OECD Economic Outlook
Volume 2012/1

Chapter 1

GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

Summary

- The projection presented in this *Economic Outlook* rests on the assumption that policy actions will be sufficient to prevent destabilising euro area developments, that there will be no major disturbances affecting oil prices, and that disruptive US fiscal consolidation will be avoided.
- The projection shows a muted and uneven recovery in OECD economies, reflecting both lingering effects from past turmoil and particularly strong fiscal headwinds in the euro area countries under market pressure, and a gradual cyclical recovery in most emerging economies.
- Mirroring the relative strength of recovery, unemployment would decline modestly in the United States and Japan but continue to rise in the euro area throughout 2012 and 2013, with increasing slack strengthening disinflation pressures. Structural policy could help mitigate labour market slack and ensure that cyclical unemployment does not become structural.
- The outlook would call for the maintenance of current accommodative monetary policy settings in the United States and Japan, and a further easing in the euro area.
- Budget consolidation is assumed to take place in most OECD countries except Japan; in the United States it is assumed to be weaker than current legislation would imply and in the euro area broadly in line with official consolidation plans, with unforeseen cyclical budget shortfalls compensated to only a small extent by additional consolidation measures.
- Risks around the projection are extensive and predominantly on the downside, though tail risks are somewhat lower than in December.
- The euro area crisis remains the most important downside risk to the global economy at present, though recent policy measures have created a window of opportunity to tackle the economic, fiscal and financial imbalances at the root of the crisis. Some signs of rebalancing within the euro area have emerged in response to the policy measures taken, mainly in deficit countries, but the process will take time. Structural reforms could play a major role in speeding up adjustment and boosting growth and thereby fiscal sustainability.
- The recently agreed increases in the euro area firewall and IMF resources have significantly raised the capacity to deal with direct government funding problems during the rebalancing process. Nonetheless, potential turbulence in the secondary government bond markets could have repercussions for the stability of the banking system and ultimately public finances, and therefore may also need a policy response, which could involve further action by the ECB through its government bond purchasing programme.
- Other serious downside risks include that no action will be agreed to counter pre-programmed fiscal tightening in the United States in 2013 and that a relatively moderate further deterioration in supply conditions in the oil market could trigger a significant upward spike in oil prices in the near term.
- With a growing perception that the burden of the crisis has not been shared fairly, the risk of disruptive policy changes has probably increased, with potential adverse long-term, and possibly near-term, effects on growth prospects. It is important that policy approaches be seen as fair and measured.

Introduction

Immediate downside risks have been averted so far…

The prospects for the global economy are somewhat brighter than six months ago, with the immediate downside risks in the euro area associated with sovereign defaults and systemic bank failures having been contained so far by policy actions. These have improved confidence and financial conditions, but clear fragilities remain. The breathing space created needs to be used to bolster confidence that the economic adjustment required to durably solve the underlying solvency problems and imbalances at the root of the euro area crisis will be forthcoming. In a number of other OECD economies, the post-crisis healing process is advancing gradually. This is the case particularly in the United States, where it is helped by the avoidance of excessive fiscal consolidation this year and hopefully next. In the emerging economies, a gradual cyclical upswing is now getting underway, supported by moves to ease domestic monetary conditions now that inflation has eased.

… but growth is likely to remain subdued

The projection presented here rests on the assumption that policy actions will be sufficient to prevent destabilising euro area developments, that there will be no major disturbances affecting oil prices, and that excessively rapid fiscal consolidation will be avoided. On this basis, a muted, and possibly bumpy, recovery in the OECD economies is foreseen, supported by accommodative monetary policies and a gradual firming of confidence. Growth is set to be stronger in the United States and Japan than in the euro area, reflecting both lingering effects from past turmoil and particularly strong fiscal headwinds in the countries under market pressure (Table 1.1). With the upturn projected to occur in the emerging market economies, global growth should gradually move back to its long-run average. OECD-wide unemployment would remain very high, while inflation would drift down, particularly in the euro area where an already sizeable negative output gap is increasing further, arguing for additional monetary policy easing.

This chapter is organised as follows. After reviewing the main forces at work, it sets out the projection and discusses the structural measures that could help improve employment and growth outcomes. It then turns to the progress being made in tackling the real imbalances at the root of the euro area crisis and the policy requirements that would facilitate adjustment and further damp the risks of contagion. Finally, it sets out the main macroeconomic and financial policy requirements that are appropriate given the projections, and discusses the short-term effects of structural reforms.

Table 1.1. **The global recovery is slowly regaining momentum**

OECD area, unless noted otherwise

	Average 1999-2008	2009	2010	2011	2012	2013	2011	2012	2013
								Q4 / Q4	
	Per cent								
Real GDP growth[1]	2.4	-3.8	3.2	1.8	1.6	2.2	1.4	1.8	2.4
United States	2.5	-3.5	3.0	1.7	2.4	2.6	1.6	2.4	2.7
Euro area	2.1	-4.4	1.9	1.5	-0.1	0.9	0.7	0.2	1.3
Japan	1.1	-5.5	4.5	-0.7	2.0	1.5	-0.6	1.9	1.6
Output gap[2]	1.4	-4.1	-2.6	-2.5	-2.8	-2.6			
Unemployment rate[3]	6.4	8.2	8.3	8.0	8.0	7.9	7.9	8.0	7.7
Inflation[4]	2.7	0.5	1.9	2.5	2.2	1.9	2.7	2.1	1.9
Fiscal balance[5]	-2.1	-8.1	-7.5	-6.3	-5.3	-4.2			
Memorandum Items									
World real trade growth	6.7	-10.7	12.8	6.0	4.1	7.0	3.4	5.7	7.5
World real GDP growth[6]	3.8	-1.2	5.1	3.6	3.4	4.2	3.1	3.8	4.4

1. Year-on-year increase; last three columns show the increase over a year earlier.
2. Per cent of potential GDP.
3. Per cent of labour force.
4. Private consumption deflator. Year-on-year increase; last 3 columns show the increase over a year earlier.
5. Per cent of GDP.
6. Moving nominal GDP weights, using purchasing power parities.

Source: OECD Economic Outlook 91 database.

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Key forces acting

Financial conditions

Euro area financial markets remain fragile…

The improvement in euro area financial markets that followed strong action to provide additional liquidity and funding to the euro area banking sector seems to have run its course. Indeed, the situation remains fragile, with market turbulence and sovereign debt concerns intensifying once more in the aftermath of the elections in Greece. Key recent developments include:

… despite some improvements in bank and sovereign funding costs…

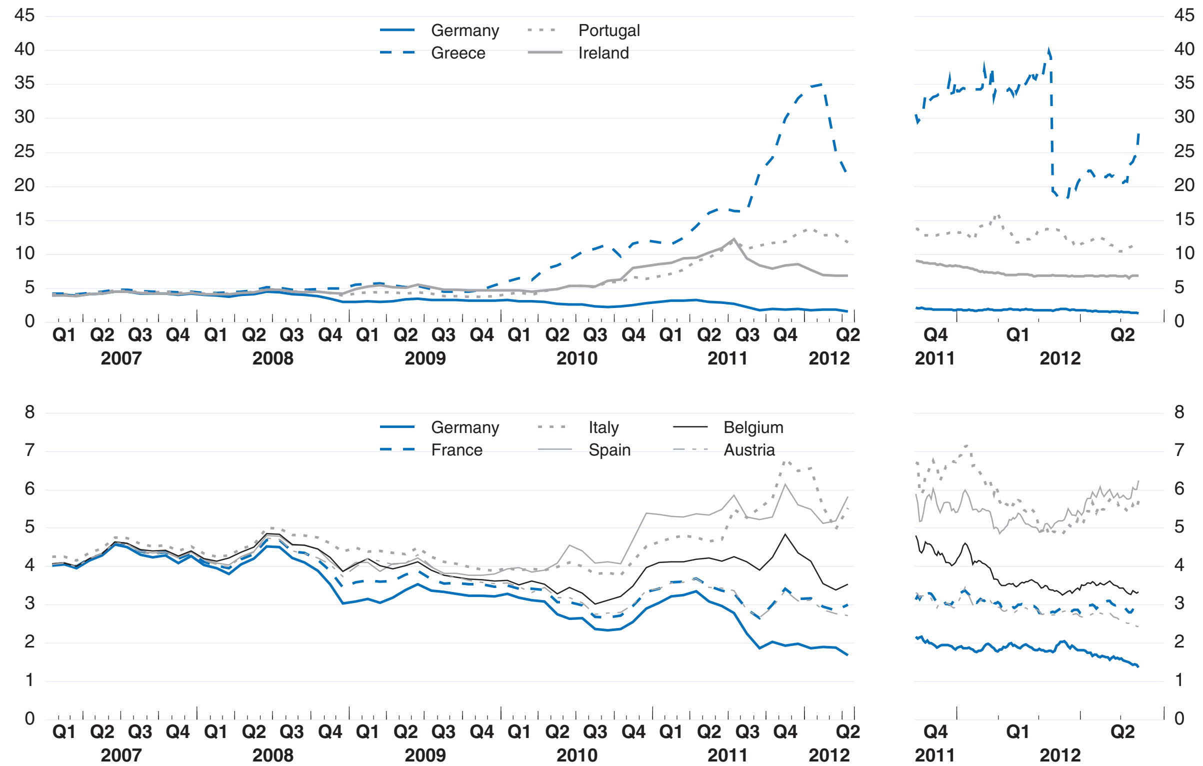
- Following declines in sovereign bond yields during the first quarter of 2012 in many economies under market pressure, renewed concerns about fiscal and banking sustainability, and about possible spillovers from developments in Greece, have led to some backing-up, most notably in Spain and Italy (Figure 1.1). Concerns about banks' medium and long-term funding have also reappeared in the euro area, with money market spreads and credit default swap rates recently turning up again (Figure 1.2).

… and bank lending remains subdued

- Recent euro area bank lending numbers remain weak, though the extent to which weak credit growth reflects supply or demand factors remains uncertain. The two long-term refinancing operations undertaken by the ECB in December and February helped to markedly soften the pace at which credit standards appeared to tighten at the start of the year. Even so, fundamental differences across the euro area

Figure 1.1. **Investors continue to discriminate strongly across euro area sovereign bonds**

10-year sovereign bond yield, in per cent



Source: Datastream.

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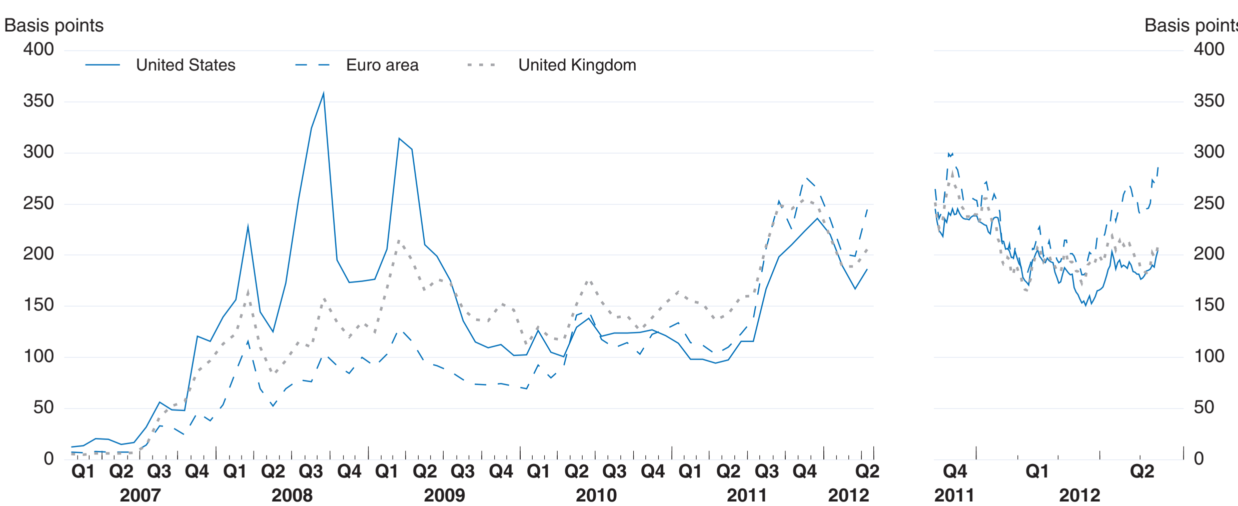
Figure 1.2. **It is relatively expensive to insure unsecured bank debt against default**

Annual rates of five-year credit default swap contracts on very large banks



Note: Banking sector 5-year credit default swap rates.

Source: Datastream.

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remain clearly visible. In Germany, there has been little tightening of credit standards at all, and the IFO survey suggests that companies continue to enjoy good access to bank credit. By contrast, in euro area countries under market pressure, credit standards have tightened considerably.

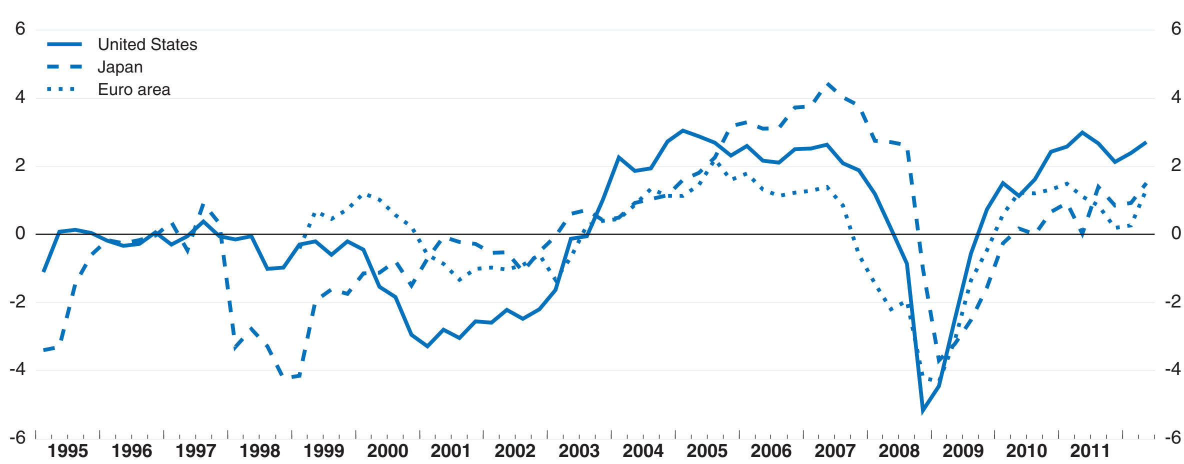
Financial markets have strengthened outside the euro area

Financial conditions in other OECD economies and emerging economies have tended to stabilise or improve as markets have reacted to better news and become less risk averse. Global equity prices have increased since the end of 2011, and yields on government and investment-grade corporate bonds have remained low, with spreads narrowing. In the United States, the banking sector, which is less highly geared than in the euro area, now seems to have been restored to good health overall. The euro and the dollar effective exchange rates have been broadly flat in recent months, but the yen effective exchange rate has depreciated since mid-February, possibly reflecting a decrease in safe-haven effects and the Bank of Japan's moves to ease monetary policy by more than had been expected. Mirroring an enhanced willingness to take risk, capital inflows into emerging markets have picked up this year, reversing the tendency prevailing in the latter half of 2011.

These changes provide a mild boost to growth prospects

Putting these developments together, the OECD financial conditions indices (FCIs) show some recent improvements in all the main regions (Figure 1.3), including in aggregate euro area conditions, notwithstanding recent turbulence. On the basis of past relationships between the FCIs and activity, the recent changes in the FCIs imply that GDP growth in the

Figure 1.3. **Aggregate financial conditions have improved this year**



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). Estimation done with available information up to 11 May 2012.

Source: Datastream; OECD Economic Outlook 91 database; and OECD calculations.

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United States and the euro area could be raised by around ¼ and ½ percentage point in 2012 and 2013 respectively, and by a little over ¼ percentage point in Japan in 2013, compared with the outcome if the FCIs had remained unchanged since the end of last year. The OECD projection for the euro area does not build in any direct additional allowance for possible bank deleveraging over and above the effects that operate via the credit standards component of the FCI. This implies that negative bank deleveraging effects in the projections are confined to the few euro area countries where banks are under particularly intense pressure.

Safe-haven government bond yields are very low

The current very low government bond yields in the United States, Germany, Japan and the United Kingdom, four sovereign issuers seen as safe havens, reflect underlying supply-demand conditions in the bond markets, including expectations of a prolonged period of low policy rates. Recent empirical studies suggest that US quantitative easing and the first UK quantitative easing could have lowered medium and long-term government bond yields by around 100 basis points in both countries, although there is considerable uncertainty around these estimates.[1] Stronger financial regulation worldwide, together with rising investor appetite for safe assets and collateral that is readily accepted in financial transactions, has also raised demand for safe-haven government bonds. At the same time, the global supply of safe assets has decreased, with the debts of several euro area sovereigns no longer being regarded as risk-free. These underlying supply-demand forces seem likely to persist, but yields may nonetheless increase in the countries concerned due to rising public debt levels (see Box 1.2 below for details).

