

Summary

- Global growth and trade are projected to strengthen at a moderate pace through 2014 and 2015.
- Activity in the OECD economies will be boosted by accommodative monetary policies, supportive financial conditions and a fading drag from fiscal consolidation. However, unemployment is likely to decline only modestly, with 11¼ million extra people unemployed at end-2015 than at the onset of the crisis, and inflationary pressures will be muted.
- Growth in many of the large emerging market economies (EMEs) is expected to remain modest relative to past norms, with tighter financial and credit conditions and past policy tightening taking effect and supply-side constraints also damping potential output growth.
- The recovery in the United States should gain pace, lowering unemployment and reducing economic slack, with inflation rising close to target. A more modest upturn is likely in the euro area, with unemployment remaining high and disinflationary pressures ebbing only slowly. Stronger fiscal consolidation will check growth momentum in Japan, but core inflation could continue to rise, although, abstracting from indirect tax effects, still remain below its target.
- Normal demand-side accelerator-type mechanisms, healthier corporate balance sheets and reduced uncertainty should help business investment to strengthen gradually, and thereby push up trade intensity.
- Monetary policy needs to remain accommodative, especially in the euro area, where a further interest rate reduction is merited given low inflation developments, and in Japan, where asset purchases should be continued as planned. In the United States, where the recovery is more firmly based, asset purchases should be ended in 2014 and policy rates should start to be raised during 2015. In China, monetary policy will need to be eased if growth were to slow sharply.
- The planned slowing in the pace of fiscal consolidation in the United States and some euro area countries is warranted given past efforts, but strong consolidation should proceed steadily in Japan given high government indebtedness.
- Structural reforms in all economies remain essential to enhance resilience and inclusiveness, strengthen growth and job prospects, and ease both external imbalances and long-term fiscal burdens.
- Significant risks remain to the baseline projection. These are still tilted to the downside despite the improving outlook.
- The extent of the slowdown and the fragility of the banking system in China are uncertain. Risks also remain from the possible interaction of financial vulnerabilities in some EMEs and prospective monetary policy normalisation in the United States. Events in Ukraine have also raised geopolitical uncertainty.
- In the euro area, there is a risk that inflation could weaken further if growth disappoints, or the euro appreciates further, or inflation expectations become unanchored. With financial fragilities persisting, it is also urgent to improve the health of the banking sector, complete the establishment of a fully-fledged banking union and sustain reform momentum. The comprehensive assessment of euro area banks must provide reliable estimates of capital needs and be followed by swift recapitalisations or, if necessary, resolutions.
- Output and investment growth could surprise on the upside if pent-up demand and increasing household formation rates were to boost US activity more quickly than projected, and if a positive outcome from the comprehensive assessment of euro area banks improved confidence and eased financial fragmentation.

The global recovery is gaining momentum but risks remain tilted to the downside

Introduction

The global recovery is expected to strengthen at a moderate pace, despite some near-term weaknesses and still significant risks and vulnerabilities. Global growth this year is projected to be marginally softer than expected in the November *Economic Outlook*, at just under 3½ per cent, reflecting moderating activity in the large emerging market economies (EMEs), especially China, before picking up to almost 4% in 2015 (Table 1.1). Still-accommodative monetary policies, the continued feed-through of past improvements in financial conditions and reduced fiscal consolidation will support activity in the OECD economies, with growth in the United States stronger than in Japan and the euro area. Given the moderate pace of the recovery, the OECD-wide unemployment rate may decline by only ½ percentage point over 2014-15 to 7.1% by end-2015, still leaving 11¼ million more people unemployed than in early 2008. This will keep inflation low, especially in the euro area. In the major EMEs, who are displaying less of their former dynamism, growth is projected to

Table 1.1. **The global recovery will gain momentum only slowly**

OECD area, unless noted otherwise

	Average 2001-2010	2011	2012	2013	2014	2015	2013 Q4 / Q4	2014 Q4 / Q4	2015 Q4 / Q4
Per cent									
Real GDP growth¹									
World ²	3.4	3.7	3.0	2.8	3.4	3.9	3.2	3.5	3.9
OECD ²	1.7	2.0	1.5	1.3	2.2	2.8	2.0	2.4	2.8
United States	1.6	1.8	2.8	1.9	2.6	3.5	2.6	2.7	3.6
Euro area	1.1	1.6	-0.6	-0.4	1.2	1.7	0.5	1.4	1.8
Japan	0.8	-0.5	1.4	1.5	1.2	1.2	2.5	1.0	0.9
Non-OECD ²	6.9	6.4	5.2	5.0	4.9	5.3	4.9	5.0	5.3
China	10.5	9.3	7.7	7.7	7.4	7.3	7.6	7.4	7.2
Output gap³	0.3	-2.0	-2.2	-2.5	-2.2	-1.6			
Unemployment rate⁴	6.8	7.9	7.9	7.9	7.5	7.2	7.7	7.4	7.1
Inflation⁵	2.2	2.5	2.0	1.4	1.6	1.9	1.3	1.8	2.0
Fiscal balance⁶	-3.9	-6.5	-5.9	-4.6	-3.9	-3.2			
<i>Memorandum Items</i>									
World real trade growth	4.9	6.5	3.2	3.0	4.4	6.1	4.0	4.9	6.4

1. Year-on-year increase; last three columns show the increase over a year earlier.

2. Moving nominal GDP weights, using purchasing power parities.

3. Per cent of potential GDP.

4. Per cent of labour force.

5. Private consumption deflator. Year-on-year increase; last 3 columns show the increase over a year earlier.

6. Per cent of GDP.

Source: OECD Economic Outlook 95 database.

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remain close to current rates, as the impact of tighter financial conditions and past policy tightening takes effect. The balance of risks remains somewhat to the downside, despite the improving economic outlook, taking into account concerns about uncertain prospects in China, the impact that steps toward monetary policy normalisation in the United States may have on some EMEs, fiscal challenges in Japan, and, in the euro area, remaining financial fragilities and possible additional disinflationary pressures. Geopolitical uncertainty has also risen, in part due to the events in Ukraine. On the upside, some of these concerns could ease more quickly than expected, and investment turn out stronger than projected if, for example, the Asset Quality Review were to strengthen confidence in euro area banks, and if pent-up demand were to boost US activity more quickly than expected.

Supportive monetary policy and structural reforms are still required but to a different extent across OECD countries

With a moderate recovery, high unemployment, still large estimated slack, subdued inflation and downside risks, accommodative macroeconomic policies are still needed in the main OECD areas. In the United States, where the underlying recovery is more firmly based, a gradual reduction of monetary policy stimulus should proceed during the coming two years, although policy rates should remain well below historical norms. In contrast, monetary accommodation needs to be increased as planned in Japan, and monetary policy should be eased further in the euro area, with additional non-conventional stimulus being warranted if inflation were to show no sign of returning toward the 2% target. Micro and macro-prudential instruments should be developed as soon as possible and used fully, if needed, to prevent possible credit excesses and related asset price bubbles in particular markets. In view of high and still-rising government debt, there is little room for fiscal accommodation. Nevertheless, given significant past consolidation, the United States and some euro area countries can afford the planned slowdown in structural budget improvements, in contrast to Japan where consolidation should proceed steadily given daunting fiscal challenges. The OECD economies also need to continue with structural reforms to enhance resilience and inclusiveness, accelerate the recovery and improve economic outcomes in the medium term in order to reduce unemployment durably and ease both external imbalances and long-term fiscal burdens.

The EMEs face different policy challenges

Policy requirements differ across the EMEs. China faces a difficult policy dilemma since sustaining a robust growth momentum may require policy measures that could heighten financial stability and public finance risks. Prudential measures should be used to slow gradually rapid credit expansion and harder budget constraints should be imposed on local governments, thereby helping to rebalance the economy towards domestic consumption and minimise risks of disruptive financial turbulence. If growth were to slow sharply, monetary policy will have to be eased. In other EMEs, the appropriate monetary policy stance will depend on inflation and exchange rate developments. In these economies,

growth-enhancing structural reforms should be re-started to help improve macroeconomic fundamentals and boost investors' confidence.

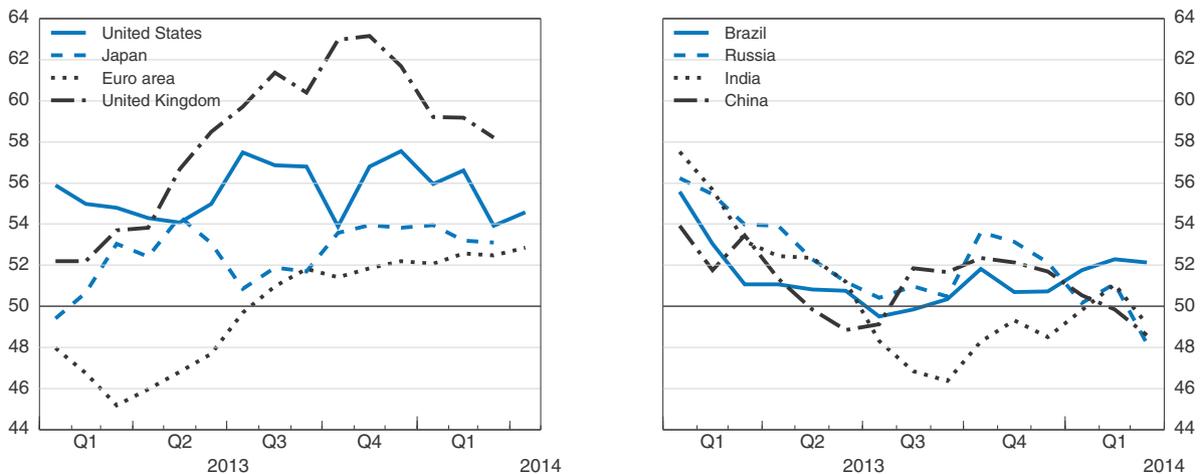
This chapter is organised as follows. First, cross-cutting issues that have an important bearing on the momentum of the global recovery and other forces acting are discussed. Subsequent sections set out the projections, along with the implications for inflation, labour markets and external balances, and discuss the main macroeconomic policy requirements. Indicators of potential financial vulnerabilities are reported in an annex.

Key forces shaping economic prospects

Recent indicators have been mixed and affected by one-off factors

Global growth picked up in the latter half of last year, helped by a recovery in private final demand in many major OECD economies, stronger trade growth in the EMEs and a temporary boost from higher inventory levels. More recently, uncertainty about the near-term pace of the recovery has risen, with one-off factors, such as unusual weather conditions, temporary tax-induced spending and a moderation in inventory accumulation, making it difficult to interpret developments in some economies in the first quarter of 2014, including the United States, Canada, Germany and Japan. There has also been confirmation of a further growth slowdown in China and some of the other large EMEs recently affected by financial turmoil. Survey indicators have diverged across countries as well, with forward-looking indicators such as all-industry new orders holding up well in the large OECD economies, especially in the United States and the United Kingdom, but being at much softer levels in the major non-OECD economies (Figure 1.1).

Figure 1.1. **New orders are more buoyant in the OECD than in most of the BRICs**



Note: Based on composite new orders indices from PMI surveys.
Source: Markit.

The slowdown in the EMEs

Concerns about growth momentum in China and other EMEs have risen

In several EMEs, GDP growth in the second half of 2013 was weaker than projected by the OECD last November. Indicators of current conditions and near-term prospects for the BRIICS are also somewhat weaker than expected earlier, though they have edged up in India and Brazil, albeit from relatively low levels. This partly reflects a tightening of financial conditions (see below). In China, growth appears to be moderating. PMI survey indicators and retail sales growth have softened (Figure 1.1) and there are signs that the necessary adjustment of the property market may have started, with the strength of house price and sales growth having eased in early 2014. The recent growth developments in the EMEs should be seen against the background of already downward revised growth projections for BRIICS over the past year and a reduction in their estimated potential growth rates.

Financial conditions have tightened somewhat in China...

In China, despite some recent easing, financial conditions have tightened somewhat over the past six months. Growing uncertainties about economic prospects and the ensuing policy response, and risks related to continued strong credit growth in early 2014 despite restraining policy measures, have pushed down equity prices and led to some increase in long-term government bond yields. The nominal effective exchange rate has remained stronger than last year, in spite of its recent depreciation following attempts by the authorities to curb carry-trades driven by expectations of sustained renminbi appreciation and the widening of the daily renminbi-dollar exchange rate band. In contrast, interbank market rates have declined from their recent highs to below levels in the second half of 2013.

... and driven by greater financial market volatility...

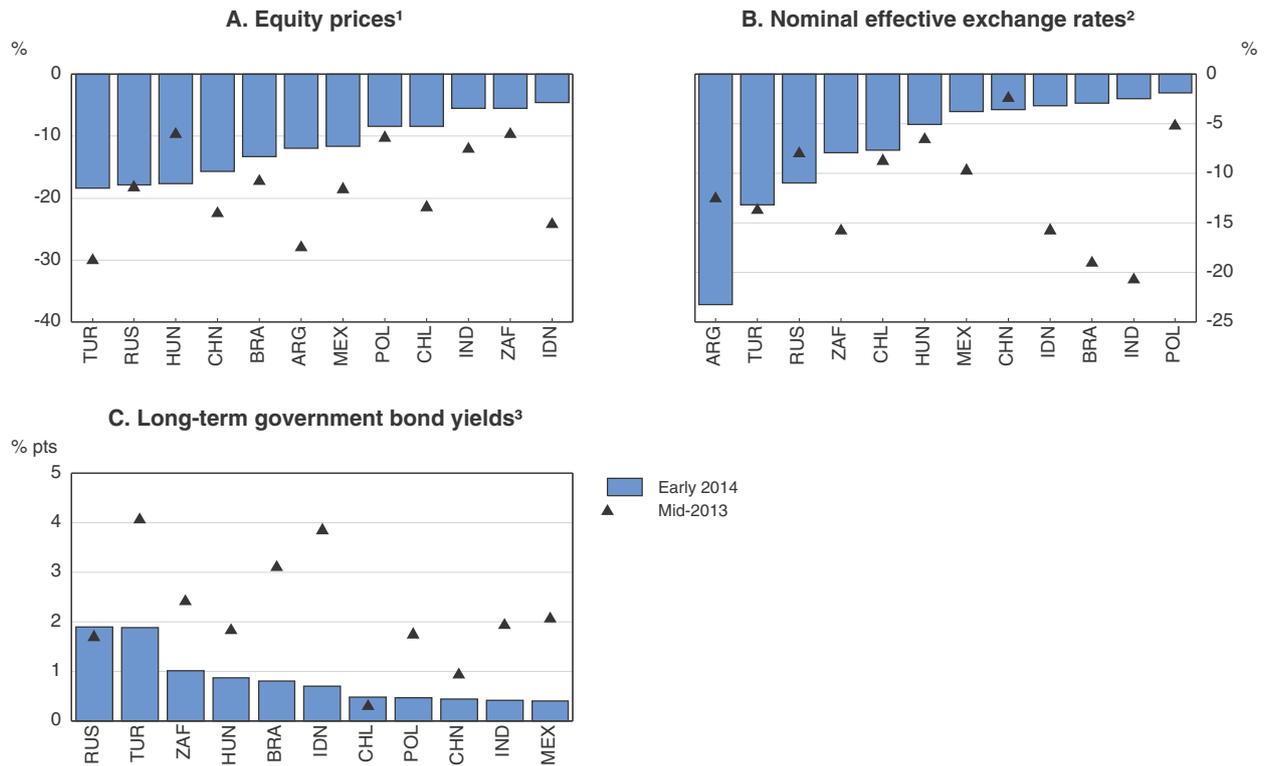
In early 2014, another bout of financial market volatility occurred in several EMEs outside China, resulting in increasingly tight financial conditions, though asset price corrections were smaller and more differentiated than in mid-2013. Against the backdrop of the tapering of asset purchases by the US Federal Reserve, the combination of an increase in geopolitical and economic uncertainty, in particular in Turkey, Argentina and more recently related to the events in Ukraine, and weaker-than-expected data releases in early 2014 led to a renewed deterioration in investors' sentiment in a number of EMEs. This triggered capital outflows and also declines in exchange rates and bond and equity prices. In response, several central banks raised policy rates, notably in Turkey, and some intervened in currency markets.

... have tightened to a larger extent in several other EMEs but by less than in the mid-2013 turmoil

In early 2014, the asset price corrections were, however, less acute than in mid-2013 (Figure 1.2) and there was less contagion across EMEs. For instance, exchange rates hardly depreciated during the turbulent period in Brazil, India and Indonesia, which seems to be related to recently improving external imbalances (India and Indonesia), higher policy rates (Brazil, India and Indonesia) and an improved monetary

Figure 1.2. **The financial turmoil in EMEs in early 2014 was less acute than in mid-2013**

In per cent



1. Percentage change from peak to trough between 2013Q2 and 2013Q3 for the mid-2013 period, and between December 2013 and end-March 2014 for the early 2014 period. Equity prices are expressed in domestic currency.
2. Percentage change from peak to trough between 2013Q2 and 2013Q3 for the mid-2013 period, and between December 2013 and end-March 2014 for the early 2014 period. A decline in the nominal effective exchange rate implies its depreciation.
3. Percentage point change from trough to peak between 2013Q2 and 2013Q3 for the mid-2013 period, and between December 2013 and end-March 2014 for the early 2014 period.

Source: OECD Economic Outlook 95 database; and Datastream.

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policy framework (India). In several EMEs, exchange rates have subsequently appreciated, more than offsetting the losses of early 2014, and long-term government bond yields have stabilised or even declined. Nevertheless, overall financial conditions in the EMEs outside China have tightened significantly since mid-2013, with higher policy rates and bond yields offset only partially by nominal effective exchange rates remaining between 10% and 20% lower than a year ago. Even if depreciation has improved the trade outlook, this has increased the burden of debt denominated in foreign currencies and raised inflationary pressures.

The risk of financial crisis in the EMEs has receded but vulnerabilities remain

Given the weaker and more differentiated reaction of financial markets in EMEs in early 2014 to the tapering of asset purchases by the US Federal Reserve than in mid-2013 (when the tapering discussion started), risks of a financial meltdown in EMEs have eased. With most EMEs now having flexible exchange rates, higher foreign exchange reserves and higher capital buffers in their financial institutions than before earlier

event shocks, such as those in Asia and Russia in 1997-98, they also look less vulnerable to financial crisis than in the past. Nevertheless, serious turmoil in some EMEs cannot be excluded whilst monetary policy in the United States normalises and long-term interest rates rise (Rawdanowicz et al., 2014). Several of them are still highly dependent on portfolio inflows and short-term loans from foreign banks, have a high share of debt in total foreign liabilities, and domestic companies have large foreign currency debts. In China, it is unclear whether the authorities will succeed in slowing rapid credit expansion, in the context of growing risks to financial stability (Box 1.1), and rebalancing growth from investment to

Box 1.1. Risks in China's financial system and potential international spillovers

The regular commercial banking sector in China has become large, with total assets exceeding 200% of GDP by end-2012 (see table below), i.e. below the average for the OECD countries but significantly above other BRIICS. This has been associated with a rapid expansion of domestic claims of depositary institutions (comprising commercial banks, the central bank, and other banking institutions), increasing by 30% of GDP between 2008 and 2012, when they reached 155% of GDP. Such a fast pace, which often has presaged financial crises for advanced countries in the past (Zhang and Chen, 2013), raises concerns about credit quality and financial stability, especially as economic growth looks set to be weaker in the coming years than in the past five years. The formal commercial banking sector seems, however, well capitalised (see table below) and is in a transition to being subject to more stringent regulation than envisaged in Basel III. Non-performing loans are small and banks have made sizeable loss provisions. This suggests that banks have large buffers to absorb losses in case of a negative shock. Nevertheless, some of the banking indicators may not adequately account for off-balance sheet exposures and several risks are present.

Selected indicators of the banking sector

	2007	2008	2009	2010	2011	2012	2013
Banking institutions							
Total assets (CNY tr)	53.1	63.2	79.5	95.3	113.3	133.6	151.4
Total assets (% of GDP)	199.8	201.1	233.2	237.4	239.5	257.5	266.2
Commercial banks							
Total assets (CNY tr) ¹	41.0	47.8	61.5	74.2	88.4	104.6	117.4
Total assets (% of GDP)	154.2	152.3	180.4	184.7	186.9	201.5	206.4
Liquidity ratio	37.7	46.1	42.4	42.2	43.2	45.8	44.0
NPL ratio	6.1	2.4	1.6	1.1	1.0	1.0	1.0
Provisioning coverage ratio	41.4	116.6	153.2	217.7	278.1	295.5	282.7
Leverage ratio ^{1,2}	5.5	6.0	5.5	6.1	6.4	6.5	7.1
Capital adequacy ratio ³	..	..	11.4	12.2	12.7	13.3	12.2
Core capital adequacy ratio ⁴	..	..	9.2	10.1	10.2	10.6	10.0

Note: In per cent unless indicated otherwise.

1. The 2013 figure is based on OECD's estimations of rural commercial and foreign banks' total assets and liabilities.

2. Total owner's equity over total assets.

3. Net tier 1 capital over risk-weighted assets.

4. The data for 2013 are not fully comparable with previous years due to a change of methodology for calculation.

Source: China Banking Regulatory Commission (CBRC) and OECD estimates.

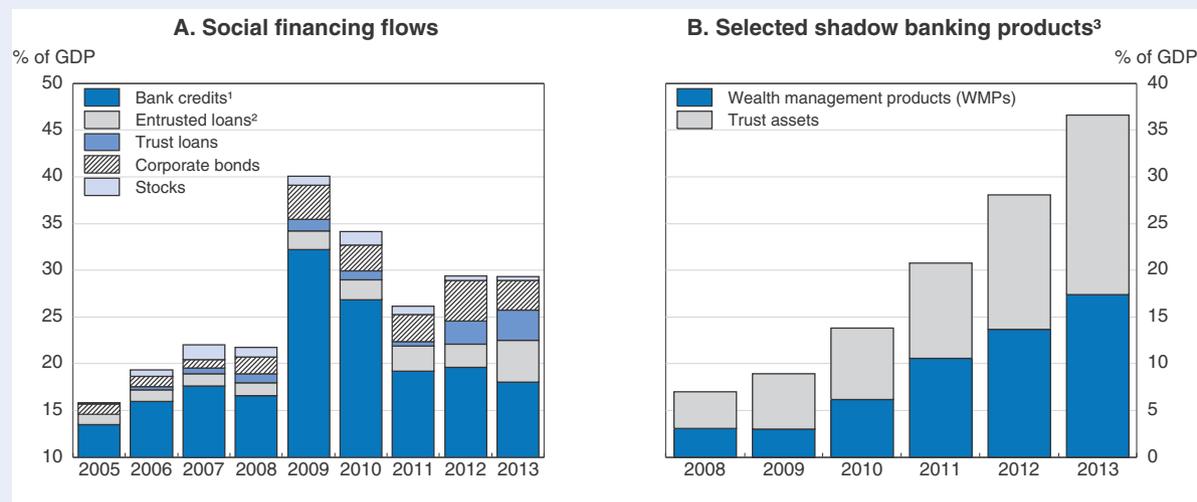
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Box 1.1. Risks in China's financial system and potential international spillovers (cont.)

Credit expansion has been increasingly taking place outside the regular banking sector, leading to a rapid expansion of the so-called shadow banking sector (see figure below), even if it is still relatively small compared with many advanced OECD countries (FSB, 2013). Estimates of the size of the shadow banking sector range widely, between 44% and 69% of GDP as of end-2012.¹ Shadow banking has boomed in response to tighter regulation of regular banking activity to damp credit growth since 2010 and to caps on deposit interest rates, in an environment of unmet demand for credit and search for higher yield by wealthy individuals and cash-rich enterprises. The most popular shadow banking products include wealth management products (WMPs) and trust products (TPs), which together are estimated to account for over 35% of GDP in 2013 (see figure below). The former are short-term (up to one-year) investment products. Regulated banks sell WMPs and manage pooled money off-balance sheet by investing mainly in longer-term fixed-income bonds. The WMPs allow banks which offer these products to shift some of the assets off balance sheet to reduce obligatory deposit reserves and to report a favourable deposit base by setting the expiration date of WMPs for the end of reference period (IMF, 2012b), which is longer than the maintenance period of reserve requirements. The TPs are longer-term investment products, and trust companies lend funds entrusted by their clients to real-estate and industrial projects as well as investing them in financial products.

Shadow and regular banks are exposed to Local Government Financing Vehicles (LGFVs), by making loans to them and investing in their bonds, which risks undermining the asset quality of the banks. The LGFVs were established by local governments to finance infrastructure and public real estate projects. Their debt increased rapidly over recent years to an estimated CNY 19 trillion, or 37% of GDP, at end-2012, with some analysis suggesting that nearly half of this debt would be non-performing without fiscal subsidies and special accounting practices enabling LGFVs to understate financial costs by capitalising interest expenses (Zhang et al., 2013).

Credit has increased rapidly



1. Including bank loans denominated in local and foreign currencies as well as bank's acceptance bills.
 2. Business-to-business loans by bank intermediation.
 3. The year-end outstanding balances are referred to, although the value of WMPs for 2013 is as of end-September. Possible overlaps between the WMPs and trust assets, or the WMPs sold by trust companies, are not adjusted.
- Source: People's Bank of China; CBRC; Kwan (2014); National Bureau of Statistics of China; and China Trustee Association.

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Box 1.1. Risks in China's financial system and potential international spillovers (cont.)

The banking sector is sensitive to declines in real estate prices given that nearly 30% of total bank loans, including loans to LGFVs, are allocated to the real estate sector.² Falling prices will reduce the actual and expected profitability of real-estate projects, on which their repayment capacity depends, thereby jeopardising creditors. The negative consequences of this could be amplified by negative feedback effects between the real economy, real estate prices and the financial sector. Such feedbacks would largely depend on the feasibility for, and the willingness of, local governments to give fiscal supports to failing LGFVs, with implications for their creditors. Local governments, however, have almost no freedom to change the tax rate and tax base (OECD, 2013a) and their revenues largely depend on land sales (IMF, 2013). Thus, lower revenues could entail reduced financial support to LGFVs and in turn curtail public investment and weaken bank balance sheets. If so, local governments might be encouraged to accelerate the sale of land, amplifying the initial price declines (OECD, 2013c).

There is also the risk of a run on shadow banking products, as most of them do not come with an explicit guarantee of the principal. If individual shadow banking products were to default, leading to losses of principal, a general run on shadow banking products could not be excluded. This risk, however, will be mitigated if banks offering such products and trust companies bail out failed shadow banking products for fear of reputational damage, although such bailouts would be associated with higher demand by rescuing financial institutions for liquidity. Such a risk could materialise this year as a large part of TPs is set to mature in 2014. The strong interconnectedness between regular banks and shadow banking products highlights the systemic importance of these products.

The risk of a systemic crisis in China's financial system will depend on the authorities' response. They have already implemented some micro-prudential regulations to limit LGFVs financing and increase the level of oversight of the WMPs, but it remains to be seen if they will be effective.³ The central government seems to have enough fiscal space to bail out failed LGFVs and financial institutions to minimise the risk of contagion. The central government is a major landowner and shareholder (Ueda and Gomi, 2013) and its official debt was CNY 9.4 trillion (18% of GDP) at end-2012 (National Audit Office, 2013). However, the fiscal cost could be very high, reflecting sizeable governmental contingent liabilities and the under-estimation of the size of LGFVs' liabilities.⁴ Such intervention could also aggravate moral hazard problems. The recent rescue of a TP institution (Credit Equals Gold No.1) may underpin individual investors' beliefs in future bailouts by related financial institutions and governments.

The risk of international financial and trade spillovers could be larger than expected from direct linkages alone. The Chinese banking sector is not deeply integrated with global financial markets, implying limited financial spillovers. Foreign banks accounted for less than 2% of total banking sector assets as of end-2012, and financial claims on Chinese banks of the OECD countries are very small (below 1% of GDP, with the exception of the United Kingdom). Financial turbulence in China could, however, weaken further international investors' asset values and sentiment, with negative implications for financial stability in other EMEs. This spillover could, in particular, go through Hong Kong where large Chinese companies and banks have a significant presence in equity markets.⁵ With credit-dependent economic growth, the policy-induced slowdown in credit or financial turmoil in the banking sector could damp domestic growth and spill over to other countries via trade. Simulations of the NiGEM model suggest that a 2-percentage point decline in domestic demand growth during one year could reduce OECD growth by 0.1%, with a somewhat stronger impact in Japan and some other BRIICS. This relatively small impact is found in other studies (e.g. by IMF, 2012a) and seems to reflect the fact that China is not yet a dominant export destination for OECD countries and a part of its imports is re-exported and thus dependent on demand outside China (Ollivaud

Box 1.1. Risks in China's financial system and potential international spillovers (cont.)

et al., 2014). However, such simulations fail to account for confidence effects and disruptions of global value chains with knock-on effects on production and profits in other countries. Slower Chinese growth could also lower commodity prices as China is the largest consumer of many commodities.⁶

1. In line with the PBOC (2013) definition, the shadow banking sector refers here to credit intermediation, involving entities and activities outside the regular banking system, with the functions of liquidity and credit transformation. Depending on which financial facilities are covered, there are several estimates of the size of shadow banking, such as Tao and Deng (2013) (43.9% of GDP), Standard & Poor's (2013) (44.1% of GDP), Ueda and Gomi (2013) (64.4% of GDP), and Zhu et al. (2013) (69.4% of GDP).
2. Estimated by OECD with reference to CBRC (2013) and PBOC (2014a, 2014b).
3. The National Development and Reform Commission tightened the eligibility criteria of corporate bond issuance in December 2012 and reformed its investigation and approval process in April 2013. The China Banking Regulatory Commission strengthened supervision of WMPs in March 2013 and capped total bank loans to the LGFVs in May 2013. In February 2014, the PBOC introduced regulation to shorten the maturity of financial assets of WMPs.
4. The debt-to-GDP ratio covers explicit government debt only. If contingent liabilities for which the government co-signs, as well as those for which the government does not assume the legal responsibility of repayment but commits to supporting failed debtors, are taken into account, the central government's debt-to-GDP ratio would have been 23% at end-2012. Likewise, general government's debt-to-GDP ratio would have been 54% at that time. Debt would be even larger if LGFVs' debt is fully accounted for. Zhang et al. (2013) suggest that the recent survey by the National Audit Office (2013) on local government and LGFVs debt could involve an underestimation of local government debt in 2012 by around 12.8 trillion due to under-reporting of LGFVs liabilities. Adjusting for this, local and general government debts as of end-2012 would be CNY 28.7 trillion and CNY 40.6 trillion (78% of GDP), respectively.
5. For example, the market capitalisation of an index of representative 40 Chinese companies (so-called H-Shares) amounted to USD 317 billion, accounting for 10% of the overall Hong Kong stock market at end-2013. This was equivalent to 2% and 7% of the market capitalisation of New York Stock Exchange and Tokyo Stock Exchange, respectively, at end-2013. Meanwhile, the market capitalisation of all internationally-tradable shares (B-Shares) in Shanghai and Shenzhen was USD 30 billion at end-2013.
6. According to IMF (2012a), a temporary 1% decline of China's real fixed-asset investment would reduce commodity prices (for example, by 1.3% for metals) and the growth rate of PPP-weighted G20 GDP by 0.06 percentage point after 4 quarters, with the effects persisting up to 8 quarters.

