward-looking provisioning, contingent capital and capital surcharges for systemically important financial institutions. Regulators have agreed that counter-cyclical buffers will be set at the national level in the range of 0 to 2½ per cent of risk-weighted assets.

The agreed reform of capital and liquidity requirements should reduce the frequency and economic costs of future financial crises. Although the proposed regulatory changes have prompted an intense debate about their impact on lending rates, credit dynamics and economic activity, estimates by the Macroeconomic Assessment Group

12. Research has found that banking-sector capital adequacy and liquidity, alongside real house price growth, are the most important banking crisis determinants in a group of 14 OECD economies over the period 1980-2006, see Barrell et al. (2010). Recently, the BCBS has also presented an evaluation of the benefits of stronger capital and liquidity requirements, see BCBS (2010).
MAG of the Financial Stability Board and the Basel Committee on Banking Supervision suggest that the impact on GDP of higher capital standards would be relatively moderate and distributed through time though, as noted above, effects could be larger were banks to rush to attain the new standards ahead of the deadline. Furthermore, because it removes the previous uncertainty regarding the new capital framework, the fact that agreement has been reached should in itself work in the direction of supporting lending activity.

Problems with too-big-to-fail institutions must be addressed…

A key issue that regulatory reform yet has to address is the presence of banks that are so big or so interconnected that they become systemically important and therefore cannot be allowed to fail. Because these systemically important financial institutions enjoy a de facto government backstop, they have an incentive to take excessive risk and benefit from a competitive edge in terms of funding costs and collateralisation requirements over smaller competitors that do not enjoy such a guarantee. One manifestation of their advantage is that the largest banks are significantly less capitalised than their smaller competitors, which enables them to offer investors a higher return on equity (Table 1.7). Although such institutions existed before the crisis, and contributed to the excesses that led to the financial collapse, the crisis has exacerbated the problem: government support has become explicit and concentration has increased considerably.

### Table 1.7. The largest banks hold less capital to generate a higher return on equity

<table>
<thead>
<tr>
<th>United States</th>
<th>Europe</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tier 1 capital</td>
<td>Pre-tax profit</td>
</tr>
<tr>
<td>per cent of risk-weighted assets</td>
<td>per cent of Tier 1 capital</td>
</tr>
<tr>
<td>Top 10 banks</td>
<td>8.8</td>
</tr>
<tr>
<td>11th to 50th largest banks</td>
<td>10</td>
</tr>
<tr>
<td>51st to 100th largest banks</td>
<td>13</td>
</tr>
<tr>
<td>101st to 150th banks</td>
<td>12</td>
</tr>
<tr>
<td>151st to 200th banks</td>
<td>15</td>
</tr>
</tbody>
</table>

*Source: The Banker Database and OECD calculations.*

StatLink [http://dx.doi.org/10.1787/888932346819](http://dx.doi.org/10.1787/888932346819)

… with restructuring or through other means

The too-big-to-fail problem can be addressed in different ways. The most direct way is to break up systemically important institutions. Where political economy considerations make this option unrealistic, an

13. The gross welfare cost of the measure could be benign, as empirical research indicates that banking involves no significant economies of scope or scale beyond a relatively small size (Amel et al, 2004). Practical options are available to ensure that the transition cost is limited as well: one of them is to group the key central support services of the former megabank in a separate entity that would serve the individual banks resulting from the break-up.
alternative possibility is to impose higher capital requirements, including in the form of contingent capital notes, as has been proposed recently in Switzerland.\textsuperscript{14} In addition, systemically important financial institutions could be mandated to prepare “living wills” detailing how they should be unwound, including how losses would be distributed across creditors and counterparties, in case of failure. A difficulty in applying specific regulations to a particular set of firms is that this implies implicit regulatory recognition of the too-big-to-fail status, which works in the direction of compounding the problem they try to address. This difficulty may, however, be overcome in the case of requirements to hold more capital in equity or contingent notes if, instead of applying to a designated set of institutions, the surcharge is universal but specified as an increasing function of bank size and interconnectedness.