Demand and activity developments

Economic conditions are improving moderately but remain fragile

Global economic conditions are now improving moderately, with confidence having started to stabilise or recover and some immediate near-term risks having receded. Even so, the recovery remains slow and fragile, with demand and supply indicators both pointing to a muted upturn in the OECD economies, with the euro area lagging behind, and a moderate cyclical upswing getting underway in many emerging economies. Key activity and demand developments include:

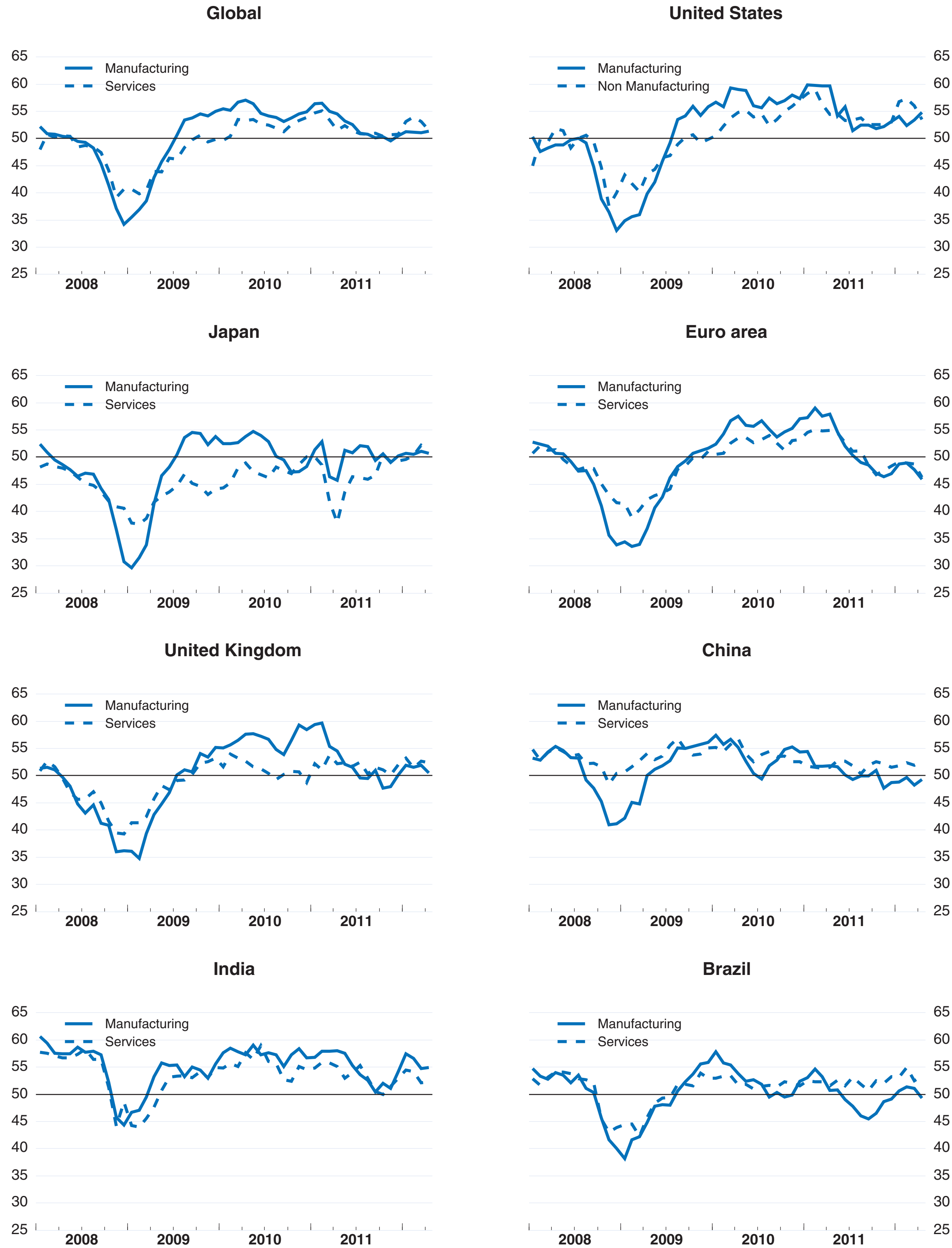
Business sentiment has stabilised or begun to recover…

- Business sentiment and order books continue to fluctuate, but have tended to either stabilise or turn up over the past six months in many of the major OECD and non-OECD economies (Figure 1.4), whereas they had been expected to weaken for some time in the baseline scenario in

1. The calculation uses results reported in D'Amico and King (2011), Gagnon *et al.* (2011), Krishnamurthy and Vissing-Jorgensen (2011), Hamilton and Wu (2012), Meaning and Zhu (2011), and Joyce *et al.* (2011). According to them and Stroebel and Taylor (2011), who study the effects on US mortgage rates, and Oda and Ueda (2007) and Lam (2011), who study the effects of the Bank of Japan's asset purchases, asset purchases corresponding to 1% of nominal GDP reduce long-term interest rates by estimates that range from not statistically significant to 28 basis points, with an average of 7 basis points across the studies.

Figure 1.4. **Business confidence has tended to stabilise or improve**

PMI indicators



Source: Markit.

the November 2011 *Economic Outlook*. In the euro area as a whole, sentiment has been broadly flat, fluctuating around a low level, but intra-area disparities have continued to widen with substantial weakening of sentiment in economies under market pressure, such as Italy and Spain, but somewhat stronger outturns in Germany, especially in the services sector. The PMI surveys in the major emerging market economies are mixed, with some signs that the moderation of output growth in India and Brazil may be easing, but conflicting signals provided by different business sentiment surveys in China.

… global trade may be picking up…

- The full restoration of global supply chains following natural disasters in Asia boosted trade in the early months of 2012. Estimates by the Dutch Central Planning Bureau (CPB) suggest that global merchandise trade volumes in the three months to February were 6¼ per cent (at an annualised rate) higher than in the previous three months. High-frequency trade-related indicators presently provide mixed signals. Export order books are consistent with trade growth picking up, especially outside Europe, but container and bulk commodity shipping rates are more consistent with much softer outcomes in the near term, though in part their weakness reflects significant excess capacity in shipping markets.[2]

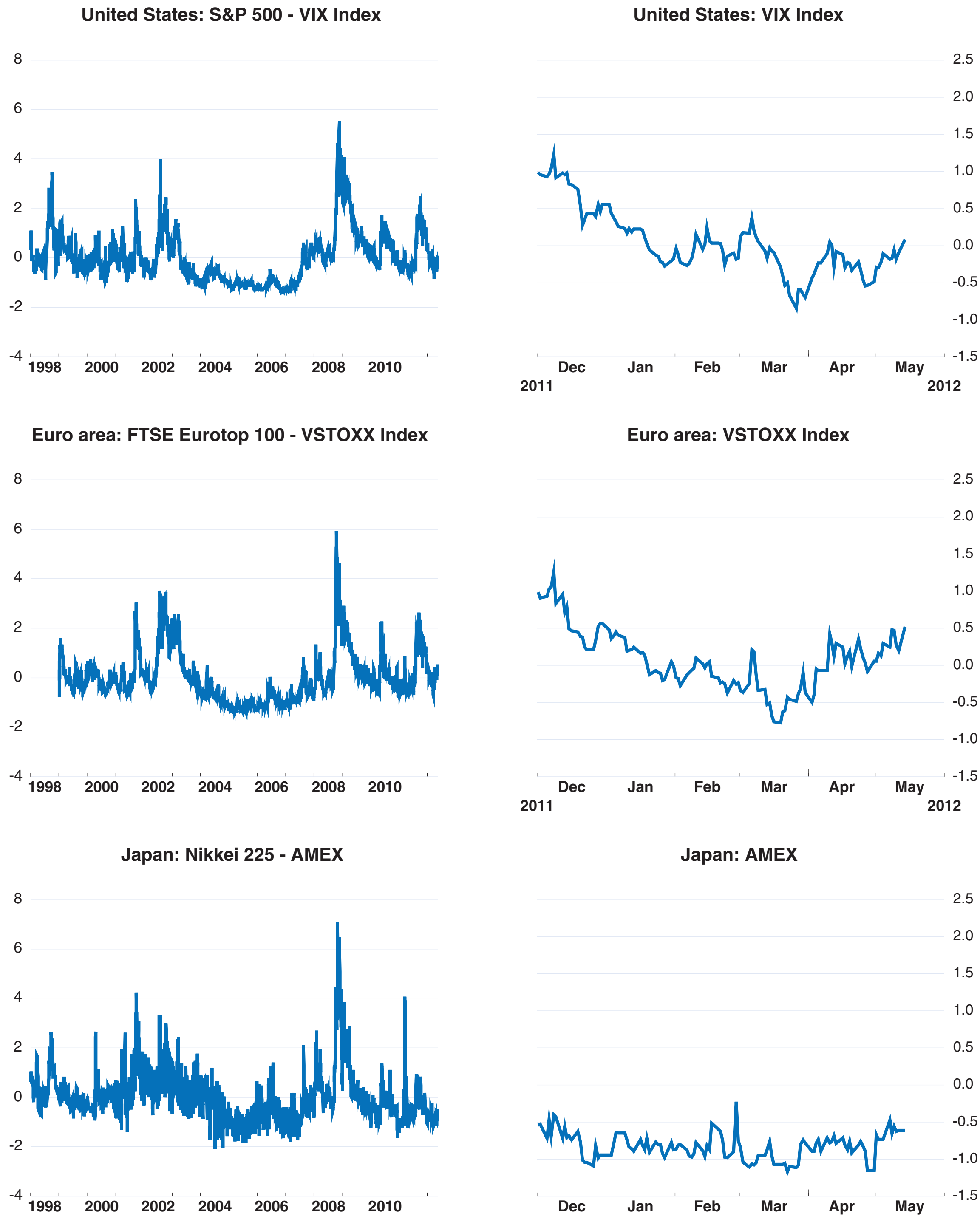
… business investment should strengthen…

- Business investment remains well below longer-term norms in many countries, but has risen gradually since the start of the recovery, buoyed by strong corporate profitability and generally healthy corporate balance sheets. The pace of the upturn has slowed outside of Japan, where reconstruction demands are continuing to boost investment, reflecting the option value of delaying new investment amidst heightened uncertainty in the latter half of 2011, as well as subdued expectations about economic prospects (OECD, 2011a). However, these latter factors may gradually fade, particularly in the United States, where investment intentions have rebounded and stock market volatility, a measure of uncertainty, has diminished considerably (Figure 1.5).[3,4] In the euro area, the underlying conditions for investment have improved a little in recent months with the stabilisation of confidence, albeit at a low level, but

2. A potential concern was that constraints on the lending of euro area banks might have an adverse impact on trade growth in 2012, given that they account for a large share of global trade finance. At present, this risk does not seem to have materialised, with some signs that non-European banks are replacing at least part of the shortfall in lending by European banks, especially in Asia (Vause *et al*., 2012).
3. In the IT sector, indicators of aggregate activity, such as the US Tech Pulse Index and global semi-conductor billings, have gone through a period of pronounced weakness stemming from soft consumer demand, especially in Europe, supply disruptions arising from natural disasters in Asia, and, for semiconductors, a correction from high inventory levels. Signs of a possible upturn have recently appeared, and if this is sustained, it would provide a boost to IT-related investments and activity in the latter part of this year and 2013.
4. A simple indicator-type model for business investment in the United States, in which investment growth is related to survey measures of investment intentions, the OECD US financial conditions index and US stock market volatility (OECD, 2011a), points to solid growth in investment volumes of around 6¼ per cent this year, a little above the projected growth rate of 5½ per cent.

Figure 1.5. **The implied volatility of share prices has moderated**[1]

Normalised figure[2] – 1998 to last available point



1. Implied volatility can be interpreted as market expectation of risk (future volatility) and is derived from at-the-money call option prices (interpolated) using the Black-Scholes formula. For more recent data (Datastream), the Cox-Rubinstein binomial method is used for American style options.
2. VIX from 1st April 2004; VSTOXX from 1 January 1999; AMEX from 1st January 2001 to June 2007. NIKKEI 225 earlier, and again from July 2007.

Source: Bloomberg (weekly, 1998-2000), Datastream (daily, 2001-last observation).

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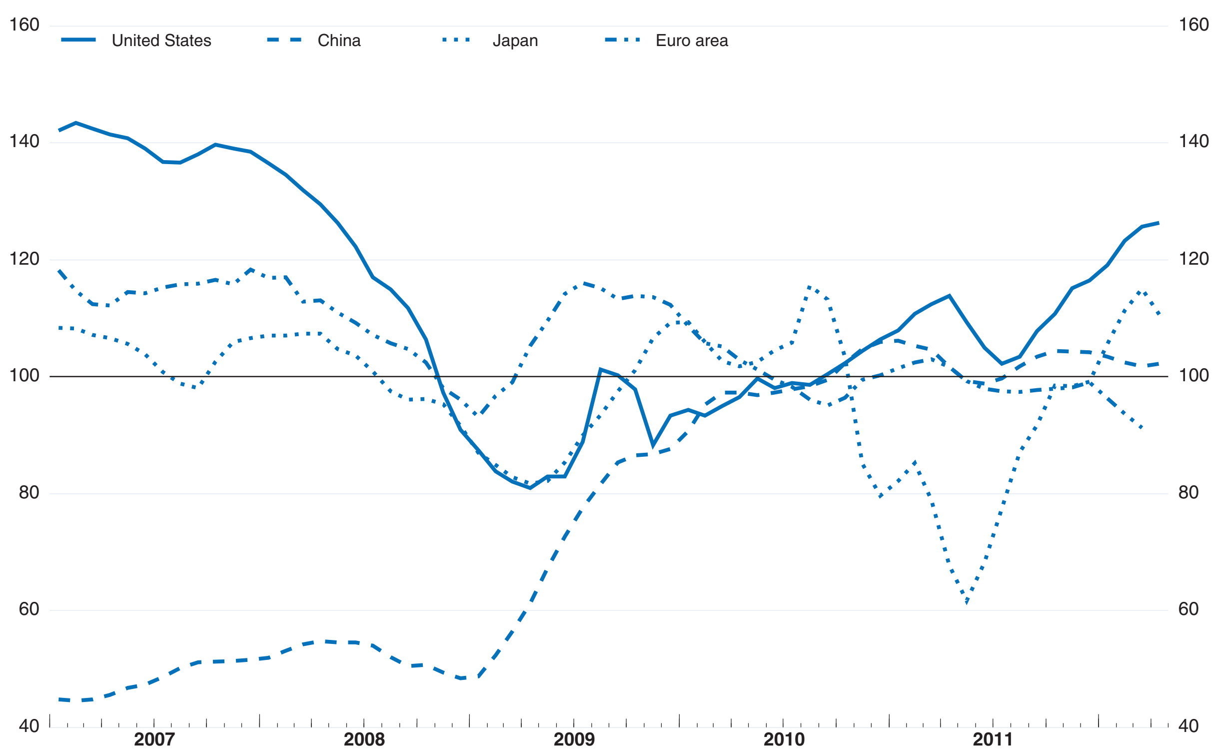
normal cyclical forces are likely to hold back investment for some time.[5] At the margin, weak bank lending could damp some investment expenditure, especially in the European economies under market pressure and for small firms, but generally healthy corporate bond markets and the upturn in equity markets increasingly offer alternative sources of finance for large enterprises.

... and car sales have recently been buoyant in some countries

- Car sales constitute an important part of consumer demand, with information available on a timely basis. Recent high-frequency information on sales points to diverging near-term activity developments, with weak outcomes in the euro area, a modest upturn in sales in China, but stronger outcomes in the United States and in Japan, helped by the reintroduction of the government's subsidy programme for purchases of environmentally friendly cars (Figure 1.6).

Figure 1.6. **Recent trends in new car registrations diverge across regions**

2010 = 100, 3 months moving average



Source: Bureau of Economic Analysis; China Association of Automobile Manufacturers; Japan Automobile Manufacturers Association and European Central Bank.

StatLink http://dx.doi.org/10.1787/888932608069

5. For the euro area, an indicator-type model using survey measures of production expectations and the euro area financial conditions index points to area-wide investment growth of around 1¼ per cent in 2012. This compares with a projected growth rate of just over 1¾ per cent in the five euro area members for which business investment projections are available (Belgium, Finland, France, Germany and the Netherlands).

But household balance-sheet adjustment is continuing…

- Household saving rates remain high relative to pre-crisis norms, but have recently begun to edge down in many OECD countries. Nonetheless, total private consumption growth remains comparatively subdued, particularly in the euro area and the United Kingdom, though less so in the United States. This reflects the ongoing need for balance sheet adjustment and debt deleveraging (Box 1.1), and subdued growth

Box 1.1. **Cross-country progress in private sector deleveraging**

In the run-up to the crisis, households and non-financial businesses in several countries increased their indebtedness to exceptionally high levels, while financial institutions expanded their balance sheets massively. Much of this debt build-up appears to have been driven by low global interest rates and financial innovation, in the context of inadequate regulation. The latter provided increased scope for regulatory arbitrage and excessive risk-taking by financial institutions, especially those regarded as being too big to fail (Blundell-Wignall and Atkinson, 2011; Slovik, 2012), and amplified feed-back loops between higher household debt and higher property prices. In many countries, a large part of the increase in indebtedness and leverage in the run-up to the crisis can probably be regarded as being "excessive." Questions that are relevant for economic prospects are whether any such overhangs will be followed by declines in debt ratios in coming years and the possible implications for activity.

Among the countries where debt increased strongly before the crisis, the United Kingdom and the United States have seen significant reductions in household debt, cutting household debt-to-income ratios by close to 20 percentage points since 2007 (see table below). In the United States, the debt ratio of the financial sector has fallen below the level in 2007, partly because of write-offs related to the collapse of Lehman Brothers and consolidation in the banking sector. In the United Kingdom, the ratio of non-financial corporate debt to GDP has declined moderately since 2007 but remains well above its 2000 level, while debt in the financial sector has continued to increase relative to GDP. The debt-reduction process has barely begun in other large countries that experienced a credit boom over the past decade and in some, debt is still rising relative to GDP.

Using the increase in debt ratios from their pre-boom levels in 2000 as a simple indicator of the risk of potential deleveraging pressures, three groups of countries can be distinguished: (i) no reduction in indebtedness appears to be likely in Japan and Germany; (ii) following considerable debt reduction, a mild further reduction in indebtedness might occur in the United States; (iii) significant cuts in indebtedness risk taking place in many other countries, though it bears mention that recent run-ups in debt occurred from low levels in some (including France, Belgium and Italy) and have generally been accompanied by increases in the net worth of households.

Deleveraging in the coming years may have large economic consequences though these will differ depending on the current pace of debt reduction, the time period over which debt is to be reduced and the debt reduction strategies adopted. In the United States, should deleveraging continue at its pace over the past four years, with continued significant write-downs of household debt, the debt ratio would regain its 2000 level in 2015. For households in the United Kingdom, at the adjustment speed observed since 2008, the adjustment period would be longer, at around ten years, reflecting the larger debt overhang. In both countries, the major headwinds associated with deleveraging, namely the increase in saving rates and reduction in residential investment, are, however, likely behind them (though falling saving rates and rising residential investment may contribute less to the recovery than is usual).

In other countries where household debt ratios could fall but the process has not started, growth might be reduced temporarily as debt reduction commences. The assumption behind these projections, however, is that household deleveraging does not generate strong headwinds for growth in 2012 and 2013, but that it is a negative risk to growth.