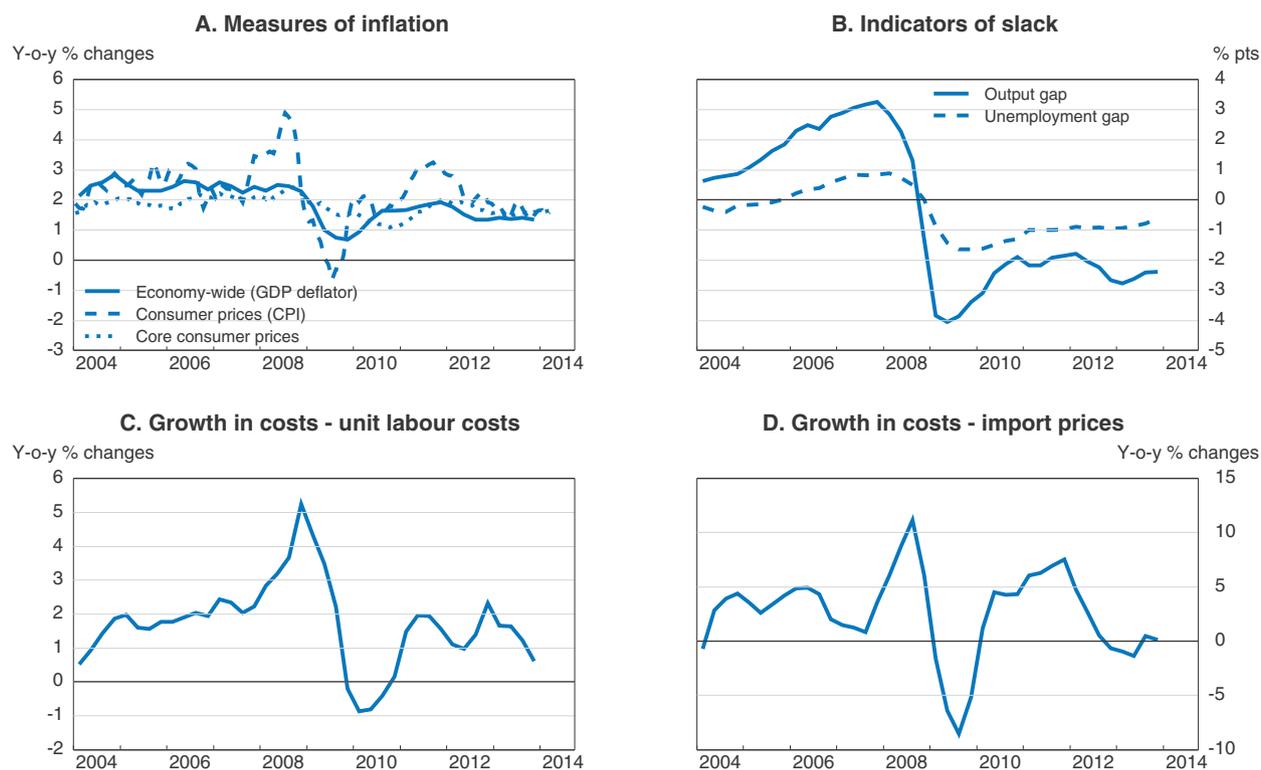
consumption without disruption. With the EMEs accounting for a larger share of global GDP than in the past, a significant slowdown in these economies could have strong effects on global growth. Although model simulations suggest that without a major financial crisis even a significant slowdown in the EMEs would not have large effects on the main OECD areas,¹ such results fail to account for possible negative confidence effects that could weigh on investment (see below) and consumption, including among EMEs.

Disinflation

Price inflation has fallen to very low levels in the OECD area as a whole

Price inflation in the OECD area as a whole has declined by around 1½ percentage points since late 2011, reflecting both persistent economic slack and weak cost growth (Figure 1.3). In the majority of economies, import price growth is only modest, reflecting stable commodity prices and the downward pressure placed on exporters' profit margins due to soft demand conditions. Unit labour cost growth is also weak, reflecting soft labour market conditions and subdued wage growth. Persistent economic slack over the past two years has also been associated directly with moderating inflation (Box 1.2).

1. Simulations on the NiGEM global macro-model suggest that a one-year, 2-percentage point decline in domestic demand growth in the main EMEs, including China, could lower OECD GDP growth by around ½ percentage point in the first year, with the impact on the US economy being relatively small compared to that on Japan, reflecting their relative trade integration with the non-OECD economies (Ollivaud et al., 2014).

Figure 1.3. **Inflationary pressures in the OECD are currently weak**

Source: OECD Economic Outlook 95 database; and OECD, Main Economic Indicators database.

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Box 1.2. **Disinflation in the OECD economies**

Headline consumer price inflation in the OECD economies has fallen by 1¼ percentage points since September 2011 and in many economies has been well below central banks' targets in recent months. Inflation has also eased in the large non-OECD emerging market economies but does not appear to be particularly low: inflation in the BRIICS is currently 5% (year-on-year) and almost 7¼ per cent excluding China. This box sets out the key factors that can account for the disinflation in the OECD economies.

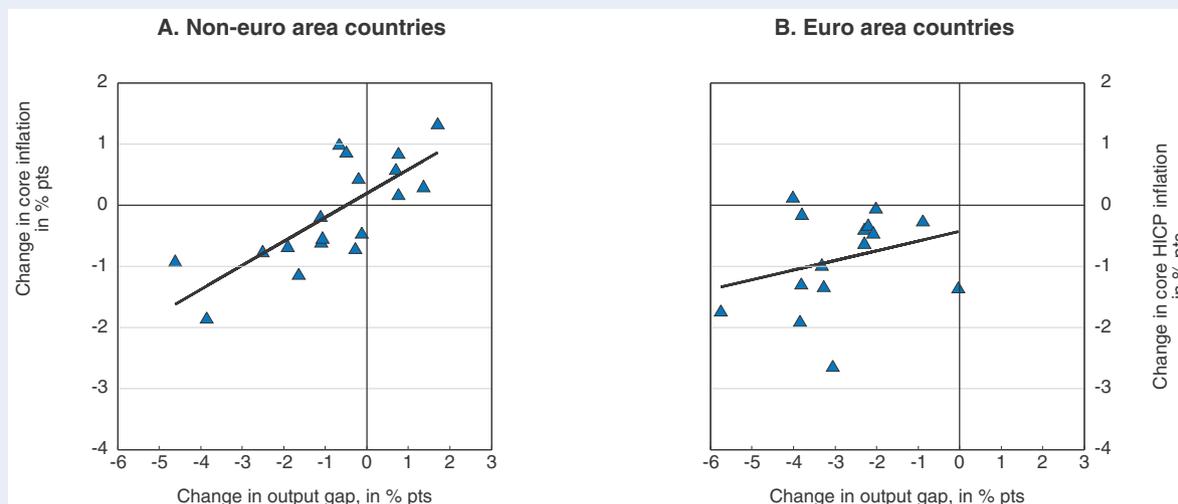
A large part of the disinflation in OECD over the past 2½ years appears to be due to sizeable falls in energy price inflation. Declines in food price inflation and in core inflation have also contributed to the overall drop in headline inflation.

- The sharp decline in energy price inflation, from double-digit figures during 2011 to more subdued rates in 2012 and 2013, accounts for around 1¼ percentage points of the fall in OECD headline inflation since the peak in September 2011. This reduction in the growth of household energy prices reflects weaker commodity price growth (reflecting both supply improvements and a softening of demand, especially from China) and the fading effects of earlier increases in administered prices in many countries. This has been a relatively important factor behind disinflation in the euro area and the United Kingdom, and a more modest influence in the United States. Japan is an exception amongst the major economies, with energy prices having risen quite strongly, reflecting the increased demand for imported energy since the earthquake in 2011 and also the large depreciation of the yen.

Box 1.2. Disinflation in the OECD economies (cont.)

- A decline in food price inflation accounts for a further $\frac{1}{4}$ percentage points of the fall in OECD-wide inflation, with the annual rate of OECD-wide food price inflation slowing from over 4% to 1.7%, which is low by historical standards. Food price disinflation may not persist, with food commodity prices turning up in 2014.
- Disinflation in non-food, non-energy goods and services prices accounts for the remaining $\frac{1}{4}$ percentage point decline in OECD-wide inflation. This decline in core inflation is likely due to sizeable domestic economic slack. Indeed, there is a clear positive relationship between the changes in core inflation and output gaps over the past two years, particularly outside of the euro area (see first figure below). Subdued non-commodity import price growth has also helped to contain cost pressures and contributed to the current softness in non-energy industrial goods price inflation. However, Japan is again an important exception amongst the large economies, with prices being pushed up, helped by the depreciation of the yen and improvements in economic conditions.
- In some countries recent inflation softening also reflects one-off factors. Notable examples include the falls in the price of health care services in the United States (in April 2013 and January 2014), and the passing of the earlier boost from increases in indirect taxes and administered prices in many European countries (discussed further below).

Disinflation and increasing economic slack



Note: Changes in inflation are from 2012Q1 to 2014Q1; changes in the output gap are from 2011 to 2013. OECD estimates are used where 2014Q1 data are not yet fully available. Iceland is excluded.

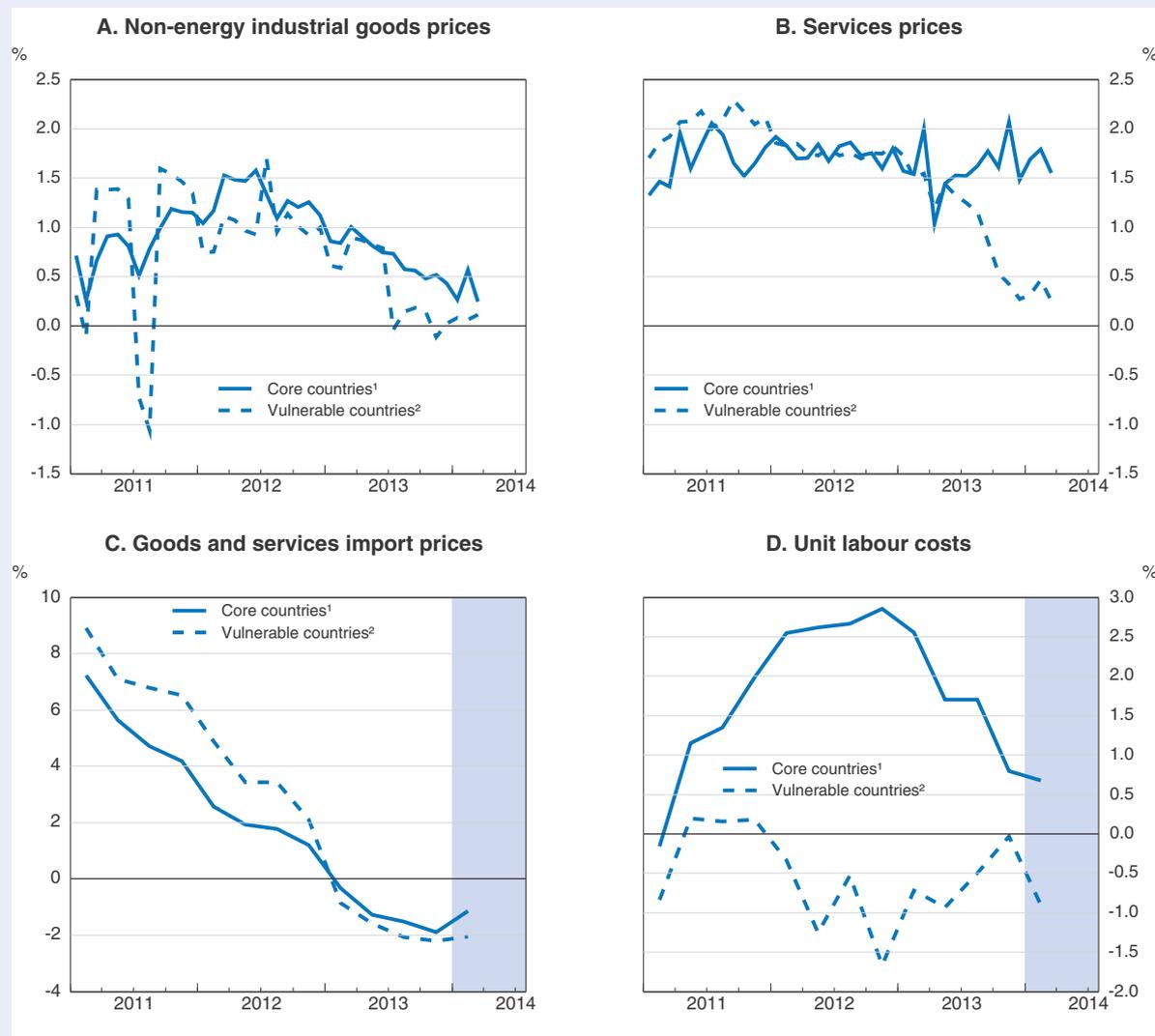
Source: OECD Economic Outlook 95 database; OECD Main Economic Indicators database; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888933048717>

In the euro area, the annual rate of headline consumer price inflation declined steadily to 0.5% in March, with a risk that disinflationary pressures could intensify if the extent of economic slack persists, the euro appreciates further or inflation expectations become unanchored. Falling energy prices can account for three-fifths of the 2½ percentage point decline in the headline inflation rate since September 2011 but there has also been a reduction of 1 percentage point in the year-on-year rate of core inflation (abstracting from energy, food, alcohol and tobacco).

Box 1.2. **Disinflation in the OECD economies (cont.)****Disinflation in euro area prices and costs**

Year-on-year percentage changes



1. Core countries include Austria, Belgium, Finland, France, Germany and Netherlands.

2. Vulnerable countries include Greece, Ireland, Italy, Portugal, Slovenia and Spain.

Source: Eurostat; OECD Economic Outlook 95 database; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888933048736>

Core inflation has fallen particularly sharply in the countries that have come under pressure to undertake far-reaching reforms (Greece, Ireland Portugal, Spain and also Italy), reflecting relative price adjustments necessary to regain competitiveness and aid external rebalancing in the euro area. For this group overall, the annual rate of core inflation is around $\frac{1}{4}$ percentage point and is negative in some countries. In the core euro area economies, non-energy, non-food inflation has also eased, but remains well above zero and is still close to the average rate since 1999.

Box 1.2. Disinflation in the OECD economies (cont.)

The factors accounting for disinflationary pressures in the euro area reflect those for the OECD as a whole, but with some important differences:

- Increases in indirect taxes and reductions in subsidies in the periphery countries boosted inflation directly during 2012 (and also the previous two years), although this was offset in part by their adverse impact on demand, and masked more subdued rates of underlying inflation. Estimates based on inflation at constant tax rates suggest that the fading of these measures could account for up to ½ percentage point of the fall in the annual rate of euro area inflation from September 2012 to December 2013.¹ This suggests that the underlying decline in euro area core inflation during 2013 was milder than suggested by the headline data (EC, 2014).
- Unit labour costs have fallen in the vulnerable countries, aside from Italy, in recent years. Given the importance of labour in the production of many services, this has likely contributed to lower service price inflation. Indeed, inflation in services prices has fallen to unusually low levels in the vulnerable countries (with price declines in some), driving the euro area aggregate to very low levels by historical standards (see figure above). However, this will also reflect the upward boost from indirect tax increases having now passed. By contrast, services inflation in the core countries has been relatively constant (ECB, 2014a), though, if sustained, the recent slowing in unit labour cost growth in the core economies could start to push down inflation.
- Weak import price pressures have contributed to broad-based disinflationary pressures in both core and vulnerable countries (ECB, 2014a), reflecting the appreciation of the euro since mid-2012 and subdued global manufactured goods prices. Rates of inflation in non-energy non-food goods prices are very low across core and vulnerable countries (see figure above). Subdued domestic cost growth and soft demand conditions, amidst sizeable economic slack, also help to account for the recent weakness in goods price inflation.

1. While estimates using constant tax rates assume full pass-through and so may overstate the effect of taxes, increases in administered prices and reductions in subsidies are likely to have played a similar role.

The risk of intensified disinflationary pressures is especially strong in the euro area...

Disinflationary pressures are now strongest in the euro area, where headline inflation is well below the ECB objective of a rate close to 2% and the annual rate of core inflation declined by around ¾ percentage point over the year to March, to just 0.7 per cent, before rising back to an estimated 1% in April. Disinflationary pressures were expected in many vulnerable economies, reflecting a necessary relative price adjustment to regain competitiveness, with weak demand and structural reforms strengthening competition and compressing price and wage increases. However, inflation has also weakened noticeably in several core countries, including France and Germany, where the annual headline rate is now at 0.7% and 1.1% respectively and unit labour cost growth is less than 1%. In part, this reflects a common decline in import price pressures brought about by an appreciation of the euro effective exchange rate. Even so, it has heightened the risk that any renewed weakness in demand, further appreciation of the euro, declines in commodity prices, or an unanchoring of inflation expectations, could result in a period of very low area-wide inflation, or even deflation, thereby constraining activity by further raising real interest rates and intensifying debt service burdens in many economies. Longer-term inflation expectations remain well-anchored,

but, as shown by the experience of Japan in the 1990s, deflation can still set in whilst inflation expectations remain positive.

... but weaker elsewhere

This risk appears less acute in the other major OECD economies, as long as inflation expectations remain well-anchored and there are no further large exchange rate movements. If the recovery gains sufficient momentum to strengthen employment demand in all economies, as it already has started to do in the United States, Japan and the United Kingdom, then labour cost pressures should start to rise slowly as labour market slack diminishes and wage growth picks up.

A sustained acceleration in business investment will be essential if the recovery is to gain greater momentum

Business investment developments

Business investment has been weak since the crisis began, largely reflecting subdued demand growth and low levels of capacity utilisation, as well as financial constraints in some countries, notably the euro area, and heightened uncertainty. Measures of uncertainty rose sharply both in 2008-09 and then following the intensification of the euro area crisis in mid-2011, and the share of financial assets held as currency and deposits by non-financial enterprises is presently well above longer-term norms. Amongst the major OECD economies, the (nominal) share of business investment in GDP is presently around 1 percentage point below pre-crisis norms, and well below steady-state levels implicit in OECD long-term projections (Box 1.3; Chapter 4). In the euro area, in particular, the share of business investment in GDP is at very low levels, as is the non-financial corporate profit share, notwithstanding a small rise during 2013.

The pre-conditions for stronger investment growth now appear more favourable, especially outside the euro area...

The pre-conditions for stronger investment growth have improved. Corporate balance sheets are generally healthy, outside of the vulnerable economies in the euro area; greater risk appetite, as reflected in stronger equity prices and strong demand in corporate bond markets, has raised the availability of external finance; and solid profit growth, outside the euro area, has further improved the availability of internal funding. By some measures, policy uncertainty has also declined, especially in the United States (Figure 1.4) and also in the euro area with continued progress towards a full banking union. In the latter half of 2013, business investment growth picked up in a large number of economies, particularly sharply in the United Kingdom, and capital goods orders in some of the major OECD economies point to a further pick-up in the first half of this year.

... and a broader investment upturn is projected in the next two years

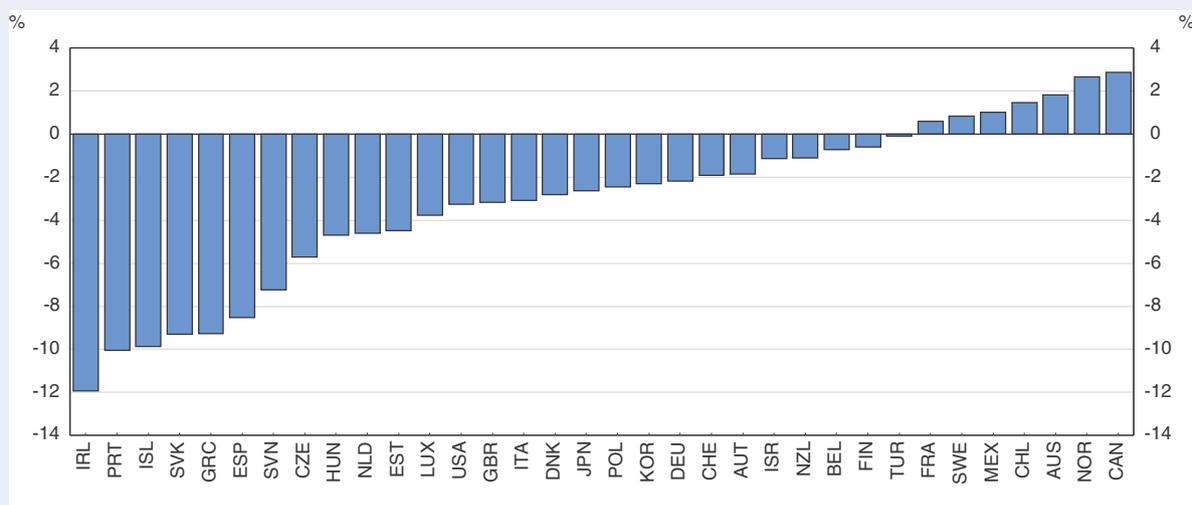
Conditional on the outlook set out below, a broader and stronger investment upturn should occur in 2014-15, with accelerator mechanisms helping investment growth to outpace output growth in many economies, including the United States (after a weak first quarter in 2014), Japan, the United Kingdom and Korea. Prospects are weaker in parts of the euro area, reflecting subdued final demand, less favourable balance sheet developments, impaired credit channels and still high barriers to product

Box 1.3. Investment is low relative to pre-crisis norms and longer-term needs

During the crisis the level of investment fell sharply relative to GDP and has not yet recovered. In a majority of OECD countries, current-price investment ratios are considerably below pre-crisis average levels (see first figure below). The largest gaps are for business and housing investment, with the ratios of both to GDP around 1 percentage point below pre-crisis averages in the major advanced economies. The recovery of business investment in particular, appears to have been sluggish compared to earlier downturns.

Investment is below pre-crisis levels in most OECD economies

Total investment as a percentage of GDP in 2013 less 1996-2007 average



Source: OECD Economic Outlook 95 database; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888933048755>

A significant part of the shortfall in business investment can be linked to weak demand, as discussed in the main text,¹ but other factors are likely to have also played a dampening role, including: increases in the user cost of capital; a prolonged period of heightened economic and policy uncertainty; and higher levels of corporate leverage preceding the crisis. With the recovery in activity underway and many of these other drags having receded, business investment might be expected to increase once more.

Another indication of the difference between current investment levels and longer-term needs can be obtained by estimating an illustrative steady state investment-to-output ratio using inputs from the OECD long-term growth projections (see Chapter 4). From around 2020 onwards in the long-term database, the constant-price capital-output ratio moves around a long-run level according to changes in the real cost of capital, with output gaps generally closed from this point. Assuming that an equilibrium ratio is attained at a particular point in time, the capital-output ratio, the depreciation rate and the growth rate of potential output in the long-term baseline can be used to calculate an implicit steady state investment-to-output ratio that is required to maintain this.

This steady-state level of investment to (potential) output is given by: $i^* = \frac{k^*(g+\delta)}{(1+g)}$, where k^* is the steady-state capital-output ratio, δ is the depreciation rate which is assumed to be constant over time, and g is the endogenous potential growth rate, which is dependent upon labour utilisation, physical and human capital intensity and multi-factor productivity. In the calculations below, k^* is set at the ratio of (non-residential) capital to trend output in 2025 in the long-term baseline scenario, by which time current trends in capital intensity have generally stabilised but is not so distant that new forces pushing up the cost of capital have taken hold. Steady-state values for g and δ are approximated by the average over 2020-2025.

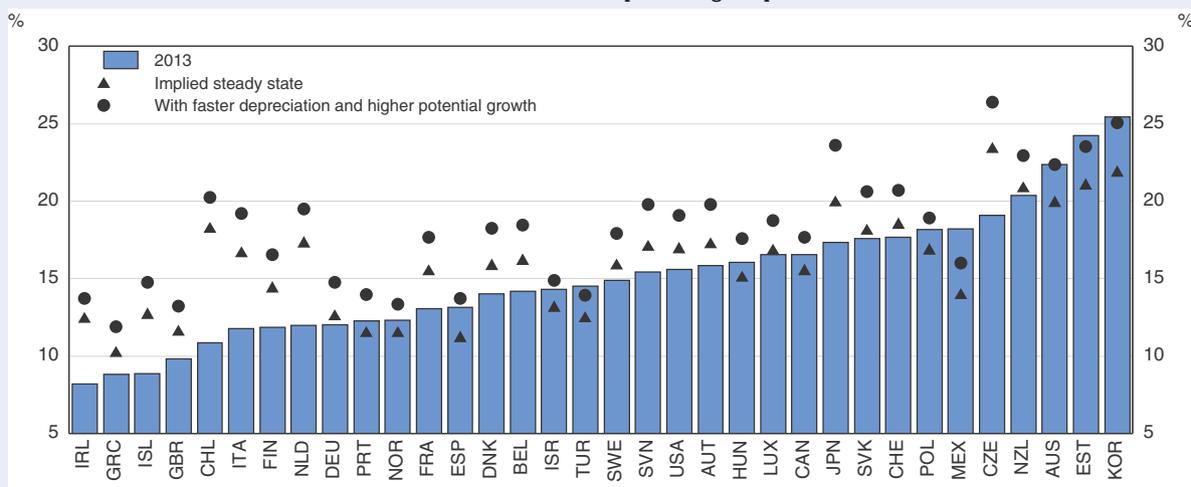
Box 1.3. Investment is low relative to pre-crisis norms and longer-term needs (cont.)

The resulting values for the implicit steady-state level of investment are shown in the figure below compared to the current ratio of investment to potential GDP. In most OECD economies, investment ratios in 2013 are below the illustrative steady-state level, with a gap of 2 percentage points or more in one-third. But there is a fairly large range, with the current investment ratio above this implicit longer-term level in some countries. The strong investment growth projected in 2014 and 2015 helps to close this gap in many economies, including Germany and the United States, but still leaves a considerable shortfall to make up in several economies.²

The calculations are only illustrative, since the growth rate of potential output and the user cost of capital, and hence the implied steady state capital-output and investment-output ratios, fluctuate over the full OECD long-term projections and are thus sensitive to the assumptions made about the steady-state capital ratio, depreciation rate and potential growth rate of output. Consequently the catch-up in investment needed to reach a given steady-state capital output ratio is also affected. For instance, a continuation of the past steady upward trend in the depreciation rate, reflecting the change in the mix of capital goods, would raise the steady-state level of investment required to maintain any given capital stock. Alternatively, trend output growth could be stronger than in the baseline if additional growth-enhancing structural reforms are undertaken.

Investment ratios are below illustrative steady state estimates in most OECD economies

Non-residential investment as a percentage of potential GDP



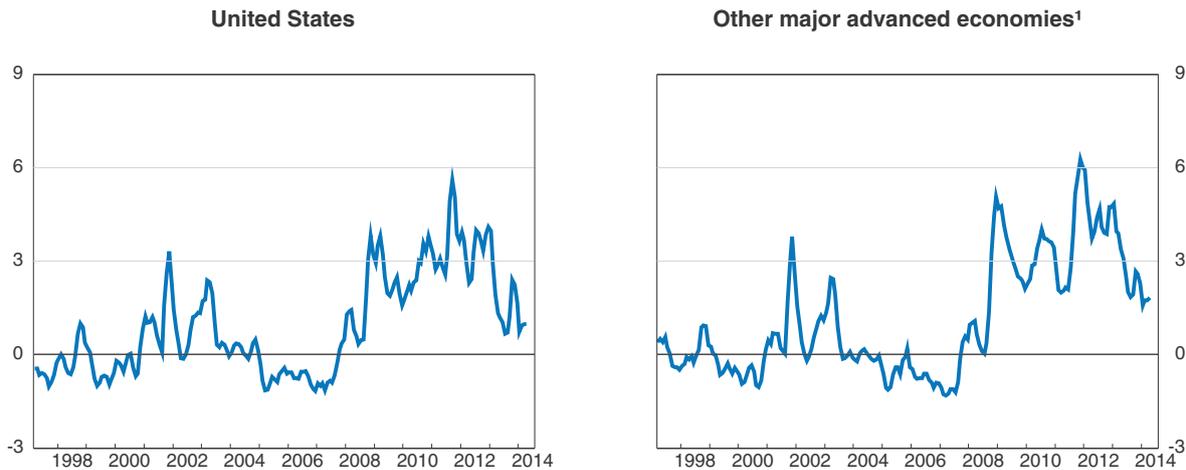
Note: Countries are ordered by the 2013 investment ratio.

Source: OECD Economic Outlook 95 database; and OECD calculations.

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A simple way of visualising the sensitivity of the calibrated implicit steady-state investment ratio is to add ½ percentage point to both the baseline depreciation rate and the baseline potential growth rate. The average effect of these two changes across countries, for a given capital-output ratio, is to raise the required steady-state investment ratio by 2¼ percentage points (unweighted), with the largest effect in Japan (adding 3½ percentage points to the required ratio). The higher depreciation rate and stronger potential output growth each account for around one-half of these additional effects.³ Lower rates of depreciation or potential output growth would be associated with correspondingly lower investment ratios.

