COUNCIL

OVERVIEW OF THE OECD BUSINESS AND FINANCE OUTLOOK 2015
(Note by the Secretary-General)
Meeting of the Council at Ministerial Level, 3-4 June 2015

Background Document

This document provides a preview of the overview chapter from the upcoming OECD Business and Finance Outlook, scheduled for release on 24 June 2015.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.
1. The financial crisis that began in 2007 and peaked in September 2008 with the bankruptcy of Lehman Brothers and AIG’s bail-out has passed, but some legacies remain to be addressed. The international banking system has undergone major repairs, as comprehensive reforms to the regulatory framework for banks have been substantially agreed and are in the process of being phased in. Balance sheets have been recapitalised and probabilities of major bank defaults have fallen; bank interconnectedness has declined, even if it still remains high. Most advanced economies have recovered from the recession of 2009 but recoveries have often been weak and uneven despite low interest rates for several years. Discouragingly, the business sector continues to display subdued appetite for capital expenditure. Inflation remains too low for comfort, employment performance continues to be lacklustre and public finances remain a concern, constraining policy options in many countries. The business and finance outlook remains complex and the manner in which banks, shadow banking intermediaries, institutional investors, and companies in both emerging and advanced economies are trying to deal with it presents new risks. These challenges can put at risk growth, the recovery of employment levels and the possibility of workers having access to a reasonable retirement income.

The limits of central bank liquidity policies

2. The global financial landscape today reflects legacies of the crisis. Large amounts of public money were spent supporting the financial system at the peak of the crisis, leaving a legacy of high public indebtedness. Policy interest rates were reduced to near-zero in most advanced economies to fight recession and these persist even today. Cash injections and other measures to increase the liquidity of the banking system (‘quantitative easing’) were put into place partly to provide additional stimulus and avoid a ‘freeze’ in money markets triggered by concerns of counterparty risk. One of the outcomes of these measures is a world awash with liquidity, flattening yield curves and a reduction of risk premia as reflected in financial asset prices. This strategy has encouraged large players in the financial markets to pursue a ‘search for yield’ and to pay prices for assets in bond and equity markets that may not realistically reflect inherent risks.

A risk puzzle

3. The resulting disconnect in risk arises when listed companies, who conduct a large proportion of the world’s capital formation, see considerable risk on the horizon while major players in financial markets seem completely unconcerned. This puzzling behaviour raises the spectre of a potential new crisis and the need to take appropriate measures to anticipate repercussions when one or the other of these views eventually proves to be wrong. The needed response must be built around three structural realities in the world economy:

- The centre of gravity of the global economy is shifting from the advanced economies around the North Atlantic to the Asia-Pacific region, in particular a group of highly competitive and mostly-emerging economies. Financial claims on non-financial businesses in advanced economies operating in open competitive markets are thus underpinned by their ability to adapt global value chains to this reality.

- Populations in advanced economies, especially in Japan and in much of southern and central Europe, are ageing. They will be increasingly dependent on commitments from pension funds and insurance companies as well as on returns from their own savings managed as collective products by investment companies. Pension plans and retirement products such as annuities and mutual funds must meet customer expectations about returns, while being designed to take account of longevity risk in an environment of low interest rates.
Notwithstanding large-scale financial reform designed to insulate taxpayers from the need to cover losses, local problems can easily become systemic in an interconnected system. This implicitly guarantees much more of the claims in the system than what is explicitly insured, creating potentially adverse incentives.

4. How can the system deliver on these promises? A number of priorities stand out and are discussed below and covered in detail in the different chapters of the OECD Business and Finance Outlook 2015 to be released on 24 June 2015.

Global value chains and investment

5. The global environment in which financial markets operate must include effective macroeconomic adjustment mechanisms. The issue is not just current account imbalances. The world has benefitted from the globalisation encouraged by open international trade and investment regimes. Business sectors in both advanced and emerging market economies have developed Global Value Chains (GVCs) that transfer technology and distribute production where it can be carried out most effectively. This behaviour has contributed to productivity gains in emerging markets, especially in Asia, prior to the crisis. Subsequently, however, while sales per worker (which includes foreign value-added) have continued to rise, the trend does not appear to have been matched by growth in domestic value-added.

6. This ‘outsourcing’ has also led to important shifts of production by multi-national enterprises (MNEs) mostly away from advanced economies, which has resulted in weaker capital formation in these countries. Value-added per employee has not been rising in listed companies of advanced economies since the crisis. Transferring investment in this way may improve operational efficiency, but this should not be confused with investment in R&D and genuine productivity growth.