Box 1.1. **Cross-country progress in private sector deleveraging** *(cont.)*

Debt indicators in the private sector

Per cent

	Households' gross debt-to-disposable income ratio			Non-financial corporations' gross debt-to-GDP ratio			Financial corporations' gross debt-to-GDP ratio[1]		
	2011 Q3[2]	Pre-crisis level 2007	Pre-boom level 2000	2011 Q3[2]	Pre-crisis level 2007	Pre-boom level 2000	2011 Q3[2]	Pre-crisis level 2007	Pre-boom level 2000
United States[3]	118.3	137.6	100.7	106.7	116.5	113.3	308.1	333.9	277.4
Japan[3]	124.5	136.7	143.6	153.1	148.1	172.8	555.7	519.1	566.6
Germany	94.3	103.0	116.4	74.6	77.7	78.9	319.3	322.1	290.1
France	101.1	92.9	70.4	104.5	89.9	82.0	335.0	275.4	185.3
Italy	80.1	71.1	44.7	92.7	88.3	66.7	207.0	178.7	124.7
United Kingdom[3]	160.7	183.4	117.1	113.4	116.9	93.3	853.7	810.1	569.2
Canada[3]	183.7	137.3	112.6	103.5	100.7	111.0	327.4	298.7	238.0
Australia	183.7	186.4	124.0	74.3	83.8	72.7	289.5	315.9	191.1
Belgium	91.7	84.1	67.8	73.0	72.5	79.4	346.6	391.6	268.5
Greece	97.8	74.7	28.6	68.4	63.9	47.9	219.2	154.4	109.4
Ireland[3]	228.7	228.2	..	298.2	166.5	..	1404.3	1101.5	..
Korea[3]	154.9	145.8	95.9	158.6	143.9	..	373.2	349.5	..
Netherlands	290.5	261.0	174.3	111.1	118.2	136.6	670.6	669.7	491.0
Portugal	154.1	154.4	111.7	148.9	128.8	118.8	304.1	257.6	202.4
Spain	140.5	147.4	85.6	132.6	128.4	72.8	239.5	232.7	154.9
Sweden	169.3	160.0	108.7	148.2	139.4	119.0	266.5	245.3	184.3
Switzerland[3]	213.4	201.0	186.0	99.0	88.1	83.6	671.0	734.0	605.3
Euro area	107.9	105.6	85.3	96.8	91.4	78.8	381.7	365.4	269.1

1. Gross debt is defined as total financial liabilities – including deposits – less shares and financial derivatives.
2. Or latest available.
3. Not consolidated.

Source: OECD national accounts, OECD Economic Outlook 91 database, national central banks, national statistical institutes, ECB, Eurostat

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As concerns debt-reduction strategies, household debt write-downs or defaults may mitigate the negative effects of deleveraging on economic activity by redistributing losses from debtors with a high propensity to consume to creditors with a lower propensity. Such an adjustment is relatively easy to initiate at a comparatively low cost by debtors in the United States because of the non-recourse nature of mortgage loans but is more costly elsewhere in the OECD because of the unlimited liability of households as borrowers. However, large-scale household defaults could risk destabilising the financial system if additional private capital injections were not available, requiring public capital injections to safeguard the banking system. While this might simply transform a household debt problem into a public debt one, the economic costs may still be lower than keeping household spending compressed for long periods to honour debt obligations.

The restructuring of household debt, including debt forgiveness to write down debt to a certain percentage of disposable income or the value of the underlying collateral, could also raise the average propensity to spend and, by reducing foreclosures, would also lower the social cost of home eviction and prevent fire-sales of repossessed property. Several OECD countries have public programmes that provide subsidies for household debt restructuring and discussions are on-going in some to increase such support. For example, in the United States, discussions centre on how the government-sponsored agencies, Freddie Mac and Fanny Mae, as owners and guarantors of mortgages, could reduce the extent of mortgages that are underwater, *i.e.* mortgages higher than the value of the underlying property.

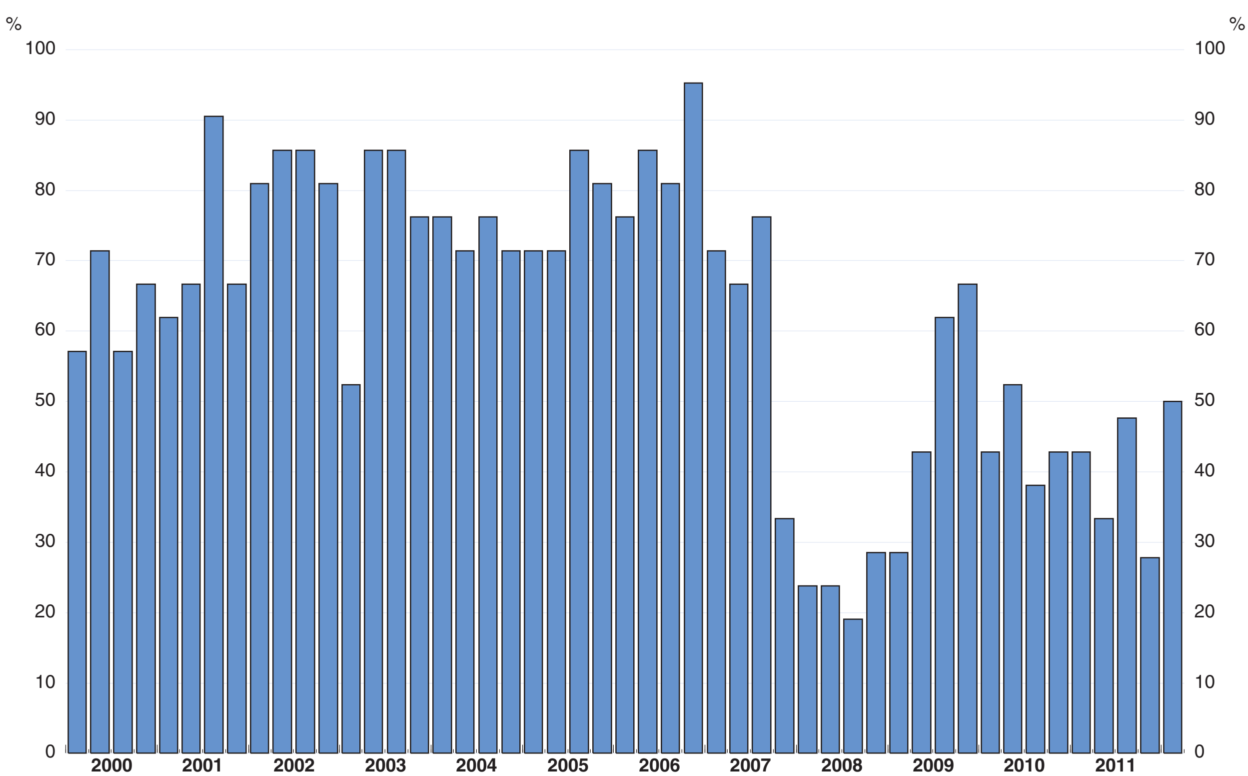
of real disposable incomes, which are being constrained by labour market slack (see below), high oil prices and ongoing fiscal consolidation. Soft consumer confidence, even after recent improvements, and tighter constraints on bank loans may also moderate consumption growth in the near term. In the United States, additional balance sheet adjustment is likely to be required, but with household debt deleveraging much further advanced than elsewhere, a higher saving rate will not be required to ensure adjustment. With improved job creation reducing the need for precautionary saving, the US saving ratio is projected to be close to 4% in 2013, around ½ percentage point lower than in 2011-12. The saving ratio is projected to be broadly flat through the projection period in Japan and the euro area. In the latter, this reflects small declines in Germany and France and an upward drift in saving in several of the economies under market pressure.

… and housing market developments are mixed

- Recent housing market developments are mixed (Figure 1.7; Table 1.2). In the United States, ongoing housing market weakness remains a key factor constraining the pace of the recovery (FRB, 2012), but some

Figure 1.7. **House prices are falling in real terms in many countries**

Proportion of countries with rising house prices, based on quarter-on-quarter change



Note: House prices deflated by the private consumption deflator, published and forecasted. Calculation based on 21 countries (18 available in 2011q4 and 10 available in 2012q1).

Source: National sources.

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Table 1.2. **House price-to-rent ratios remain high in some countries**

	Per cent annual rate of change				*Level relative to long-term average* [1]		
	2003-2009	**2010**	**2011** [2]	**Latest quarter** [3]	**Price-to-rent ratio**	**Price-to-income ratio**	**Latest available quarter**
United States	0.7	-5.3	-5.8	-5.5	100	87	Q4 2011
Japan	-2.7	-2.1	-1.9	-2.4	63	66	Q3 2011
Germany	-1.4	0.6	3.2	7.3	85	80	Q1 2012
France	5.0	3.9	3.9	1.7	142	135	Q4 2011
Italy	2.3	-3.5	-3.8	-4.7	103	114	Q3 2011
United Kingdom	1.6	3.1	-4.5	-4.0	134	125	Q4 2011
Canada	5.9	5.5	5.0	-0.8	161	136	Q1 2012
Australia	3.1	9.1	-5.1	-6.2	139	121	Q1 2012
Belgium	5.4	3.5	-0.2	0.5	165	148	Q3 2011
Denmark	3.6	0.3	-5.4	-9.6	114	111	Q4 2011
Finland	3.0	6.6	-0.2	-2.8	133	99	Q1 2012
Greece	1.7	-8.5	-8.3	-11.3	88	97	Q1 2012
Ireland	1.0	-11.2	-14.0	-18.5	87	87	Q1 2012
Korea	0.8	-0.2	1.4	2.5	110	63	Q1 2012
Netherlands	1.4	-3.4	-4.5	-5.9	126	130	Q1 2012
Norway	5.5	6.0	6.6	5.5	170	128	Q1 2012
New Zealand	5.0	0.7	-1.8	1.2	150	120	Q4 2011
Spain	3.7	-5.9	-9.0	-9.5	119	118	Q1 2012
Sweden	5.9	6.3	-0.6	-4.2	132	125	Q1 2012
Switzerland	1.6	3.9	3.6	4.4	96	95	Q1 2012
Total of above euro area[4,]	2.0	-0.9	-1.0	-0.8	113	110	Q1 2012
Total of above countries[5]	1.1	-1.9	-2.9	-3.1	106	96	

Note: House prices deflated by the private consumption deflator.
1. Average from 1980 (or earliest available date) to latest quarter available = 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. Germany, France, Italy, Belgium, Finland, Grece, Ireland, Netherlands and Spain.
5. Using 2010 GDP weights, calculated using latest country data available.

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

StatLink http://dx.doi.org/10.1787/888932609494

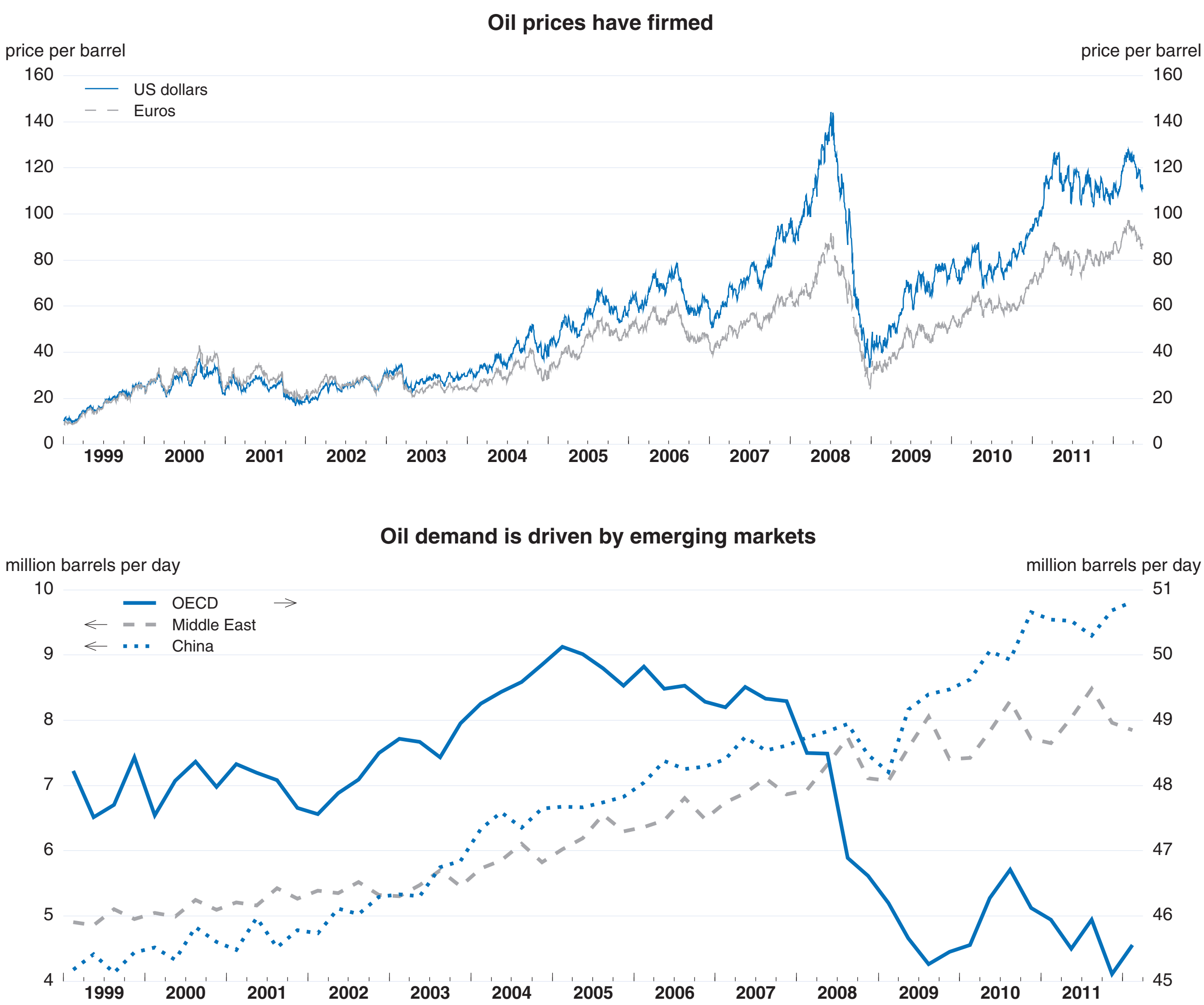
tentative signs of an upturn in housing market prospects have emerged, with builders' optimism edging up, accompanied by a higher level of housing starts and sales. Nominal prices appear to be stabilising, the price-to-rent ratio is finally back in line with historic norms, and the overhang of unsold properties is at the lowest level since 2006. Even so, a large shadow inventory remains from properties in foreclosure and, potentially, from properties whose owners are currently in arrears with their mortgage payments. However, this should be set against a rate of household formation that has been low for an extended period, possibly indicating some pent-up shadow demand. In the euro area, house price developments are pointing to diverging near-term economic prospects, with house prices now rising in Germany after years of stagnation, but continuing to decline in

Greece, Ireland, Italy and Spain. In some countries, such as Canada, Belgium, France, Australia, Norway and Sweden, house prices are now very high relative to rents and incomes, pointing to possible price corrections at some point, or further corrections in those countries in which real house prices are already declining.

Commodity prices have risen

Crude oil prices rose steeply in the early part of this year, mainly due to supply disruptions in the Middle East and Africa, continuing outages in North Sea oil production and concerns that supply disruptions might spread (Figure 1.8, upper panel). More recently, prices have eased somewhat, with oil inventories rising and OPEC crude oil supply strengthening. Overall, the price increases so far this year are likely to damp growth slightly over the next two years (Table 1.3), an effect

Figure 1.8. **Oil prices are high**



Source: OECD, Main Economic Indicators database; Datastream; and IEA, Monthly Oil Data service.

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Table 1.3. **Effects of an oil price increase on GDP and inflation – Survey of recent estimates**

Study	Approach	Type of stock	Impact on real GDP			Impact on inflation		
			United States	Euro area	Japan	United States	Euro area	Japan
			Deviation from baseline in the second year (in %)					
Carabenciov *et al.* (2008), IMF	Macro-econometric model	(Permanent) 10% increase	-0.20	-0.06	-0.04	0.27	0.16	0.08
Barell and Pomerantz (2004), NIESR	NiGEM Macro-econometric model	(Permanent) $10 increase	-0.48	-0.39		0.52	0.29	
European Commission (2004)	QUEST Macro-econometric model	(Permanent) 25% increase		-0.39			0.29	
European Commission (2008)	QUEST III Dynamic stochastic general equilibrium model (DSGE)	Gradual increase of 100% over a period of three years		-0.60			1.30	
OECD Global Model, Hervé *et al.* (2010)	Macro-econometric model	(Permanent) $10 increase	-0.31	-0.20	-0.31	0.41	0.31	0.10
Jimenez-Rodoriguez and Sanchez (2004), ECB	Vector autoregression (VAR)	Impulse response to a 1% oil price shock	-0.04[1]	-0.01[1]				

1. Accumulated effects in the growth rate to the 8th quarter:

Source: OECD.

StatLink http://dx.doi.org/10.1787/888932609513

reinforced by the recent strengthening of international food and other non-oil commodity prices. Oil prices will be subject to conflicting forces over the projection period. On the one hand, prices could come down further if the risk premium associated with supply-side disruptions diminishes. On the other, underlying upward pressure on prices seems likely to continue, with growth in China and other emerging economies pushing up oil demand (Figure 1.8, lower panel) and crude oil production from existing fields likely to decline at a significant rate in the future.[6] On balance, the projection embodies a moderate upward price movement, of $5 per year in nominal terms. Non-oil commodity prices are assumed to remain constant at recent levels over the projection period.

6. On the supply side, crude oil production from fields that were producing in 2010 is projected to drop by around a quarter by 2020, see IEA (2011).

The near-term projection

Growth is likely to recover only slowly…

Although some positive signals have appeared in recent indicators, the recovery seems likely to remain gradual and bumpy, particularly given the possibility of renewed tensions arising from sovereign debt and banking sector problems in the euro area. The projection presented here rests on the assumption that such tensions continue to be contained successfully and that other downside risks do not materialise. On this basis, near-term output growth is projected to remain modest in the OECD economies and pick up gradually towards trend rates in the major emerging market economies, developments which should foster a further recovery of confidence. Ongoing support from accommodative monetary policies (Box 1.2),

Box 1.2. **Policy and other assumptions underlying the projections**

Fiscal policy settings for 2012-13 are based as closely as possible on legislated tax and spending provisions. Where government plans for 2013 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. Otherwise, in countries with impaired public finances, a tightening of the underlying primary balance of at least 1% of GDP in 2013 has been been built into the projections. In euro area countries where lower growth than earlier expected would imply that nominal targets will be missed, it is assumed that one-third of the cyclical weakening relative to the GDP growth embedded in consolidation plans under the excessive deficit procedure and stability programmes is offset with further structural tightening, with the remaining two-thirds showing up in higher headline deficits. Where there is insufficient information to determine the allocation of budget cuts, the presumption is that they apply equally to the spending and revenue sides, and are spread proportionally across components. These conventions allow for needed consolidation in countries where plans have not been announced at a sufficiently detailed level to be incorporated in the projections. Along this line, the following assumptions were adopted (with additional adjustments if OECD and government projections for economic activity differ):

- For the United States, the assumptions for 2012 are based on legislated measures. Given the legislative uncertainty about budget policy next year, the general government underlying primary balance is assumed to improve by 1½ per cent of GDP in 2013.
- For Japan, the projections are based on the revised Medium-term Fiscal Framework announced in August 2011. The projection also includes reconstruction spending of around 2% of GDP in 2012 and 2013 combined and the tax increases planned to finance such spending over a longer time horizon.
- In the large European Union countries, structural budget components are assumed to evolve as follows. For Germany, the government's medium-term fiscal plans, as announced in March 2012 and presented in the Stability Programme, have been built into the projections. For France, the projections incorporate the government's medium-term consolidation programme as well as the legislated shift of about 0.7% of GDP away from employers' social contributions toward indirect and personal income taxes. For Italy the projections incorporate the government's medium-term fiscal plans, as presented in March 2012 in its Stability Programme, including additional tightening so as to offset part of the budgetary effects of lower growth in 2013 relative to the growth assumption embedded in the Stability Programme. For the United Kingdom, the projections are based on tax measures and spending paths set in the March 2012 budget.