1. Evidence from business surveys in the United States and euro area also suggests that demand conditions have likely constrained production and investment.
2. In several countries, the data are on a SNA 2008 basis, which incorporates a broader definition of investment.
3. An important caveat to this exercise is that changes in potential output growth could change the steady-state capital-output ratio both indirectly, and directly by raising the equilibrium real interest rate in proportion to the rise in the potential growth rate. The full incorporation of the 2008 System of National Accounts will also lead to changes in these ratios.

Figure 1.4. **Policy uncertainty is starting to fade**

Note: Data shown are a 3-month-moving average of non-seasonally adjusted data which were normalised over the period 1997-2007.

1. First principal component calculated from Economic Policy Uncertainty Indices for Canada, France, Germany, Italy and the United Kingdom.

Source: Scott Baker, Nicholas Bloom and Steven J. Davis at www.PolicyUncertainty.com; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888933048869>

market competition in some economies. The risks around this central scenario are broadly balanced. Investment growth may be weaker if interest rates were to increase sharply or if final demand growth were to slow once more. However, it could also surprise on the upside if accelerator effects are stronger than expected or if confidence were to improve more quickly as uncertainty is removed, for instance because of a successful outcome from the Asset Quality Review of euro area banks.

Trade developments

Trade intensity has been very low...

Following an initial rebound in the early stages of the recovery, global trade growth has until recently moved in line with global output growth, well below pre-crisis norms. In the decade prior to 2008, trade intensity rose steadily, with trade growth being around 1¾ times the pace of global GDP growth. This reflected the rapid globalisation of economic activities during this period, with new global supply chains being constructed, the rapid development of many EMEs, especially China, and the boost to cross-border services trade provided by new ICT developments and financial globalisation. The factors behind the weaker recent level of trade intensity remain unclear, but may include the one-time nature of earlier boosts to trade intensity, an increased number of trade restrictions since the crisis began (OECD/WTO/UNCTAD, 2013) and changes in the composition of final expenditure in the major economies.² In particular, as discussed above, fixed investment (a trade-intensive expenditure

2. The trade-restrictive measures introduced by G-20 members since October 2008 presently cover around 5% of G-20 merchandise imports. Only one-fifth of the measures introduced since the start of the crisis have subsequently been eliminated (OECD/WTO/UNCTAD, 2013).

category) has been much weaker than in the pre-crisis period, and import growth has slowed particularly sharply in those economies in which investment has been the weakest relative to pre-crisis norms.³

... but may now be beginning to rise

There are some early signs that trade intensity may now be rising, with trade growth exceeding global output growth in the fourth quarter of last year. This was helped by stronger demand in the major OECD economies, particularly for fixed investment and inventories, and a resurgence of trade involving EMEs, especially in Asia. Global export orders have also strengthened over the past six months in all G7 countries. For trade intensity to pick up further, much depends on whether capital investment can strengthen gradually, as projected. If so, trade growth could pick up to just over 5¼ per cent at an annualised rate by the latter half of 2014 and around 6½ per cent by the latter half of 2015, around 1½ times the level of global GDP growth. In the medium-term the direct effects of the trade facilitation measures in the recently concluded Bali agreement should boost global activity and trade, and could even have a positive near-term effect on business confidence and investment.⁴ A successful conclusion to the current negotiations on the transatlantic and transpacific trade agreements could further boost such effects.

Financial conditions in the advanced economies

Financial conditions have eased further...

Financial conditions remain supportive of growth, with the OECD financial conditions indices strengthening further in the United States and Japan and remaining broadly unchanged in the euro area as a whole but improving considerably in the vulnerable countries (Figure 1.5). The progressive reduction of securities purchases by the Federal Reserve has not led to increased volatility in US financial markets. The sell-off in EMEs at the beginning of the year temporarily and negatively weighed on equity prices and boosted volatility in the advanced OECD economies, but as investors sought safe havens government bond yields declined and exchange rates appreciated.

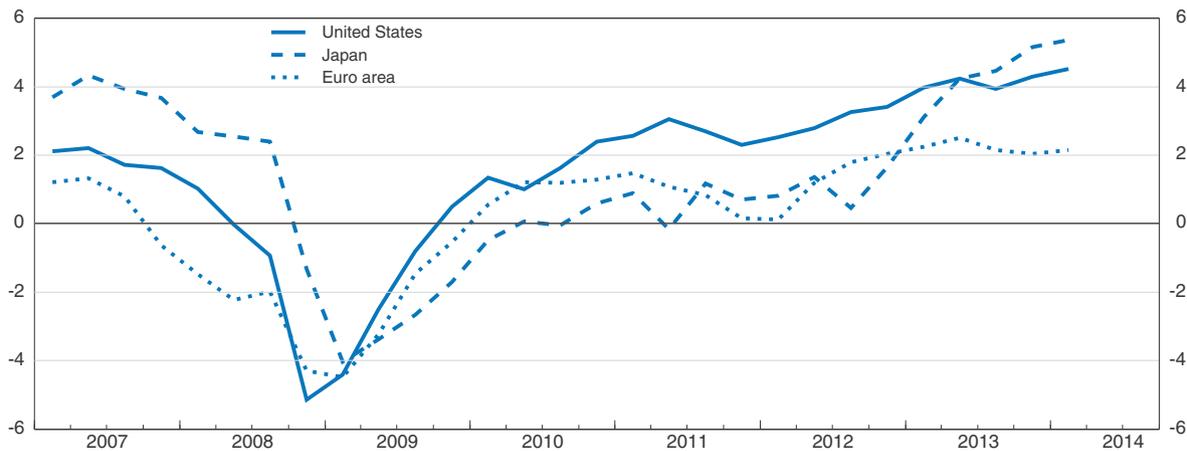
Key developments in the main economies include:

... in the United States...

- In the United States, equity prices have climbed to new record highs and spreads between government and corporate bond yields have recently stabilised close to the pre-crisis levels following declines last year. As the safe-haven effects in January gradually gave way to changing market sentiment driven by the stronger economic outlook and earlier expected interest rate increases, short and medium-term government bond yields have inched up and the dollar effective

3. Evidence from input-output tables and empirical studies suggests that investment and exports are the most import-intensive components of domestic demand (Pain et al., 2005; Bussière et al., 2013).

4. The long-run benefits from the trade facilitation agreement are estimated to be just under \$1 trillion (equivalent to 1.3% of world GDP in 2013) by Hufbauer and Schott (2013).

Figure 1.5. **OECD financial conditions remain accommodative**

Note: A unit increase (decline) in the index implies an easing (tightening) in financial conditions sufficient to produce an average increase (reduction) in the level of GDP of ½ to 1% after four to six quarters. See details in Guichard et al. (2009). Based on available information up to 25 April 2014.

Source: Datastream; OECD Economic Outlook 95 database; and OECD calculations.

StatLink  <http://dx.doi.org/10.1787/888933048888>

exchange rate has appreciated from its late-2013 levels. Bank lending standards were on balance eased and demand for bank credit was reported to have increased in the last quarter of 2013.

... Japan...

- In Japan, in the context of continued quantitative and qualitative easing, government bond yields have declined in real terms given the recent pick-up in inflation. The yen effective exchange rate has also remained weaker than in the first half of 2013. Following the correction in stock prices in early 2014, due to the temporary yen appreciation and spillovers from Asian EMEs, stock prices reverted close to their November levels. At the turn of 2014, bank credit standards eased again and demand for loans from firms increased, supporting moderate credit growth.

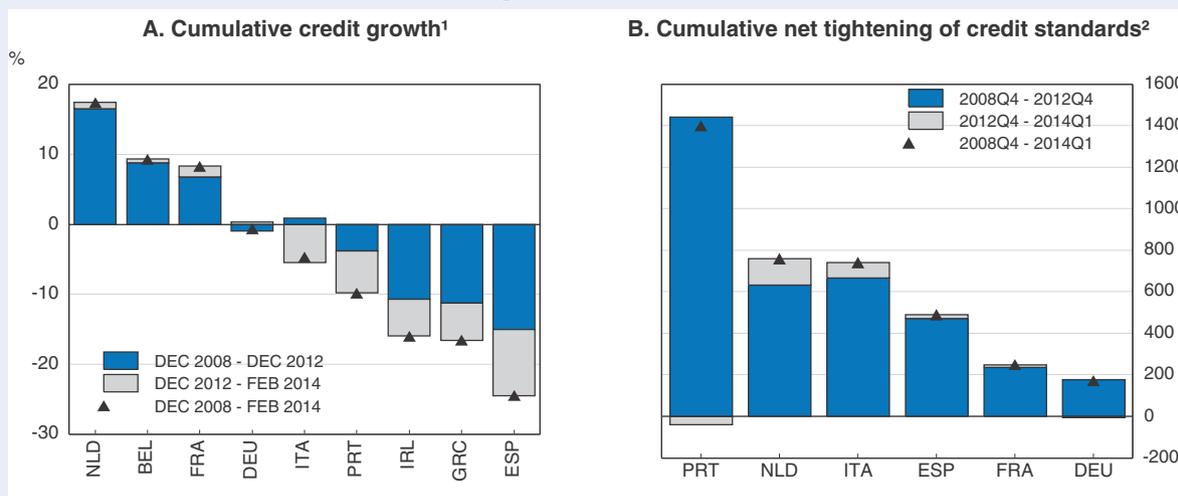
... and vulnerable euro area countries but less so in the euro area as a whole

- In the euro area, government bond yields and CDS spreads have dropped significantly in the vulnerable economies, amid receding uncertainty, strengthening macroeconomic momentum and progress with rebalancing and reforms. Consequently, governments and banks have been able to access capital markets on improved terms and 10-year government bond spreads over German bonds fell to a level not seen since early 2010. Moreover, Target 2 balances have continued to diminish and bank lending rates for non-financial corporations have dropped marginally in Greece and Portugal but not in other vulnerable countries (Box 1.4). The strengthening of the euro nominal effective exchange rate compared with the previous quarter and somewhat higher interbank overnight interest rates weighed negatively on overall euro area financial conditions. Interbank interest rates have edged up

Box 1.4. Financial fragmentation in the euro area

Since the onset of the euro crisis, the financing of the private and public sectors has become significantly costlier and more difficult to obtain in the vulnerable euro area countries than in the core countries. In particular, bank lending rates in the vulnerable countries have increased almost continuously in comparison with Germany and credit conditions have been tightened by more in the vulnerable countries than in the core countries (see first figure below). This, together with adverse demand effects, resulted in larger declines in credit in the vulnerable countries.¹ While over the past two years financial fragmentation, as measured by spreads in government bond yields, has receded, credit conditions for non-financial corporations have not yet materially converged.

Credit growth and standards



1. Approximate growth rates of loans to non-financial corporations from domestic MFIs excluding the ESCB derived from linking annual growth rates not adjusted for sales and securitisation (before 2010) and annual growth rates adjusted for sales and securitisation. Using the unadjusted series for the entire period would in most countries show weaker credit growth.
2. Sum of net percentage of banks tightening credit standards for loans to enterprises for the last three months based on quarterly bank lending surveys. Given the qualitative nature of the survey, this indicator may not indicate accurately the actual degree of tightening.

Source: European Central Bank; and OECD calculations.

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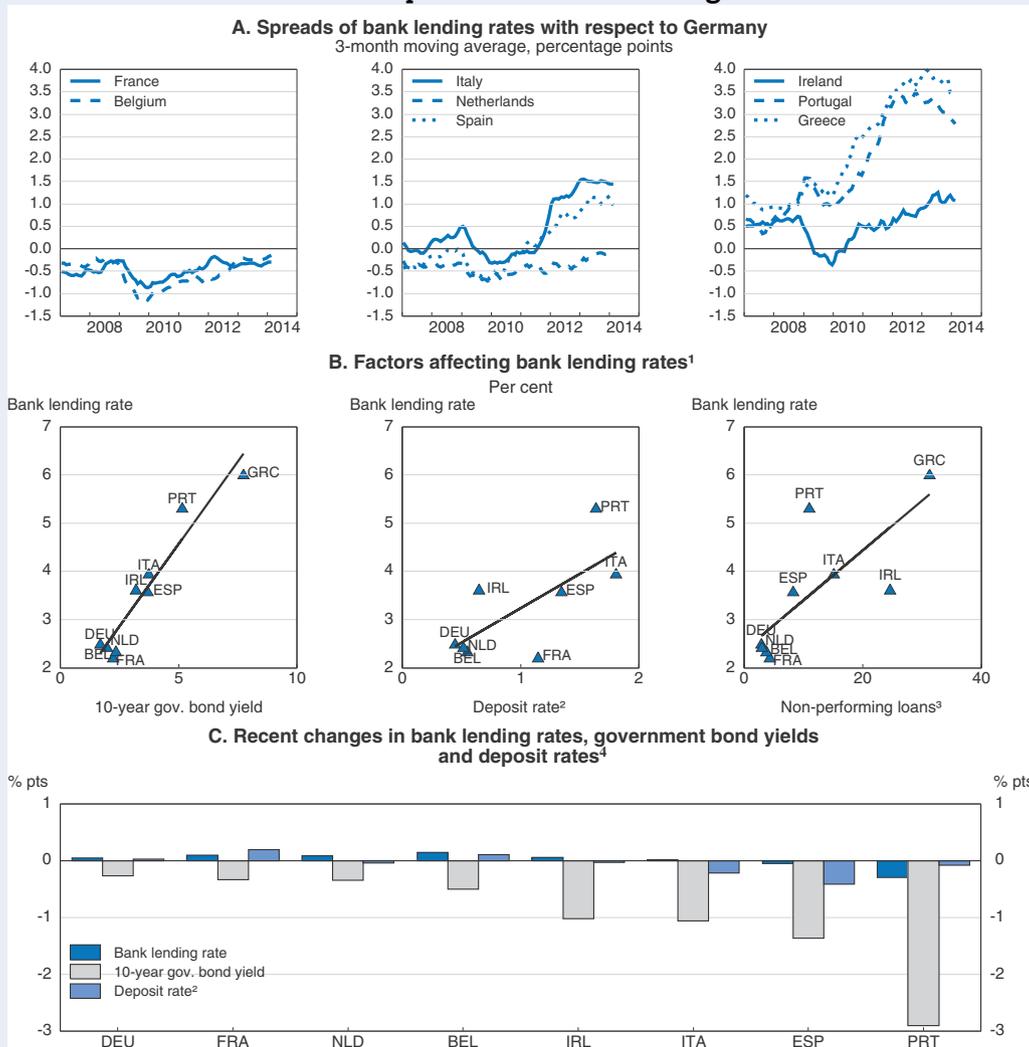
Tighter credit conditions, especially in terms of bank lending rates, for non-financial corporations in the vulnerable countries reflect three interlinked factors, whose effects have likely varied over time and are difficult to quantify empirically:²

- **Credit risks of borrowers:** With a deeper and more prolonged recession in the vulnerable countries, given the need to unwind pre-crisis excesses, defaults have increased and lending to corporations has become riskier. Indeed, empirical evidence suggests that diverging perceptions of credit risk across euro area countries can explain the differing cost of borrowing (ECB, 2013a). This is consistent with the observation that bank lending rates are generally higher in countries with higher ratios of non-performing loans (NPLs) to total loans (see figure below; Illes and Lombardi, 2013).
- **Funding costs:** Banks in the vulnerable countries generally offer higher bank deposit rates (see figure below), and face higher bond spreads at issuance and wider senior financial CDS spreads than banks in the core countries. This partly relates to greater sovereign risks, especially with the intensification of sovereign debt tensions in 2010 and the ensuing massive increase in government bond yields, given interconnectedness between banks and sovereigns and some arbitrage between returns on deposits and government bonds. The role of funding costs is supported by estimates from empirical models of bank lending rates (Al-Eyd and Berkmen, 2013).

Box 1.4. Financial fragmentation in the euro area (cont.)

- **Mark-ups:** Banks in vulnerable countries could also have increased mark-ups in an attempt to raise capital to meet regulatory requirements (Cohen and Scatigna, 2014) and improve access to market funding, especially as provisions and write-offs for NPLs have been eroding bank retained earnings. Bank lending rates tend to be negatively related to leverage ratios according to empirical studies (Al-Eyd and Berkmen, 2013). Rising mark-ups could also have been facilitated by increased market power following the restructuring of the banking sector in the vulnerable countries.³

Developments in bank lending



Note: The bank lending rate is the total cost of borrowing rate for new loans to non-financial corporations (all maturities), defined as a weighted average of bank lending rates on loans with a rate fixation period of up to one year and rates on overdrafts, using outstanding amounts as a weighting scheme.

1. Average for the three months to February 2014.
2. The deposit rate is the deposit rate of agreed maturities to non-financial corporations and households. For Belgium, the deposit rate is a weighted average of the deposit rates with agreed maturities to non-financial corporations and household weighted by volumes. Data for Greece are not available.
3. Non-performing loans are expressed as a ratio to total loans as of the latest date available, from 2012Q4.
4. Changes between August 2013 and April 2014 for 10-year government bond yields, and between August 2013 and February 2014 for other variables.

Source: European Central Bank; IMF Financial Soundness Indicators; and OECD calculations.

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Box 1.4. Financial fragmentation in the euro area (cont.)

According to the ECB bank lending survey, the effects of the costs of funds and balance sheet constraints have substantially eased recently. Risk perceptions are now the main factor contributing to tighter credit conditions for non financial companies in the periphery (ECB, 2013a; ECB, 2014b).

Looking ahead, credit conditions for non-financial corporations are likely to converge gradually across the euro area but to remain more differentiated than prior to the crisis. In particular, the recent large fall in government bond yields and CDS spreads should gradually feed through to bank funding costs and in turn bank lending rates in the vulnerable countries (figure below). Similarly, with the projected return to growth in the periphery, even if modest, credit risks and thus bank lending rates should ultimately decline. Cleaning up bank balance sheets and recapitalisation in the context of the forthcoming asset quality review and bank stress tests could also reduce funding costs. Nevertheless, financial fragmentation is not likely to be eliminated fully as differences in economic growth and credit risk perceptions across the euro area countries are likely to persist.

1. Deleveraging in the private sector, high unemployment and weak economic prospects have likely weakened demand for credit.
2. Empirical evidence is mostly available for the cost of credit and comes from bank lending pass-through models based on an error-correction framework where the change in the bank lending rate is regressed on its own lags; on simultaneous and lagged changes of market rates and other proxies of the credit channel (such as measures of the bank funding costs, leverage, credit risk, economic uncertainty, and PMIs); and the adjustment to the estimated long-term relationship.
3. Bank market power is found to affect negatively credit conditions for SMEs in Europe, including the cost of credit (Ryan et al., 2014). Since the onset of the crisis, market concentration has increased and the number of credit institutions has declined particularly in the vulnerable countries (ECB, 2013c).

from historical lows and have been more volatile amid shrinking liquidity, with LTROs loans continuing to be repaid. In the first quarter of 2014, bank credit standards were eased marginally although credit demand remained weak, but less so than in previous quarters. Credit continued to decline but non-financial corporations increased bond issuance and non-bank borrowing.

Household spending and balance sheets**Household demand is being boosted by stronger balance sheets and higher employment**

Consumption growth has been solid in the United States and Japan, and is slowly recovering in the euro area. On-going improvements to household balance sheets due to strong asset price growth and improving labour market outcomes continue to support household demand in the United States and, to a lesser extent, Japan, with additional balance sheet adjustment taking place whilst saving ratios remain close to their current levels.⁵ On a quarterly basis, spending growth and the saving rate are, however, likely to be volatile in Japan during 2014 and 2015, reflecting expenditure-shifting ahead of the increase in the consumption tax rate in April and the further rise planned next year. In the euro area in aggregate, household demand is starting to recover but remains fragile, reflecting weak income growth, high unemployment, continued declines in property values and the need for debt deleveraging.

5. In the United States, the recent growth of household consumption has also been boosted by stronger expenditure on medical services following the Affordable Care Act.

Housing markets are improving on average in the OECD with large country differences

Housing market developments

House prices and housing investment are now rising in over half of the OECD economies (Table 1.2). In Europe, strong house price growth is continuing in Germany (based on data from the big cities) and Switzerland, and has also resumed in the United Kingdom, even though

Table 1.2. **Housing market developments continue to diverge**

	Per cent annual rate of change				Level relative to long-term average ¹		Latest available quarter
	2004-2011	2012	2013 ²	Latest quarter ³	Price-to-rent ratio	Price-to-income ratio	
Australia	2.4	-3.3	3.8	6.6	145	128	Q4 2013
Austria	2.0	9.5	2.4	2.7	..	..	Q1 2014
Belgium	4.2	0.1	0.6	0.7	158	147	Q4 2013
Canada	5.2	3.4	1.5	3.2	166	131	Q1 2014
Czech Republic		-4.0	-1.2	-0.9	..	..	Q4 2013
Denmark	1.2	-5.9	1.5	1.5	112	108	Q4 2013
Estonia		3.5	7.0	12.3	..	..	Q4 2013
Finland	2.3	-1.3	-0.1	-2.3	133	99	Q1 2014
France	3.6	-2.3	-2.8	-2.2	129	128	Q4 2013
Germany	-0.2	4.6	4.6	5.1	91	83	Q4 2013
Greece	-0.3	-12.6	-9.2	-7.0	84	103	Q4 2013
Hungary		-9.3	-4.9	-1.9	..	..	Q4 2013
Iceland		1.3	2.1	6.5	..	..	Q1 2014
Ireland	-3.7	-13.2	-0.3	4.3	96	92	Q4 2013
Israel	4.0	0.9	6.8	5.8	110	..	Q4 2013
Italy	0.3	-5.4	-6.9	-5.5	93	108	Q4 2013
Japan	-2.1	-1.9	-1.3	-1.9	62	63	Q3 2013
Korea	1.2	0.6	-1.4	0.1	103	60	Q1 2014
Luxembourg		2.5	3.6	3.6	..	..	Q4 2013
Netherlands	-0.5	-8.5	-8.6	-1.4	104	117	Q1 2014
New Zealand	2.1	4.2	8.5	8.2	170	132	Q4 2013
Norway	5.2	5.5	1.1	-2.6	164	122	Q1 2014
Portugal	-0.2	-3.6	-3.8	-1.5	83	94	Q1 2014
Slovak Republic		-4.4	-2.2	-3.4	..	..	Q4 2013
Slovenia		-8.4	-5.2	-2.7	..	..	Q4 2013
Spain	-0.9	-11.1	-7.6	-4.9	104	107	Q4 2013
Sweden	4.6	-2.6	2.5	3.3	134	122	Q1 2014
Switzerland	2.2	4.8	5.3	2.8	101	95	Q1 2014
Turkey		3.2	5.9	6.7	..	..	Q4 2013
United Kingdom	-0.2	-0.2	1.3	3.5	134	125	Q4 2013
United States	-2.8	1.5	6.5	6.6	104	90	Q4 2013
Euro area ⁴	0.8	-2.5	-2.2	-0.9	106	107	Q4 2013
Total OECD ⁴	-0.6	-0.2	2.1	2.8	106	95	Q4 2013

Note: House prices deflated by the private consumption deflator.

1. Average from 1980 (or earliest available date) to latest available quarter = 100.

2. Average of available quarters where full year is not yet complete.

3. Increase over a year earlier to the latest available quarter.

4. Using 2010 GDP weights, calculated using latest country data available.

Source: Girouard *et al.* (2006); and OECD.

UK prices are already above longer-term norms relative to rents and incomes. Markets remain softer in other parts of the euro area, reflecting weak income growth and tighter financing conditions. Recent data however suggest that the long declines in real house prices in Ireland and the Netherlands may now have started to bottom out. In the United States, housing developments are mixed. Prices continue to rise, but new home sales, starts and builders' confidence have turned down, in part due to adverse weather conditions in the first quarter of 2014, but also because of a moderation in mortgage purchase applications since long-term mortgage rates rose last summer. Existing home sales have also declined, although much of this appears to reflect a welcome drop in the level of distressed sales. Looking ahead, given the likelihood of continued solid income growth, further easing of credit standards and pent-up demand after a period of subdued household formation rates, the housing market recovery should continue through this year and next. In Japan, real house prices are continuing to edge down, but land prices have now begun to stabilise and housing investment has been very buoyant, although this has now faded given the temporary boost provided by the demand for sales contracts to be finalised ahead of the consumption tax increase in April.

Economic prospects

Growth prospects and risks

Economic prospects are for a continued moderate recovery in...

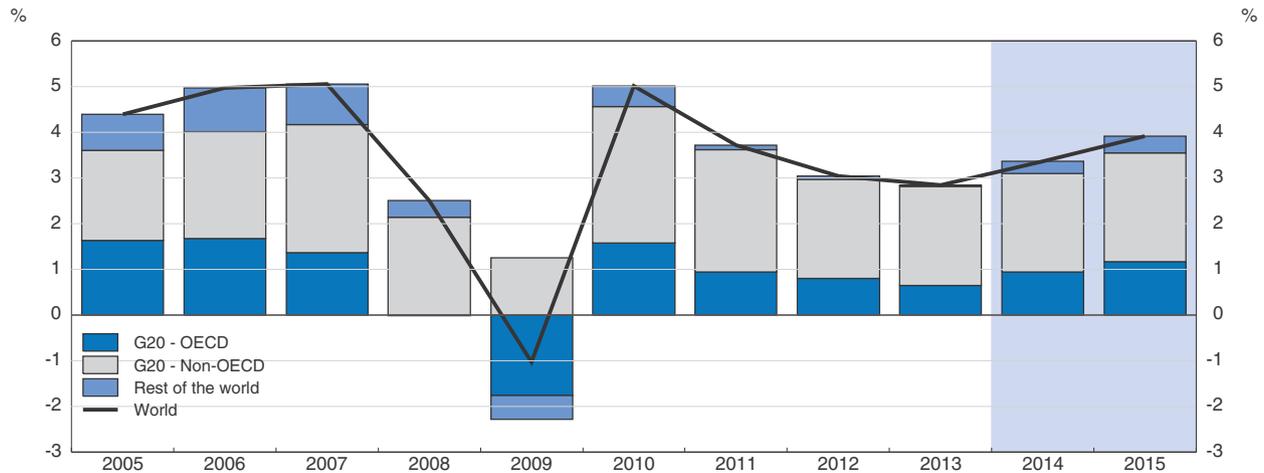
The near-term outlook is for global activity and world trade to strengthen gradually through the rest of this year and 2015 (Figure 1.6). In the OECD economies, the drag from fiscal consolidation is set to fade considerably (outside of Japan), financial conditions remain favourable and accommodative monetary policies continue to provide support (Box 1.5). However, still-high unemployment in many countries and the subdued pace of growth in many EMEs relative to past norms are likely to limit the momentum of the recovery, thereby checking the associated rebound in business investment and slowing the extent to which current disinflationary pressures ease.

The key features of the economic outlook for the major OECD economies are as follows:

... the United States...

- In the United States, the momentum of the recovery slowed in the first quarter, in part reflecting severe weather-related disruptions that should be reversed in the second quarter and a slowdown in inventory accumulation. However, the recovery should gain pace steadily, with private demand benefitting from favourable financial conditions, strengthened household and corporate balance sheets, accommodative monetary policy and the easing drag from fiscal consolidation. Reduced uncertainty and normal cyclical forces should also boost business investment. Export prospects should improve, but this will be more

Figure 1.6. **Global growth is picking up, led by the OECD economies**
Contribution to world real GDP growth



Source: OECD Economic Outlook 95 database.

StatLink  <http://dx.doi.org/10.1787/888933048907>

Box 1.5. Policy and other assumptions underlying the projections

Fiscal policy settings for 2014 and 2015 are based as closely as possible on legislated tax and spending provisions. Where government plans 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 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.

In the United States, the general government underlying primary balance is assumed to improve by around $\frac{2}{3}$ per cent of GDP in both 2014 and 2015, roughly as implied by current legislation, including the Bipartisan Budget Act.

In Japan, the projections incorporate the consumption tax increases from 5% to 8% in 2014 and to 10% in 2015. They also incorporate the fiscal stimulus package (about 1.1% of GDP) that will accompany the consumption tax increases. Overall, the underlying primary balance is assumed to improve by $\frac{3}{4}$ per cent of GDP in 2014 and by close to $1\frac{3}{4}$ per cent of GDP in 2015.

In euro area countries, fiscal consolidation in 2014 and 2015 is assumed to proceed so as to attain the amount of structural consolidation (measured as the change in the structural primary balance) that is implied by draft budget laws or, if these are not available, the stated targets in consolidation plans under the Excessive Deficit Procedure and Stability Programmes.

In the large euro area countries, fiscal policy is assumed to evolve as follows. For Germany, the budgetary plans of the new federal government, as contained in the coalition agreement, have been built into the projections. For France, the projections incorporate a cumulative reduction in the structural deficit of $1\frac{1}{2}$ per cent of GDP in 2014 and 2015, with consolidation shifting toward greater efforts on the spending side, as foreseen in its Stability Programme. For Italy, the projections incorporate about $\frac{1}{2}$ per cent of GDP in structural fiscal contraction over two years, also as foreseen in its Stability Programme.

For the United Kingdom, the projections are based on tax measures and spending paths set out in the March 2014 budget.

Box 1.5. Policy and other assumptions underlying the projections (cont.)

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 upper bound of the target Federal Funds rate is assumed to be raised gradually between March and December 2015 from the current level of 0.25% to 1.5%.
- In the euro area, the main refinancing rate is assumed to be cut to 0% in May 2014 and then kept at this level throughout the projection period.
- In Japan, the uncollateralised overnight call rate is assumed to remain at 0.1% for the entire projection period.
- In the United Kingdom, the Bank rate is assumed to be increased gradually between May and December 2015 from the current level of 0.5% to 1.5%.