7. The tougher post-crisis environment is also leading to considerable divestment of international operations by MNEs. This suggests that restructuring and retrenchment continues to be a focus. Adjustment mechanisms need to work better to encourage compensating investment in other activities including R&D and social infrastructure, and to generate better employment performance. Unless this is done, ‘secular stagnation’ concerns will continue, protectionist threats to the open trade and financial system can be expected, and new doubts will emerge that resources for ageing populations promised by institutional investors like pension funds and insurance companies will be sufficient when called upon.

The international financial system

8. The currencies of most advanced economies float reasonably cleanly, facilitating adjustment, and for most of the post-Bretton Woods period this arrangement has worked well; but, the weight of emerging economies has risen to around half the world economy and these economies often manage their exchange rates heavily against the US dollar. Fiscal and monetary authorities in advanced economies may try to compensate while market pressures drive yields down. This encourages the creation of potentially higher-yield but riskier and potentially illiquid assets to satisfy the demand of longer-term investors in pursuit of returns to meet their long-term promises. At the same time, the lack of international competitiveness due to exchange rate overvaluation discourages new investment.

Declining company returns

9. International adjustment by itself is not enough. The returns on equity of listed companies have declined in much of the world, particularly in Europe and in emerging markets. These returns are now often below capital costs and even below the (low) cost of debt in emerging economies. This is a sign of potential over-investment, lack of competition and persisting inefficiencies. If performance is to improve,
real returns on capital that will be reflected in returns on equity must be raised to make capital formation more attractive. In emerging markets this requires reducing over-investment and inefficiency and finding a better balance between consumption and investment, especially where financial repression and State-Owned Enterprises play a large role (the latter account for 45% of the listed sector in EMEs). There is a need to move away from replicative investment in manufacturing towards a greater focus on social infrastructure, the quality of labour and domestic demand linkages. In the advanced economies it requires supplementing better international adjustment mechanisms with pro-competition policies, involving effective measures at the micro-economic level, that encourage innovation and investment.

**Banks and shadow banking**

10. As deleveraging ceases to be a priority, the supply of bank credit should improve and begin to ease financing constraints facing many businesses, especially small and medium-sized enterprises. It is important that new supervisory and regulatory regimes preserve the improvements that have been introduced to date, and ensure that past excesses are not repeated. Notwithstanding these reforms and improvements, banks still remain interconnected and vulnerable to rising exposures to each other, especially through large derivative positions and the collateralisation of borrowing, in the event that prices in financial markets suddenly and unexpectedly change. The best way to deal with this is clear separation of insured deposit banking from prime broking, custody and collateral services and derivatives trading so that losses in one segment do not absorb the capital of other lines of business. However, to the extent that the reforms associated with Volcker, Vickers and Barnier finally depart from this goal, it is all the more important to ensure strong bank capital bases which can act as shock-absorbers and contain local losses without damaging counterparties.

11. The strengthened regulatory framework that now applies to banks has increased their need for cash and high quality liquid assets, mainly government paper, and raised the costs of using repurchase agreements and derivatives. This has encouraged them to shift some activities to processes often referred to as shadow-banking. These do not primarily deal directly with non-financial lenders or borrowers but intermediate mainly between other non-bank financial institutions. These other institutions are generally either cash-short (such as pension funds and insurance companies), or cash-long (such as money market funds). In the low-interest rate environment all of these funds need to improve their yields on investments. This incentivises them to re-use assets through securities lending and the buying of alternative assets with complex derivatives aspects. But, to engage in these activities also draws them into the need for cash for margin and collateral management according to the new regulatory rules. Shadow banking involves the main broker dealers, custody banks, lending agents and centralised clearing counterparties (CCPs) intermediating the needs of cash-poor institutional investors looking to re-use assets and cash-rich non-banks that are searching for greater exposure to securities given the low interest rates on cash. Shadow bank activities include securities borrowing and lending, trading and clearing of derivatives, custody services and collateral management.

12. While shifting these activities away from the banks moves certain risks it does not eliminate them. Rather it transfers them, at least partly, to the shadow-banking world. These risks boil down to various types of market and credit risks, including counterparty risk, reinvestment risk, re-hypothecation risk, maturity transformation risk and clearing risk. It is precisely because of these risks that counterparties must provide collateral to insure exposed positions. Securities being lent to improve yields must be collateralised, and cash provided for margin payments are frequently reused (‘re-hypothecated’). This allows a relatively small amount of cash to collateralise a large set of positions so long as these are well-hedged or balanced. But, in the event of a surprise in market developments, large net cash demands can materialise quickly which would put stress on the entire system allowing little time to work out problems.
13. So long as the system remains inter-connected, and especially if shadow bank activities are not separated from traditional deposit-taking and bank lending activities, the financial system remains exposed to unforeseen shocks. Some ways to minimise these risks include improving transparency, especially as regards data on derivatives and collateral; establishing minimum holdings of cash to address maturity transformation risks; limiting the re-use of cash in repurchase markets; establishing minimum capital requirements for CCPs; and providing last resort facilities to broker-dealers.