The concept of general government financial liabilities applied in the OECD *Economic Outlook* is based on national accounting conventions. These require that liabilities are recorded at market prices as opposed to constant nominal prices (as is the case, in particular, for the Maastricht definition of general government debt). In 2010 and 2011, euro area programme countries (Greece, Ireland and Portugal) experienced large declines in the price of government bonds. For the purpose of making the analysis in the *Economic Outlook* independent from strong fluctuations in government debt levels on account of valuation effects, the change in 2010 and 2011 in government debt for these countries has been approximated by the change in government liabilities recorded for the Maastricht definition of general government debt.

Box 1.2. **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 target Federal Funds rate is assumed to remain constant at ¼ per cent for the entire projection horizon. The current forward guidance on interest rates is assumed to be maintained.
- In the euro area, the overnight rate is assumed to be reduced to near-zero levels in mid-2012 and remain at that level until the end of 2013.
- In Japan, the current interest rate policy needs to be continued until inflation is firmly positive. The short-term policy interest rate is assumed to remain at 10 basis points for the entire projection horizon.

In all these economies, quantitative easing and other unconventional measures are assumed to be unchanged, including in the euro area where the projection for inflation and activity might argue for additional measures, in part because the transmission of such policies is hard to build in given the assumption of unchanged exchange rates.

For the United States, Japan, Germany and other countries outside the euro area, 10-year government bond yields are assumed to converge slowly toward a reference rate (reached only after the projection period), determined as future projected short rates plus a term premium and an additional fiscal premium. The latter premium is assumed to be 2 basis points per percentage point of gross government debt-to-GDP ratio in excess of 75% and an additional 2 basis points (4 basis points in total) per percentage point of the debt ratio in excess of 125%. For Japan, the premium is assumed to be 1 basis point per percentage point of 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 remain unchanged at their recent levels for the remainder of this year and in 2013 for all other euro area member countries.

The projections assume unchanged exchange rates from those prevailing on 4 May 2012: $1 equals 79.85 JPY, €0.761 (or equivalently, €1 equals $1.31) and CNY 6.31.

The price of a barrel of Brent crude oil is assumed to increase at a rate of $5 per year from the second quarter of this year onwards, based on the price that prevailed in April. Non-oil commodity prices are assumed to be constant over the projection period at the average level of April 2012.

The cut-off date for information used in the projections is 15 May 2012. Details of assumptions for individual countries are provided in Chapters 2 and 3.

improved financial market conditions and the gradual firming of confidence should provide continued impetus to growth in the United States, where the recovery in private sector domestic demand since the recession is already in line with that seen in recent recoveries.[7] The same factors should help activity to strengthen gradually from the latter half of this year in most major European economies, and augment the boost to activity in Japan provided by reconstruction expenditures. Even so, the

7. Private sector domestic demand has risen at an average annual pace of 3½ per cent per annum in the United States since the trough of the recession in mid-2009, broadly in line with the pick-up following the trough of the 1991 and 2001 recessions. GDP growth has been slower, at an average rate of close to 2½ per cent per annum, in part reflecting stronger declines in the volume of government consumption and investment than in the aftermath of the previous two recessions.

pace of the upturn will remain constrained by the drag exerted from continued fiscal consolidation in most OECD economies, with further declines in output in many countries under market pressure in Europe. The key features of the economic outlook for the major economies are as follows:

... in the United States...

- Growth in the United States is expected to pick up gradually through the projection period, against a backdrop of supportive financial conditions and accommodative monetary policy. However, the momentum of the recovery is likely to remain modest, with some drag on activity from ongoing fiscal consolidation and from prolonged housing market adjustments, and with the negative output gap narrowing only slowly through 2013. Private consumption growth should nonetheless be supported by stronger labour market conditions and improved confidence, although ongoing balance-sheet adjustment may limit declines in the household saving rate. Healthy corporate balance sheets, low interest rates, normal cyclical forces and reduced uncertainty should also help business investment growth to pick up through the projection period. Supported by continued modest employment gains, the unemployment rate is projected to decline further to just below 7½ per cent by the end of 2013, still leaving significant, albeit diminishing, labour market slack.

... in the euro area...

- Area-wide output remained unchanged in the first quarter, with activity developments diverging widely across member states. Financial conditions have improved modestly, and monetary policy is accommodative, but ongoing fiscal consolidation, deteriorating labour market conditions and, in some cases, private sector deleveraging will all act as a drag on area-wide activity this year and next. Overall, provided policy actions can continue to contain sovereign debt and banking problems and thereby foster further improvements in confidence, activity should recover slowly from the second half of this year, helped by further gains in net exports. However, area-wide growth is not projected to reach trend levels until late in 2013, allowing a large negative output gap to open up, with the unemployment rate rising further to a little over 11%. Differences between developments in Germany and the economies under market pressure are expected to persist. In Germany, domestic demand should strengthen and unemployment decline further, against a background of low interest rates, few balance sheet pressures and little ongoing fiscal consolidation. In the EU/IMF programme countries, as well as Spain and Italy, the opposing forces are at work, with domestic demand likely to continue to contract and unemployment continuing to rise. However, stronger export growth will provide a positive boost to activity in these countries, especially in Ireland.

... in Japan...

- After stalling at the end of last year, output growth has resumed in Japan. Financial conditions have continued to improve, and fiscal policy will provide some additional stimulus to activity this year. Ongoing reconstruction expenditure will help to support demand, with public reconstruction spending possibly amounting to 1½ per cent of GDP in 2012. As public reconstruction efforts fade, continued solid business investment growth and a recovery in export growth, fuelled by the pick-up in global demand, are likely to be the main forces supporting the recovery, with the negative output gap diminishing gradually through the projection period.

… and in emerging markets…

- A gradual cyclical upswing is now getting underway in the major emerging market economies, with their contribution to global growth likely to remain substantial throughout the projection period. In China, after a marked slowdown in the first quarter reflecting softer export growth and a sharp temporary correction in inventories, output growth should pick up through 2012 and stabilise at between 9-9½ per cent in 2013, with monetary policy easing and increased outlays on social spending supporting domestic demand. In India, growth should strengthen gradually through the projection period, and be just above 7½ per cent on a calendar-year basis in 2013, helped by improvements in confidence, a cyclical upturn in investment, stronger external demand and the modest effects from the recent reduction in policy interest rates. However, high inflation will continue to act as a drag on real incomes. In Brazil, a period of weak growth now seems to be ending, with domestic demand set to strengthen on the back of strong policy support, favourable financial conditions and a tight labour market. Even with the impact of policy stimulus likely to soften next year, GDP growth should still be around 4¼ per cent on a calendar-year basis, with robust domestic demand being offset by further net export declines. In Russia, GDP growth is expected to remain close to potential rates, at around 4¼ per cent per annum on average over 2012-13, with incomes and domestic demand sustained by the high level of oil prices.

Inflation is drifting down gently

Headline inflation is drifting down in many economies, but only slowly in the United States and the euro area, with recent increases in oil prices and, in Europe, administered prices and indirect taxes, partially offsetting favourable base effects. The oil price increase since the start of 2012 will likely add a little under ¼ percentage point to headline inflation in the OECD economies this year, and a little more in the emerging market economies, given the relatively energy-intensive nature of production in these economies. The assumed slight upward drift in oil prices will serve to keep headline inflation rates marginally above core inflation rates through the projection period. However, with long-term inflation expectations in the OECD economies, especially survey-based measures, remaining reasonably well anchored, substantial spare capacity in many OECD economies should bear down on price inflation through much of the projection period (Figure 1.9). Core inflation is set to remain relatively sticky in the United States, dropping only to around 1¾ per cent, with unit labour costs continuing to rise by between 2¼-2¾ per cent per annum as the labour market firms. In the euro area, where the

Figure 1.9. **Underlying inflation is likely to remain subdued**

12-month percentage change

Note: PCE deflator refers to the deflator of personal consumption expenditures, HICP to the harmonised index of consumer prices and CPI to the consumer price index. Unit labour costs are economy-wide measures.

Source: OECD Economic Outlook 91 database.

StatLink http://dx.doi.org/10.1787/888932608126

output gap seems likely to widen through most of the projection period, disinflationary pressures are likely to be stronger, notwithstanding the impact of further increases in indirect taxes in France and Italy, and core inflation could eventually drift down to a little below 1½ per cent. In Japan, deflation is expected to diminish gradually over the projection period. In the major emerging market economies, a period of below-trend growth has alleviated underlying inflationary tensions arising from past capacity pressures, and the likely cyclical upturn is not projected to be at a pace that would raise core inflation significantly, although the effect of higher commodity prices will be seen in headline inflation.

Labour markets are likely to continue diverging…

The recent upward drift in aggregate euro area unemployment hides sharply divergent developments, with large increases from already-high levels in the economies under market pressure, more moderate increases elsewhere and continuing declines in Germany. In contrast, the US unemployment rate has declined by ¾ percentage point during the past half year. These differences across areas and countries may continue in the near term. In the projection, total OECD employment rises by around ¾ per cent in 2012 and just under 1% in 2013 (Table 1.4), with ongoing job growth in the United States and many other non-European economies offset in part by job losses in some European economies, as well as in Japan, where the labour force is shrinking. The OECD-wide unemployment rate is projected to remain broadly flat this year and next. This would leave a large and persistent degree of labour market slack in most OECD economies (Figure 1.10).

Table 1.4. **OECD labour market conditions are diverging**

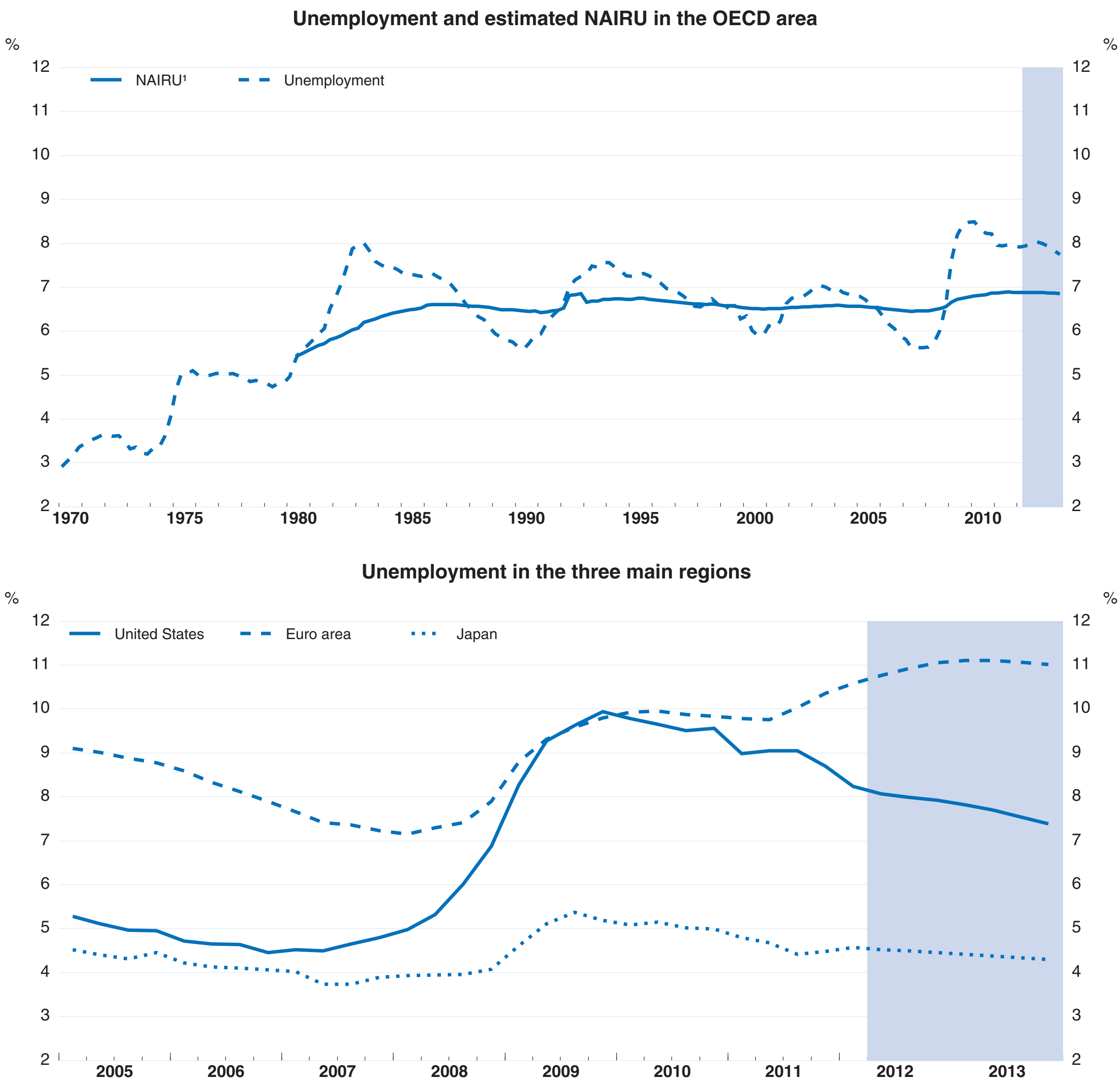
	2008	2009	2010	2011	2012	2013
	Percentage change from previous period					
Employment						
United States	-0.5	-3.8	-0.6	0.6	1.8	1.6
Euro area	0.9	-1.8	-0.5	0.1	-0.6	-0.1
Japan	-0.4	-1.6	-0.4	-0.2	0.1	-0.2
OECD	0.6	-1.8	0.6	1.0	0.7	0.9
Labour force						
United States	0.8	-0.1	-0.2	-0.2	0.8	1.1
Euro area	1.0	0.3	0.1	0.1	0.3	0.1
Japan	-0.3	-0.5	-0.4	-0.7	0.0	-0.3
OECD	1.0	0.5	0.7	0.6	0.7	0.8
Unemployment rate	Per cent of labour force					
United States	5.8	9.3	9.6	8.9	8.1	7.6
Euro area	7.4	9.4	9.9	10.0	10.8	11.1
Japan	4.0	5.1	5.1	4.6	4.5	4.4
OECD	6.0	8.2	8.3	8.0	8.0	7.9

Source: OECD Economic Outlook 91 database.

StatLink http://dx.doi.org/10.1787/888932609532

Figure 1.10. **Considerable labour market slack is set to persist**

Percentage of labour force



1. NAIRU is based on OECD Secretariat estimates. For the United States, it has not been adjusted for the effect of extended unemployment benefit duration.

Source: OECD Economic Outlook 91 database.

StatLink http://dx.doi.org/10.1787/888932608145

... although there are significant uncertainties...

In addition to the general uncertainty about the projections for activity, the unemployment projections are afflicted by a specific uncertainty concerning the strength of the link between activity and unemployment. This is the case for both Europe and the United States:

... in Europe...

- In some European economies as in 2008-09, it is possible that lower working hours might cushion employment, although the scope for doing so is more limited at present, with average working hours now close to estimated trend levels, rather than above them as in 2007-08. Aggregate employment in the euro area is declining broadly in line with the fall in output at present, a larger and faster change than seen on previous occasions, bringing the unemployment rate back towards a level that might normally be expected given output developments (Box 1.3). This absence of labour hoarding is projected to continue, with

Box 1.3. **Using Okun's law to track recent cyclical developments**

The cyclical relationship between output and the unemployment rate is often assessed by means of the so-called Okun's law (Okun, 1962). The relationship can be considered in terms of changes in unemployment and output (the "first difference" approach), or as a means of inferring the inherently uncertain economy-wide output gap conditional on an estimate of the unemployment gap (the "gap" approach), see for instance (ECB, 2011; Bernanke, 2012).

Two important empirical issues are whether the statistical relationship between output and unemployment is stable over time and whether it differs across countries. If it is unstable, it would complicate the usefulness of a simple rule-of-thumb of this kind. Possible factors that could lead to variation over time and across countries include differences in labour market institutions that affect labour market outcomes (IMF, 2010), and variation in factors such as labour productivity, hours worked, labour force participation and capital accumulation that cause the output gap to change independently of the unemployment gap (Daly and Hobijn, 2010; Bouis et al., 2012).