Although their impact is difficult to assess, the following quantitative easing measures are assumed to be taken over the projection period, implicitly affecting the speed of convergence of long-term interest rates to their reference rates. In the United States, asset purchases are assumed to cease towards end-2014 and the stocks maintained until the end of the projection period. In Japan, asset purchases are assumed to increase in line with the stated plans of the monetary authorities. In the euro area, no additional purchases are built into the projections, and no new Long-Term Refinancing Operations are assumed. In the United Kingdom, the stocks of assets purchased are assumed to remain unchanged from current levels until the end of the projection period.

In the United States, Japan, Germany and countries outside the euro area, 10-year government bond yields are assumed to converge slowly toward a reference rate (reached only well after the end of the projection period), determined by future projected short-term interest rates, a term premium and an additional fiscal premium. The latter premium is assumed to be 2 basis points per each percentage point of the gross government debt-to-GDP ratio in excess of 75% and an additional 2 basis points (4 basis points in total) per each percentage point of the debt ratio in excess of 125%. In Japan, the premium is assumed to be 1 basis point per each percentage point of the gross government debt-to-GDP ratio in excess of 75%. The long-term sovereign debt spreads in the euro area vis-à-vis Germany are assumed to decline by one-third from their recent levels by end-2015.

The projections assume unchanged exchange rates from those prevailing on 14 April 2014: one US dollar equals 101.60 JPY, EUR 0.72 (or equivalently one euro equals 1.38 dollars) and 6.22 renminbi.

The price of a barrel of Brent crude oil is assumed to increase at a rate of \$5 per year from the third quarter of 2014 onwards, from an assumed price of \$110 in the second quarter of 2014. Non-oil commodity prices are assumed to be constant over the projection period at their average levels of March 2014.

The cut-off date for information used in the projections is 30 April 2014. Details of assumptions for individual countries are provided in Chapters 2 and 3.

than offset by growing imports. Solid employment growth is projected to continue, with the unemployment rate declining to just below 6% by end-2015 and the negative output gap fading steadily. An upside risk is that pent-up demand for durable and capital goods and a pick-up in household formation rates could help output growth to strengthen even faster than projected.

... and the euro area... ● In the euro area, growth has picked up a little faster than anticipated and confidence has continued to improve. Nonetheless, the recovery is set to gain momentum only slowly. Supportive area-wide financial conditions, further monetary accommodation and improving external demand should all help to boost activity. The drag from fiscal consolidation is also set to ease modestly this year and in 2015. However, ongoing, though receding, financial fragmentation, still-weak balance sheets and weak labour markets will check growth prospects in many economies. Improving export prospects and a gradual upturn in private investment are expected to help the recovery strengthen, but private consumption is projected to remain subdued throughout this year and next. The large negative output gap is set to close only slowly, with the area-wide unemployment rate remaining above 11¼ per cent until the latter half of 2015. GDP growth in Germany, Austria and a number of smaller economies, including Ireland, is projected to be a ½ percentage point or more above that for the area as a whole.

... but growth is set to ease in Japan ● In Japan, domestic demand growth accelerated ahead of the April consumption tax increase, with some consumption and housing expenditure being brought forward, but is now projected to moderate, with fiscal consolidation weighing on growth. Nonetheless, accommodative monetary policy, the feed-through of improved financial conditions and improved private sector confidence should all provide support to growth and help business investment to gain greater strength. Net exports have been a significant drag on activity, with imports surging and exports stagnating despite the large depreciation of the yen effective exchange rate, but are projected to become supportive as external demand strengthens.

The outlook varies in the large non-OECD EMEs...

The growth outlook differs across the large non-OECD EMEs:

... with growth slowing in China... ● In China, growth has eased, with tighter credit conditions taking effect, and is set to remain moderate by past norms, at between 7¼-7½ per cent this year and next. The small fiscal stimulus package will help support growth in the near-term, via stronger investment in railways and a boost to spending on affordable housing projects, and stronger external demand should raise export growth. Scope also exists for monetary policy easing should downside financial risks materialise. Structural reforms, including the opening-up of service sectors to private capital and plans to enhance urban development, should also help to support activity, although the full benefits could take a while to materialise.

... and Russia... ● In Russia, growth is set to slow further in 2014, to around ½ per cent, with heightened uncertainty (reflected in declining confidence and greater financial market volatility), tighter monetary policy, high inflation and regulatory measures to slow credit growth all damping

domestic demand. If uncertainty and inflationary pressures start to fade and financial conditions ease, and higher oil revenues are used to strengthen government spending, at least temporarily, growth could turn up to around 1¼ per cent in 2015.

... but growth is set to strengthen in India...

- In India, growth is likely to gain momentum gradually, with GDP projected to rise by around 5% this year and around 6% next year. Net exports could continue to boost growth this year, reflecting the competitiveness improvements from past currency depreciation and restrictions on gold imports. These effects should fade as domestic demand strengthens. The gradual easing of inflationary pressures should help private consumption pick up. The feed-through of recently-approved infrastructure projects and a post-election decline in policy uncertainty should boost investment growth, particularly in 2015.

... and to a lesser extent in Brazil

- In Brazil, growth momentum has slowed, reflecting tighter monetary policy, moderating credit growth and increased policy uncertainty. Growth is projected to drift down to just under 2% this year, before rising by close to 2¼ per cent in 2015. Strengthening external demand and the boost from a lower real exchange rate should allow export growth to rise, particularly this year, but domestic demand is projected to pick up only as inflationary pressures ease.

Risks have diminished but remain negative on balance

The balance of risks to economic growth in the advanced OECD remains somewhat to the downside, although risks have declined with the firming of economic recovery, generally favourable financial market developments and progress with structural and financial reforms. One new source of concern is that disinflationary pressures in some OECD economies, especially in the euro area, could persist or intensify further in the event of a negative demand shock, further currency appreciation or a downward drift in inflation expectations. In addition, downside risks persist from: the interaction of financial vulnerabilities in several EMEs; the planned and necessary exit from highly accommodative monetary policy in the United States and uncertain prospects in China. Geopolitical uncertainty has also been increased as a result of the events in Ukraine, with the downside risk that this could have a significant adverse impact on growth, especially in many Central and Eastern European economies. Other long-standing risks remain, with possible adverse developments stemming from fragilities in the euro area and fiscal challenges in Japan. On the upside, the recovery could prove to be more robust than expected, particularly if: pent-up demand helps to boost future growth in the United States; the Asset Quality Review helps to improve confidence in euro area banks; and cash-rich corporations boost investment by more than projected as the recovery deepens.

Labour market developments

Labour market slack is being reduced gradually in...

Labour market slack is being reduced only slowly in the OECD as a whole, with diverging developments across countries (Table 1.3, Figures 1.7 and 1.8). Although the OECD unemployment rate has declined by around ½ percentage point in the past year, it remains more than 1½ percentage points higher than at the start of the crisis, with negative effects on household incomes and the momentum of the recovery. Key developments across economies include:

... the United States...

- In the United States, employment growth has remained steady. The unemployment rate has continued to decline, by around 1¼ percentage point over the past year, in part reflecting the expiry of the extended unemployment benefits programme in January. Long-term unemployment (over 1 year) remains high, but short-term unemployment (under six months) is almost back to pre-crisis rates. Although the rate remains very low, the decline in labour force participation has recently eased, with some previously-discouraged workers returning to the labour force. OECD estimates suggest that the present cyclical shortfall in the participation rate (for those aged 15 and over) may be only around 1 percentage point, with this set to be eliminated over the next 18 months given the economic growth outlook and demographic trends. With steady job growth projected to persist, the unemployment rate could decline further to below 6% by the end of next year. Wage pressures could continue to pick up relatively quickly,

Table 1.3. **OECD labour market conditions are likely to improve slowly**

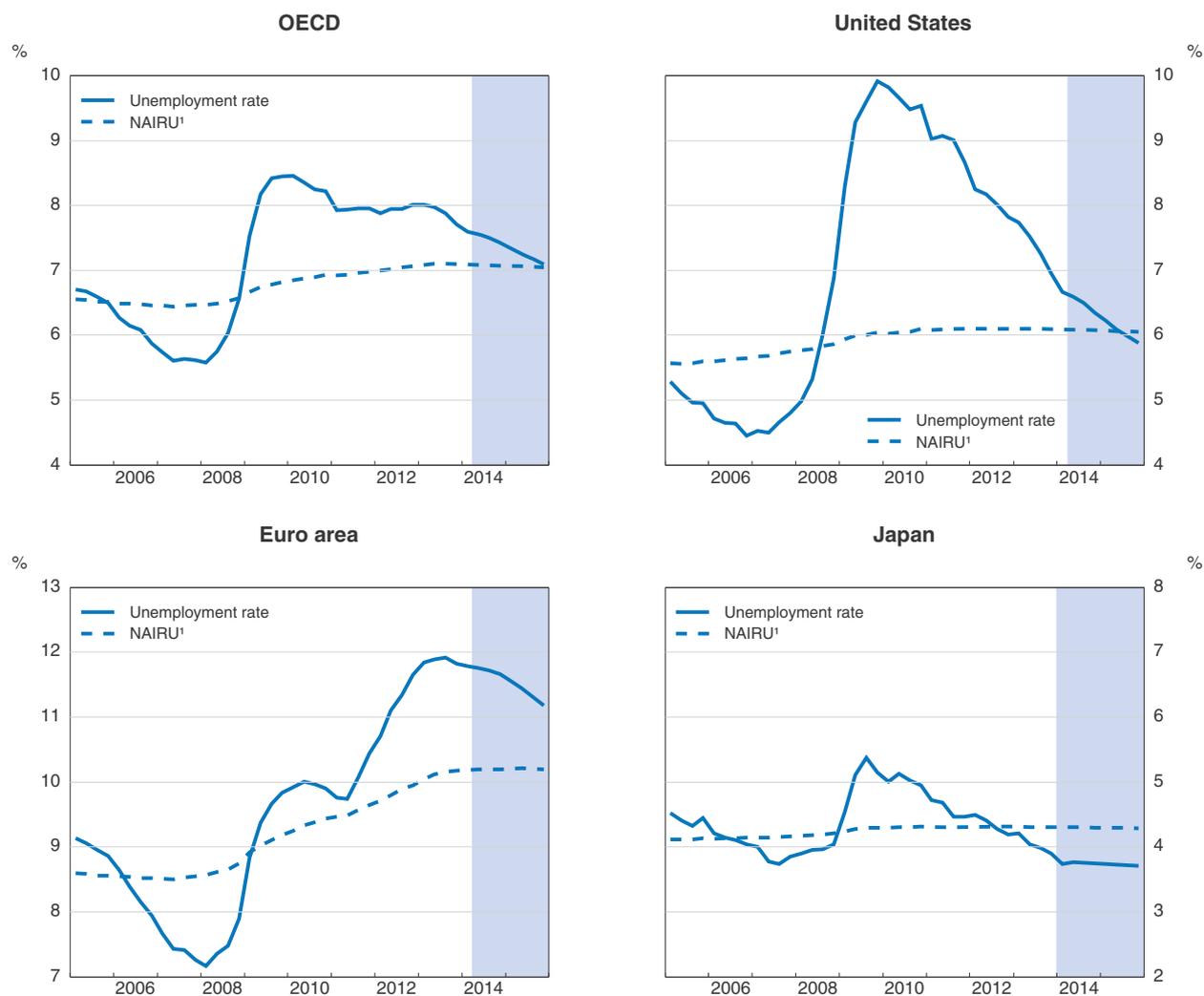
	2010	2011	2012	2013	2014	2015
Percentage change from previous period						
Employment						
United States	-0.6	0.6	1.8	1.0	1.6	1.6
Euro area	-0.4	0.3	-0.7	-0.7	0.2	0.6
Japan	-0.3	-0.1	-0.3	0.7	0.1	-0.1
OECD	0.3	1.0	1.0	0.7	1.1	1.2
Labour force						
United States	-0.2	-0.2	0.9	0.3	0.7	1.1
Euro area	0.2	0.4	0.6	0.0	0.0	0.2
Japan	-0.3	-0.6	-0.6	0.3	-0.2	-0.2
OECD	0.5	0.6	1.0	0.6	0.7	0.9
Unemployment rate						
Per cent of labour force						
United States	9.6	8.9	8.1	7.4	6.5	6.0
Euro area	10.0	10.0	11.2	11.9	11.7	11.4
Japan	5.0	4.6	4.3	4.0	3.8	3.7
OECD	8.3	7.9	7.9	7.9	7.5	7.2

Source: OECD Economic Outlook 95 database.

StatLink  <http://dx.doi.org/10.1787/888933050332>

Figure 1.7. **Labour market slack is diminishing slowly**

Percentage of labour force

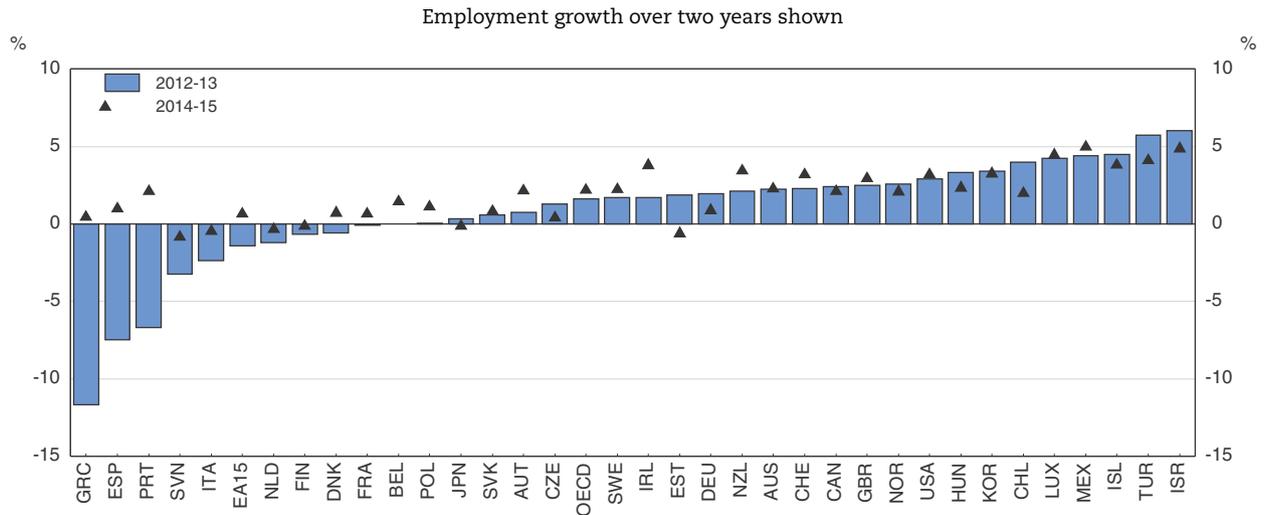


1. The NAIURU is based on OECD estimates.
Source: OECD Economic Outlook 95 database.

StatLink  <http://dx.doi.org/10.1787/888933048926>

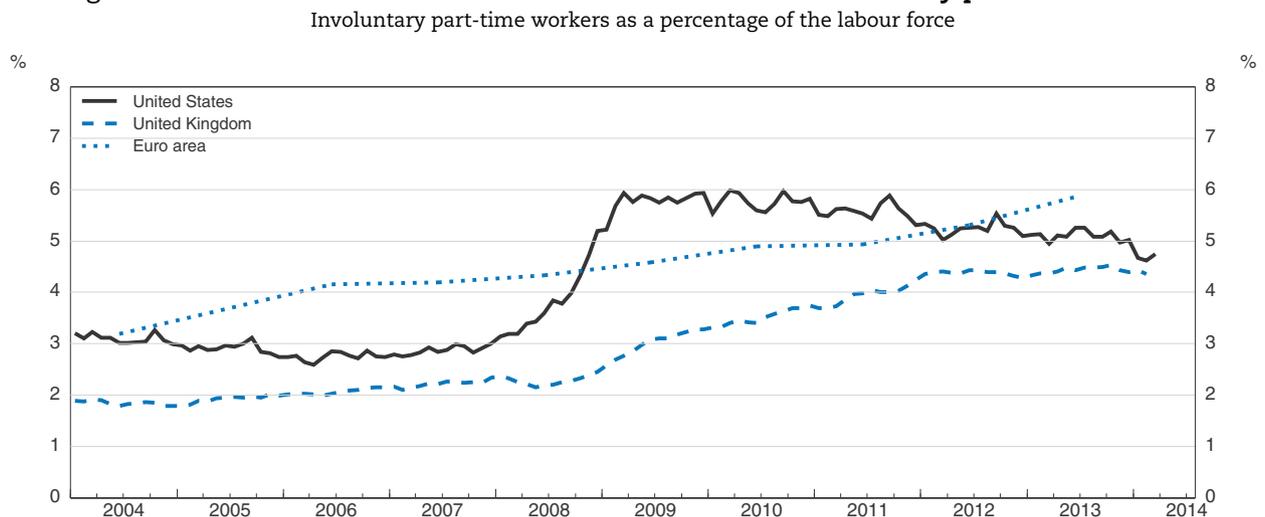
as some empirical work suggests that short-term unemployment has a stronger influence on wage setting than long-term unemployment (Krueger et al., 2014), possibly reflecting insider-outsider effects. However, sizeable additional economic slack also remains from involuntary part-time employment, with the share of these workers in the labour force currently around 2 percentage points higher than in the pre-crisis years (Figure 1.9).⁶ This is reflected in the projection, with

6. This includes workers who are unable to find a full-time job and those who are unable to work more hours due to slack work or business conditions. The latter category has declined by around ½ million persons over the past year.

Figure 1.8. **Employment is projected to grow in almost all OECD countries**

Source: OECD Economic Outlook 95 database.

StatLink <http://dx.doi.org/10.1787/888933048945>

Figure 1.9. **Considerable economic slack remains due to involuntary part-time workers**

Note: US and UK data are for those aged 16 years and over; euro area data are for those aged 15-74 years. The US data are those working part-time for economic reasons, including those who could not find a full-time job and full-time workers working reduced hours. The UK and euro area data are part-time workers who could not find a full time job.

Source: Bureau of Labor Statistics; Eurostat; Office for National Statistics; and OECD calculations.

StatLink <http://dx.doi.org/10.1787/888933048964>

compensation per employee projected to pick up only gradually, to around 3¼ per cent at an annualised rate by the latter half of 2015.

- ... **Japan...**
- In Japan, the unemployment rate has declined by around ¼ percentage point over the past year, the long-term decline in the labour force has been halted and the job-offers-to-applicants ratio continues to rise steadily, reaching its highest level in over six years. Female labour force participation has also risen by a further ½ percentage point, albeit from a low level. Wage growth has so far been driven largely by increases in

bonuses and overtime payments. However, if output growth remains sufficient to keep the unemployment rate below the OECD estimate of the long-term sustainable rate, as projected, regular wage growth should pick up, with total compensation per employee projected to rise by around 1½ per cent this year and 2½ per cent in 2015. Yet-to-be tackled reforms to raise product market competition and to increase trade openness would boost medium-term growth and employment prospects still further.

... and the United Kingdom...

- In the United Kingdom, the unemployment rate has fallen more rapidly than expected, declining by over ½ percentage point during the past year. Job growth has remained strong so far in the recovery, with only limited improvements in labour productivity. However, long-term unemployment (over a year) as a share of the labour force remains higher than prior to the crisis. Given the growth outlook, solid job growth is likely to continue (Figure 1.8), with the unemployment rate projected to decline to around 6½ per cent by the latter half of 2015. With the share of underutilised part-time workers in the UK labour force remaining high (Figure 1.9), wage growth should pick up only moderately, to between 3¼-3½ per cent (annualised rate) in the latter half of 2015.

... but the current slack in the euro area is set to persist for some time

- In the euro area, the unemployment rate has remained unchanged at just below 12% over the past year, with further job losses in Italy, stable employment levels in France and continued job growth in Germany. A resumption of job growth in Ireland and Portugal has also helped unemployment rates in these economies to decline by between 1½ to 2 percentage points over the past year. Long-term (over 1 year) unemployment remains high, at around 30% of total unemployment. With only a gentle recovery likely for the euro area, currently extensive labour market slack should fade only slowly. Area-wide unemployment is projected to decline by just over ½ percentage point over the next 18 months, with the drop largely accounted for by falling unemployment in the vulnerable economies and additional unemployment declines in Germany and Austria.

Labour market reforms remain essential to foster employment growth

Labour market reforms remain essential to foster employment growth and reduce the risk that persistent cyclical unemployment increasingly becomes structural. Efforts to improve labour utilisation by reforming labour market regulations and welfare systems have recently intensified in a number of OECD economies (OECD, 2014), particularly in many euro area countries under stress. Additional reforms are needed to strengthen and redesign active labour market and social policies so as to cushion the near-term effects of high unemployment and improve the matching of workers and jobs, especially in many European countries and the United States, where the expiry of extended unemployment benefits in January 2014 reinforces the need for such measures. Reforms of disability benefit schemes are also required in the United States to

moderate the fall in labour force participation.⁷ In several economies, especially Japan, reforms to improve childcare services and reduce tax and benefit disincentives to second earners would encourage higher female labour force participation. Product market reforms to relax regulatory restrictions in sectors in which there is a strong potential for new job growth could also help improve labour market outcomes, including in Japan, Canada, Germany and France.

Low inflation is set to continue

Inflation is set to drift up slowly...

The currently subdued inflationary pressures in the OECD economies seem likely to persist for some time, with economic slack being removed only slowly. With medium-term measures of inflationary expectations remaining well-anchored, despite some softening in one to two-year ahead measures of expectations, inflation should start to edge up in most economies over the next 18 months, though the projected difference in growth outcomes is likely to be reflected in diverging inflation outcomes.

... in the United States and Japan but remain particularly low in the euro area

Core inflation in the United States seems likely to drift up slowly to approach the inflation target of 2% by the end of 2015, as economic slack is eroded and cost pressures begin to strengthen. In the euro area, core inflation is more likely to remain soft given anticipated growth prospects and subdued labour cost growth, rising only to 1.2% (annualised rate) by the latter half of 2015, remaining well below the ECB definition of price stability. In Japan, the year-on-year rate of core consumer price inflation is now around $\frac{3}{4}$ per cent, helped by strong import price growth, and longer-term inflationary expectations have risen. The increases in the consumption tax rate in 2014 and planned for 2015 will also raise the consumer price level by around 2 percentage points and 1.4 percentage points, respectively. However, abstracting from this, a durable rise in inflation will require regular wage growth to pick up substantially. This has yet to occur, but with a tighter labour market helping wage growth to strengthen over the next 18 months, the annualised quarterly rate of core inflation, abstracting from indirect tax increases, could be close to $1\frac{1}{2}$ per cent by the final quarter of 2015.

Inflation pressures in EMEs should ease if currencies stabilise

Despite sluggish growth, underlying inflationary pressures remain substantial in many large EMEs, including India and Brazil. Sizeable exchange rate depreciations have pushed up import prices markedly and inflation expectations are not fully anchored. These factors should start to ease as monetary policy tightening impacts fully on the economy, provided financial market pressures do not intensify once more. In India,

7. The drop in the US labour force participation rate in recent years has coincided with a significant inflow into disability benefit schemes, with the share of the population of 20-64 year olds receiving disability benefits rising to around $7\frac{1}{4}$ per cent, close to levels in many European economies. This suggests that eligibility requirements may need to be tightened and rehabilitation services strengthened.

consumer price inflation has already fallen sharply, to around 8%, as food price inflation eased to more normal levels after a period of poor weather and an adjustment to administered prices, and is projected to continue easing through the next 18 months, to a little over 6½ per cent in 2015, helped by the small negative output gap. A similar outcome is expected in Brazil, although inflation could still be at or above 5¼ per cent through much of next year. In China, headline inflation has edged up to around 2½ per cent, with food price pressures having started to rise. Non-food consumer price inflation remains modest, at close to 1½ per cent. The estimated positive output gap is now small and likely to remain so given projections for output growth, so that core inflation should edge up only marginally from its current level.

Global imbalances

Current account imbalances are set to widen...

Although global imbalances have declined considerably since 2008, they are projected to drift up in 2014 and 2015 (Table 1.4). Additional growth-friendly structural reforms would help to reduce saving-

Table 1.4. **World trade will strengthen only gradually**

<i>Goods and services trade</i>					
	2011	2012	2013	2014	2015
	Percentage change from previous period				
World trade¹	6.5	3.2	3.0	4.4	6.1
OECD exports	6.2	2.9	1.9	4.1	5.5
OECD imports	5.4	1.3	1.0	3.6	5.5
Trade prices²					
OECD exports	9.1	-3.8	0.4	2.4	1.5
OECD imports	10.7	-2.9	-0.4	2.3	1.5
Non-OECD exports	14.3	-0.1	-1.7	-0.1	2.7
Non-OECD imports	11.1	-0.4	-1.4	-0.9	2.3
Current account balances	Per cent of GDP				
United States	-2.9	-2.7	-2.3	-2.5	-2.9
Japan	2.0	1.1	0.7	0.2	0.7
Euro area	0.8	2.1	2.8	3.1	3.2
OECD	-0.6	-0.5	-0.1	0.0	0.0
China	1.9	2.6	2.0	1.2	1.5
	\$ billion				
OECD	-281	-213	-28	-6	-25
United States	-458	-440	-379	-436	-544
Japan	118	66	34	11	34
Euro area	106	251	362	416	444
Non-OECD	622	561	438	414	458
China	136	215	183	114	161
Major oil producers	580	568	451	446	486
Rest of the world	-94	-222	-195	-146	-188
World	341	349	411	409	433

Note: Regional aggregates include intra-regional trade.

1. Growth rates of the arithmetic average of import volumes and export volumes.

2. Average unit values in dollars.

Source: OECD Economic Outlook 95 database.

StatLink  <http://dx.doi.org/10.1787/888933050351>

investment imbalances in many countries, as would further fiscal consolidation in several external deficit economies.

... in the United States...

- In the United States, the relative strength of domestic demand pushed up the non-oil deficit during 2013, but this was offset by rising exports of services and declining net imports of petroleum products. Looking ahead, further strong growth of domestic demand is expected to result in a renewed widening of the US current account deficit to 3% of GDP by end-2015. There are some upside risks if the composition of expenditure growth shifts even more towards business investment, which is more import intensive than other expenditure categories. Reforms to reduce the generosity of the tax treatment of interest expenses and fiscal consolidation could help to increase saving by reducing reliance on debt finance. This would improve resource allocation and reduce both the fiscal and external deficits.

... the euro area...

- The aggregate current account surplus of the euro area increased further in 2013 to a little over 2¾ per cent of GDP and is projected to rise further to around 3¾ per cent of GDP by 2015. This reflects a combination of the persistent large external surpluses of Germany and the Netherlands, and a marked improvement in the external balances of the vulnerable economies. Significant adjustments have occurred in these latter countries, with domestic demand heavily compressed and economic slack and structural reforms combining to bring about improvements in price and cost competitiveness. Ireland, Spain, Italy, and, more recently, Portugal and Greece all now have a current account surplus and all are projected to have a rising surplus through 2014-15, helped by improvements in external competitiveness. Nonetheless, further progress and reforms are needed to help bring down high net external indebtedness in most of these countries and ensure that relative costs achieve levels that are consistent with external debt stability during normal cyclical conditions. Priorities include keeping already-agreed ambitious medium-term fiscal targets and reforms in both labour and product markets to help strengthen productivity and improve price and non-price competitiveness. Reforms are also needed in the external surplus countries to rebalance and strengthen growth, prevent the area-wide adjustment process from being too one-sided, and limit the risks of intensifying disinflationary pressures and further increases in the area-wide external surplus. In particular, a key priority is to further improve domestic investment prospects by undertaking product market reforms to open sheltered sectors such as professional services and network industries. In addition to reforms in specific economies, additional area-wide initiatives to strengthen competition (such as steps at the EU level to deepen the Single Market) and improve credit availability for firms by strengthening the banking system would foster investment and help to lower the area-wide external surplus.

- ... and, to a lesser extent, Japan...**
- In Japan, the current account remained in surplus in 2013 as a whole, although it moved into deficit in the fourth quarter. The depreciation of the yen effective rate helped to boost the investment income balance, but had little impact on the trade balance, which has slipped further into deficit. Imports have surged, reflecting both stronger domestic demand growth and also the high level of energy imports. In addition, the expected boost to export performance from the yen depreciation has not materialised, with exporters preferring to hold prices fixed in foreign currency terms, thereby boosting their profitability. With export growth projected to pick up and fiscal consolidation expected to damp domestic demand growth from the second quarter of 2014, the trade balance is expected to improve over the next 18 months, allowing the overall external surplus to eventually stabilise at about ¾ of GDP.
- ... but narrow in China...**
- In China, the overall current account surplus in 2013 declined to around 2% of GDP. With domestic demand growth likely to remain strong relative to demand growth in major trading partners through 2014-15, further modest declines in the external surplus are projected, to around 1½ per cent of GDP in 2015, provided that the effective exchange rate does not depreciate significantly. Structural reforms that could further reduce the external surplus by limiting the need for domestic saving include the development of the financial sector and social safety nets. Further progress in these areas is likely as a result of the decisions taken at the Third Plenum.
- ... and in EMEs with high external deficits**
- Amongst the major EMEs with high external deficits, some improvement has already taken place, reflecting a combination of recent sizeable currency depreciations and tighter domestic monetary and macro-prudential policies. The turnaround in the trade balance has been particularly rapid in India and Indonesia, in part through one-off measures that may not persist, with smaller adjustments having occurred in South Africa and Brazil. In all of these economies, the external deficit by 2015 is projected to be at least ¾ per cent of GDP or more below that in 2013. Little improvement has so far occurred in Turkey, with the external deficit increasing to 8% of GDP in 2013. With recent policy tightening helping to slow domestic demand growth and improved export performance, the deficit is expect to decline to 6½ per cent of GDP this year, before drifting up to 7% in 2015, with the required level of external financing leaving the country vulnerable to shifts in global risk sentiment. In all these countries policy priorities include the need to implement fiscal consolidation where budget deficits are high (as in India), and enact structural reforms to remove supply-side constraints, strengthen domestic growth prospects and improve the incentives for long-term capital inflows, thereby reducing dependence on more volatile short-term capital flows.