Successful financial reform requires further progress along other dimensions. A key component of the reformed capital requirement framework will be the imposition of a maximum leverage ratio, applicable to all assets. This will guard against the inevitable regulatory arbitrage inherent to the risk-weighting approach that underpins the already agreed minimum capital ratios. Progress on a binding standard for the leverage ratio has been hindered by a lack of international convergence in accounting standards on whether or not to allow the netting of derivative positions. In addition to facilitating the adoption of a common leverage ratio, ending the netting of derivative positions in financial statements would help to reduce the possibility that investors may underestimate exposure to counterparty risk in jurisdictions where derivatives are currently still reported on a net basis. Finally, financial reform cannot be confined to banking. Other things being equal, the tightening of bank regulation will encourage the shifting of risk to other parts of the financial sector. In this respect, it is particularly important to ensure that insurance and pension fund regulations are capable of avoiding the build-up of systemic risk in these activities.

Structural Policies

The risk of lower potential output post-crisis and the need to strengthen public finances mean that growth-enhancing structural reforms are needed now more than ever before. Indeed, the medium-term effects from implementing such reforms could facilitate the fiscal consolidation that is needed over a similar timeframe (see Chapter 4), as well as providing a boost to longer-term growth and helping to narrow global imbalances. A range of possible interactions between structural reforms, saving and investment balances and fiscal consolidation

\textsuperscript{14} Contingent capital notes are hybrid debt instruments that convert into equity when a certain threshold is crossed. A potential issue is that the fear of conversion may create or amplify a panic when the issuer approaches the threshold. See Penacchi \textit{et al.} (2010) for ways to implement contingent capital notes without generating undesirable amplification effects at times of stress.
requirements suggested by past and ongoing OECD work is summarised in Table 1.8.  

... and can help fiscal consolidation directly...

... by increasing public-sector productivity...

As discussed in Chapter 4, several structural reforms can facilitate fiscal consolidation:

- Reforms to increase productivity in the public sector would improve fiscal positions markedly in many countries. Particular measures include the scope for improving public-sector efficiency by moving to national or international best practice in the provision of health and education services.

15. Such interactions arise over and above the indirect effects of reforms on budgetary and external balances via their impact on macroeconomic conditions.
Employment-friendly reforms, discussed further below, could have immediate effects on fiscal positions by lowering government expenditure, and medium-term effects by raising employment and tax revenues. OECD estimates suggest that a 1 percentage point improvement in potential employment may improve government balances by between 0.3-0.8 per cent of GDP.

The implementation of revenue-neutral changes in the tax structure, away from taxes on corporate and labour income to higher taxes on consumption and property, would have indirect benefits for fiscal positions by enhancing incentives and medium-term growth.

Reform of tax expenditures and subsidies could bolster government budgets directly and also, in many cases indirectly, through increased activity.

Additional pollution-pricing mechanisms, such as green taxes and the auctioning of emission permits, could not only aid fiscal consolidation but also enhance welfare.

Structural reforms that are already desirable on efficiency, and/or welfare and equity grounds, can also contribute to a rebalancing of global growth, in part through their impact on fiscal outcomes (Table 1.8). In particular:

Improvements in the coverage and quality of social welfare systems, which are desirable in their own right, would reduce precautionary saving in external surplus countries outside the OECD. In a context of adequate regulation, liberalisation of financial markets in the emerging economies could reduce credit constraints for the private sector, and thereby enhance welfare by reducing forced saving.

Reforms to improve the sustainability of public pension schemes by extending working lives may also help to reduce saving in OECD countries with an external surplus.17

Removal of anti-competitive product market regulations, especially in comparatively sheltered service sectors could encourage higher capital spending, narrowing the current account balance of surplus countries.

17. Such reforms would also aid fiscal consolidation efforts in all OECD countries.
... thus narrowing global imbalances

Simulation and scenario analyses suggest that a comprehensive package of reforms could help to narrow global imbalances by up to one-third in the medium term.\textsuperscript{18} Many of these reforms are also desirable in countries that do not have large fiscal or external imbalances. If implemented more broadly, this could weaken the overall impact of reforms on global imbalances. It would, however, enhance welfare, by providing a stronger boost to economic growth in the medium-term.