New Secretariat empirical estimates for both the first-difference and gap versions of Okun's law have been derived for the G7 economies plus the aggregate euro area using annual and quarterly data from the late 1960s (data permitting) through to 2011. Collectively, the results suggest that considerable care needs to be exercised in seeking to back out estimates of output gaps given developments in unemployment. In particular, key findings include:

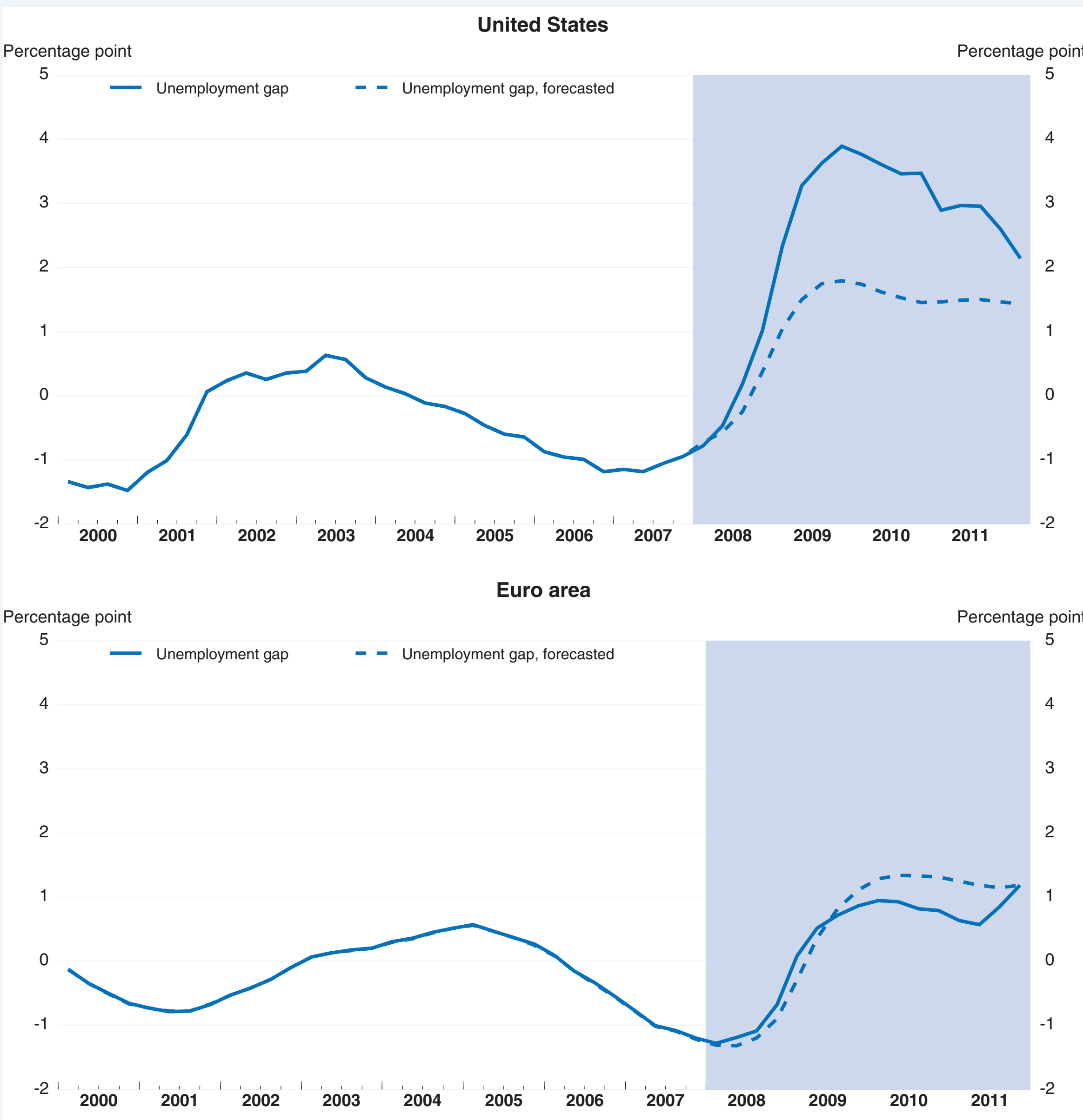
- Unemployment is more responsive to output in the United States, Canada and the United Kingdom than in the euro area and Japan. This pattern emerges from both versions of the model and is consistent with the findings from many other studies, see, for example, (IMF, 2010; OECD, 2012e). These differences across countries are statistically significant, which means that versions of Okun's law estimated for one country cannot be readily used as a benchmark in other countries.
- In the "gap" versions of the model, representative findings are that the Okun coefficient – the near-term decline in the output gap typically associated with a percentage point rise in the unemployment gap – was close to 2½ per cent in the United States and Canada, based on a 35-year plus sample period, but over 4 in the aggregate euro area, based on a 25-year sample, and around 7 in Japan.
- There is evidence of structural instability in the Okun's law relationship in all of the countries in at least one of the specifications estimated. Using rolling regressions, with a window of 15 or 20 years respectively, reveals that the change in unemployment associated with a given change in output has risen over time in the euro area economies, possibly reflecting greater flexibility arising from labour market reforms, and, to a lesser extent, Japan. In the other countries, the steady-state relationship between output and unemployment changes appears to fluctuate slowly around a longer-term norm.

The estimated equations can also be used to interpret recent movements in the US and euro area unemployment rates/gaps conditional on OECD estimates of the economy-wide output gap. The projections below are derived from the "gap" model, with the unemployment gap regressed on the lagged unemployment gap, plus current and lagged values of the output gap. These relationships were estimated separately up to the end of 2007 for the United States and the euro area and used to obtain predicted outcomes for the unemployment gap conditional on OECD estimates of the output gap.

Box 1.3. **Using Okun's law to track recent cyclical developments** *(cont.)*

The simulated results (see figure below) suggest that in the United States the recent unexpectedly rapid declines in the unemployment rate (and the unemployment gap) may simply reflect a gradual adjustment towards a more normal pattern of output and unemployment, with firms rehiring workers that had been laid off exceptionally rapidly in the recession (OECD, 2011b). In the euro area, it appears that the converse may be occurring. The unemployment gap in late 2009 and 2010 was much lower than might have been expected, possibly reflecting factors such as widespread use of short-time working schemes, and the recent sharp rises in the unemployment rate have acted to close this gap.

Gauging spare capacity using Okun's law



Source: OECD Economic Outlook 91 database.

StatLink http://dx.doi.org/10.1787/888932608164

employment set to decline by a little over ½ per cent this year and fall a little further in 2013. Given very muted increases in the labour force, this would push up the unemployment rate to over 11% in 2013.

... and the United States

- In the United States, the sizable recent fall in unemployment is puzzling, given output growth at or below trend. One possibility is that this simply reflects a one-off readjustment aligning employment more closely with production, with strong rehiring of workers being the counterpart to the exceptionally rapid declines in employment during the recession (Bernanke, 2012; Box 1.3). An alternative possibility is that unexpectedly robust employment growth could persist; in particular, the average private sector workweek has recently returned to pre-crisis levels, and thus it is likely that a greater proportion of rising labour demand may now be met by increases in employment rather than in hours worked.[8] Additional uncertainties arise regarding the participation rate, which has continued to decline even as hiring has picked up. A pro-cyclical upturn in the labour participation rate would normally be expected to constrain the speed at which improved employment outcomes lowered the unemployment rate. However, a considerable part of the recent fall in the aggregate participation rate may not be reversed as it reflects ongoing demographic change, with a rising share of over 55-year olds in the working-age population and a declining share of the prime-age 25-54 year olds, the cohort with the highest participation rate (Aaronson *et al*., 2012). Thus it is possible that higher employment growth may result in more rapid declines in the unemployment rate than would normally be expected. In the projection, greater weight is placed on the one-off readjustment story, with employment growth expected to average a little over 1¾ per cent per annum in 2012-13, well below the growth rates observed since last autumn. With the increase in the labour force held down in 2013 by the assumed termination of the extended entitlement to unemployment benefit, this employment growth will still enable the unemployment rate to decline by a further ½-¾ percentage point over the projection period.

Structural measures are needed to foster near-term employment growth

Against a backdrop of persistently high unemployment, many countries have begun to actively implement structural reforms to boost employment in recent years, with reform intensity being particularly strong in those countries in which sizable fiscal consolidation is being undertaken (OECD, 2012a). Labour market reforms remain essential to foster near-term employment growth and reduce the risk that higher unemployment becomes permanently entrenched. In a context of ongoing fiscal consolidation, hiring incentives can be raised by reforms that include: strengthening public employment services and training programmes to improve the matching of workers and jobs, which may

8. A third possibility is that GDP growth has been under-estimated in recent quarters.

require that such expenditures be sheltered from fiscal consolidation efforts; growth-friendly tax reforms to shift the tax burden towards tax bases that are less harmful for job creation, such as property and consumption taxes; and temporary reductions in labour taxation, where feasible through well-targeted marginal job subsidies (for new hires where net jobs are rising) rather than via across-the-board reductions in payroll taxes.[9] In the euro area economies under market pressure, the impact of the labour market downturn could also be cushioned by broader use of work-sharing arrangements and maintaining the resources necessary to help fund short-time working schemes. In this context it will be important to build in incentives so that schemes focus on protecting long-term viable jobs. Product market reforms to relax regulatory restrictions in sectors in which there is a strong potential for new job growth, such as retail trade and professional services, could also serve to improve labour market outcomes relatively quickly. Other structural measures that might help to improve long-term labour market outcomes, such as rebalancing employment protection towards less-strict protection for regular workers, but more protection for temporary workers, and reductions in unemployment benefit duration, may be less effective when labour demand is particularly weak. and should be pursued in the current context only when existing policy settings in these areas is clearly excessive.

World trade growth will pick up

World trade growth is projected to continue to pick up, to grow at a rate a little over 7½ per cent by the latter half of 2013, broadly following its normal pattern relative to world GDP growth through the projection period. The recent monthly merchandise trade data from the CPB (quoted above) and a benchmark dynamic-factor model of trade growth that uses a wide range of trade indicator variables (Guichard and Rusticelli, 2011) both suggest that, if anything, trade growth could turn out to be a little stronger than projected in the first half of this year.

External imbalances will shift across countries…

Global imbalances are set to remain at their recent overall levels, but with a changing geographical composition (Figure 1.11; Table 1.5). The sum of all external balances in absolute terms is projected to remain between 3¾-4 per cent of world GDP over the projection period, well below the level immediately prior to the crisis. Two notable developments that may be durable are the increase in the external surpluses of the oil producers and the declines in the current account surpluses of Japan and China:

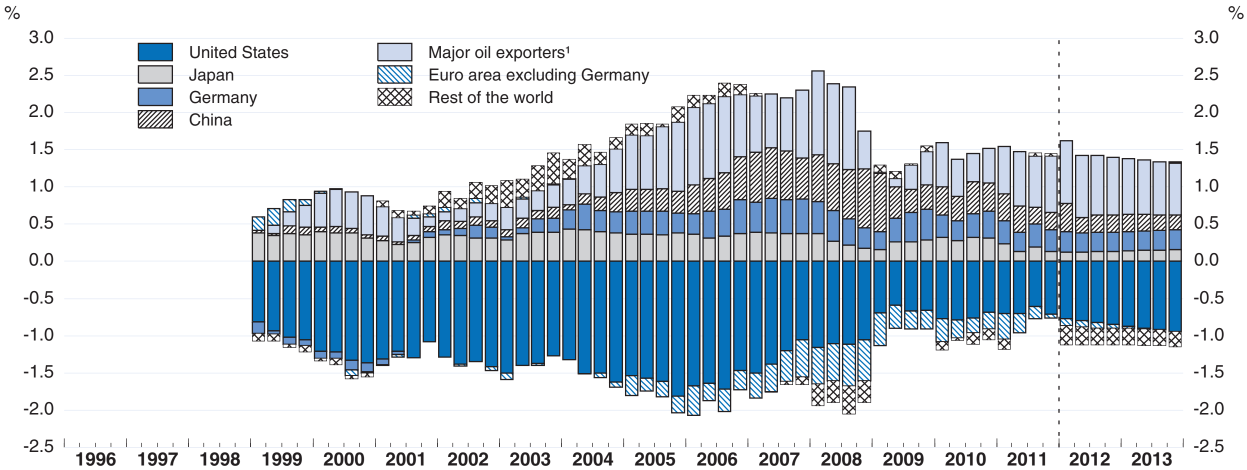
… with the external surpluses of the oil producers rising…

- The already sizable external surpluses of the high-saving oil-producing economies are increasing further, taking them to around ¾ per cent of world GDP (and just over 3% of global saving), on the back of the

9. A full range of structural reforms that could help to increase near-term employment growth and minimise the employment cost of the downturn are discussed in detail in OECD (2011b).

Figure 1.11. **Progress in reducing global imbalances has stalled**

Current account balance, in per cent of world GDP



Note: The vertical dotted line separates actual data from forecasts.

1. Include Azerbaijan, Kazakhstan, Turkmenistan, Brunei, Timor-Leste, Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Russian Federation, Saudi Arabia, United Arab Emirates, Yemen, Ecuador, Trinidad and Tobago, Venezuela, Algeria, Angola, Chad, Rep. of Congo, Equatorial Guinea, Gabon, Nigeria and Sudan.

Source: OECD Economic Outlook 91 database.

StatLink http://dx.doi.org/10.1787/888932608183

assumed modest upward drift in oil prices. Whilst partial re-spending of oil revenues is likely to reduce the external surpluses of oil-producing economies somewhat, much of the additional revenue accrued is likely to be saved, as is appropriate for countries in which a finite resource is being depleted. Recycling of the sizable surpluses of the oil producers will likely be exerting some downward pressure on the yields of safe assets, especially government bonds. Assuming, for the sake of illustration, that all of the oil producers' external surpluses are invested in US government securities, the overall size of their surpluses may be acting to keep US long-term bond rates lower than they otherwise would be by up to 20-25 basis points.[10]

… the Japanese trade deficit persisting…

- In 2011, Japan experienced its first annual merchandise trade deficit for several decades. Whilst some of the factors underlying this may fade, the likely structural shift away from domestic nuclear power, along with the acceleration in the overseas production plans of domestic companies triggered by the earthquake, is projected to keep the trade balance in deficit. However, the overall current account balance is

10. As discussed above, recent estimates of the effect of central banks' asset purchases point to an average reduction of 7 basis points in long-term bond rates effects for purchases corresponding to 1% of annual nominal GDP. With oil producers' surpluses now equivalent to around 3½ per cent of US GDP, the exogenous demand for US long-term bonds that could arise, under the extreme assumption that all of the surplus represents new investment in such securities, might be lowering the yields by up to 25 basis points, all else being equal.

Table 1.5. **World trade is set to strengthen, but imbalances remain**

	2009	2010	2011	2012	2013
Goods and services trade volume	Percentage change from previous period				
World trade[1]	-10.7	12.8	6.0	4.1	7.0
of which: OECD	-12.0	11.4	5.3	3.2	5.8
OECD America	-12.5	12.6	5.9	4.5	6.4
OECD Asia-Pacific	-13.0	15.9	5.0	4.8	7.4
OECD Europe	-11.6	10.0	5.0	2.3	5.1
China	-4.0	24.4	9.2	6.2	11.0
Other industrialised Asia[2]	-10.1	18.4	7.2	5.0	8.6
Russia	-17.2	14.6	9.3	8.4	8.0
Brazil	-8.4	24.5	7.6	7.4	11.2
Other oil producers	-4.2	2.8	4.5	6.6	8.6
Rest of the world	-10.2	9.4	6.8	4.8	7.2
OECD exports	-11.6	11.5	5.7	3.7	6.1
OECD imports	-12.4	11.3	4.8	2.7	5.5
Trade prices[3]					
OECD exports	-9.1	2.6	9.1	-0.8	1.9
OECD imports	-11.3	3.6	10.7	0.1	1.9
Non-OECD exports	-13.3	10.1	12.9	4.3	2.2
Non-OECD imports	-8.5	8.6	10.7	3.0	2.0
Current account balances	Per cent of GDP				
United States	-2.7	-3.2	-3.1	-3.7	-4.3
Japan	2.8	3.6	2.1	1.6	1.9
Euro area	0.1	0.4	0.5	1.0	1.5
OECD	-0.5	-0.6	-0.6	-0.8	-0.8
China	5.2	4.0	2.8	2.3	1.7
	$ billion				
United States	-377	-471	-473	-584	-698
Japan	143	196	120	94	116
Euro area	21	43	62	131	194
OECD	-194	-254	-289	-374	-389
China	261	238	202	191	165
Other industrialised Asia[2]	132	104	186	76	79
Russia	49	70	99	129	100
Brazil	-24	-47	-53	-68	-87
Other oil producers	87	234	392	456	459
Rest of the world	-85	-105	-145	-165	-156
Non-OECD	418	494	681	619	559
World	225	240	392	245	170

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

Source: OECD Economic Outlook 91 database.

StatLink http://dx.doi.org/10.1787/888932609551

projected to remain positive, at around 1¾ per cent of GDP, reflecting the strong income flows from Japan's net external assets. More generally, the excess saving of the Japanese private sector that has been the counterpart of the continuous external surplus has also facilitated the smooth and inexpensive financing of the huge public debt. A trend towards lower excess saving, reflecting the impact of demographic developments, could affect both of these outcomes.

… and the Chinese external surplus narrowing further

- The Chinese current account surplus declined to around 2 % of GDP in the latter half of 2011. After a temporary rise in the first quarter of 2012, the projections embody further declines in the surplus this year and next, to around 1½ per cent by end-2013, reflecting relatively strong domestic demand growth and the planned moves to raise the shares of service sector activities and household consumption in the economy. Import spending will also be supported by the increase in oil prices over the projection period.

Elsewhere, a persistent deterioration in the terms of trade and relatively robust domestic demand growth are projected to result in a marked widening of the US current account deficit by around 1% of GDP over 2012-13. For the aggregate euro area, soft domestic demand, not least reflecting ongoing fiscal consolidation, is projected to more than offset the effects of a terms-of-trade deterioration, with the euro area current account surplus rising by around 1% of GDP from 2011 to 2013. (Trends in imbalances within the euro area are discussed below.)

Structural reforms would help narrow imbalances

Durable reductions in global imbalances, in line with G20 objectives, as well as in intra-euro area imbalances (see below), will likely require greater adjustment of real exchange rates as well as structural reforms and fiscal adjustments, with actions undertaken in both external-deficit and external-surplus economies (OECD, 2011c). Structural reforms with beneficial effects on global rebalancing would also provide much-needed support for global demand growth.

Risks are significant and mainly to the downside…

Risks around the baseline scenario are extensive and predominantly on the downside, though tail risks are presently somewhat lower than in December. The main risk around the projection, discussed further below, remains the possible adverse developments that could result if the euro area debt crisis were to worsen significantly once more. In addition there are a number of other specific risks that could affect growth outcomes if they materialised:

… including disruptions to oil supply…

- Against a backdrop of firming oil demand and limited spare capacity, even a relatively moderate further deterioration in supply conditions could trigger a significant upward spike in oil prices in the near term, with adverse effects for economic activity. An increase in the oil price of $10 per barrel relative to the assumption used for the projection could reduce GDP growth by around ¼ percentage point over 2012-13 and raise headline inflation by a little under ¼ percentage point in both years (see Table 1.3).

… a sharp fiscal contraction in the United States…

- As discussed below, US budgetary policy remains opaque, with current legislation still implying the possibility of an extremely sharp fiscal tightening in 2013, amounting to close to 4% of GDP, compared with the normative assumption of tightening of around 1½ per cent of GDP in the projection. Based on the simulation analysis reported in OECD (2011a), additional tightening of 2½ per cent of GDP could imply a further drag on US GDP growth in 2013 of between 1¼-1¾ percentage points, and possibly even more in some circumstances (DeLong and Summers, 2012), partially offsetting projected GDP growth of just over 2½ per cent that year.

... rapid private sector deleveraging in Europe...

- In contrast to the United States, the deleveraging process has barely started in many continental European countries. If deleveraging does not occur via defaults, reductions in household indebtedness could imply higher household saving rates or reduced residential investment. In the financial system, deleveraging could curtail output growth significantly if it were to involve reduced lending, but the cost to growth would be comparatively low if it were achieved by raising equity. The attainment of the 9% Tier-one capital ratio in the European Union by 30 June 2012 could in particular result in curtailment of credit, although this is not expected at present. Anecdotal evidence suggests that the risk of credit supply contraction beyond that already built into current financial conditions is higher in the Central and Eastern European countries than in the euro area, as trans-national banks may face fewer restrictions on reducing lending in the former countries.

... and sluggish growth in China

- In China, medium-term uncertainties relate to the ease with which the transition to lower trend growth rates can be achieved (see Chapter 4). In particular, there is a risk that the process of slowing the growth of fixed investment and raising the share of household consumption in aggregate demand may not be achieved smoothly. In the shorter term, lingering concerns also remain about domestic property market developments, with property prices continuing to decline and a risk that housing investment could be markedly weaker.