Monetary policies need to remain supportive in the OECD though to a different extent

Economic policy requirements in the major economies

A nascent recovery and still large estimated slack call for accommodative macroeconomic policy, but with increasingly differentiated policy stances in the main OECD areas. Government debt remains high in many countries and is merely expected to stabilise in the OECD over next 18 months (Table 1.5), limiting the extent to which fiscal policy can be used to support the economy. In the context of still large estimated output gaps, high unemployment and below-target inflation, this implies that accommodative monetary policy should be maintained. However, with the recovery more advanced in the United States and the United Kingdom, monetary stimulus should be reduced gradually, in contrast to Japan, where additional easing is already planned, and the euro area, where additional accommodation is needed. In China, monetary policy will have to be eased if growth were to slow sharply. Prudential measures should also be used in a timely manner to gradually slow rapid credit expansion and harder budget constraints should be imposed on local governments. In several other EMEs, monetary policy may still have to be tightened and fiscal positions improved.

Table 1.5. **Fiscal positions will continue to improve**

Per cent of GDP / Potential GDP

	2011	2012	2013	2014	2015
United States					
Actual balance	-10.7	-9.3	-6.4	-5.8	-4.6
Underlying balance	-8.7	-7.8	-5.2	-4.9	-4.1
Underlying primary balance	-5.7	-4.8	-3.0	-2.4	-1.7
Gross financial liabilities	98.8	102.1	104.3	106.2	106.5
Euro area					
Actual balance	-4.1	-3.7	-3.0	-2.5	-1.8
Underlying balance	-3.6	-2.3	-1.5	-1.0	-0.6
Underlying primary balance	-1.0	0.3	0.9	1.4	1.8
Gross financial liabilities	95.9	104.4	106.7	107.7	106.9
Japan					
Actual balance	-8.8	-8.7	-9.3	-8.4	-6.7
Underlying balance	-8.0	-8.1	-8.8	-8.2	-6.8
Underlying primary balance	-7.2	-7.2	-7.9	-7.1	-5.4
Gross financial liabilities	209.5	216.5	224.6	229.6	232.5
OECD¹					
Actual balance ¹	-6.5	-5.9	-4.6	-3.9	-3.2
Underlying balance ²	-5.9	-5.1	-3.9	-3.5	-2.8
Underlying primary balance ²	-3.7	-2.9	-2.0	-1.5	-0.8
Gross financial liabilities ²	102.1	107.1	109.5	111.1	111.2

Note: Actual balances and liabilities are in per cent of nominal GDP. Underlying balances are in per cent of potential GDP and they refer to fiscal balances adjusted for the cycle and for one-offs. Underlying primary balance is the underlying balance excluding net debt interest payments.

1. Excludes Chile and Mexico.

2. Excludes Chile, Mexico and Turkey.

Source: OECD Economic Outlook 95 database.

StatLink  <http://dx.doi.org/10.1787/888933050370>

Caution is warranted in reducing monetary stimulus

In the projection period policy rates are likely to remain low by historical standards and simple policy benchmark rules.⁸ This poses some risks to price and financial stability in the future. Nevertheless, caution is needed in withdrawing monetary stimulus, as policy rates are still at or close to the zero lower bound. Notwithstanding the progress achieved in improving the state of public finances, additional sustained consolidation will be needed in several countries in the coming years, calling for some offset from monetary policy. Uncertainty about the post-crisis level of neutral interest rates and the possibility that they might be lower than they used to be prior to the crisis provide another argument for keeping policy rates low. Updated OECD estimates of neutral interest rates (Bouis et al., 2013) indicate that they remained negative in real terms in 2013. Although these estimates are inherently uncertain, they suggest that policy interest rates at zero output gaps and on-target inflation could remain lower for longer than in the past.

United States

In the United States, the gradual scaling down of monetary stimulus is required...

Accommodative monetary policy remains warranted but should be scaled down gradually. Policy accommodation is required as current economic slack remains large (with the negative output gap estimated at 3½ per cent of GDP in 2013), inflation is low and inflation expectations are well anchored. However, a reduction in monetary policy stimulus will be needed given the projected narrowing of output and unemployment gaps and the projected increase of inflation towards its target. There are risks that prolonged strong monetary accommodation could unanchor inflation expectations and generate asset price bubbles once again. The path set by the Federal Reserve for reducing monthly purchases of securities from the \$55 billion in April to zero later this year seems appropriate and it would allow policy rates to start rising in 2015 as currently envisaged by FOMC members and expected by markets. With the unemployment rate declining close to 6½ per cent, the Federal Reserve rightly modified its forward guidance in March by removing the reference to the initially announced unemployment threshold for considering rate increases, and indicating that a broad and transparent set of indicators would be considered, including indicators on labour and financial markets and inflation. It also stated that it would likely be appropriate to maintain the current target range for the federal funds rate “for a considerable time” after the asset purchase programme ended, especially if projected inflation remained below the 2% target, and longer-term inflation expectations remained well anchored. This shift from state-contingent to qualitative criteria reflects the fact that guidance should be

8. In particular, various variants of the Taylor rule.

employed during a gradual normalisation of monetary policy to smooth market expectations rather than to provide extra stimulus.

... and must be accompanied by a careful communication strategy to prepare investors

A US exit from very accommodative policy in the context of a strengthening US economy should be beneficial for the global economy, but may also result in unavoidable negative spillovers in the short term. Even if the latest decisions to reduce Federal Reserve's asset purchases did not trigger a bond sell-off similar to the one observed in mid-2013, and investors see increasingly differentiated risks across EMEs (see above), there is still a risk of an abrupt increase in US bond yields and ensuing spillovers to other countries, especially EMEs (Rawdanowicz et al., 2014). To avoid overshooting of yields and unsettling financial markets at home and abroad, the Federal Reserve will have to normalise its interest rates and asset holdings at a measured pace and prepare investors for this by a carefully-designed communication strategy. For example, the Federal Reserve could consider providing guidance on the path of the policy rate towards its medium-term level and the time profile for an eventual normalisation of its balance sheet. The normalisation process will be a difficult balancing act in view of persisting, albeit diminished, downside risks and fiscal headwinds, and uncertainties about longer-lasting impacts of the crisis on productive capacities, neutral interest rates and monetary policy transmission.

The easing of fiscal consolidation is appropriate but long-term fiscal issues have yet to be tackled

The slowdown in fiscal consolidation is appropriate given the much improved near-term budget picture. Fiscal consolidation is slowing markedly this year and uncertainty about the near-term fiscal path has also declined. Fiscal drag, estimated at 1¼ per cent of GDP in 2013, is projected to amount to only around ⅔ per cent of GDP in both 2014 and 2015 (Table 1.5). This is partly due to the Bipartisan Budget Act enacted in December 2013 which replaced the 2014 spending cut scheduled under sequestration with a slight increase in the spending cap for 2014 and 2015. The Act also reduced the likelihood of surprises to the medium-term path of federal spending: after 2015 discretionary spending is expected to follow the path laid out under sequestration. The early February debt ceiling increase resolved the final important source of fiscal policy uncertainty for at least the next year, as the next debt limit deadline will probably fall toward end-2015. The relative ease with which the increase was enacted also gives hope that future fiscal deadlines may be less disruptive than has been the case over the last few years. Looking out to the longer term, legislators have yet to agree on a programme of spending cuts, including entitlement reforms, or revenue increases to address the pressures that rising health-care costs and an ageing population will put on the public finances.

United Kingdom

In the United Kingdom, monetary policy should remain accommodative but be gradually tightened next year...

With the unemployment rate falling close to its threshold level, the Bank of England provided further guidance in February, which – as in the United States – was justified in view of the changing aims of guidance as the start of monetary policy normalisation draws closer.⁹ The recent decline in inflation and inflation expectations, the lack of immediate inflationary pressures, especially in the context of sizeable estimated slack (even if it is narrowing faster than expected) and weak wage growth, and still nascent recovery suggest that current stimulus could be maintained in 2014. However, from next year, the policy rate should be increased gradually, as currently expected by markets, to ensure price and financial stability. By the end of 2015, the employment and output gaps are projected to be largely closed and inflation will be close to the target, while policy rates are likely to be significantly below neutral levels, even if the latter could be lower than prior to the crisis. Monetary policy tightening should be accompanied by timely prudential measures to address the risks of excessive house price inflation. When policy rate increases start, it would be desirable that the Bank of England provides some clear and transparent information about the likely path for interest rates and time profile for an eventual normalisation of its balance sheet.

... and fiscal consolidation should accelerate as planned

Structural fiscal consolidation is continuing at a steady pace of about 1% of GDP this year. Meanwhile, the headline deficit has been falling faster than previously anticipated, but this is estimated to be mainly for cyclical reasons. Now that the recovery is strengthening the government should, as planned, accelerate the pace of structural fiscal adjustment and rely most heavily on spending restraint. All the measures needed to follow the planned tightening path should be specified to help reinforce the plan's credibility.

Japan

In Japan, the three-arrow policy strategy is being implemented

The authorities are pushing ahead with their three-arrow policy package: very expansionary monetary policy to end deflation and attain a 2% inflation target; flexible fiscal policy to give temporary support to the economy; and structural reforms to boost the potential growth of the economy. So far, progress has been most evident in the monetary and fiscal domains, but much remains to be done to rapidly improve structural policy settings.

Bold structural reforms will be key for the success of the strategy

Structural reforms are now fundamental for boosting economic growth and thus helping alleviate fiscal challenges. The authorities have specified numerical targets in the new growth strategy aimed at

9. The Bank of England provided guidance for after the unemployment threshold had been met and stated that there remained scope to absorb spare capacity further before raising the policy rate and that the appropriate path to a normal rate (which is likely to be lower in the medium term than prior to the crisis) was expected to be gradual, though the actual path would depend on economic developments.

increasing Japan's potential growth rate to 2% (OECD estimates of the current rate are about $\frac{3}{4}$ per cent), but it is not clear how these objectives are to be achieved.¹⁰ The strategies to reform the agriculture and energy sectors are in line with OECD recommendations (OECD, 2013d), but bolder reforms are urgent. They should involve fundamental changes in product markets, including greater international openness, to strengthen competition and spur efficiency gains and innovation, especially in the service sector where productivity has lagged behind. The OECD's product market regulation indicators show that Japan's barriers in some network industries are among the highest in the OECD and those in services are far away from best performance, even if they are close to the OECD average, leaving large scope for improvements that would boost living standards and help restore Japan's fiscal sustainability.

Fiscal consolidation should proceed steadily to reduce the risk of financial market turmoil

Japan's fiscal stance is turning around sharply, from fiscal easing of some $\frac{3}{4}$ per cent of GDP last year to a similar amount of fiscal consolidation in 2014. Given that fiscal contraction this year is largely due to the consumption tax increase, and given the timing and composition of the stimulus package meant to partly offset its negative impact on the economy, as well as other measures like the corporate tax cut, the drag on GDP growth this year should be relatively modest. It will be much larger in 2015, when fiscal consolidation worth close to $1\frac{3}{4}$ per cent of GDP is planned, including a large cut in investment spending which tends to have a high fiscal multiplier. The government approved a new medium-term fiscal plan last August, confirming that it aims to lower the primary budget deficit (relative to GDP) of central and local governments from an estimated 6.7% in the fiscal year just ended to 3.3% in FY 2015, achieve a primary surplus by FY 2020, and thereafter steadily reduce the public debt ratio. It will be challenging to meet the 2015 objective with currently decided policy measures, even under optimistic growth assumptions. In any case, keeping to specific headline deficit objectives may be less important for market confidence than showing steady progress toward fiscal sustainability. The top priority should be to produce a detailed and credible long-term plan of measures to consolidate public finances. The plan should include social security reforms to limit spending increases, particularly in the areas of health and long-term care, as well as revenue increases. Such a plan will be instrumental in reducing the risk of an abrupt shift in market sentiment that could fuel a spiral of adverse market reactions (OECD, 2013b). Given the already very high level of government

10. Even if the targets were to be achieved, they may not suffice to raise potential growth significantly. For example, the objective of raising the employment rate of women in the 25-44 age group from 68% to 73% in 2020, in part by eliminating waiting lists for childcare centres by 2017, will have relatively modest overall effects. On the assumption that the adjustment takes eight years, the overall employment growth rate would be raised by 0.2 percentage point per annum on average and the associated increase in the average annual potential output growth rate would be 0.1 percentage point.

debt, a rise in the real yields of sovereign bonds, or disappointing growth outcomes, would seriously aggravate debt dynamics.

**Increasingly
accommodative monetary
policy is needed**

Inflation outcomes and expectations have risen significantly since the start of the quantitative and qualitative easing programme in April 2013. However, inflation is still below target and is expected by the OECD to remain so (excluding the consumption tax increase effects) at least until end-2015. Thus, it is appropriate to keep increasing the already large monetary policy stimulus over the medium term as planned. If inflation were to undershoot its target persistently and the economic slowdown were to turn out to be greater than expected, boosting quantitative and qualitative monetary easing even further than currently envisaged (i.e. doubling of the monetary base between end-2012 to end-2015) might be warranted notwithstanding the associated risks. This could involve larger purchases of longer-term government and private bonds, rather than expanding the two loan support programmes, as done recently. These loan programmes may entail inefficiencies as high funding costs and a lack of access to funds do not seem to hinder banks' credit provision, and loans targeted to selected sectors in one of the programmes raise concerns about resource misallocation and an uneven playing field.

Euro area

**In the euro area, further
monetary policy stimulus is
needed**

Very low underlying inflation and large economic slack are expected to persist for several quarters.¹¹ Accordingly, the main refinancing policy rate should be reduced to zero, and possibly the deposit rate to a slightly negative level, and they should be maintained at these levels at least until end-2015. Together with recent improvements in financial markets, this should contribute to reduce interbank overnight interest rates and ultimately bank lending rates (Box 1.4), helping to stimulate growth and reverse disinflationary pressures. Additional non-conventional measures would be required if inflation did not show clear signs of returning toward the ECB target or, a fortiori, if a deflationary scenario threatened to occur. Such measures should be introduced swiftly even if inflation expectations appear still to be anchored, as stable expectations may be conditioned on an assumption that corrective policy will be implemented, and could therefore change abruptly if policy is seen to be inactive. The ECB has therefore rightly stated that it stands ready to act quickly and with force and that all options are available. These could include terminating sterilisation of the Securities Markets Programme,¹² and providing financing via new LTROs at longer maturities, possibly at a constant near-zero policy rates. Purchases of government or corporate bonds, or programmes to foster bank lending to the non-financial private sector, could also be envisaged.

11. The OECD estimate of the negative output gap in 2013 was lowered to 3½ per cent of GDP as a result of a downward revision of potential real GDP growth (Chapter 4).

12. This could raise liquidity by around 175 billion euros, roughly doubling the amount of excess liquidity.

Risks of renewed financial market stress call for further measures...

... including a comprehensive and credible assessment of banks' capital positions...

With only a modest recovery, disinflationary pressures and an unfinished structural reform agenda, a risk remains that financial market stress could re-emerge and undercut the recovery. It therefore remains urgent to improve the health of the banking sector, continue building effective institutions and sustain reform momentum.

- The comprehensive assessment of euro area banks by the ECB and the EBA this year will be the key for restoring confidence in the banking system and minimising the risks of disruptive financial market stress. Banks' balance sheets have been improving gradually and banks have raised capital (EBA, 2013), resulting in lower CDS spreads and higher equity valuations. Nevertheless, deleveraging and recapitalisations are not finished and impaired assets are still rising. The comprehensive assessment should be used as an opportunity to provide reliable estimates of capital needs and be followed by swift recapitalisations or, if necessary, resolutions. If this were to be the case, credit conditions offered by banks could ease (Box 1.4), with an upside risk for the momentum of the recovery. Thresholds to assess capital adequacy in terms of core tier 1 capital were chosen at 8% of risk-weighted assets in the baseline scenario and 5.5% in the adverse scenario (ECB, 2014c). They reflect the prevailing regulatory minimum requirements and seem appropriate given the demanding macroeconomic scenarios employed (ECB, 2014d).¹³ It would be, however, desirable to report leverage ratios under the adverse scenario, given the evidence that this indicator has more predictive power for financial stress than risk-weighted capital ratios.¹⁴ The adoption of a common definition of non-performing assets is welcome as it will help evaluate assets and the adequacy of loan-loss provisions consistently across countries. To minimise the risk of renewed tensions, it is crucial to clarify how any identified capital shortfalls of viable banks will be rectified.¹⁵ If recapitalisation were undertaken quickly and successfully, it could also be an upside risk, boosting confidence and the pace of the recovery.

13. Regulatory requirements will be, however, more stringent with the full implementation of the EU Credit Requirements Regulation/Directive 4. As of 2019, EU banks will have to apply a more restrictive definition of core tier 1 (CT1) capital and meet CT1 requirements in terms of risk-weighted assets between 7% and 14.5% (4.5% main capital ratio + 2.5% conservation buffer + 0-2.5% countercyclical buffer + 0-5% macro-prudential systemic risk buffer, which will include the 1-3.5% buffer for global systemically important financial institutions).

14. See Blundell-Wignall and Roulet (2012 and 2013) and Haldane and Madouros (2012). The ECB (2013b) has indicated that the leverage ratio will be used as supplementary information in the Asset Quality Review.

15. The ECB announcement of the comprehensive assessment recognised the potential need for public backstops, but stressed that capital shortfalls should be made up primarily by private investors (ECB, 2013b). Capital shortfalls identified in the baseline scenario of the stress tests are expected to be made up within six months, and the ones identified in the adverse scenario within nine months, after the release of the results (ECB, 2014c).

... completing the establishment of a fully-fledged banking union as quickly as possible...

- Following the completion of the single supervisory mechanism in November 2014 and the recent enactment of a single bank resolution regime, an adequate joint fiscal backstop and, possibly, a joint deposit guarantee should be set up. The establishment of a single fund for the resolution of banks and an associated backstop should be followed up by decisions ensuring that adequate funding for the resolution fund and the fiscal backstop is available, both in the 8-year transition phase when the single fund will be formed and subsequently, including adequate provisions to allow a cross-border resolution of failing banks.¹⁶ At the same time, incentives to guard against moral hazard in policy decisions or market behaviour need to be built into such arrangements.

... and continuing with structural reforms and fiscal consolidation

- The financial market improvement and cyclical upturn should not be used as an excuse to delay structural reforms and progress with fiscal consolidation. Without structural reforms there is a high risk of continued economic weakness with negative implications for meeting medium-term fiscal targets that depend on growth increases. A lack of steady progress on fiscal adjustment and public-sector deleveraging could in turn rekindle financial tensions, especially in the vulnerable countries, and set off negative feedbacks between the cost of financing, growth and fiscal balances.

Some slowdown in the pace of structural fiscal adjustment is appropriate

Given the progress already made and the still weak economy, some slowdown in the pace of structural fiscal adjustment in the euro area is appropriate. At the same time, lower financial market pressure creates a risk that consolidation efforts become confined to stabilising public debt burdens rather than restoring room for active fiscal policy to counter future shocks. After structural fiscal consolidation of just over ½ per cent of GDP in 2013, area-wide consolidation is expected to amount to a bit less than ½ per cent of GDP both this year and next. In Germany, the fiscal stance is expected to be slightly expansionary over the projection period. In France, the pace of consolidation is slowing slightly, to about ¾ per cent of GDP both this year and next. Italy's fiscal stance will only be slightly contractionary in 2014 and 2015. Spain, Portugal and Ireland are planning larger fiscal efforts (between 1% and 1¾ per cent of GDP) and do not have room for a gentler approach. Greece is sharply reducing the pace of fiscal consolidation now that it enjoys a primary surplus. Some countries have now completed most of their required structural fiscal adjustments, while others, like Spain, Ireland and France, will need to continue well beyond 2014. In these countries, the automatic stabilisers should be allowed to operate fully around planned structural consolidation paths.

16. The Single Resolution Mechanism will be backed by a €55 billion fund financed by industry levies. The build-up of a common fund was accelerated from 10 to eight years and its mutualisation was frontloaded (40% of contributions will be mutualised from the first year and 60% from the second year) compared with the initial proposal.

Governments should also avoid relaxing fiscal adjustment efforts relative to the structural commitments they have made even if there are positive growth surprises or reduced financial market pressure. In particular, large countries should not use improvements in financing conditions brought about by smaller countries' fiscal efforts as an excuse to relax their own fiscal adjustments, because a significant risk of renewed market frictions remains.

China

In China, the current monetary policy stance is appropriate but some stimulus would be required if growth were to slow sharply

The current broadly neutral monetary policy is consistent with low inflation and subdued future inflationary pressures given signs of growth moderation. However, should growth weaken significantly or domestic liquidity conditions tighten sharply, monetary stimulus would be warranted through reductions in the reserve requirement ratio (RRR). In parallel, rising financial stability concerns (Box 1.1) should be addressed by financial regulation and macro-prudential measures, ensuring a reduction in off-balance sheet credit growth whilst avoiding a sharp slowdown in economic activity. The deregulation of interest rates is expected to be completed within two years, with the abolition of the deposit rate cap this year bringing lending and deposit rates closer to market-clearing levels and weakening the attractiveness of shadow banking products. This effect could be strengthened by reducing the currently high RRR (20% for big and 16.5% for small and medium-size financial institutions) which disadvantages regular commercial banks. As recently proposed by the authorities, deposit insurance and a resolution system for financial institutions will precede full liberalisation. Better monitoring and control of risks in the shadow banking sector is also needed.

The broadly neutral fiscal policy stance is appropriate

The central government's fiscal deficit projection for 2014 is about 2.1% of GDP, a slight increase from last year's 1.9% estimate. In April, the State Council announced a small targeted fiscal stimulus package to support near-term growth. Further fine-tuning measures might follow if momentum continues to falter. Recent survey results on local government debt placed it at 33.2% of GDP in June 2013, an increase of 6½ percentage points in 2½ years.¹⁷ Adding central government debt, China's total government debt was about 56% of GDP in June 2013. While this remains a manageable amount for the country as a whole, some local governments face tough fiscal conditions and will struggle to repay their debts. The central government has not yet provided an explicit resolution scheme if problems occur. As laid out in the Third Plenum report and proposed at the National People's Congress last March, the central government should impose harder budget constraints on local

17. The increase may be somewhat overstated because of a finer coverage in the most recent survey.

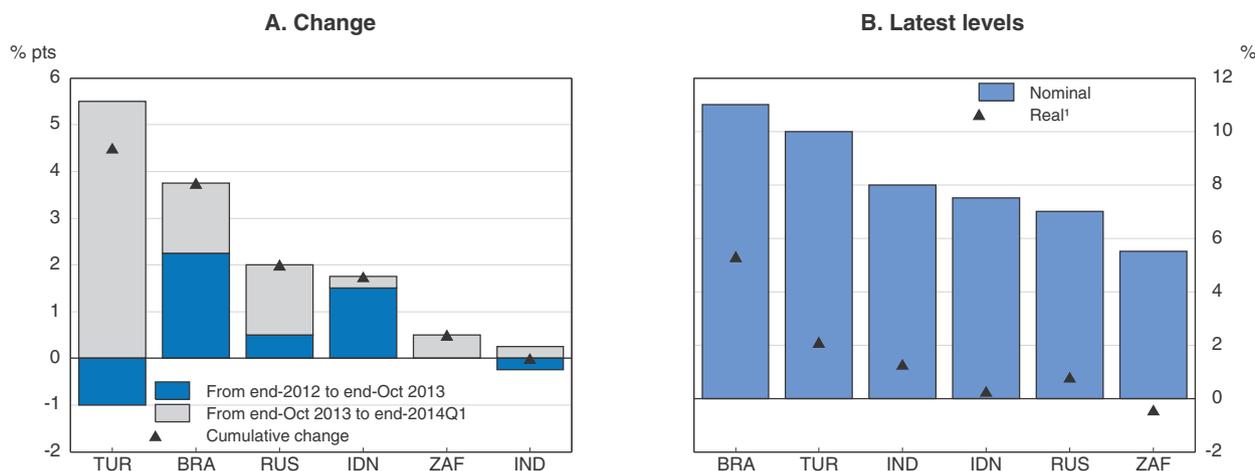
governments, improve transparency, and enhance monitoring of local government expenditures.

Other EMEs

In other EMEs, the appropriate monetary policy stance will depend on inflation and exchange rate developments

Several EMEs have increased policy rates (Figure 1.10), helping reduce capital outflows and inflationary pressures. Diverging trends in inflation and GDP growth call for differentiated policy responses. The current monetary policy stance is appropriate in Russia, and should be eased gradually in Indonesia and possibly India and South Africa, but in Brazil, where inflation is not expected to decline in the near term, further tightening is desirable. Additional increases in policy rates would be, however, needed if currencies were to depreciate further and inflation outcomes and expectations were to increase. This would pose a policy dilemma given already subdued growth in many EMEs and the limited scope for offsetting fiscal stimulus, notably in India, where high government deficits need to be brought down, and in Brazil, where the fiscal position must improve durably to reinforce the credibility of fiscal announcements. Nevertheless, weaker currencies and higher policy rates could help rebalance the economy towards exports and improve current account balances, as recently experienced in India and Indonesia. Thus, exchange rates should be allowed to adjust flexibly to changing fundamentals, though transparent and temporary interventions may play some role in reducing short-term currency volatility and financial instability.

Figure 1.10. Policy interest rates in many EMEs have been increased



Note: The policy interest rates are: the Selic rate target for Brazil; the repo rate for India; the main Bank Indonesia policy rate for Indonesia; the target interest rate for overnight funding operations for Mexico; the one-week liquidity provision and absorption open market operations for Russia; the repo rate at which the private banks borrow rands from the Reserve Bank for South Africa; the one-week repo rate for Turkey.

1. Real policy interest rates are calculated based on the latest available year-on-year change in the overall consumer price index.

Source: OECD, Main Economic Indicators; and OECD Economic Outlook 95 database.

StatLink  <http://dx.doi.org/10.1787/888933048983>

Further policy actions are needed to minimise risks of financial turmoil and entrenched subdued growth

Better regulation and supervision may be needed to ensure that the capital and liquidity buffers of financial institutions are sufficient and to reduce currency mismatches. Reducing regulatory burdens on foreign direct investment and product markets and removing tax incentives for debt over equity financing should help to bring about a safer structure of foreign liabilities and reduce the risks of volatile capital flows (Ahrend and Goujard, 2012). EMEs should also re-start growth-enhancing structural reforms to help improve their economic prospects more generally and boost investors' confidence. In particular, they could raise comparatively low levels of labour productivity by reducing still high regulatory barriers to competition and restrictions to FDI and trade, by developing infrastructure, and by improving access to education and teaching quality (OECD, 2014).

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ANNEX 1.1

Indicators of potential financial vulnerabilities

The following table and set of diamond charts show the position of OECD and non-OECD countries on a number of indicators that could reveal potential exposure to financial turbulence. The main focus of the table is on domestic vulnerabilities of OECD and BRIICS countries, that of the diamonds on financial account vulnerabilities of OECD and non-OECD G20 countries.

The table presents indicators typically associated with financial vulnerabilities (*e.g.* International Monetary Fund, 2012; European Commission, 2012) arising primarily from the domestic economy in four broad categories: the real economy, the non-financial sector, the financial sector and public finances. Possible weaknesses in the real economy are captured by the difference between the potential and the actual GDP growth rate, the difference between the actual unemployment rate and the natural rate of unemployment (or NAIRU), the current account deficit and the evolution of relative unit labour costs. Indicators of financial market excesses related to the non-financial sector are debt of households and non-financial corporations and real house price growth. Core Tier-1 capital additions required to reach 5% (without any normative implications) of total assets in each of the country's selected banks, non-performing loans, and financial corporations' debt are included to account for the direct risk exposure of the financial sector. The calculations of the Core Tier-1 capital additions are based on over 1200 commercial banks, including 915 in the United States, 197 in the OECD euro area countries, 23 in the United Kingdom, 11 in Canada and 7 in Japan. Vulnerabilities stemming from the public sector are quantified along three dimensions: government net borrowing, gross government debt and the difference between 10-year sovereign bond yields in real terms and the potential real GDP growth rate.

The four OECD countries with the weakest scores are labelled in dark grey, the four OECD countries with the next weakest scores in light grey. Higher values indicate a larger vulnerability. The table also includes the current sovereign credit ratings issued by Standards and Poor's.

The diamond charts (an updated version of Ahrend and Valdivia, 2012) display financial-accounts-related risk factors to financial stability for OECD and non-OECD G20 countries based on previous OECD empirical analysis (Ahrend and Goujard, 2012a, 2012b). The analysis shows that a bias in gross external liabilities towards debt, in particular bank debt, substantially increases the risk of financial crises (bank debt being defined as debt to a foreign bank). In contrast, a larger share of FDI in gross external liabilities decreases such risk. Shorter banking debt maturities have also been found to increase the crisis risk, mainly by increasing exposure to financial contagion. The size of reserve holdings appears to reduce the probability of crises, whereas neither external assets (excluding reserves) nor liabilities as a share of GDP are found to influence the crisis risk, except when they are exceptionally large.

The diamonds show: i) the position of each country in 2013Q3 (or the latest available) along various dimensions of its financial account structure relative to the OECD median, and ii) the country-specific change, from 2007 to 2013Q3, on each dimension relative to the 2007 OECD median (for simplicity and

without any normative implications). Indicators are measured in multiples of the standard deviation across countries for the variable in question. Larger values indicate a financial account structure that presents a greater risk to financial stability compared with the OECD median.

The main highlights emerging from the analysis include:

- The least vulnerable OECD countries include Austria, Germany and Poland.
- Vulnerable euro area countries (Greece, Ireland, Italy, Portugal, Spain, and Slovenia) score weakly on several indicators, including low growth and high unemployment rates, non-performing loans, public debt and government bond yields. In many of these countries external liabilities exhibit a systematic debt bias (above the OECD median).
- There are indications that some OECD countries (Australia, Canada, New Zealand, Norway and Sweden) which have suffered relatively little from the global financial and euro area crises are exposed to vulnerabilities stemming from the non-financial sector (most or all from household debt, house prices and relative unit labour costs). On the other hand, their financial sector does not appear to exhibit significant external vulnerabilities, as evidenced by the diamonds.
- Countries with a large financial sector – as, for example, proxied by the size of financial corporations' gross debt relative to GDP in Table A1 – tend to exhibit the largest financial-accounts-related risk factors to financial stability (in the diamond charts). These include Denmark, Iceland, Ireland, Luxembourg, the Netherlands, Switzerland and the United Kingdom.
- Overall, the diamonds suggest only modest increases in external financial stability risks for non-OECD G20 countries since 2007. The general exception to this pattern is the relatively short maturity of their external bank debt, which has become more pronounced since 2007, possibly related to increased inflows of foreign capital, and some decline in foreign exchange reserves, raising the risk of more turbulent consequences of capital outflows.