**Corporate bonds**

14. Low interest rates encourage borrowing in general, and the demand for higher yield products has encouraged companies in more speculative sectors and in emerging markets to issue higher-yield debt. Institutional investors in search of yield compete for this debt, which is often referenced in alternative products and used in securities lending and exchange-traded funds. The competition for yield has seen a dramatic fall in covenant protections, which reduces the liquidity of these bonds. In a period of stress, as might arise in a future normalisation of monetary policy, the illiquidity features may exacerbate price volatility and put pressure on collateral management in the shadow-banking sector.

**Dealing with longevity risk and pension and annuity ‘promises’**

15. The institutional investors who mobilise a large part of modern economies’ savings and try to allocate these to uses which will pay the highest returns while managing risks face tremendous challenges. Pension funds and life insurance companies, which are the largest sectors, not only have to find ways to generate sufficient returns to keep their commitments to savers, but must also manage the longevity risk associated with defined-benefit pensions and annuities arising from uncertain mortality. Defined contribution pension plans and other savings vehicles managed by insurance and investment companies may protect these financial institutions from this risk, but only by shifting it to individuals who are poorly placed to manage it.

16. How do institutional investors do this in the current and prospective low interest rate environment, in which maturing fixed income assets can only be refinanced on less remunerative terms, or with alternative investments and high-yield corporate bonds that promise high returns but are generally illiquid and seemingly over-priced? This question points to the fundamental importance of strengthening the economic environment in ways that raise the real return on capital. This can ensure that new capital formation, especially in advanced economies is attractive and eventually delivers the returns that allow the institutions’ promises to be met. Failing that, these institutions may face a challenge in delivering their commitments to retired savers dependent on them.

17. The rising share of assets invested in high-risk or potentially illiquid assets other than cash and marketable securities, such as leveraged hedge funds, high-yield corporate bonds, private equity and commodities, warrants vigilance by regulators and policymakers. There is a very real risk that the current trend for companies to return cash to shareholders via dividends and buybacks, as a way to boost short-term returns, will not be re-invested in more productive companies but instead into more leverage in alternative assets to which pension funds, in particular, are beginning to allocate more capital.

**Small businesses financing**

18. With banks adjusting to new regulatory arrangements intended to make activities other than traditional lending more costly in order to minimise systemic risks to the monetary system, external financing for investment will have to come increasingly from non-bank sources. For many large companies directly accessing the capital markets has always been the most efficient way to proceed and others have been gravitating there as universal banks become less responsive to their demands. For small and medium-
sized enterprises the relationships they can establish with banks, and the collateral where they can offer it, make banks the best sources for most external funding for them, once the strains of deleveraging have passed. But capital markets are better placed to accept the risks inherent in providing long-term funding for dynamic and innovative small businesses in their start-up and early expansion phases. They are also better positioned to provide exit opportunities for angel investors and venture capital providers whose expertise is precisely with start-ups and who want to realise gains (rather than hold positions over long periods as the pension and insurance companies do). Thus, strengthening capital markets outside the banking system is a priority.

**Capital market infrastructure**

19. Strengthening capital markets involves more than bringing sources and users of funds together. It also requires building a strong institutional infrastructure which can handle the flows of money and information with transparency and integrity. The day-to-day operation of the markets must encourage price discovery that creates incentives to match providers and users of funds in ways that capital will be used most productively.

20. At the same time, risks must be borne by those best placed to bear them. The institutions and people that make markets function on a day-to-day basis, from the exchanges and the dealers to the accountants and the analysts, have had to adapt for many years to major changes ranging from the shift of the world’s economic centre of gravity to the Asia-Pacific region to the move of financial activity online, as digitalisation has advanced. They have also had to cope with sudden shocks, from large oil price changes to recurrent financial crises. The regulatory environment has been changing in response to these forces. Several issues relating to incentives operating on key people who make illiquid markets function, the fragmentation of markets, high-frequency trading, complexity of investment chains and their implications have risen to the forefront. These may not have such high visibility as the other issues discussed above, but it is essential that policymakers do not lose sight of their importance for the financial sector.