Pent-up demand pressure is an upside risk...

- Pent-up demand pressure, notably in the United States, is a significant upside risk to the projections with, for instance, car sales still remaining well below medium-term trend levels (Haugh *et al.*, 2010). Moreover, family formation in the United States has been well below normal in recent years; an eventual return to normal would give a boost to the housing market.

... and structural reforms could improve growth prospects earlier than anticipated

- The implementation of structural reforms in labour and product markets has accelerated recently in several OECD economies, especially in the euro area countries under market pressure (OECD, 2012a). Over time, these reforms should help to boost activity levels, with the impact possibly emerging earlier than assumed in the projection.

There are renewed risks of asset price bubbles in emerging economies...

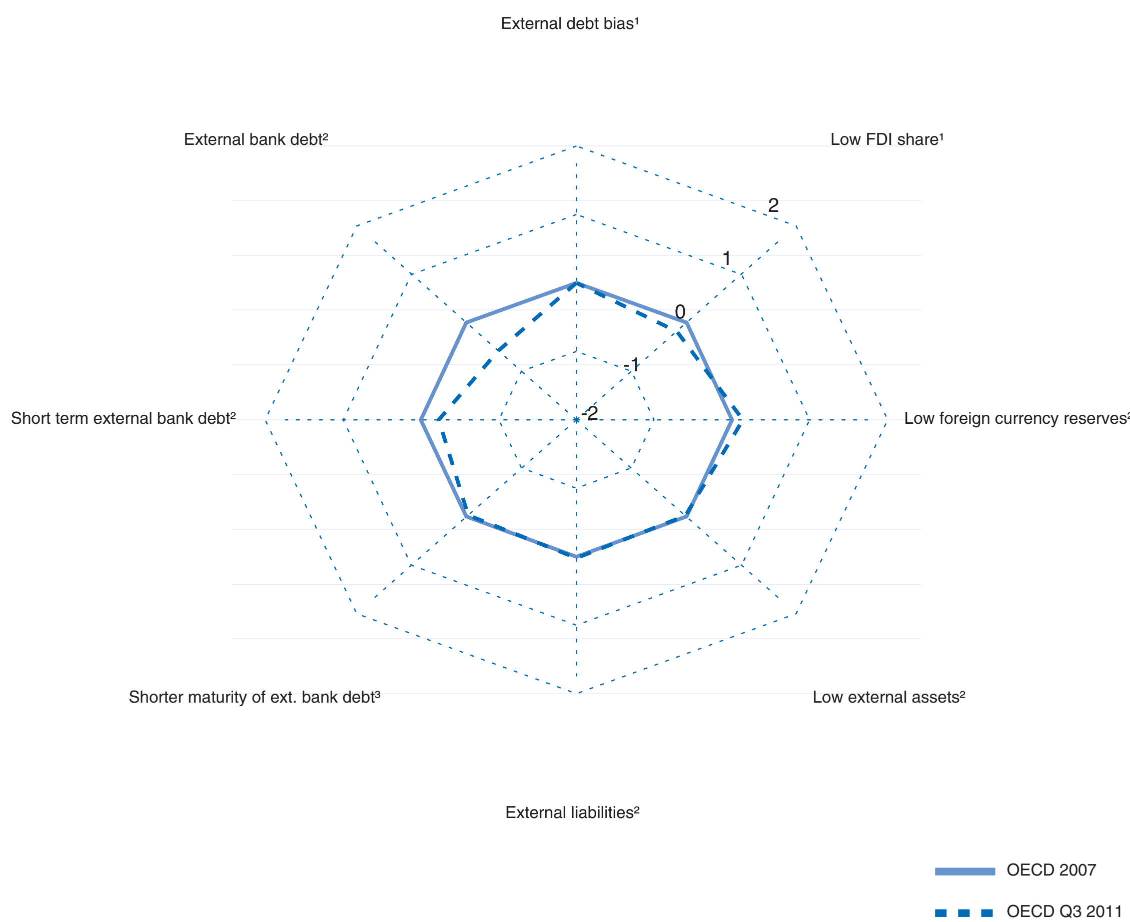
- The moderate increase in global risk appetite and the low returns presently available from many financial investments in many OECD economies is likely to stimulate capital flows towards emerging economies to benefit from higher returns. Such considerations underline the need for appropriate prudential controls and fiscal policies which do not unduly push up returns and thereby attract capital inflows.

... and more generally from persistent financial fragilities...

- International financial integration should enhance economic efficiency and boost growth, but also increases the risk of suffering financial fragilities associated with the particular asset composition of the external financial account and international capital flows. Recent OECD work suggests that, apart from slightly lower external bank debt, only limited progress has been made since 2007 in making the structure of the external financial account more robust in OECD economies in general (Figure 1.12). This could be a source of negative risk in the future, unless structural measures are taken to damp fragilities.

Figure 1.12. **Financial account related risk factors to financial stability**

Median across OECD countries for individual risk factors expressed in multiples of standard deviation. 2011 compared with 2007.



1. As a % of external liabilities.
2. As a % of GDP.
3. As a % of external bank debt.

Note: In recent OECD work (see Ahrend and Goujard, 2011), all of these factors have been found to be associated with the risk of a crisis. Each factor is presented for the OECD median country in 2011, compared to the situation in 2007 (which is normalised to zero). Variables are measured in standard deviations of the sample. Values above zero indicate a financial account position which is less conducive to financial stability.

Source: OECD calculations.

StatLink http://dx.doi.org/10.1787/888932608202

... and the risk of policy disruptions

- The risk of disruptive policy changes has probably increased. Against the backdrop of fiscal consolidation, increased inequality and high and rising unemployment, a sense may be spreading that the burden of the crisis has not been shared fairly. This risks giving rise to policy upheavals with adverse long-term, and possibly near-term, effects on growth prospects. This would be the case, for example, were countries to disregard or retreat from international agreements or renege on their commitments in financial and fiscal matters. The international trading system could be vulnerable to such developments. Such threats underline the need for policy action to be seen as measured and fair, and for policy settings that help bring about equitable outcomes. Policy settings over a wide front will have to be considered in this light. Amongst structural policies, and based on OECD analysis, measures that can offer a dual dividend by lowering income inequality and boosting long-run living standards include: facilitating the accumulation of human capital; making educational potential less dependent on personal and social circumstances; reducing labour market dualism; promoting the integration of immigrants and fostering female labour market participation. Reducing tax expenditures that benefit mainly high-income earners also typically contributes to both goals (OECD, 2012a).

Tackling imbalances in the euro area

The euro area crisis remains the most important downside risk to the global economy

The euro area crisis remains the most important downside risk to the global economy at present. However, a stabilisation of confidence, albeit at a low level, and an improvement in financial conditions have been generated by recent ECB policy measures, the successful private sector debt restructuring in Greece, and initiatives – both European and global – to build capacity to handle sovereign liquidity risks, help restore longer-term fiscal discipline and improve capital ratios in the banking system. These actions have created a window of opportunity which needs to be exploited fully and promptly, with the intensified financial market turbulence following the elections in Greece in early May illustrating the speed at which renewed challenges can appear.

Rebalancing challenges

The crisis has its origins in economic imbalances

The present crisis has its origins in economic, fiscal and financial imbalances that have gradually built up amongst the euro area economies. In the economies that presently appear stronger, growth was particularly reliant on exports, domestic demand was subdued, the build-up of internal and external debts was largely contained and surplus domestic saving flowed to currently weaker economies to finance consumption and investments, often in property markets. Amongst the economies that are currently under market pressure, where underlying growth was in most cases constrained by structural policy settings, there was an over-reliance on domestic demand to drive growth and a rapid accumulation of private and public sector debt. At the same time, wages became increasingly out of line with productivity, resulting in weak external competitiveness and rising external debts (OECD, 2012b).

Rebalancing calls for changes in absorption and expenditure switching…

For these imbalances to be durably reduced, growth-friendly adjustments are needed in both surplus and deficit economies so that saving and investment decisions are based on sound incentives, with competitiveness positions converging as quickly as possible towards levels that are sustainable in the long term. Rebalancing requirements differ across external deficit and surplus economies:

… in both external deficit economies…

- For those countries in which large fiscal and external deficits have built up, durable adjustment will require both expenditure-reduction, via changes in domestic absorption, and expenditure-switching, via a depreciation of the real exchange rate (Meade, 1951; Swan, 1960). Against the backdrop of low inflation in the euro area as a whole, the required expenditure switching will likely take time unless structural reforms to enhance product and labour market flexibility are undertaken. These would facilitate the necessary adjustment of the real exchange rate required to regain external competitiveness. Structural reforms are also essential to increase the flexibility of wages with respect to labour market pressures and boost productivity growth.

… and external surplus economies

- For those countries with long-standing external surpluses, domestic absorption needs to be increased and resources switched from tradable to non-tradable sectors. Adjustment will likely imply higher domestic wages and private consumption. It will also imply higher inflation than in the run-up to the crisis, given the need for improved competitiveness in the external deficit economies and close to target area-wide inflation.

Throughout the euro area, the process of rebalancing would be facilitated if it were to take place against a background of stronger growth.

The required policy adjustment has begun…

The required adjustment process has already begun and seems set to continue over the projection period. In deficit countries, increases in household saving and fiscal consolidation have driven the reduction in absorption (see below), with households and companies having little access to credit markets to offset the pressures on their incomes. This has been accompanied by an acceleration of politically-sensitive reforms designed to help lift potential growth, regain price competitiveness and restore fiscal sustainability.[11] In surplus countries, there has been less policy adjustment to foster rebalancing; fiscal policy has been mildly restrictive in order to restore long-term sustainability and structural reforms that are essential to ensure adjustment have yet to be implemented. In particular, reforms that could boost growth by removing

11. Indeed, there is a strong cross-country correlation between the intensity of ongoing fiscal consolidation efforts and responsiveness to structural reform priorities identified in *Going for Growth* in recent years (OECD, 2012a). At the EU level, the new macroeconomic imbalances procedure introduced by the so-called “six-pack” and the related surveillance procedures could also potentially help to address underlying sources of imbalances and help prevent their build-up in the future, provided they are implemented effectively and consider necessary changes in both surplus and deficit economies.

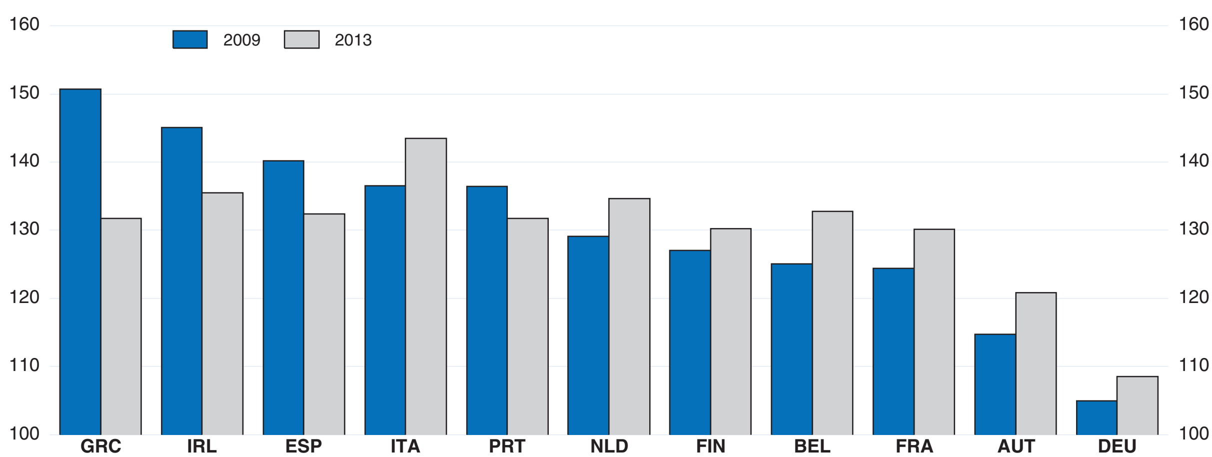
obstacles to investment and raising efficiency in service sectors, such as reductions in entry barriers and operational regulations, are still pending.

... and imbalances are beginning to unwind

Nonetheless, there are signs of progress in reversing underlying cross-border imbalances, though some changes may be more cyclical than structural in character. With Italy as an exception, the unit labour costs of the external deficit countries have declined since 2009, and by 2013 they are projected to be much more closely aligned with the majority of euro area members (Figure 1.13), although a prolonged period of adjustment on both sides would be necessary to make them more closely aligned with costs in Germany. Domestic absorption has also fallen sharply in the EU/IMF programme countries, as well as Spain, helping to bring about a marked improvement in their external trade balances (Figure 1.14). This improvement will need to be sustained, since it will take many years to bring the elevated net external debts of these economies, which currently amount to between 75 and 100% of GDP, down to more sustainable levels.[12] Further structural reforms will also be

Figure 1.13. **Euro area unit labour costs have begun to adjust**

1999=100

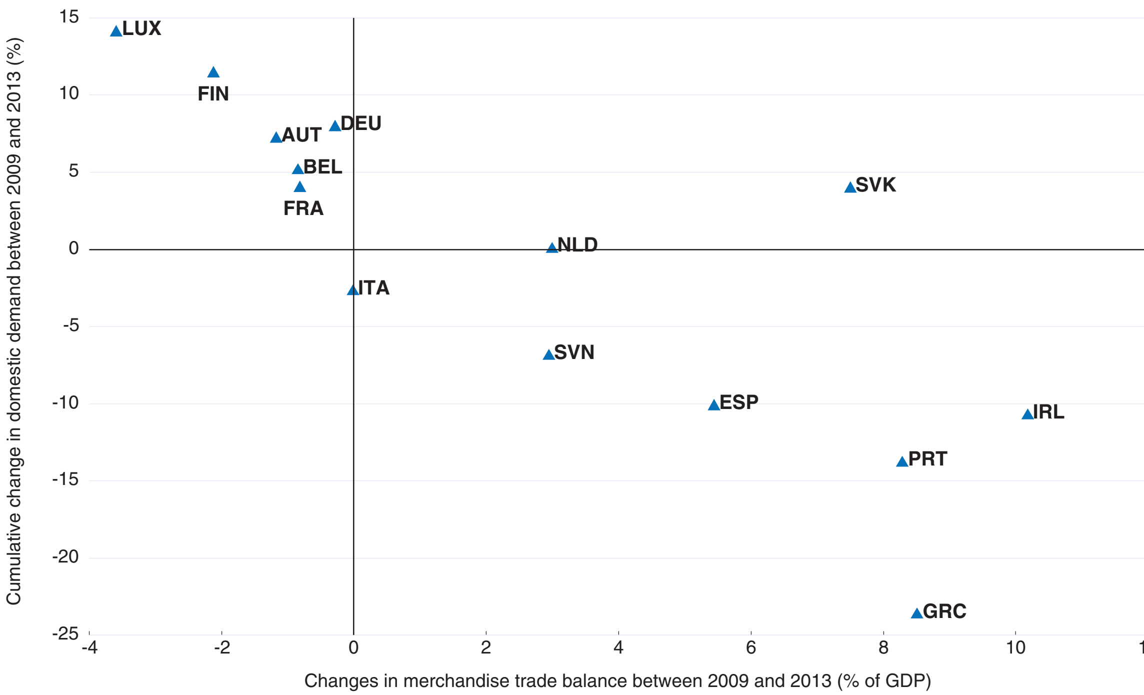


Source: OECD Economic Outlook 91 database.

StatLink http://dx.doi.org/10.1787/888932608221

12. The sustainable level of net external liabilities is difficult to know for certain, but is likely to be considerably lower than at present for these economies. For example, small open economies such as the United Kingdom, Canada and Sweden have net external liability positions between 10-25 per cent of GDP. The new macroeconomic imbalances procedure put in place by the European Commission suggests an upper sustainable threshold of 35% of GDP for net external liabilities, which given medium-term growth prospects might require attaining a current account deficit of no more than 1½ per cent of GDP and achieving approximate trade balance. In Ireland, the current account balance has already become positive, and by the end of the projection period the external deficits of Spain and Portugal are expected to be at levels that, if sustained, would help to durably reduce their net external liabilities. However, the current account deficit of Greece, projected to be 6½ per cent in 2013, is not yet at a level sufficient to durably stabilise net external liabilities.

Figure 1.14. **Changes in euro area countries domestic demand and trade balances 2009-13**



Source: OECD Economic Outlook 91 database.

StatLink http://dx.doi.org/10.1787/888932608240

required in the external surplus economies if a durable rebalancing in the euro area is to be achieved, given the muted growth in their domestic demand over 2009-13. In the absence of faster progress in the external surplus economies, the near-term consequence of the adjustments currently taking place is the development of a much more negative area-wide output gap.

Tackling financial market risks

Immediate near-term risks have been damped partially

With the rebalancing process and fiscal consolidation likely to take time, the potential for further near-term problems in the euro area remains. In particular, against the backdrop of high and rising government debt, high overall bank leverage, weak growth and still-fragile market confidence, the close relationships between the balance sheets of national governments and banking systems mean that potential remains for strong adverse feedback effects between fiscal sustainability and financial stability in the near term. Such risks were illustrated in a scenario analysis reported in the November 2011 *Economic Outlook*, in which the euro area would plunge into a deep recession with large negative effects for the global economy (OECD, 2011a). The immediate dangers of such developments have receded somewhat since last autumn, although, as shown by the unsettled situation following the parliamentary elections in Greece in early May, the dangers have not disappeared.

Firewalls have been enhanced...

The capacity to deal with contagion and turbulence in government primary debt markets has been strengthened by the end-March Euro Group agreement to enhance the funds available to help governments facing liquidity shocks. Total commitments under the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) will amount to up to €700 billion, of which approximately €500 billion is still available for new commitments. Additional funding is also likely to be available from the IMF, following the additional resources of $430 billion it has recently raised, over half of which is from EU governments. Although full deployment of all of the resources from the fragmented sources of support in the event of significant contagion will likely take some time,[13] the enhanced joint capacity of the EFSF and ESM is welcome. Combined with the total additional resources now available to the IMF, the firewall may now be close to a level sufficient to fully decouple the sovereign financing needs of the vulnerable countries from the sovereign bond markets for some time in a downside scenario. For instance, resources equivalent to around €1¼ trillion (around 13% of euro area GDP) would be required to fully satisfy the funding needs of Italy and Spain in the remainder of 2012 and 2013. The adequacy of the combined firewall for addressing such a need would depend on whether resources would have to be committed for other purposes, such as supporting the banking sector or non-euro area IMF members, and also whether a crisis could be relied on to be as short-lived as assumed. In the event of a funding shortfall, further increases in the scale of the EFSF/ESM funds would involve even more direct pressure on the fiscal positions of those countries that provide capital to these schemes. Thus, there is a possibility that any further enhancements to the existing firewall might require significant involvement by the ECB. The urgency of considering these issues has increased given the renewed uncertainty since the start of May.