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Table A1a. Indicators of potential financial vulnerabilities

	Real economy				Non-financial sector		
	Potential GDP growth rate-actual GDP growth rate differential	Actual unemployment rate-NAIRU differential	Current account deficit ¹	Relative unit labour cost	Household gross debt ^{2,3}	Non-financial corporation gross debt ^{1,3}	Real house prices
	2013	2013Q4 or latest available	2013	% change 2000Q1-13Q4	2012 or latest available	2012 or latest available	% change 2000Q1-14Q1
United States	0.1	0.9	2.3	-25.9	111.0	109.2	14.6
Japan	-0.9	-0.4	-0.7	-46.1	132.2	160.5	..
Germany	0.6	-1.3	-7.6	-11.9	93.2	72.7	-3.0
France	1.0	0.6	1.6	7.2	107.8	106.2	73.8
Italy	1.4	2.9	-0.6	15.8	81.5	94.5	16.3
United Kingdom	-0.4	0.4	4.4	-18.6	150.9	96.0	62.5
Canada	-0.1	-0.2	3.2	43.7	168.8	140.4	89.6
Australia	0.7	0.5	2.9	47.3	187.9	76.9	84.4
Austria	1.3	0.8	-2.7	-0.4	92.8	101.1	19.7
Belgium	1.0	0.5	1.7	12.9	98.4	96.8	62.5
Chile	0.3	-2.5	3.4	28.8	70.4	132.4	..
Czech Republic	2.4	0.6	1.5	34.4	66.6	64.8	..
Denmark	0.2	1.3	-7.3	16.7	324.8	112.7	23.4
Estonia	1.8	-1.3	0.5	43.4	94.5	103.9	..
Finland	2.1	1.3	0.8	7.0	123.0	101.8	29.6
Greece	1.1	11.1	-0.7	-1.1	115.9	74.7	0.2
Hungary	-0.7	-0.6	-3.0	33.8	62.6	112.4	..
Iceland	-2.3	0.3	-3.9	-23.6	..	338.3	..
Ireland	1.2	1.5	-6.6	16.3	230.4	248.5	-5.7
Israel	0.4	-0.8	-2.6	-12.3	..	75.0	28.9
Korea	0.6	-0.2	-5.4	0.6	160.0	151.3	24.6
Luxembourg	0.1	1.3	-5.2	34.0	153.4	318.8	..
Mexico	1.5	0.0	1.8	3.7	..	..	..
Netherlands	1.7	3.1	-10.4	7.0	311.5	107.4	-3.2
New Zealand	-0.4	-0.4	3.3	61.4	..	..	97.1
Norway ⁶	1.8	0.2	-10.8	52.1	213.9	104.6	79.9
Poland	1.4	-0.1	1.3	-5.9	58.8	53.5	..
Portugal	0.9	3.2	-0.5	3.4	148.8	156.5	-11.1
Slovak Republic	1.9	1.1	-2.1	31.0	54.9	77.7	..
Slovenia	1.3	1.5	-6.5	-0.6	57.8	106.5	..
Spain	1.6	4.7	-0.7	4.2	140.8	125.5	21.2
Sweden	0.8	1.0	-6.2	-7.9	171.5	149.3	83.7
Switzerland	-0.1	0.1	-13.4	28.5	203.7	100.5	43.7
Turkey	1.0	0.4	7.9	-19.7	..	3.1	..
Brazil	0.8	..	3.6	20.4	..	..	..
China	0.4	..	-2.0	97.7	..	..	..
India	1.7	..	2.5	-45.7	..	..	..
Indonesia	0.4	..	3.7	-13.3	..	..	..
Russian Federation	1.5	..	-1.6	194.5	..	..	..
South Africa	1.5	..	5.8	-17.9	..	..	..

1. In per cent of GDP.

2. In per cent of gross household disposable income.

3. Gross debt is defined as liabilities less financial derivatives and shares and other equity. Based on consolidated for most countries.

4. Long-term foreign balance sheets currency rating.

5. Economic Outlook 95 estimates.

6. Mainland (potential) GDP is used instead of total (potential) GDP where applicable.

■ Labels the 4 OECD countries with the weakest scores.

■ Labels the 4 OECD countries with the next weakest scores.

Source: OECD Economic Outlook 95 database; OECD National Accounts database; IMF Financial Soundness Indicators database; European Central Bank; European Commission; OECD Housnig Prices database; Standards & Poors; and OECD calculations.

Table A1b. Indicators of potential financial vulnerabilities (cont'd)

Core Tier-1 capital required to reach 5% of assets in selected banks ¹	Financial sector		Public finance			Sovereign credit rating S&P ⁴	Country
	Non-performing loans to total loans	Financial corporation gross debt ^{1,3}	Headline government budget deficit ¹	Gross government debt ¹	Real 10-year sovereign bond yield-potential GDP growth rate differential		
	Latest available	2012 or latest available	2013 ⁵	2013 ⁵	2013 or latest available		
0.7	2.6	326.4	6.4	104.3	-1.0	AA+	United States
2.4	2.3	568.9	9.3	224.6	0.7	AA-	Japan
3.1	2.9	331.1	0.0	85.9	-1.2	AAA	Germany
5.7	4.3	286.1	4.3	112.6	-0.4	AA	France
0.4	15.1	214.3	2.8	145.5	2.7	BBB	Italy
3.2	3.7	721.4	5.9	99.3	-0.6	AAA	United Kingdom
3.2	0.6	328.9	3.0	93.6	-1.2	AAA	Canada
3.1	1.4	312.3	1.4	33.1	-0.3	AAA	Australia
0.3	2.9	248.5	1.5	83.4	-1.2	AA+	Austria
1.6	3.8	316.2	2.7	106.7	-0.2	AA	Belgium
..	2.1	197.2	..	..	-0.7	AA-	Chile
..	5.2	127.1	1.5	57.1	-0.9	AA-	Czech Republic
3.2	4.8	460.6	0.9	55.2	-0.3	AAA	Denmark
..	1.5	119.0	0.2	13.1	..	AA-	Estonia
3.6	..	250.5	2.5	66.4	-1.6	AAA	Finland
1.6	31.3	213.0	12.7	186.0	11.5	B-	Greece
..	17.6	107.0	2.3	89.4	2.3	BB	Hungary
..	..	1 037.5	2.1	97.9	2.2	BBB-	Iceland
1.9	24.6	1 010.1	7.0	134.6	1.1	BBB+	Ireland
..	2.4	206.4	4.3	67.8	-3.3	A+	Israel
..	..	353.9	0.4	36.5	-0.7	A+	Korea
..	0.2	5 151.6	-0.1	30.3	-3.7	AAA	Luxembourg
..	3.2	..	-0.2	..	0.2	BBB+	Mexico
3.0	3.0	703.3	2.4	86.2	-0.1	AA+	Netherlands
..	..	..	0.3	40.6	1.1	AA	New Zealand
0.0	1.3	208.6	-11.1	35.6	-2.8	AAA	Norway ⁶
..	5.2	100.4	4.3	63.8	-0.3	A-	Poland
0.0	11.0	276.3	5.0	139.4	5.0	BB	Portugal
..	5.3	120.4	2.8	59.3	-0.8	A	Slovak Republic
..	18.0	144.1	14.7	80.5	4.2	A-	Slovenia
0.5	8.2	245.6	7.1	104.0	3.3	BBB-	Spain
3.9	0.6	285.1	1.3	47.1	-0.9	AAA	Sweden
6.2	0.8	577.3	-0.1	46.2	-1.0	..	Switzerland
..	2.6	99.7	..	..	-3.4	BB+	Turkey
..	2.9	..	3.3	..	7.7	BBB	Brazil
..	..	..	0.7	..	-3.8	AA-	China
..	3.8	..	7.1	..	1.6	BBB-	India
..	1.7	..	2.2	..	0.2	BB+	Indonesia
..	6.0	..	0.5	..	3.2	BBB	Russian Federation
..	3.6	..	6.1	..	3.2	BBB	South Africa

1. In per cent of GDP.

2. In per cent of gross household disposable income.

3. Gross debt is defined as liabilities less financial derivatives and shares and other equity. Based on consolidated for most countries.

4. Long-term foreign balance sheets currency rating.

5. Economic Outlook 95 estimates.

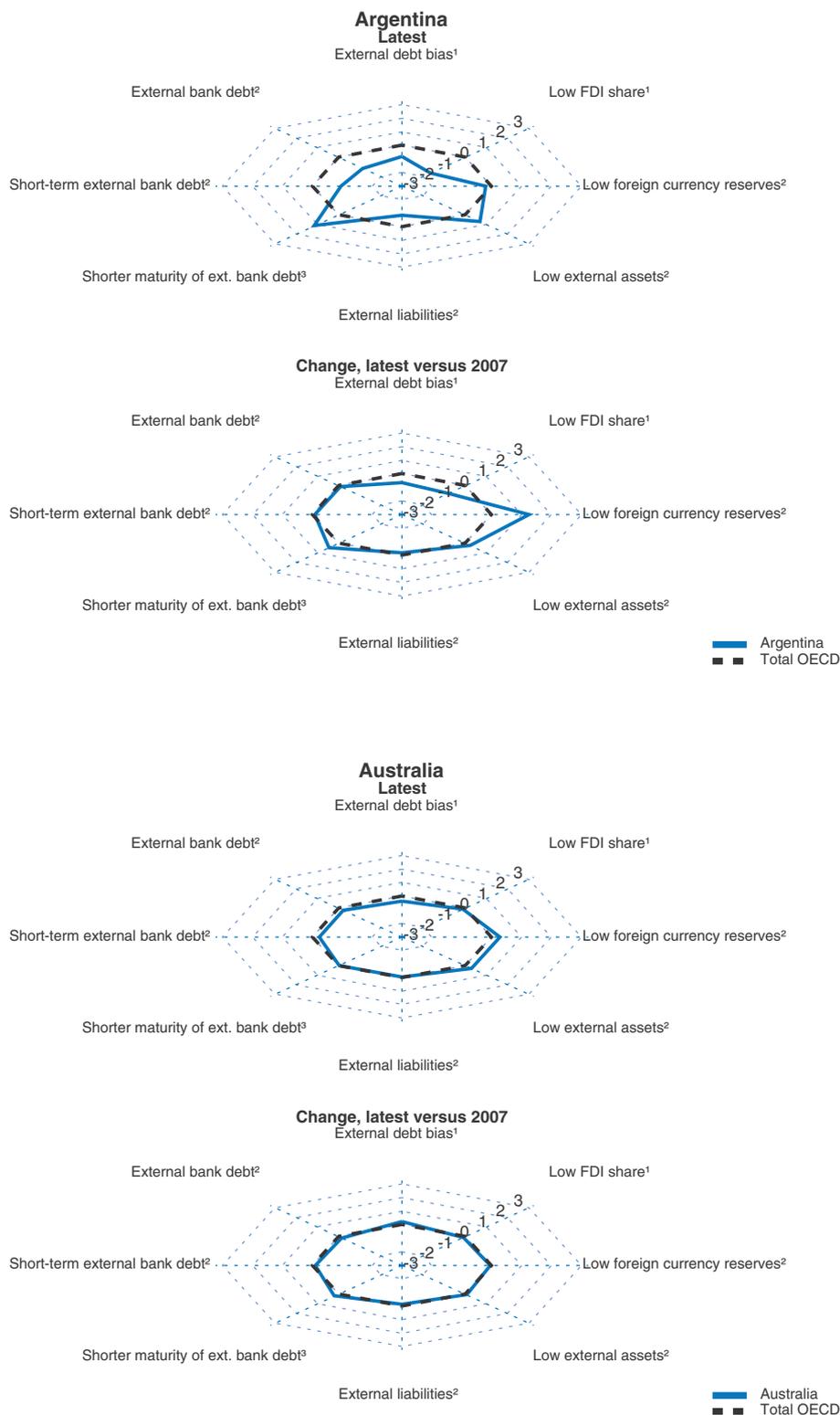
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Labels the 4 OECD countries with the weakest scores.

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Source: OECD Economic Outlook 95 database; OECD National Accounts database; IMF Financial Soundness Indicators database; European Central Bank; European Commission; OECD Housnig Prices database; Standards & Poors; and OECD calculations.

Financial-accounts-related risk factors to financial stability

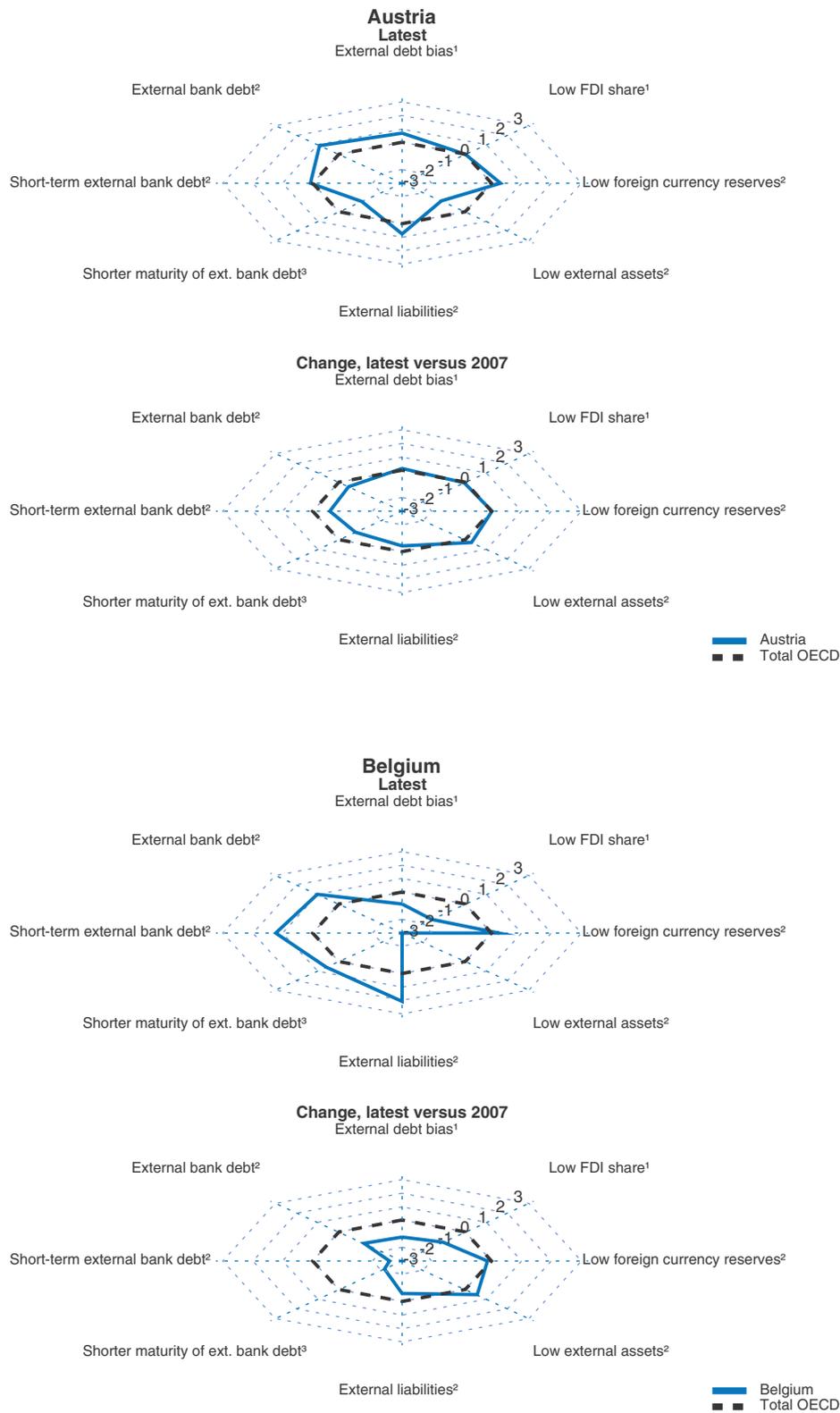


Note: The diamond charts are explained in the introduction to the annex.

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Source: OECD calculations.

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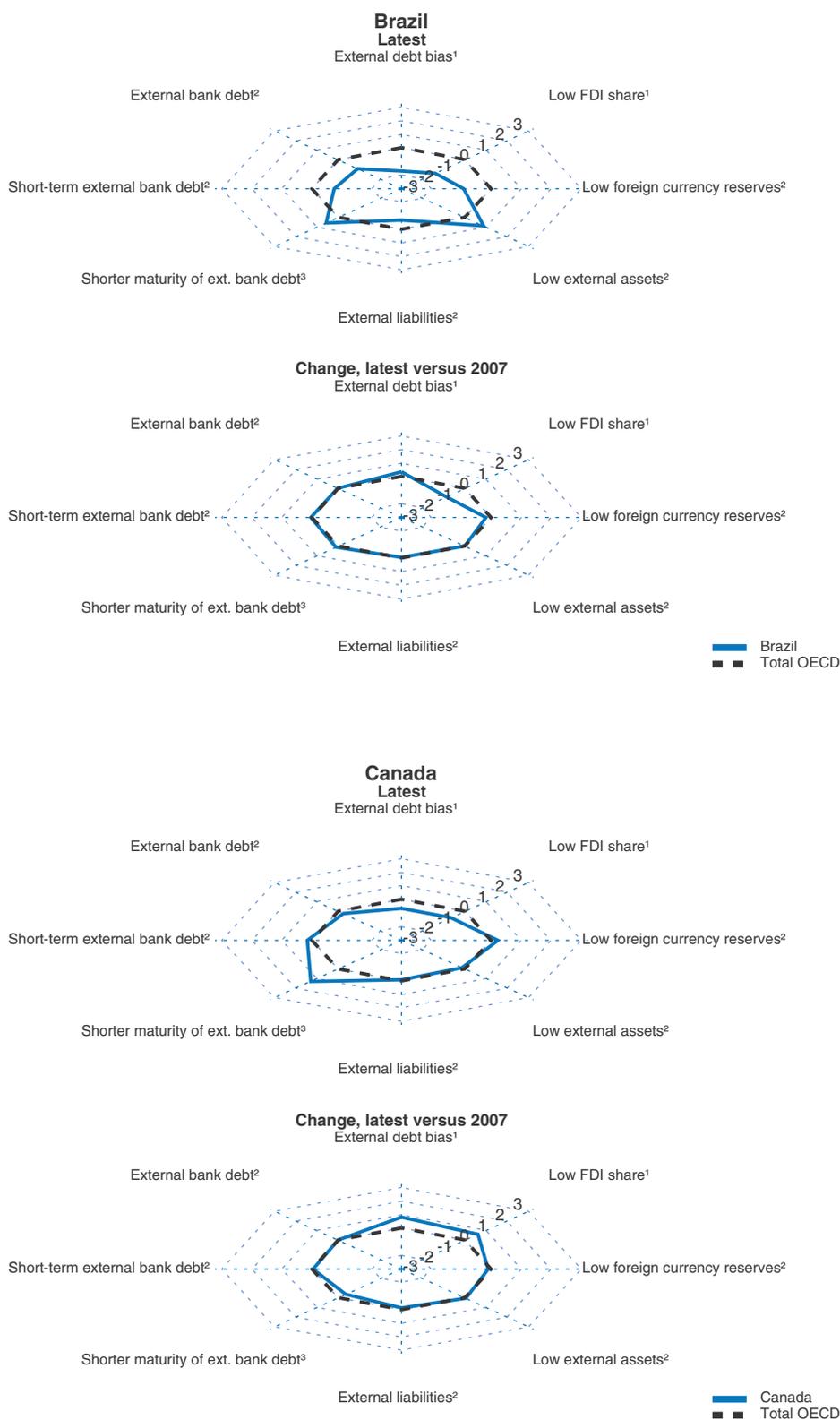


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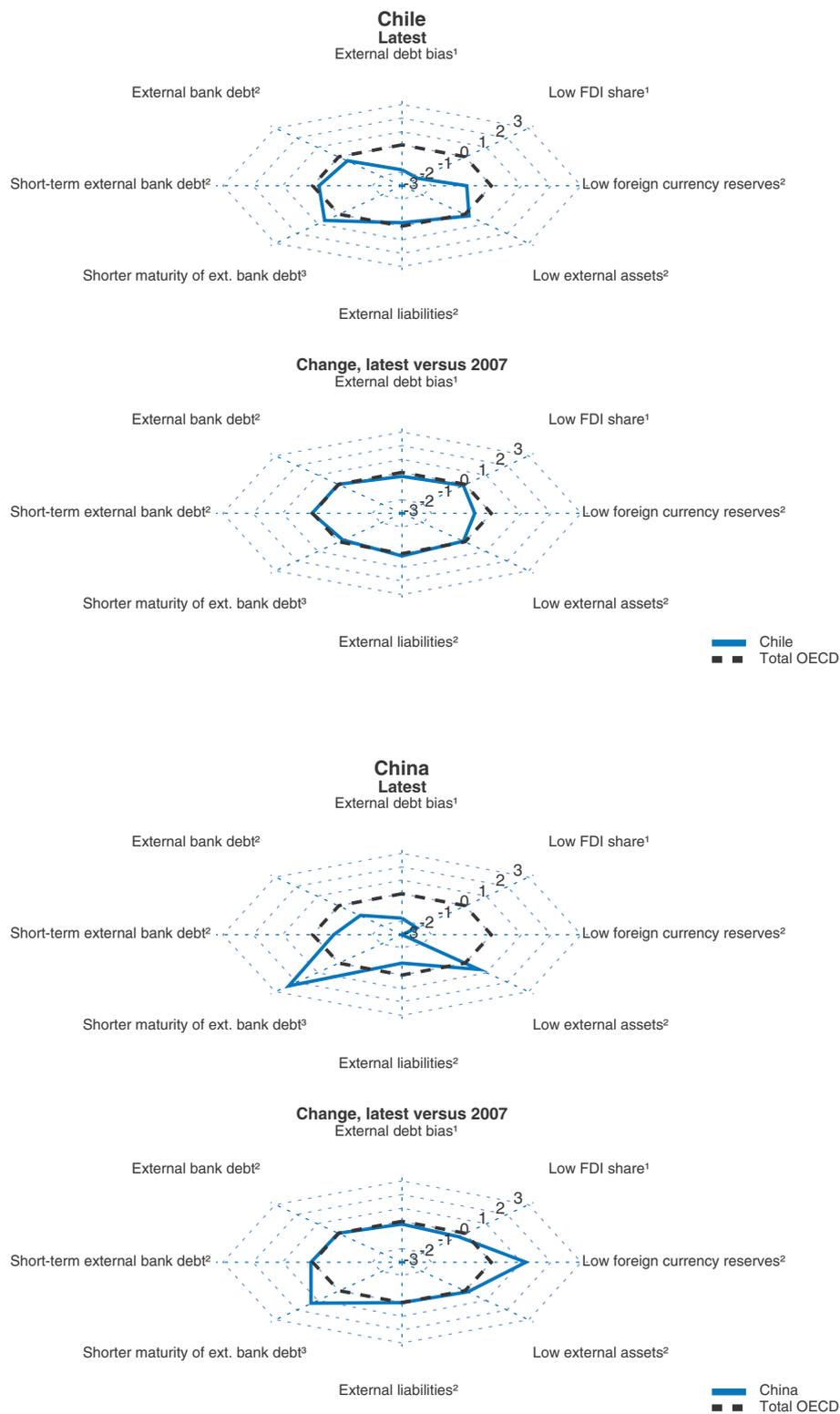


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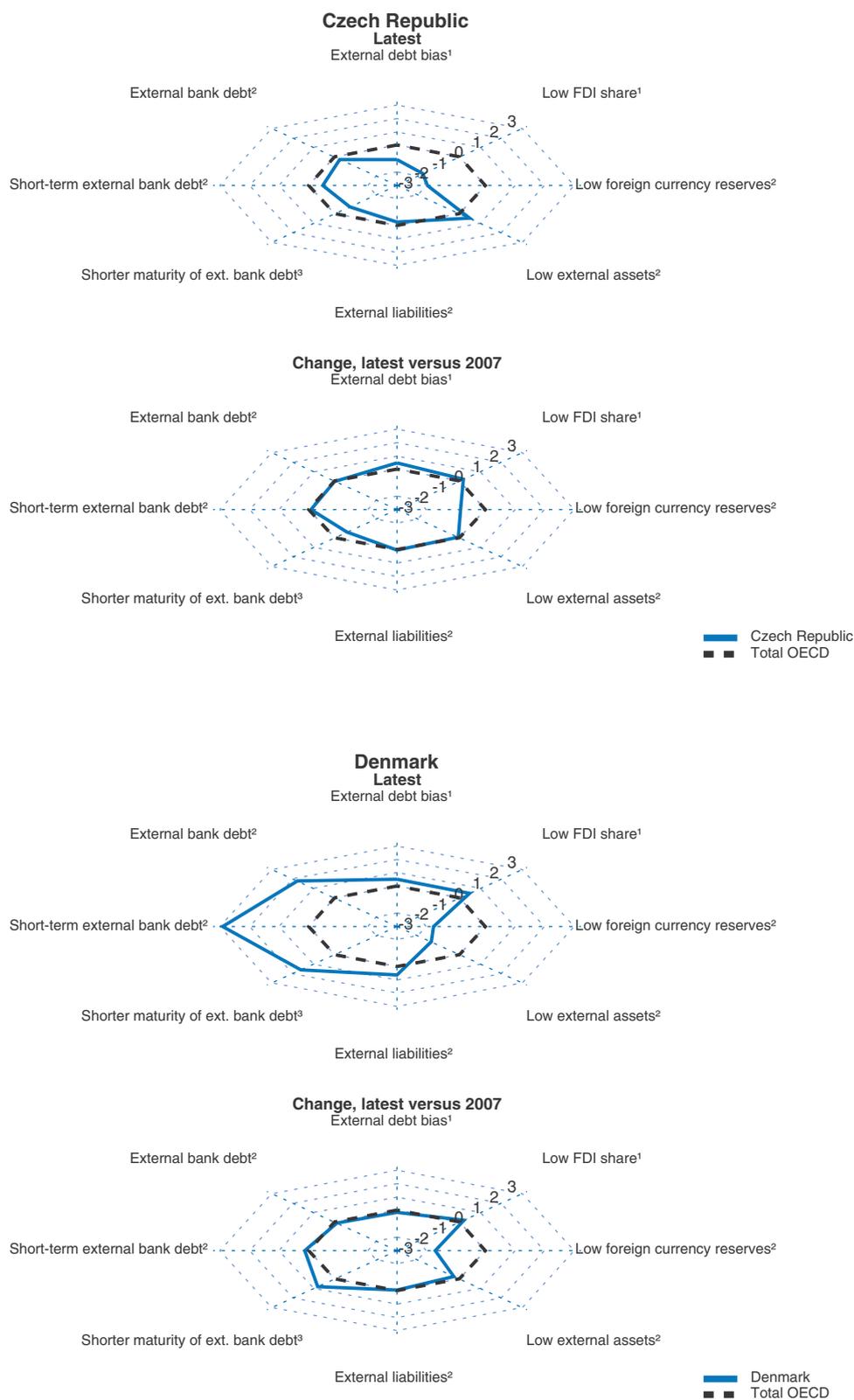


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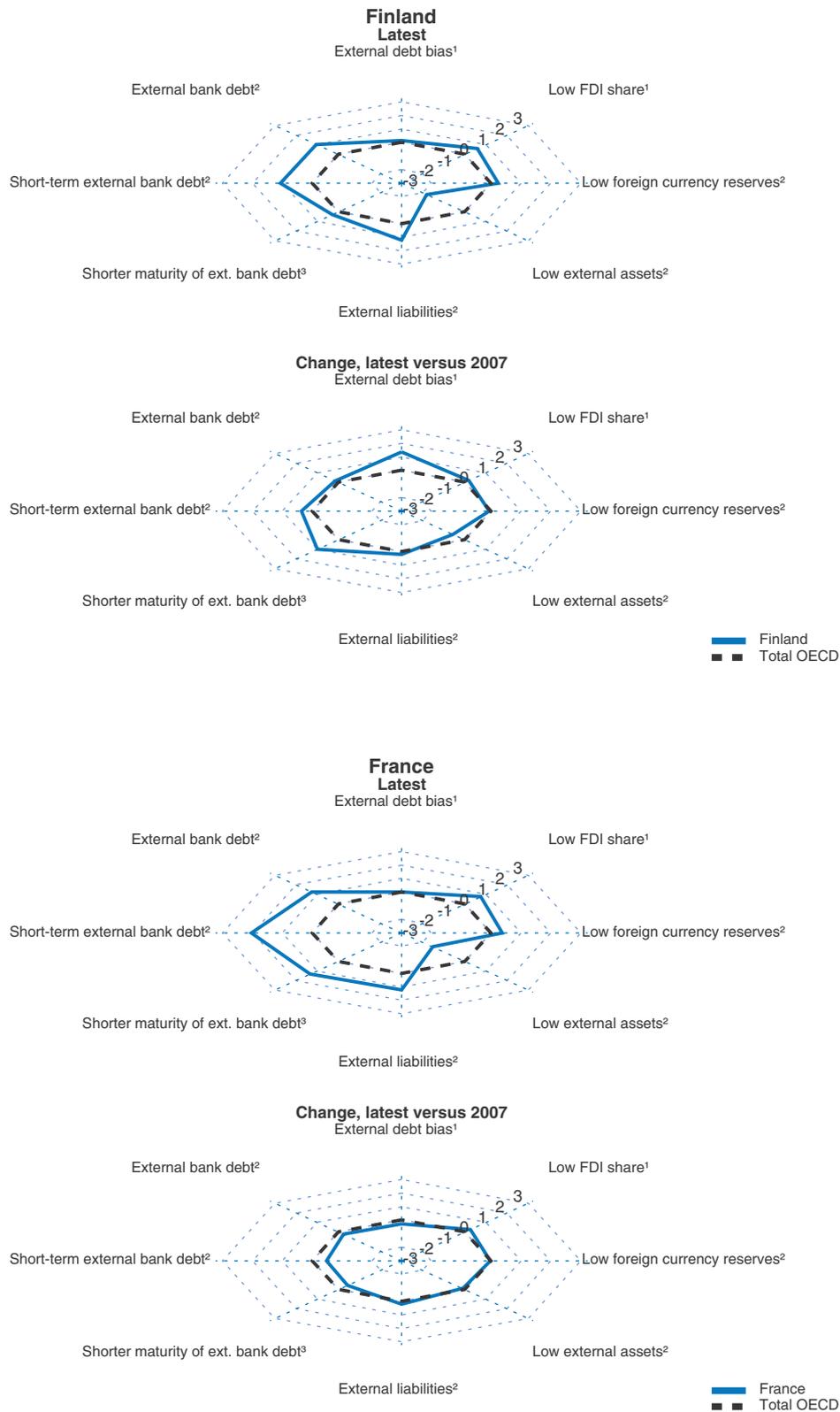