In the near term, the effects of growth-friendly structural policies could also facilitate the recovery from the crisis, with the future beneficial effects of new reforms being incorporated into forward-looking asset prices, helping to strengthen balance sheets and support demand. Equally, some reforms can also unleash pent-up demand and supply, as was the case in the past with telecoms reform. Tackling some of the legacies of the recession, especially the marked slack in labour markets, would also smooth the recovery. More generally, by raising the output capacity of the economy, growth-enhancing structural reforms would also allow monetary accommodation to continue for a longer period, contributing to a more vigorous recovery. However, the picture is more complicated in some instances; some reforms that are advisable on the basis of their strong long-term benefits, such as certain reforms to improve product market competition, can have negative side-effects in the near term if they hasten job losses in declining industries, although such side-effects will be small if competition-friendly reforms are implemented in sectors in which there is a strong potential for new job growth, such as retail trade and professional services.

Structural reforms might also have short-term benefits...

Structural reforms are especially urgent in labour markets to help countries make greater use of their available labour resources more quickly. In the absence of such reforms, there is a substantial risk that high unemployment will prove persistent. In particular, reforms can help to make the recovery more job-rich; facilitate the reallocation of jobs and workers across sectors and regions; and help ensure that job losers and vulnerable groups remain attached to the labour market. This is particularly the case in many continental EU countries where labour-market institutions remain less employment-friendly despite the reforms of recent years.

... especially in labour markets...

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... where a broad mix of reforms would be beneficial

Particular actions that should be undertaken (see \textit{OECD Economic Outlook 87}) include: maintaining spending on active labour market

\textsuperscript{18} A scenario analysis indicates that the necessary fiscal tightening required to stabilise debt-to-GDP ratios in OECD countries by 2025 could reduce the size of global imbalances – measured as the GDP-weighted sum of countries’ ratios of absolute saving-investment gaps to GDP – by almost one-sixth. If, in addition, Japan, Germany and China were to deregulate their product markets, aligning the level of economy-wide product market regulation with OECD best practice, and China were to raise public health spending by 2 percentage points of GDP (in a fiscally neutral way) and liberalise its financial markets, global imbalances could decline by twice as much (Kerdrain \textit{et al.}, 2010).
policies, with priority being given to ensuring strong activation measures for job seekers; rebalancing employment protection towards less-strict protection for regular workers, but more protection for temporary workers; scaling back crisis-related improvements in benefit generosity; and tightening eligibility criteria for benefit measures that might otherwise be used as pathways out of the labour force. Hiring subsidies and additional expenditure on training, though not structural measures, could also be considered in the current environment, although in a context of tight fiscal constraints, they would need to be only temporary and well targeted. Such measures may be particularly useful in the United States, where the experience rating of unemployment insurance, alongside uncertainty about the durability of the recovery, may be contributing to employers’ reluctance to hire new workers. Reductions in anti-competitive product market regulations could also help to make the recovery more job-rich, especially if undertaken in relatively labour-intensive service sectors, such as retail trade and professional services.

Housing market reforms can also improve labour outcomes

Restrictive housing policies, alongside negative housing equity, can limit residential mobility across regions and thus hamper the smooth functioning of labour markets by affecting the job-matching process. This is particularly important at present, given the need for reallocation of labour across sectors and regions in many OECD countries. New OECD estimates suggest that residential mobility tends to be markedly lower in countries with stricter rent regulation and high transactions costs of moving. Mobility is also typically lower in areas in which new housing supply is fairly unresponsive to improvements in the profitability of house building. This suggests that structural reforms, such as redesigning rent regulations that go beyond correcting market failures, reconsidering land-use and planning policies, and addressing barriers that raise transactions costs, could improve residential mobility, with associated labour market benefits.

19. Estimates in Andrews et al. (2010) suggest that reducing rent control from the strictest level to the average level across OECD countries (equivalent to a change of 2 standard deviations) would increase average household mobility by around 4 percentage points. Reducing the transaction costs of moving from the highest to the average level across countries (equivalent to a 2 standard deviation change) would raise the probability of moving (which is 12% over a two-year period) by 1½ percentage points.
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