... but additional measures may be needed

A further issue is that satisfying financing needs in primary markets may not suffice to prevent turbulence in the secondary government bond markets, with potential repercussions for the stability of the banking system. The loss-absorbing capacity of European banks has been strengthened by increasing their minimum Tier-one capital to 9% of risk-weighted assets by mid-2012, which banks are in the process of achieving through measures such as raising capital, retaining earnings and selling assets. Nonetheless, banks are heavily exposed to their own national sovereign debt, a development accentuated recently in some countries by

13. For example, the EFSF requires unanimity, and possibly parliamentary approval, and the ESM requires mutual consent, although there is an emergency majority voting procedure that can be invoked by the European Commission and the ECB.

the use of LTRO funds to purchase additional government bonds. Falling prices in secondary bond markets could thus generate losses that banks may not be able to absorb. Such falls in prices can coincide with governments' funding needs being met by official channels, especially if private investors believe that official investors are unwilling to bear any losses, as was the case with the recent debt restructuring in Greece. In turn, losses among banks could undermine confidence in public finances and set in motion adverse feed-back loops. Additional improvements in loss-absorbing capacity of the banking system via higher capital requirements would be the best means of guarding against such outcomes in the long run. However, this may not be feasible in the shorter term and, in the absence of sufficient capacity for the fiscal authorities to intervene in secondary markets, further ECB actions could be necessary if tensions were to rise, including through the Securities Market Programme.

Moral hazard has to be addressed by strict conditionality…

The availability of insurance, and any further additional ECB intervention, raises serious issues of future moral hazard. To reduce moral hazard, strict conditionality would have to be attached to any direct financial assistance. Moreover, if the ECB were to become involved in market support, it could be seen to be engaged in quasi-fiscal operations, with an associated loss of credibility that might render inflation control difficult in the future. Set against this, monetary policy requirements could more easily motivate further ECB actions in the secondary bond markets.

… and new fiscal governance arrangements

In the longer term, increased mutualisation of risk must be accompanied by governance changes to reduce the risk of future bail-outs. Indeed, in response to the European debt crisis, a number of legislative and multilateral initiatives have now been taken to help ensure that general government headline deficits and debt are durably reduced to below the EU's reference levels of 3% and 60% of GDP, respectively. However, the application of the various procedures and their transposition into national fiscal systems is likely to prove challenging (Box 1.4). The new fiscal framework will also be important for the restoration and maintenance of fiscal sustainability. In this regard, the new fiscal procedures might have helped to prevent the build-up of excessive fiscal deficits in some euro area countries, notably Greece, had they been in place prior to the crisis. However, by themselves, they would not have prevented the underlying problems that eventually led to fiscal imbalances emerging in countries such as Spain, Portugal and Ireland, although the problems in these countries might perhaps have been caught by the procedures now introduced to monitor private sector imbalances.

Box 1.4. **Challenges in implementing the new budgetary rules in the European Union**

Legislative initiatives to solve the euro area debt crisis include several multilateral agreements designed to reinforce fiscal and economic governance and policy surveillance. In December 2011 the "Six Pack" came into force, its name referring to the six legislative proposals to strengthen governance put forward by the EU Commission in September 2010. The "Treaty on Stability, Coordination and Governance in the Economic and Monetary Union", containing the "Fiscal Compact", was signed by 25 EU Member States in early March 2012 and is scheduled to come into force, following ratification by national legislators, in January 2013.

As a result of these reforms and already existing rules, budget policy in EU countries in the coming years will be subject to four rules, with the rule that binds differing by country and year:[1]

- Provisions in the excessive deficit procedure (EDP) aimed at attaining the 3% of GDP reference headline deficit ceiling by 2012-14, with countries already having made commitments to an annual path to reach this goal.
- Medium-term Objectives (MTO) set at a maximum structural deficit excluding one-offs of 1 or 0.5% of GDP (with the amount depending on the level and sustainability of debt) to be reached by reducing structural deficits by at least 0.5 percentage points of GDP annually.
- The debt reduction rule (DR), whereby the gap between actual debt and the 60% reference level, averaged over three years, needs to be reduced by 1/20 annually.
- The transition to the debt reduction rule from the EDP (TRANS), aimed at reducing the deficit to conform to the debt reduction rule in three years, though with annual structural adjustment not exceeding ¾ per cent of GDP.

Enforcement procedures both at EU and national level will be strengthened in the light of the almost complete failure to achieve requirements on a sustainable basis prior to the crisis. In particular, automatic financial sanctions, notably the deposition of funds into a blocked non-interest-bearing account, will apply unless a qualified majority of countries votes against it (reversed majority principle).

The multiplicity and the complexity of the fiscal rules obscure their likely impact on government finances. Complexity may also be an impediment to communication about fiscal policy and to achieving popular buy-in to a sustainability oriented policy, without which rules may be harder to enforce. There are no official projections or scenarios published of the rules' implications. Stylised simulations are used here to highlight the phasing of the rules under exact compliance with the numerical rules.[2] For each country, the fiscal position, debt servicing costs and economic growth determine what rule becomes binding over time, and the most stringent rule in terms of the structural budget balance is assumed to be the binding constraint. This might produce a structural adjustment path towards the MTO that exceeds 0.5% of GDP per annum. MTOs are assumed to remain at their current levels, although these will be reviewed during 2012. The table below indicates the phasing of the rules for selected countries under a set of assumptions conditional on the OECD's long-term growth scenario.[3]

In the short term, consolidation dynamics in almost all EU countries will be driven by the EDP requiring headline deficits in terms of GDP to fall below the 3% limit. For the purpose of the stylised simulations in this box, all EU countries are assumed to meet their deadlines to correct excessive deficits. For most countries this would be the case by 2013 at the latest. After the 3% limit is met, other rules become relevant. Once the MTO is reached, underlying balances are required to remain constant.

In the medium term, consolidation dynamics will be either driven by the MTO or the DR rule. In fact, the DR rule applies fairly rarely because, even though countries have debt-to-GDP ratios well above 60%, the MTOs are often stricter in terms of the budget balance than the implied balance under the 1/20th debt rule and because of the transitional arrangements that have been put in place. The higher the debt-to-GDP ratio and the larger the structural deficit, the more likely it is that the DR rule will be binding. By about the middle of the decade, most EU countries would attain or exceed their MTOs.

Box 1.4. **Challenges in implementing the new budgetary rules in the European Union** *(cont.)*

Most binding European Union fiscal rules under stylised assumptions

	for EDP correction	2012	2013	2014	2015	2016	2017	2018
Austria	2013	TRANS	TRANS	TRANS	DR	MTO	MTO	MTO
Belgium	2012	EDP	->MTO	->MTO	->MTO	->MTO	->MTO	MTO
Estonia	..	MTO	MTO	MTO	MTO	MTO	MTO	MTO
Finland	..	->MTO	->MTO	MTO	MTO	MTO	DR	MTO
France	2013	EDP	EDP	->MTO	->MTO	MTO	MTO	MTO
Germany	2013	->MTO	MTO	TRANS	DR	MTO	MTO	MTO
Greece	2014	EDP	EDP	EDP	TRANS	TRANS	MTO	MTO
Ireland	2015	EDP	EDP	EDP	EDP	TRANS	->MTO	MTO
Italy	2012	EDP	TRANS	TRANS	TRANS	DR	DR	DR
Luxembourg	..	MTO	MTO	MTO	MTO	MTO	MTO	MTO
Netherlands	2013	EDP	EDP	MTO	TRANS	MTO	MTO	MTO
Portugal	2013	EDP	EDP	TRANS	TRANS	TRANS	DR	DR
Slovak Republic	2013	EDP	EDP	->MTO	->MTO	->MTO	->MTO	->MTO
Slovenia	2013	EDP	EDP	->MTO	->MTO	MTO	MTO	MTO
Spain	2013	EDP	EDP	TRANS	TRANS	MTO	MTO	MTO
Czech Republic	2013	EDP	EDP	MTO	MTO	MTO	MTO	MTO
Denmark	2013	MTO	MTO	MTO	MTO	MTO	MTO	MTO
Hungary	2011	TRANS	TRANS	TRANS	DR	MTO	MTO	MTO
Poland	2012	EDP	->MTO	->MTO	->MTO	->MTO	MTO	MTO
Sweden	..	MTO	MTO	MTO	MTO	MTO	MTO	MTO
United Kingdom	2014	EDP	EDP	EDP	TRANS	->MTO	->MTO	MTO

Notes: The table shows what the European Union fiscal rules would be most binding, given a set of stylised assumptions. GDP growth and interest rates are assumed to be independent of fiscal policy and to follow the OECD Economic Outlook No. 91 until 2013 and thereafter the new OECD long-term projections. It is assumed that current EDP correction deadlines are met, superseding other rules, and that the countries just follow the rules. "EDP" stands for adjustment to the 3% of GDP deficit rule, "TRANS" stands for the transition period under the debt reduction rule, "DR" stands for the debt reduction rule, "→MTO" notes convergences to the Medium-Term Objective (MTO), and "MTO" notes that the MTO is reached.

Source: OECD calculations.

1. Countries will be also subject to an expenditure rule, requiring expenditure net of discretionary measures to grow below a medium-term rate of potential GDP until MTO is achieved. This rule is not included in the simulations of this box.
2. See also Barnes *et al.* (2012).
3. See Chapter 4.

Fostering area-wide growth

EU-wide initiatives could help to foster growth

Given the likely slow growth of private demand during the prolonged period of adjustment that is necessary to tackle imbalances, actions at the European level to foster area-wide growth could help to speed up the process and generate a more propitious environment in which to undertake structural reforms. One possible step in the near term would be to issue new jointly-guaranteed government bonds to help recapitalise the banking sector and encourage the write-off of bad loans, thereby setting the stage for increased credit availability. A side-effect of such a measure would be to take a step towards the issuance of euro-bonds, which could help increase private-sector confidence that such financing will eventually emerge as the euro area evolves, at which point sovereign debt crises would seem less intractable. A second possibility would be to increase the jointly-guaranteed resources available for the European Investment Bank to provide financial assistance to new trans-European network infrastructure projects, in areas such as transport, energy and telecommunications. Other policy measures at the EU level that can improve medium-term growth prospects include strengthening and deepening the Single Market; improving the EU co-ordination of national innovation policies; further opening markets to trade and investment; and enhancing labour mobility within the European Union (OECD, 2012c).

Policies in the main projection

Monetary policy

Additional monetary accommodation has been provided through different tools…

Reflecting the modest economic outlook, the significant downside risks and mostly moderate inflation, the monetary authorities in several OECD and non-OECD economies have provided additional monetary accommodation in recent months. Policy measures have become increasingly differentiated, reflecting cross-country differences in the pre-existing use of non-traditional monetary policy tools and in bank funding conditions. The measures have included changes in communication strategies, asset purchases, liquidity provision, lowering of required reserve requirements, reduction of collateral quality and cuts in policy interest rates:

… including enhanced communication policies…

- Enhanced use of communication policies was made in the United States and Japan. The Federal Reserve now publishes the longer-run inflation objective and provides information about individual FOMC members' expectations of the future federal funds rate, conditional on their projected economic outlook. In February, the Bank of Japan also published a clear statement about its price stability goal, which is now set at achieving an inflation rate of 1%.

… expansions of asset purchase programmes…

- Asset purchase programmes have been expanded further in Japan and the United Kingdom. In Japan, the overall size of the programme has now risen to 70 trillion yen (15% of GDP) with the new purchases being allocated to long-term government bonds. The Bank of England has also expanded its asset purchase programme to a total of £325 billion (22% of GDP).

… large scale liquidity provisions…

- The European Central Bank implemented the two LTROs, reduced the policy rate and reserve requirements, and expanded collateral eligibility for banks. Together, these measures eased policy considerably, pushing the overnight interest rate down to around 0.35%. National central banks also began to accept bank loans as collateral in their liquidity operations at their own risk. These measures allowed for some convergence in liquidity conditions within the single currency area, reducing excessive tightening of liquidity conditions in the economies under market pressure.

... and the reduction of policy rates and reserve requirements

- Interest rates were cut in Brazil already in mid-2011 and have since then been reduced by a total of 350 basis points. Since late-2011, policy rates have also been lowered in Australia, Sweden and Norway, as well as in India and Russia. In China, reserve requirements have been reduced although policy interest rates have remained unchanged.

Continuing accommodative monetary policy will be appropriate...

Looking forward, against a likely backdrop of modest economic growth, limited inflationary pressures and widespread fiscal consolidation over the next few years, monetary conditions need to remain accommodative with policy interest rates close to zero in most OECD countries and asset purchases programmes implemented as planned or expanded. In the large emerging market economies outside the OECD, monetary policy requirements differ across countries, depending on the economic outlook.

... in the United States...

- In the United States, keeping the target federal funds rate at its present level, as stated in the current forward guidance, is predicated on continued spare capacity, with fiscal tightening contributing to limit growth to close-to-trend rates. In the event of the adoption of a very restrictive fiscal policy for 2013, or a materialisation of downside risks in the euro area, the Federal Reserve would have to respond to the implications for inflation and activity by additional purchases of long-term government bonds and possibly by expanding the range of purchased assets. On the other hand, given that the neutral policy rate appears to be at or above 4%, the current forward guidance to the end of 2014 entails a risk that monetary policy would have to move in a potentially destabilising manner afterwards or be delayed with respect to economic requirements. This possibility means that potential changes in economic conditions from those currently envisaged need to be monitored closely; this might happen, for example, if political agreements were to result in little or no fiscal consolidation in the coming fiscal year or if the absorption of labour market slack did not slow down to the extent currently anticipated.

... Japan...

- In Japan, the current zero-interest-rate policy needs to be continued until inflation is firmly positive, which is not expected to occur before the end of 2013. If there are no clear signs of a trend toward achieving the 1% inflation goal, the Bank of Japan should undertake further measures, including the expansion of the scale of the asset purchase programme.

... and the euro area

- In the euro area, there is a need for easier monetary conditions given the prospects for weak economic activity and declining inflationary pressures (except for increases in administered prices and indirect taxes). With different official interest rates relevant for different banks, it will be appropriate to bring down the overnight rate to near-zero levels by decreasing both the main refinancing rate and the deposit rate. The outlook could justify going further to expand unsterilised purchases of long-term securities, possibly directed to the government bond market as well as the covered bond market. In the former case, government guarantees would be desirable to maintain a clear separation between monetary and fiscal policies.

More accommodative domestic policy and tighter exchange rate policy are desirable in China…

- In China, following some reductions in bank reserve requirements, overall monetary conditions seem to be appropriate at present, but domestic monetary conditions are relatively tight, though hard to gauge given the reliance on administrative measures and uncertainty about their transmission. Against this background, the Chinese monetary authorities might be better served by a more accommodative domestic policy with the priority being given to market-based measures rather than reserve requirements and window guidance, while allowing for faster appreciation of the effective exchange rate. Such a policy combination should help to reduce the risk of activity slowing more sharply than projected, and the risk of disorderly property market outcomes. The recent expansion of the band for daily fluctuations of the renminbi-US dollar rate is a useful step in this direction.

… while policy requirements differ across the other emerging economies

- In India, the scope to move further towards a more accommodative stance is limited, given inflation pressures and limited spare capacity. In Brazil, on the other hand, some of the monetary stimulus currently in place will have to be withdrawn to bring inflation back to the mid-range of the target band. The monetary authorities in Indonesia should also be alert to possible inflationary pressures and tighten policy if they emerge.

Taking risks related to ultra-accommodative monetary policy is warranted for the time being

The extremely accommodating monetary policy stance likely in most countries in coming years entails negative risks. Monetary easing, such as the extension of the period of near-zero policy rates and liquidity provision with long maturity and very low interest rates, potentially prompts excessive risk taking and resource misallocation that may allow zombie banks and enterprises to survive. Moreover, the expansion of the scale of asset purchase programmes increases the vulnerability of central bank balance sheets to asset price fluctuations. However, the need to support weak activity, and downside risks to growth, warrants taking the risks associated with ultra-accommodative monetary policy for the time being. To some extent the risks could be contained by prudential policies, such as preventing the ever-greening of bad loans (see below).

Rising oil prices could influence policy settings

If further increases in oil prices, including spikes due to supply disruptions, were only temporary, they might have few monetary policy implications, given well-anchored inflation expectations and the need for policy interest rates to be set to meet inflation objectives two or more years ahead. However, an upward trend drift in oil prices on the back of steadily rising demand and a slow response of supply might be more likely to influence monetary policy settings. In particular, a steady upward trend would raise questions about the inflation rate and the appropriate inflation concept to target, since a trend increase in oil prices would require slower growth of non-oil domestic prices and hence possibly tighter policy than otherwise, at least temporarily, if inflation objectives remain unchanged.

Fiscal policy

Fiscal consolidation will be widespread but debt ratios are likely to continue drifting up in many countries…

Budget outcomes in 2011 were broadly in line with expectations (as measured by OECD projections from last November) in the United States and the United Kingdom, but weaker than expected for Japan and the euro area. In the current projection, the OECD area-wide fiscal deficit is expected to fall by 1% of GDP in 2012 and by between 1 and 1¼ per cent of GDP in 2013 (Table 1.6). Gross debt in terms of GDP is set to continue drifting upwards, with 2013 debt ratios projected to exceed 2011 levels in the United States, the euro area and Japan by 8½, 4¾ and 17 percentage points, respectively.

Table 1.6. **Fiscal positions will improve only slowly**

Per cent of GDP / Potential GDP

	2009	2010	2011	2012	2013
United States					
Actual balance	-11.6	-10.7	-9.7	-8.3	-6.5
Underlying balance	-9.0	-8.6	-7.7	-6.8	-5.4
Underlying primary balance	-7.5	-7.0	-5.9	-5.0	-3.4
Gross financial liabilities	89.7	98.3	102.7	108.6	111.2
Euro area					
Actual balance	-6.4	-6.2	-4.1	-3.0	-2.0
Underlying balance	-4.9	-4.1	-3.1	-1.7	-0.4
Underlying primary balance	-2.5	-1.7	-0.5	0.9	2.3
Gross financial liabilities	87.8	93.1	95.1	99.1	99.9
Japan					
Actual balance	-8.8	-8.4	-9.5	-9.9	-10.1
Underlying balance	-7.6	-8.0	-8.8	-9.2	-9.3
Underlying primary balance	-7.1	-7.4	-8.0	-8.2	-7.9
Gross financial liabilities	188.8	192.7	205.5	214.1	222.6
OECD[1]					
Actual balance[1]	-8.1	-7.5	-6.3	-5.3	-4.2
Underlying balance[2]	-6.6	-6.3	-5.5	-4.6	-3.5
Underlying primary balance[2]	-5.1	-4.6	-3.7	-2.7	-1.5
Gross financial liabilities[2]	92.5	98.7	103.0	107.6	109.3

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 91 database.