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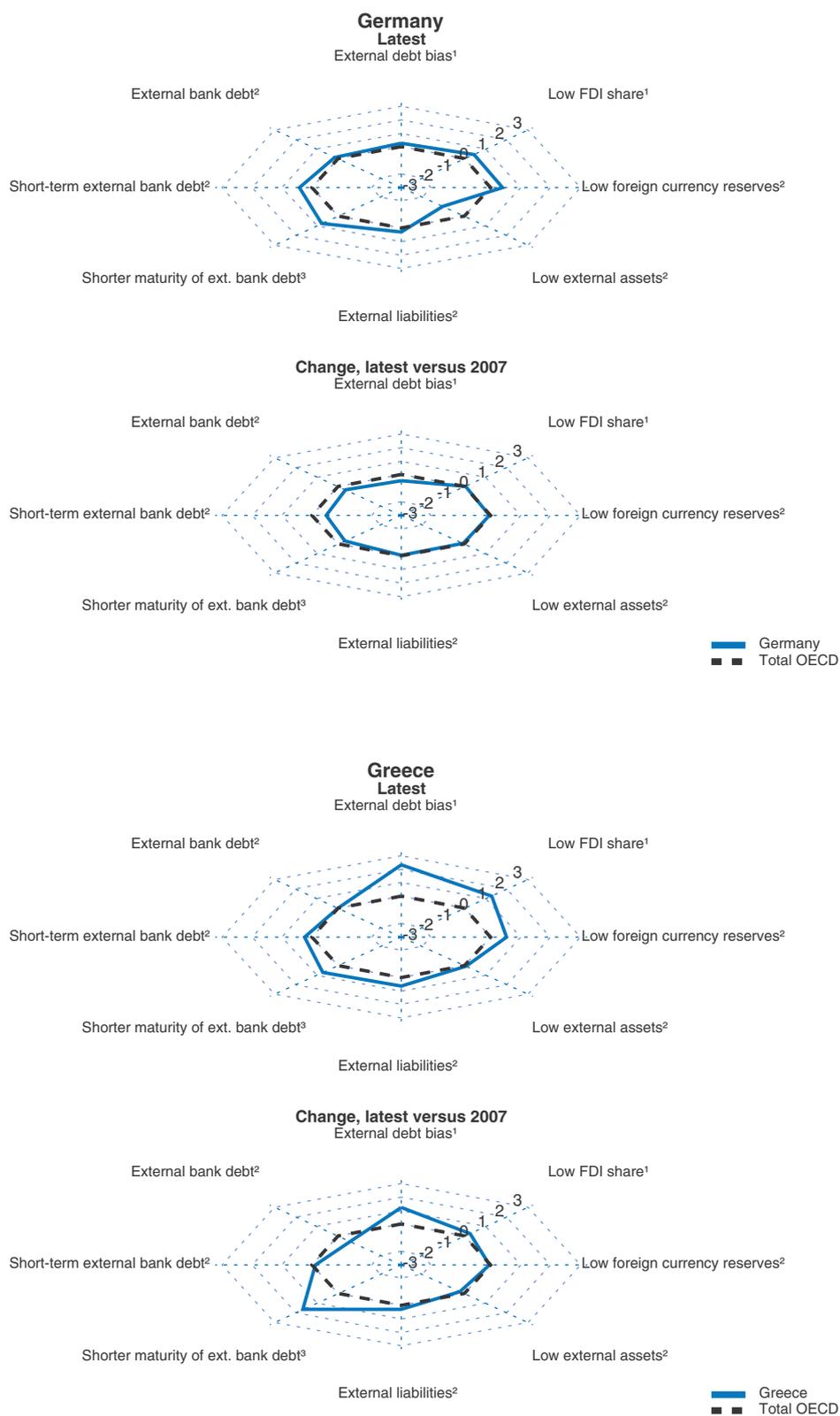


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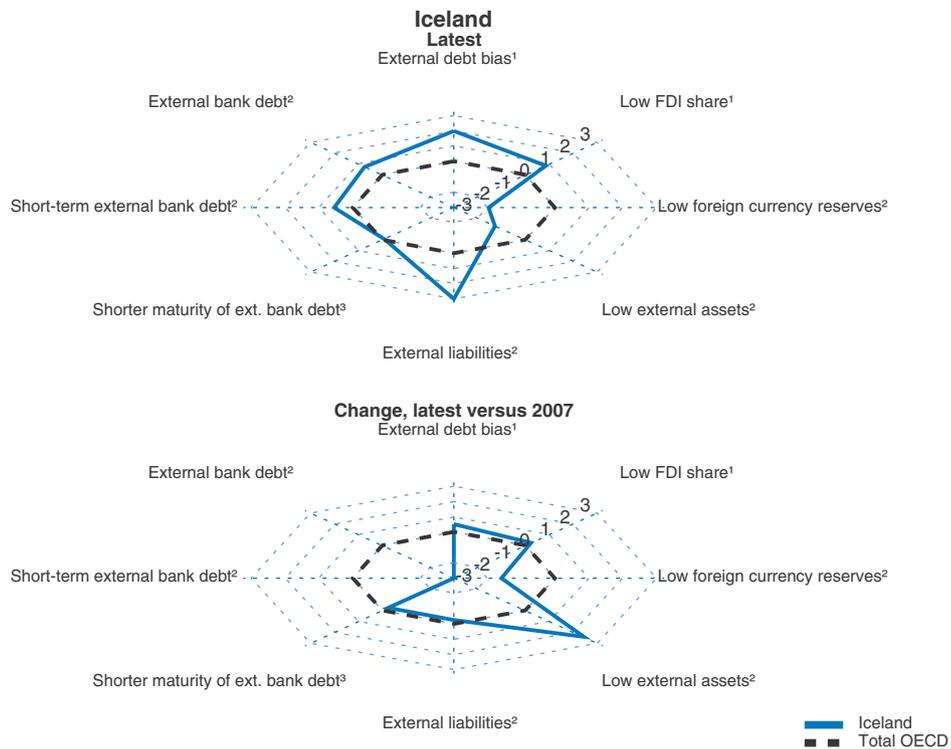
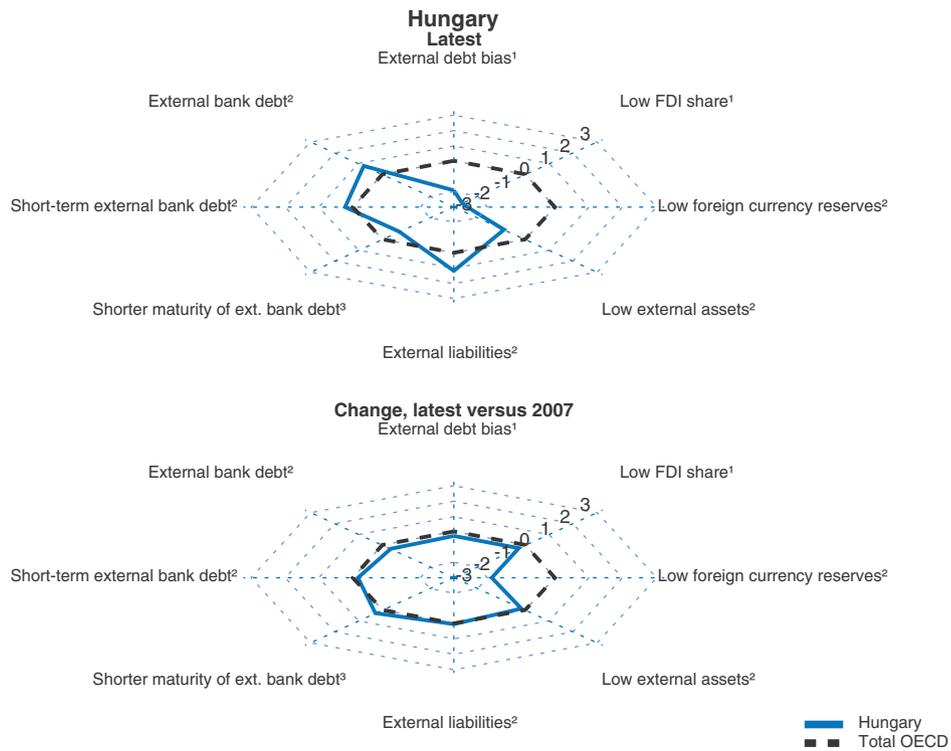


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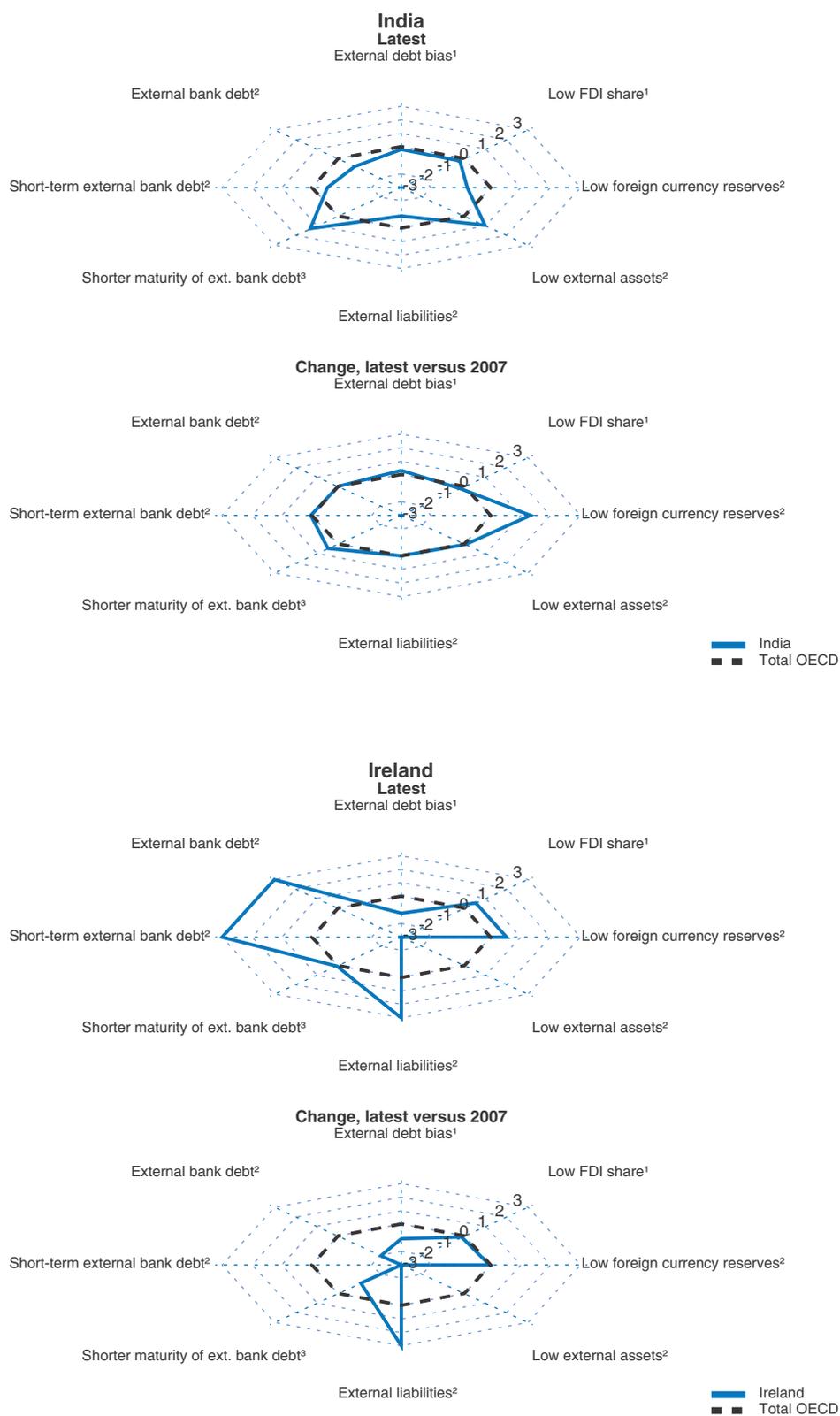


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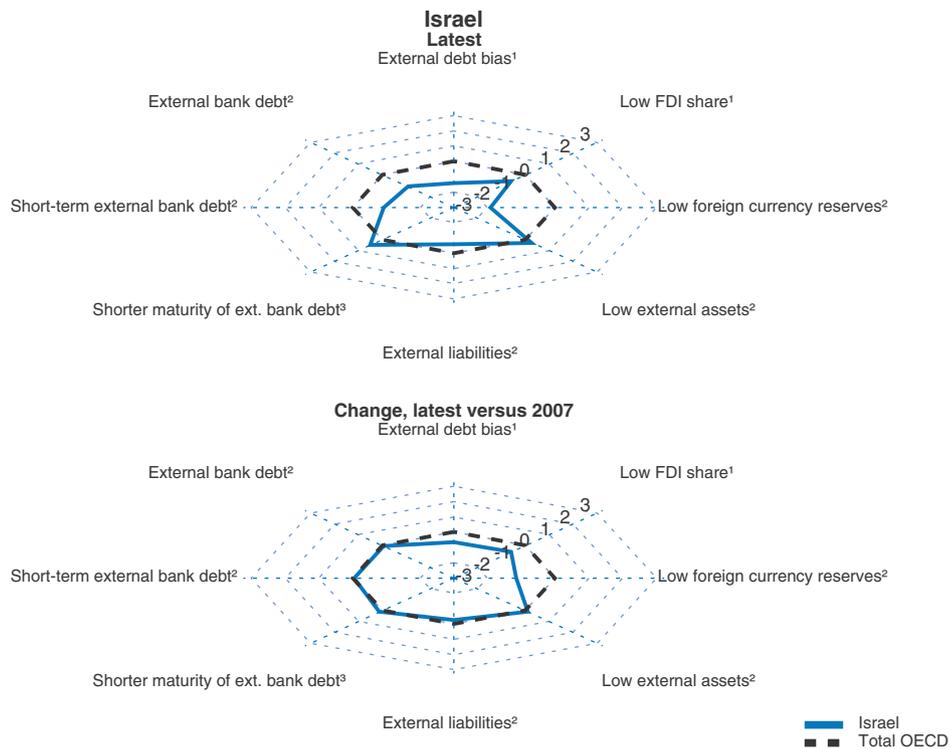
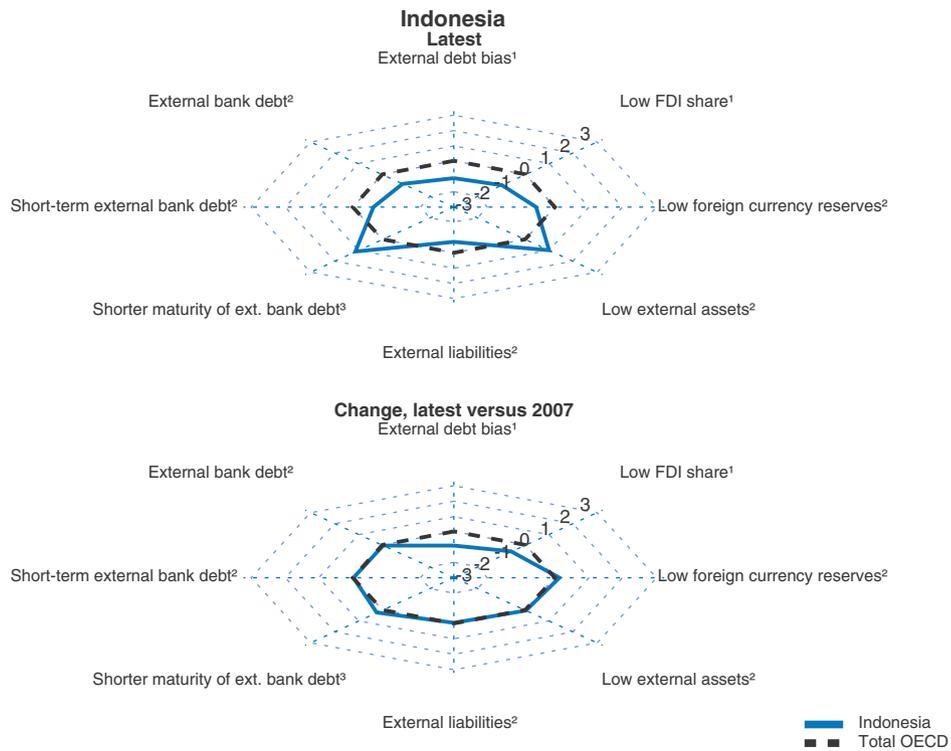


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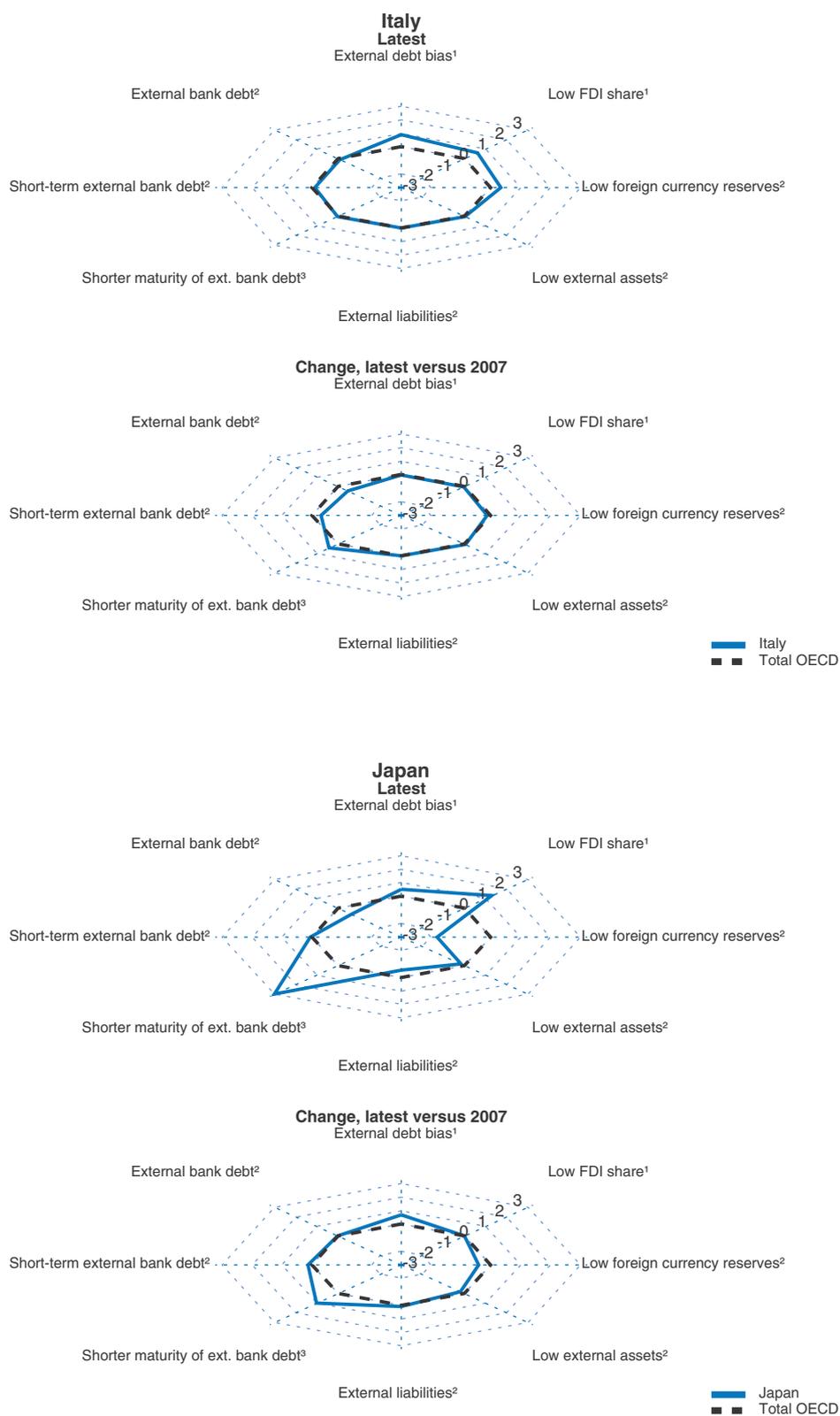


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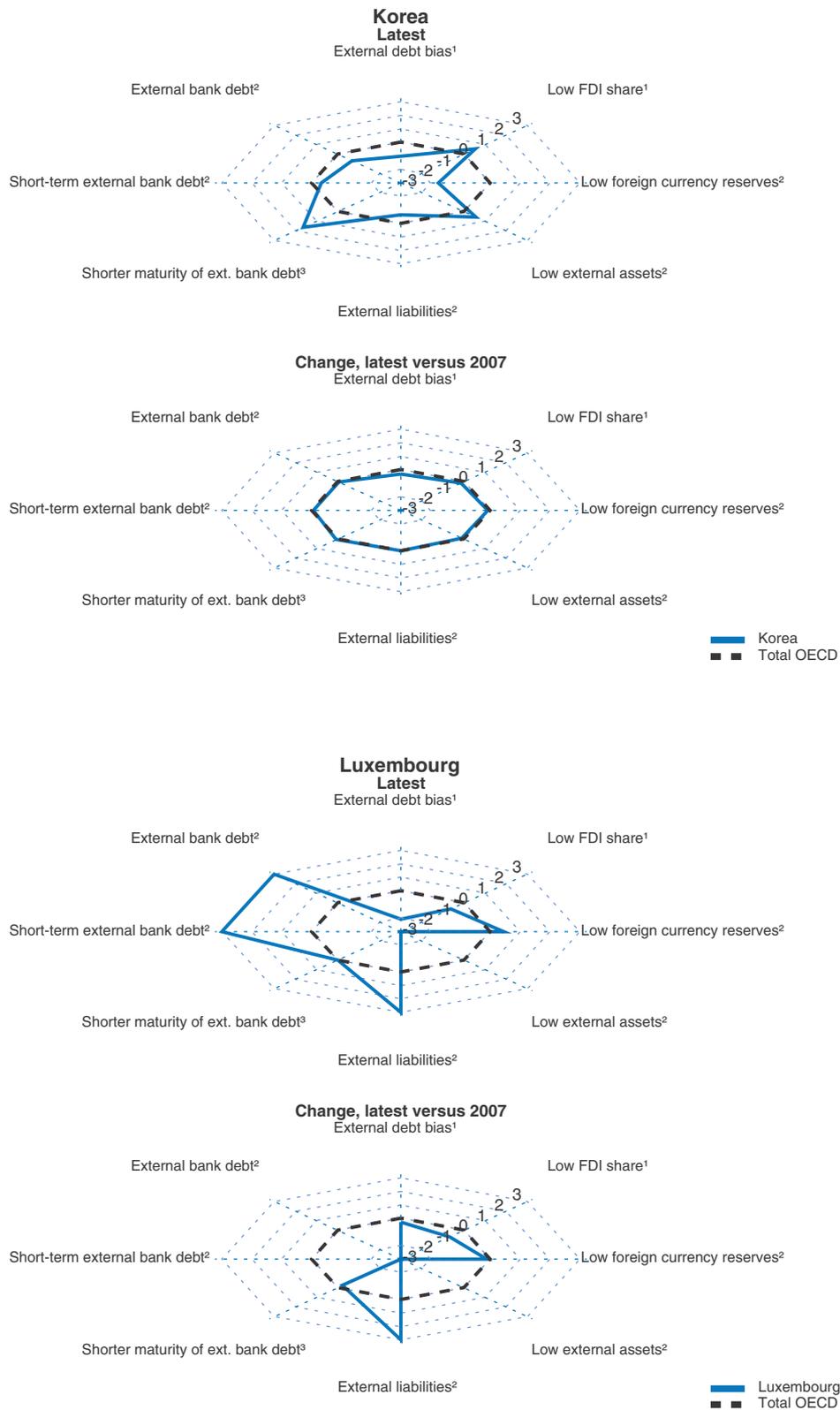


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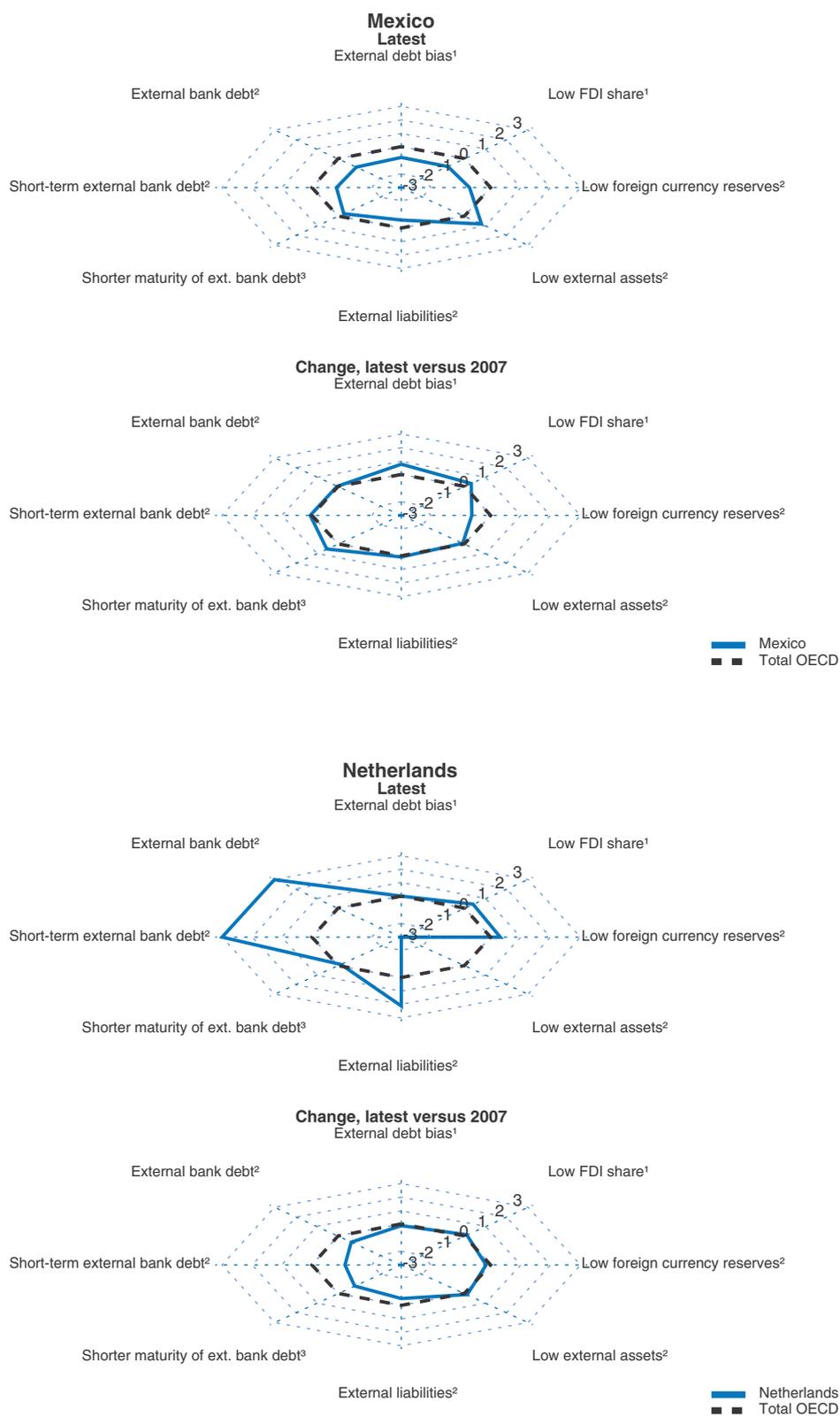