StatLink http://dx.doi.org/10.1787/888932609570

... and in most countries consolidation needs remain large

Calculations by the OECD indicate that, based on plausible assumptions about medium-term growth and interest rates, stabilising the debt-to-GDP ratio may require a tightening of underlying primary balances after 2011 of 13 percentage points of GDP in Japan, and about 6½ percentage points of GDP in the United States (see Chapter 4). Moreover, for many other countries, stabilisation of the debt ratio would occur at high levels. Bringing debt ratios back to pre-crisis levels or to more comfortable levels of some 60% of GDP would require substantially greater consolidation than for debt stabilisation.

The consolidation pace should depend on the state of the economy ...

However, decisions on the pace of consolidation must take into account the adverse effects of fiscal policies on aggregate demand. For example, in the euro area on average, a one percentage point tightening of the underlying primary balance in an individual country might typically reduce growth by around ½ per cent of GDP, although fiscal multipliers will vary in size across consolidation instruments and countries, and depend on circumstances (Barrell *et al.*, 2012). Moreover, if tightening occurs in several countries simultaneously, as is presently the case, the impact is larger. In the current environment, with limited scope for further monetary policy relaxation, the adverse impact of fiscal consolidation on growth could be much stronger than in normal times. On the other hand, a number of countries are in acute risk of losing credibility in financial markets. On balance, if economic activity turns out to be weaker than embedded in current consolidation plans, it would be appropriate in most cases to compensate implied budgetary shortfalls only partially by additional fiscal restraint, while taking into account country-specific circumstances. It is essential in any case that the credibility of consolidation plans is preserved.

... and the composition of consolidation should be choosen on the basis of its impact on...

Current consolidation plans in the OECD area incorporate a mixture of revenue raising measures and spending reductions, with public spending reductions accounting for more than half of the consolidation in most countries.[14] The composition of consolidation can have significant impact on efficiency and equity outcomes, and needs to be calibrated to attain the best balance between important competing objectives, which can also significantly influence the political acceptance of consolidation strategies:[15]

... economic efficiency...

- If carefully designed, some consolidation measures might prompt an increase in public sector efficiency and could be growth enhancing. For example, as earlier work by the OECD has shown, there is scope to improve efficiency in major spending areas of the public sector, such as health and education, and such gains could yield large savings without

14. In 17 of the 21 countries where consolidation exceeds 1% of GDP in 2012 and 2013 combined, spending reductions are expected to account for more than half of the fiscal adjustment.
15. For a discussion of consolidation instruments and trade-offs involved see Chapter 4 in OECD *Economic Outlook* 88 (OECD, 2010) and Hagemann (2012).

jeopardising the outcomes of public sector services. On the other hand, achieving consolidation by reducing public investment in infrastructure and human capital, or increasing taxes on corporate and labour income, may undermine economic growth.

... and equity

- There are many channels through which consolidation measures can affect equity outcomes by changing structural-policy settings that influence the distribution of income (see above). Areas where particular care needs to be taken include ensuring that consolidation measures do not result in reductions in educational system outputs, including weaker attainment levels, and do not weaken the re-distributional effects of the tax and transfer system.

The key fiscal policy assumptions are...

The fiscal policy assumptions employed in the projections are based on government programmes in most cases, though normative assumptions have been made where there is particular uncertainty about the likely evolution of budget policy in 2012 and 2013 (see Box 1.2 above):

... in the United States, consolidation could be a bit more ambitious than previously appeared prudent...

- In the United States, the risk of an excessively tight fiscal stance this year has been averted, with the payroll tax cut and the extensions to unemployment benefit duration having been maintained. This should mean that fiscal consolidation this year is of the order of 1% of GDP. Looking ahead to 2013, current legislation implies the expiry of the extensions of the 2001-03 tax cuts, the payroll tax cut and extended unemployment benefit duration, and automatic expenditure reductions worth around ¾ percentage point of GDP, amounting to a total tightening of close to 4% of GDP. The projection assumes this will not occur. Nonetheless, with growth prospects better than foreseen a few months ago, and less pronounced downside risks, the normative assumption employed in the projections is that there is scope for a slight increase in the pace of consolidation, improving the underlying primary balance by 1½ per cent of GDP between 2012 and 2013, somewhat faster than had previously appeared prudent. Crucially, the Administration and Congress have yet to establish an agreed credible consolidation path towards the restoration of fiscal sustainability; this is urgent and will become more so as the recovery firms and government borrowing costs increase. In this regard, there is plenty of scope to improve horizontal and vertical equity in the tax code in a way that will enhance revenue and to address long-term trends in entitlement spending.

... in Japan, consolidation should start earlier than foreseen by the government...

- In Japan, given the very high sovereign debt level, the top priority is to establish a more detailed and credible fiscal consolidation programme, including tax increases and spending limits, to put public debt firmly on a downward path towards more sustainable levels. Under currently-announced government policy, the underlying primary balance is projected to remain almost unchanged, with the headline deficit reaching 10% of GDP in 2013. This incorporates cumulative postearthquake reconstruction spending, estimated to total about 2% of GDP spread over 2012 and 2013, partially financed by temporary, albeit long-lasting, tax increases. As a step towards attaining the long-term goals of achieving a primary budget surplus by financial year 2020 and putting the public debt ratio on a downward path thereafter, the government has proposed raising the consumption tax rate to 10% by 2015. A phase-in of such an increase, which may have to be followed by more, should be enacted swiftly to demonstrate commitment to longer-term fiscal goals. Indeed, given the size of the task, and the risks associated with gross public debt above 200% of GDP, it would be prudent to start consolidation earlier than foreseen by the government.

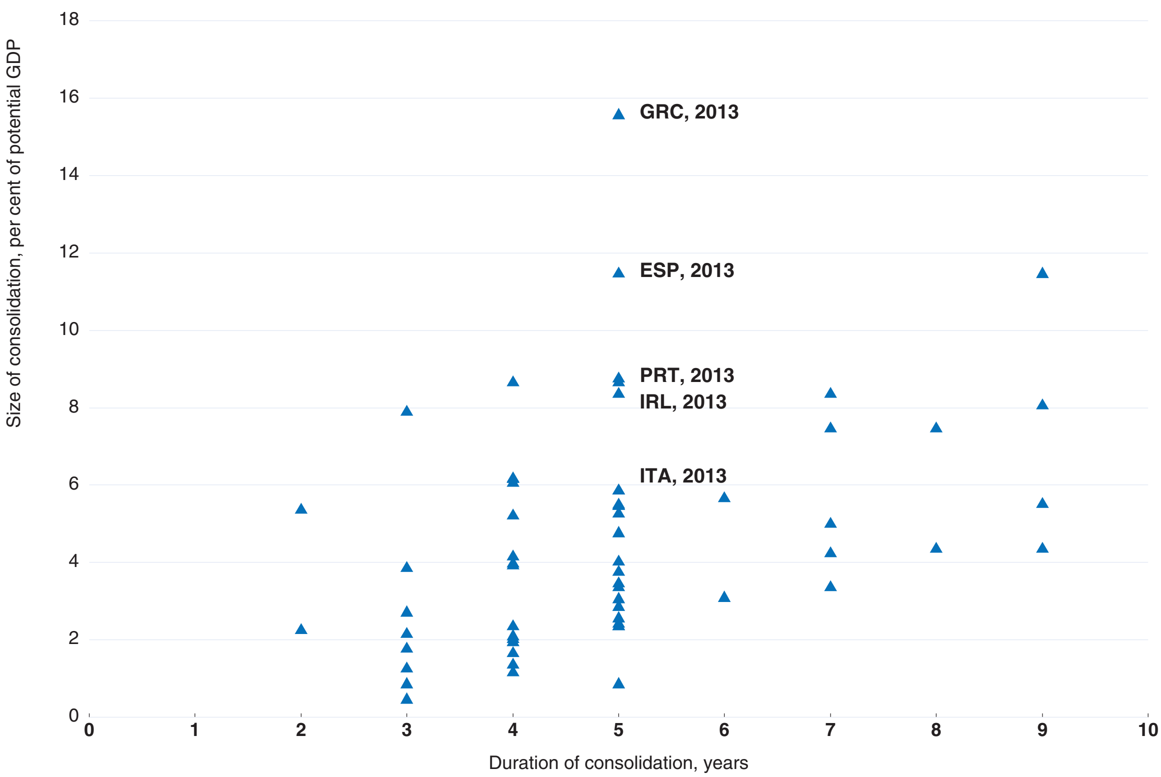
… in the euro area, structural objectives need to be met, but unforeseen cyclical weakness may leave headline deficits above their targets…

- In the euro area, a difficult balance must be struck between minimising the adverse short-term impact of consolidation on demand and the need to maintain credibility in medium-term consolidation plans. The required tightening to attain nominal budget targets in 2012 would likely amount to around 2% of GDP in the euro area as a whole, but would be much stronger in some of the countries under market pressure, notably Greece, Portugal, Italy and Spain (even with the revisions of the nominal deficit targets in the latter two countries). Hence, as discussed above, it appears appropriate that budgetary shortfalls due to unforeseen economic weakness be compensated by additional consolidation measures only partially. In the projections it is generally assumed that one-third of the cyclical weakening relative to the GDP growth embedded in the consolidation plans of euro area countries is offset with further structural tightening, with the remaining two-thirds showing up in higher-than-targeted headline deficits. This implies an area-wide tightening of close to 1½ per cent of GDP in both 2012 and 2013.

… while fiscal policies will be exceptionally tight in some countries

- Even with such assumed slippage, fiscal policy looks set to be exceptionally tight in the current and coming years in the countries under market pressure. In 2012 and 2013, underlying primary balances are projected to improve by 4½ per cent in Italy, 5% in Portugal and Greece, and 7% in Spain, following already large cumulative adjustments in the preceding two years (10½ per cent in Greece, 3¾ per cent in Portugal and 4½ per cent in Spain). These improvements are exceptionally large by historical standards (Figure 1.15). As fiscal multipliers could be unusually large in some of these countries at present, due to fragile banking systems that limit the possibility of consumption smoothing, weak confidence and no scope for monetary policy reaction at the domestic level, the induced economic weakness will limit the improvement in headline fiscal balances. While such pro-cyclical fiscal tightening is inherently undesirable, the starting point of high debt and deficits and low credibility leaves little room for manoeuvre. Only small further fiscal consolidation is assumed this year in Germany. For countries with some fiscal space, the pace of planned

Figure 1.15. **Size and duration of consolidation episodes in the OECD area since the 1980s**



Note: Consolidation episodes are identified by a rising trend in the underlying primary balance that allows for small and temporary fiscal reversals. For Greece, Ireland, Italy and Spain the largest past and current consolidations are shown (*i.e.* including projections until 2013), whereas for other OECD countries only the largest past or current consolidation is displayed.

Source: OECD Economic Outlook 91 database.

StatLink http://dx.doi.org/10.1787/888932608259

consolidation could even be eased if the state of the economy were to worsen markedly, subject to long-term sustainability.

China has scope for counter-cyclical fiscal policies while in India priority should be given to consolidation

- In China, the general government budget deficit for 2012 is planned to be equivalent to around 1¼ per cent of GDP, which is moderately supportive, with social spending set to rise significantly. Overall, with another year of strict control over new local authority borrowing, on-budget debt could fall to a little over 15% of GDP in 2012. This excludes contingent liabilities of about 28% of GDP, associated with *inter alia* bank lending to local government sponsored corporations, which could eventually become a liability of the government. While this is, in itself, comfortable, the authorities have ample scope to use fiscal policy to counter any unexpected weakening of the economy without increasing borrowing as they have accumulated significant cash balances in their budget stabilisation fund. In India, the government has planned for modest fiscal consolidation in the current fiscal year. With the government deficit projected to remain close to 8% of GDP, consolidation appears necessary to help reduce inflation, ease current account pressures and promote more balanced growth.

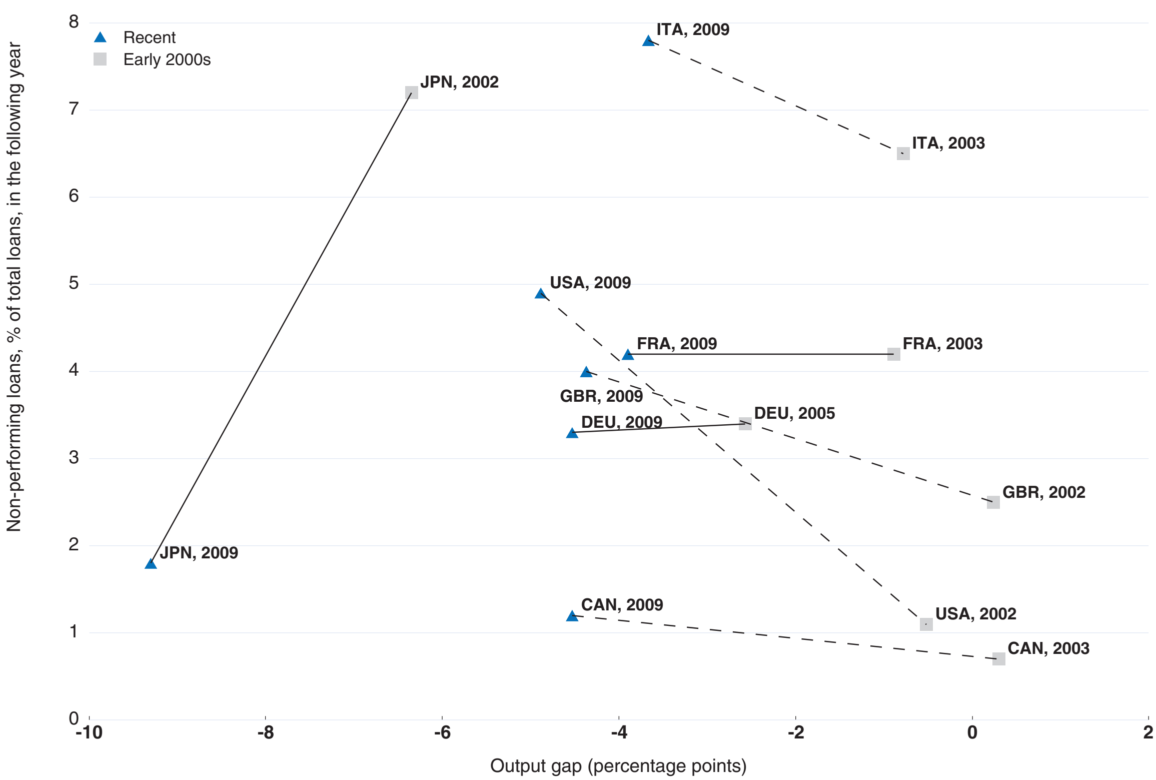
Financial market policy

Non-performing loans need to be recognised and addressed

The current environment of low interest rates and, especially in Europe, scarce equity capital might make banks reluctant to duly recognise and deal with bad loans. The opportunity cost for a bank of rolling over doubtful loans is low, compared with the alternative option of recognising these and taking capital-depleting provisions and write-offs. Indeed, in some of the largest euro area countries the shares of recognised non-performing loans in total loans are similar to their levels in the early 2000s despite a current much weaker economic situation, in marked contrast to the United States (Figure 1.16).[16] While this may reflect better risk management,[17] it underscores the need for active supervision to enforce the early recognition of non-performing loans, and steps to raise

Figure 1.16. **Output gaps and non-performing loans**

Selected countries, recent and early 2000s



Source: IMF Global Financial Stability Reports (2006, 2007, 2009) and IMF Financial Soundness Indicators.

StatLink http://dx.doi.org/10.1787/888932608278

16. In addition, the strong declining trend in the share of risk-weighted assets in the total assets of systemically important banks suggests that there might be risk assets that are not identified by the current regulatory framework (Slovik, 2011). Hence, there is a risk that many loans may become non-performing.
17. More generally, when assessing the level non-performing loans, account also needs to be taken of asset price developments over the past decade and broader changes in the composition of aggregate loan portfolios (that are independent of changes in risk-weightings).

equity as needed, including through public capital injections if private funding is not forthcoming.

The financial reform agenda needs to be implemented swiftly

While the most immediate priority for financial policy is a rapid recognition of bad loans, followed by any necessary recapitalisation, especially in the euro area, this should not delay efforts to complete the financial reform agenda set out by the G20, as greater clarity about future regulation could boost near-term activity, in particular by facilitating investment decisions. Although it is important that decisions are made rapidly to dissipate regulatory uncertainty, some standards, such as capital and liquidity requirements, have to be phased in gradually, as is planned, to avoid a credit crunch. More importantly, reform still needs to come to full fruition in a number of areas in order to check the risks of repeated financial crises in the future. The key priority is to complete the task of dealing with the risks associated with large institutions that obtain rents as a result of the *de facto* public guarantee against a systemic collapse of the financial sector. Specific capital surcharges for systemically important financial institutions (SIFIs) can be a useful tool for this purpose and should be accompanied by resolution plans vetted by regulators. Structural separation between retail and investment banking could also help to ensure that sufficient regulatory capital is available for retail institutions where some form of *de facto* government guarantee cannot be completely eliminated. Taxing the value of the residual effective government guarantee would reduce the incentive for banks to grow too big to fail.

Reforms are also required in other areas

Besides the banking sector, completing financial reform is also important in other areas. Close deadlines should be set for the vast majority of derivatives to become cleared and settled centrally, whilst ensuring that clearing houses enforce sufficient discipline regarding collateral requirements. Speeding up convergence in accounting standards would enhance the monitoring of risk globally and also help to reduce the potential for regulatory arbitrage. Other financial centres could follow the US lead to eliminate credit ratings from public rules. In addition, to reduce incentives to leverage, governments should review tax biases that favour debt accumulation rather than equity financing.

The short-term effects of structural reforms

Structural reforms can have favourable short-run effects

As discussed above, structural reforms are essential to help foster job creation and economic growth and durably tackle global and intra-euro area imbalances. However, against a backdrop of soft economic activity, there could be a temptation for governments to delay structural reforms because of a concern that they might have detrimental short-term effects. Recent OECD empirical analysis confirms that the full benefits from reforms take time to materialise, but also suggests that some reforms have marked positive effects on growth and employment over a period of 3-5 years (OECD, 2012d). Relevant examples include stronger active labour market policies, such as enhanced job search services, and growth-friendly tax reforms that seek to lower direct taxes on labour. Moreover, there is only limited evidence that reforms have negative effects in the near term though certain labour market measures, such as unemployment benefit and job protection reforms, can have mildly negative short-term effects if introduced when activity is weak. A broad reform effort, with a well designed package of labour and product market reforms, would be most likely to deliver overall gains and alleviate the transitional costs of certain individual reforms. The short-term impact of structural reforms could also be enhanced if accompanied by an effective communication strategy and a strong and well-regulated financial sector, thereby fostering confidence and enabling households and firms to spend against future reform-driven income gains.

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