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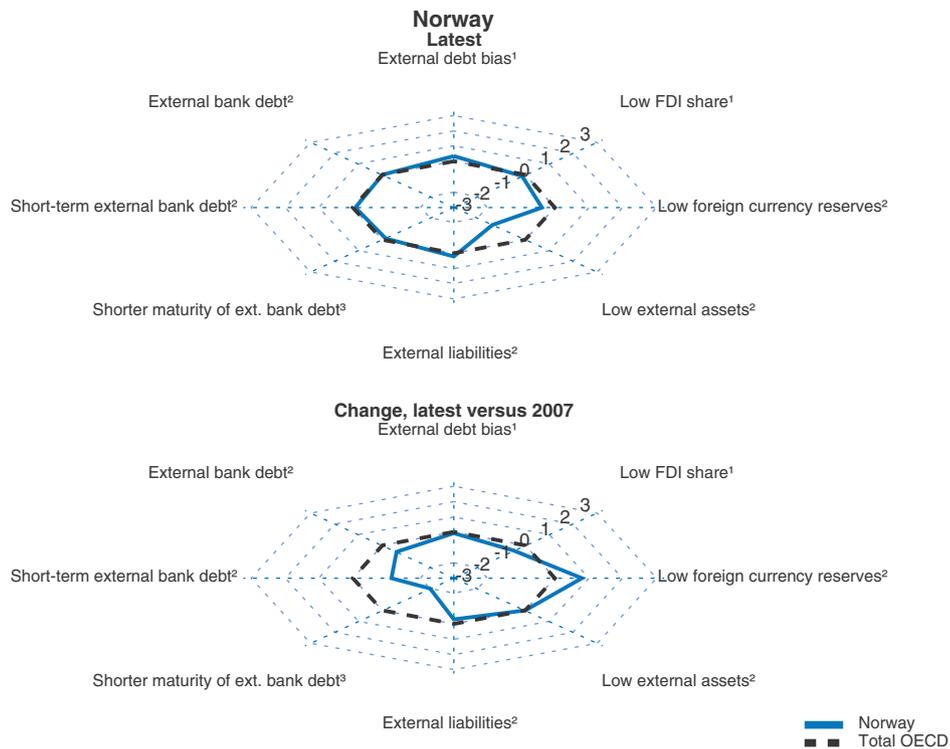
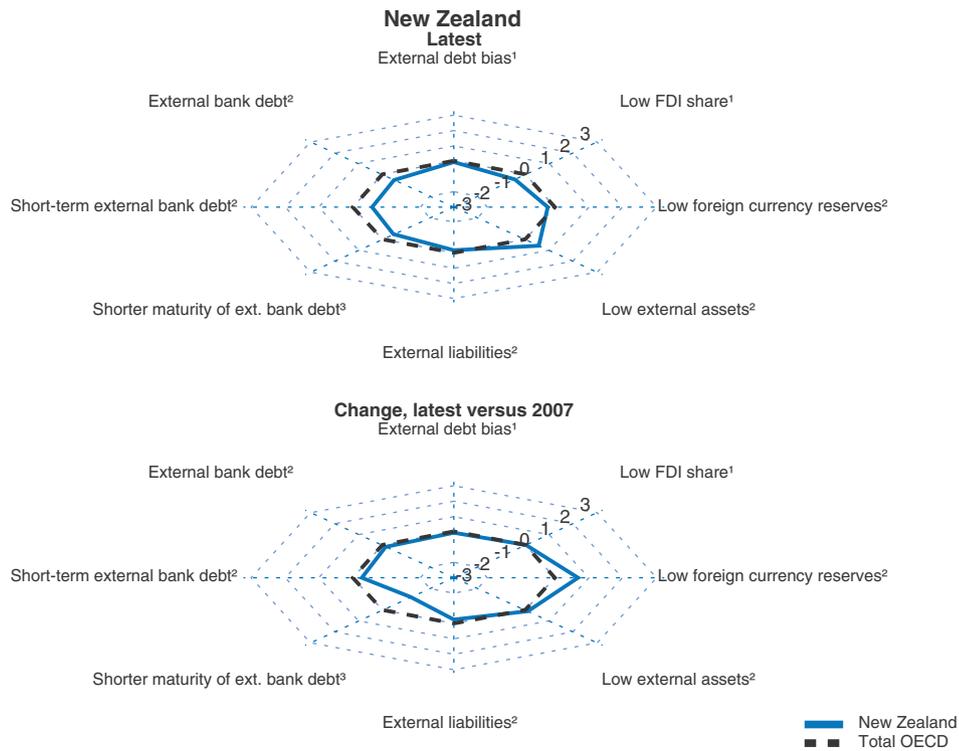


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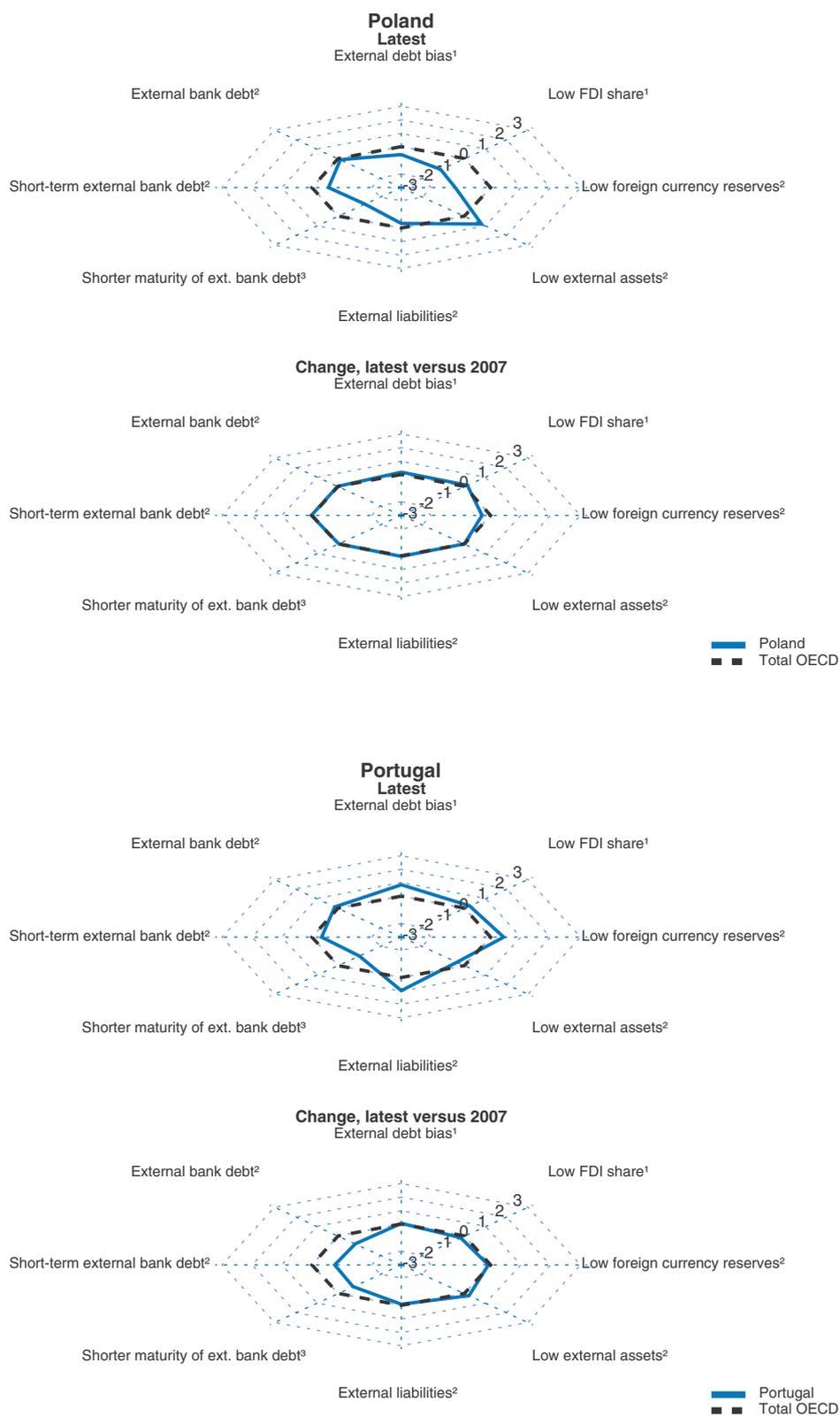


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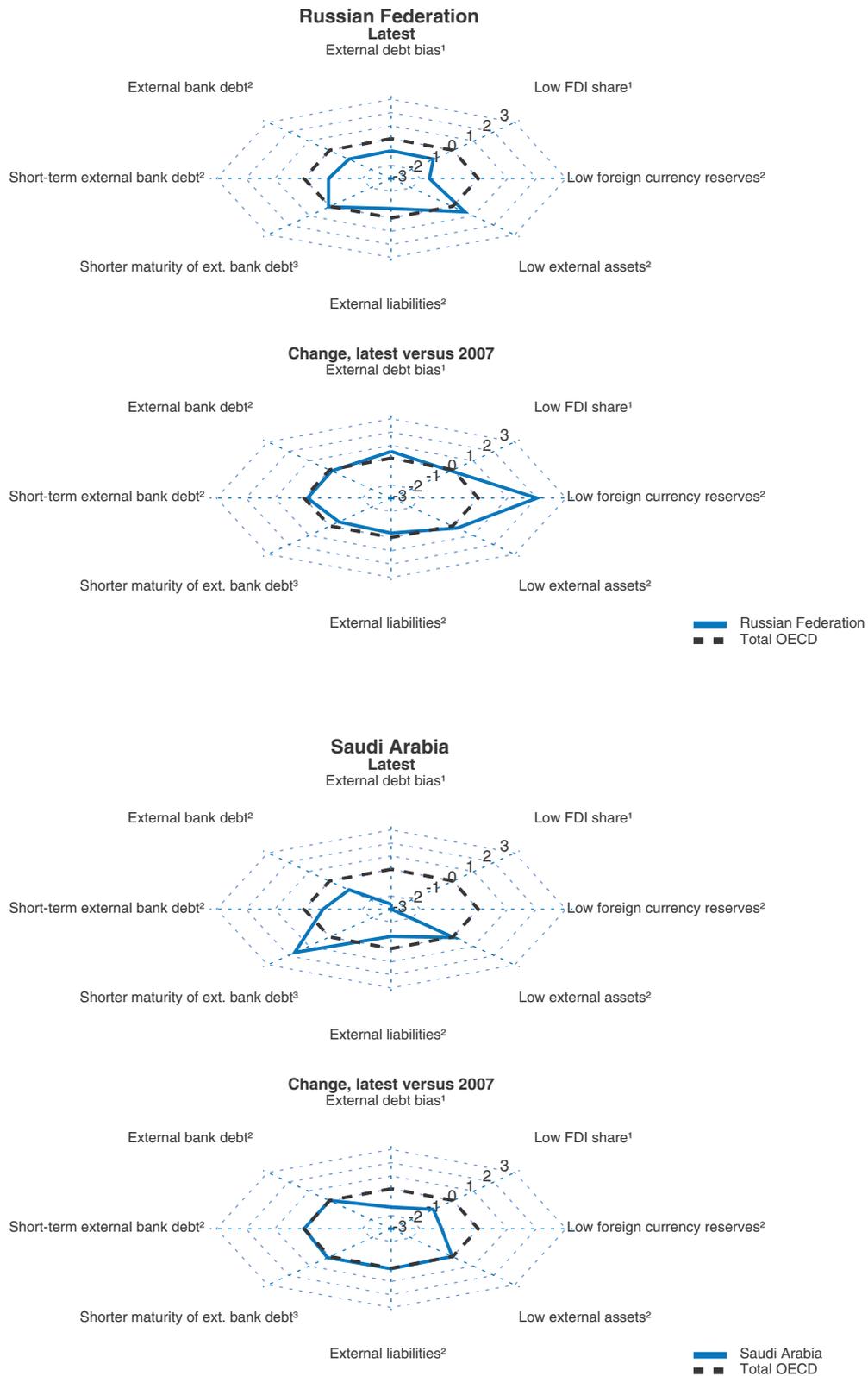


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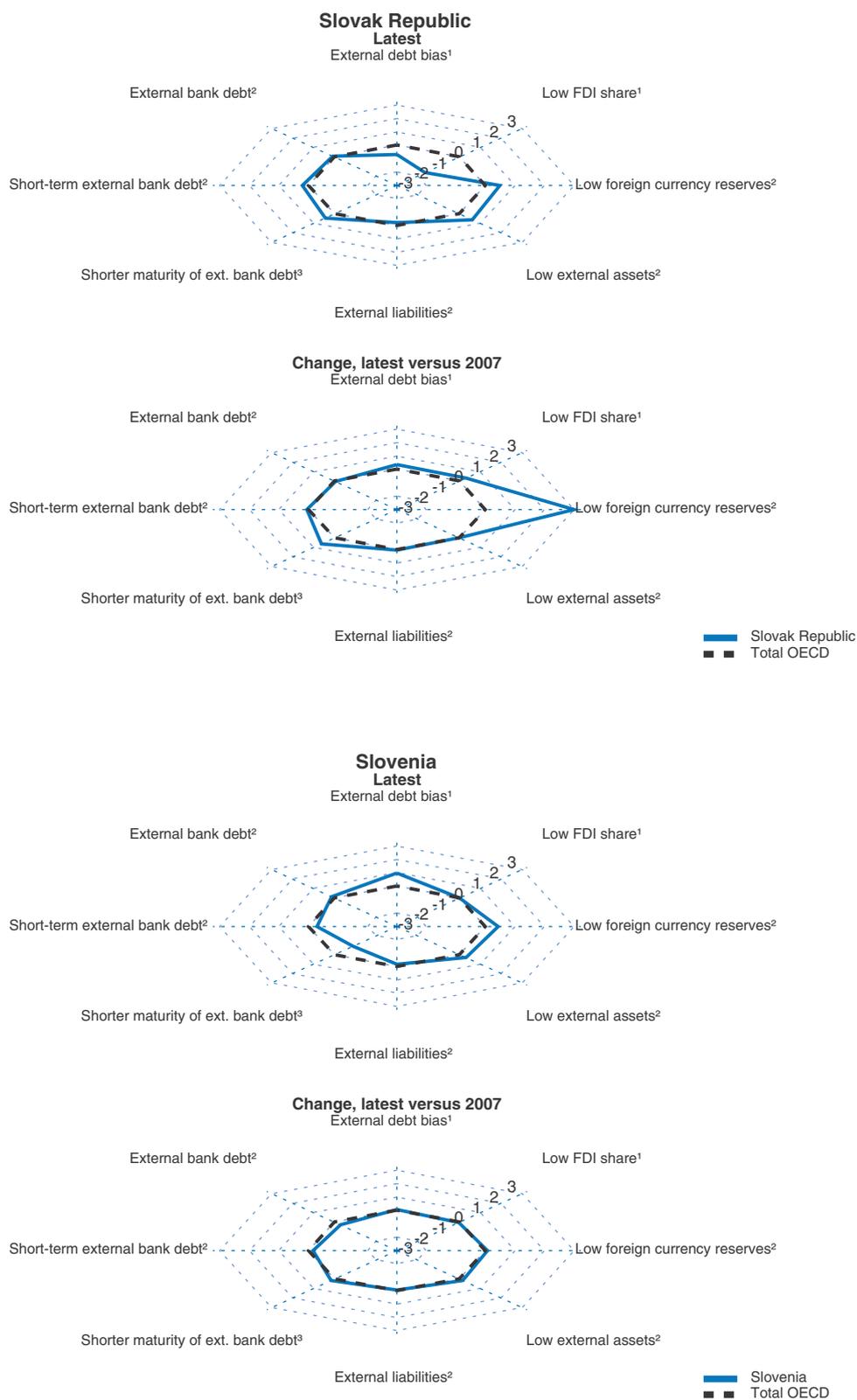


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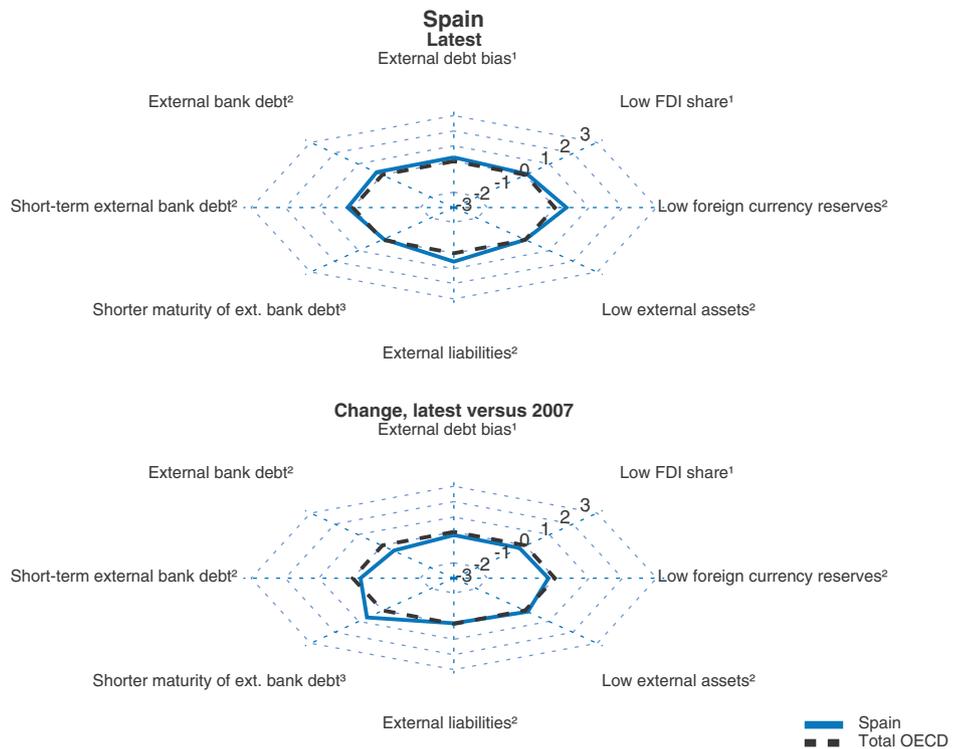
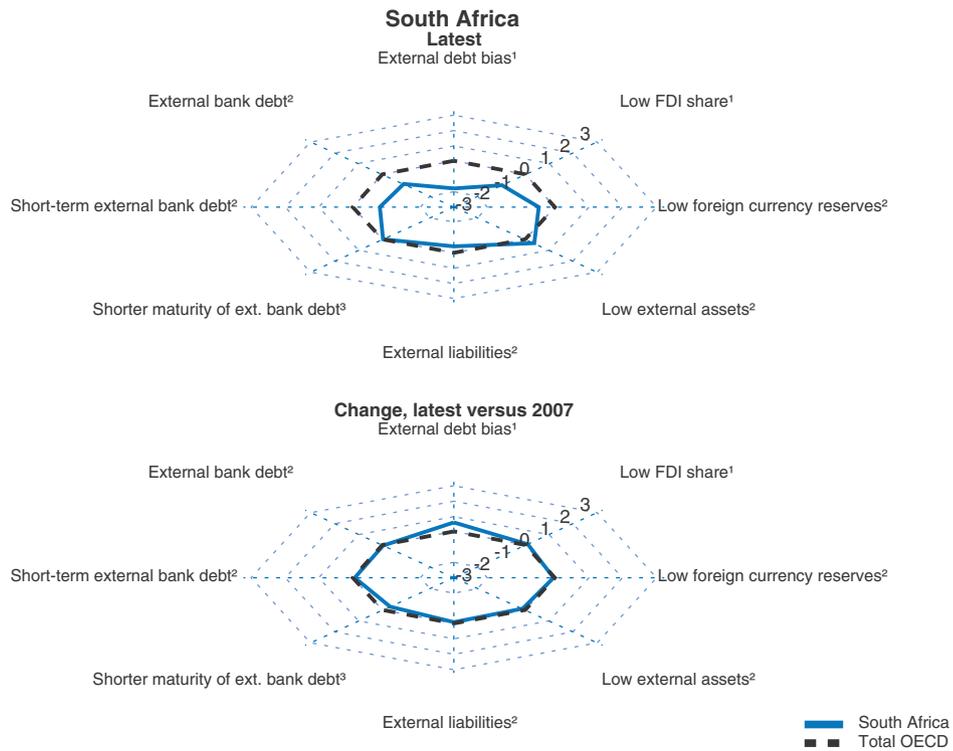


Note: The diamond charts are explained in the introduction to the annex.

(1) As a per cent of external liabilities. (2) As a per cent of GDP. (3) As a per cent of external bank debt.

Source: OECD calculations.

StatLink <http://dx.doi.org/10.1787/888933049002>

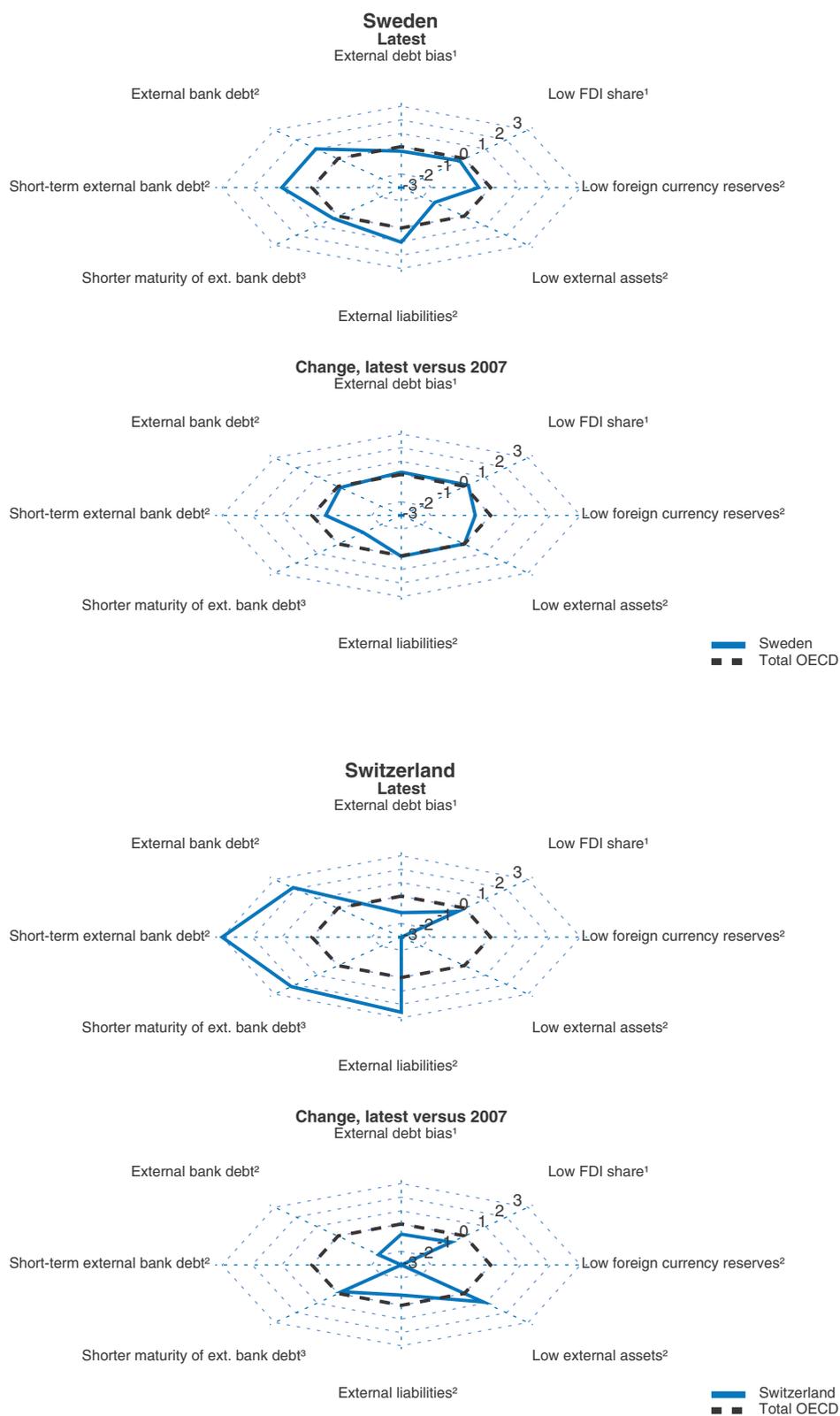


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StatLink <http://dx.doi.org/10.1787/888933049002>

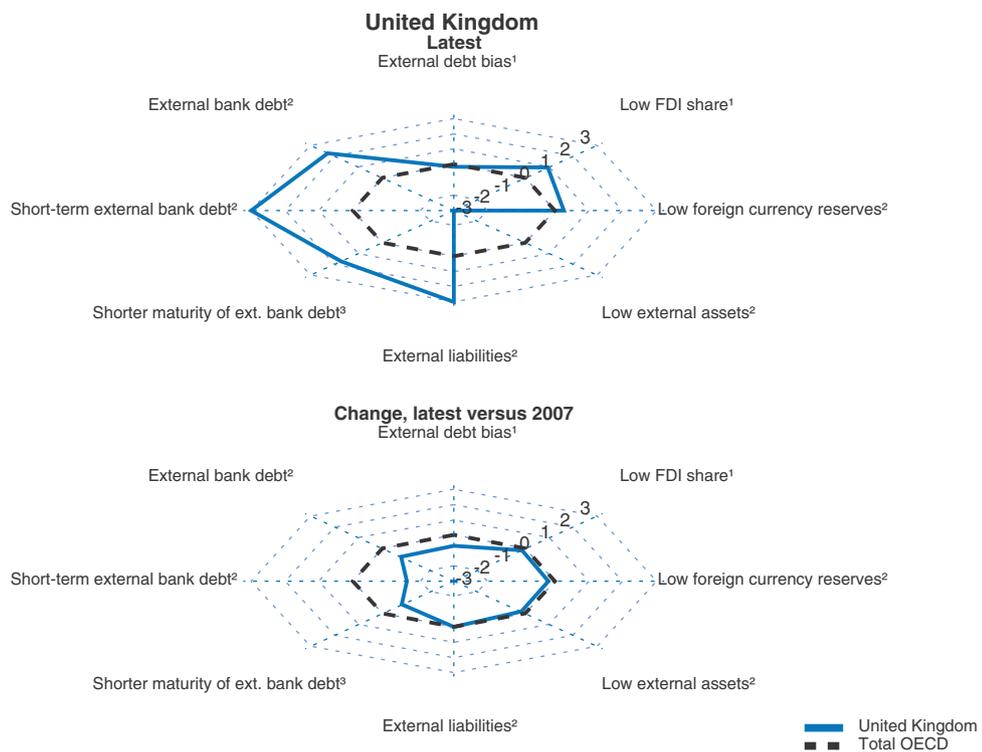
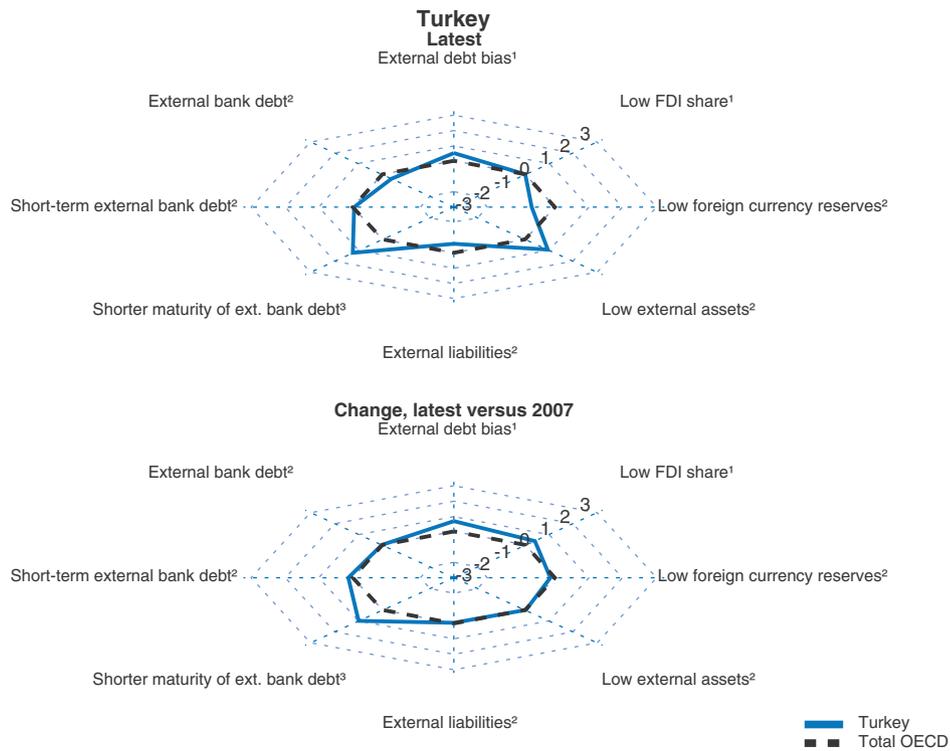


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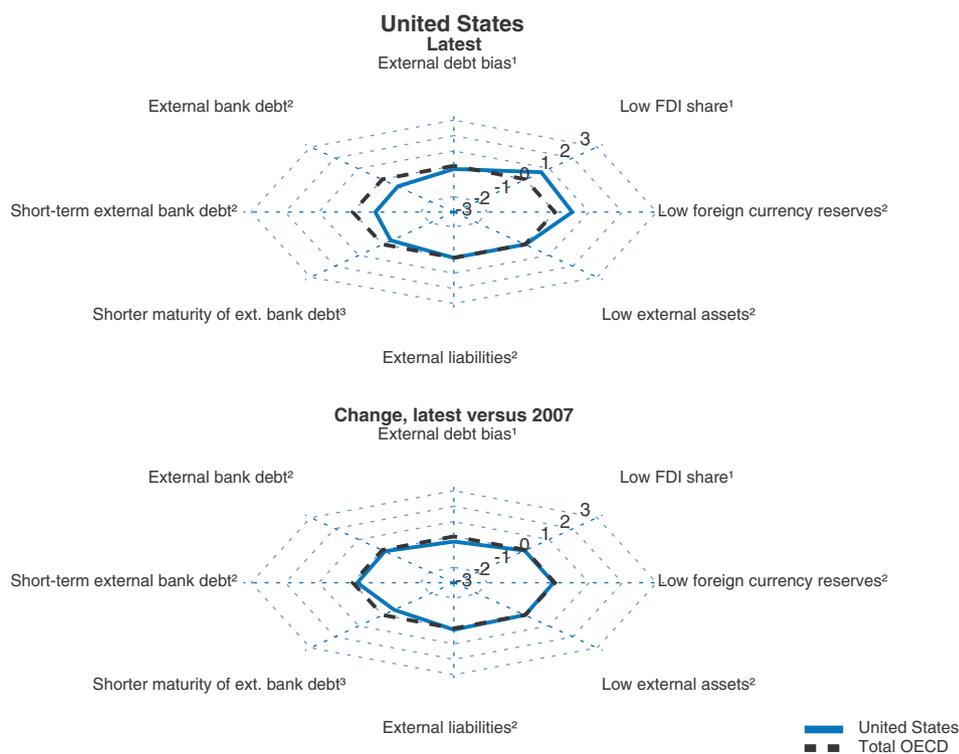


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