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BETTER POLICIES FOR BETTER LIVES

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OECD

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Global Economic Outlook

Growth rates in the major advanced economies picked up in the first half of 2013 and should be maintained through the second half of the year. Activity is expanding at an encouraging pace in North America, Japan and the United Kingdom, while the euro area as a whole is no longer in recession.

The improvement in output growth has yet to be reflected in the OECD-wide unemployment rate, which has changed little in the past two years and remains well above its pre-crisis level. Gradually declining unemployment in a number of countries, including Japan and the United States, has been offset by further increases in a few euro area countries. With the rise in unemployment in the euro area having flattened out, a gradual reduction in OECD-wide unemployment is projected to resume.

Activity has slowed in several major emerging-market economies. In China, growth appears to have bottomed out in the first few months of 2013. Financial market turbulence—triggered in part by discussions of a tapering of quantitative easing in the United States—has highlighted difficulties facing a number of emerging-market economies, especially those with large current account deficits.

While activity is likely to gather momentum over the next two years, there remain a large number of serious risks that will weigh on the outlook, including continued vulnerability of the euro area to renewed financial, banking and sovereign debt tensions, with numerous possible triggers. Many euro area banks remain insufficiently capitalised, being not only a drag on growth, but also a potential source of negative feedback loops between banks and government finances. Capital levels relative to total (non-risk-weighted) assets are low in many banks, including in the core euro area countries. High and rising non-performing loans

add to recapitalisation challenges in many euro area countries, and adequate financial support arrangements to meet shortfalls in bank capital are also still lacking.

In Japan, despite the welcome decision to go ahead with the planned increase in the consumption tax rate as of April 2014, the main risk remains the exceptionally heavy public debt burden. Although sovereign bond yields have remained remarkably low and even fallen further this year as the Bank of Japan has adopted a more aggressive anti-deflationary stance, an upsurge in fears about debt sustainability could push up yields substantially, worsening the debt dynamics while also resulting in an unwelcome tightening of monetary conditions.

In the United States, the latest episode of deadlock and brinkmanship over fiscal policy is a source of considerable near-term uncertainty and has the potential for serious negative economic consequences. Failure to reach agreement on an appropriation for 2014 and the looming impasse over the debt ceiling could lead to damaging disruptions in government spending, trigger adverse reactions in financial markets, and weaken confidence. Moreover, a further abrupt rise in US bond yields, whether related to the political impasse, to expectations of Federal Reserve tapering of asset purchases or to any other reason, represents an important risk for many emerging-market economies, particularly those that have relied heavily on large portfolio inflows to finance large current account deficits.

Macroeconomic requirements at the current juncture

Accommodative monetary policy will continue to be needed in the advanced economies for some time yet. With core inflation below target in the United States, the euro area and Japan, and projected to remain subdued in 2014-15, the main central banks have leeway to keep policy rates low and—where necessary—to maintain quantitative easing. The main differences are in the optimal timing of exit from unconventional policies.

In the United States, the pace of security purchases should be reduced in the near future, reflecting the on-going recovery and signs of possible excessive risk-taking in some segments of the financial markets. Given the fragile world economic environment, decisions on the timing and speed of lessening monetary stimulus should take into account international spillovers.

In Japan, the current quantitative and qualitative easing should continue for the time being, as inflation is still well below target and fiscal headwinds are foreseen. In the euro area, monetary policy needs to remain strongly expansionary. If needed, potential non-conventional measures could include purchases, on a non-discriminatory basis, of government and corporate bonds and adoption of programmes to incentivise bank lending.

Monetary policy requirements in the emerging-market economies vary widely. In China, some monetary easing could be envisaged, if the expected recovery of the economy fails to materialize, but it will be important to restrain the expansion of credit. In India, high inflation and a sharp depreciation of the rupee, in the context of a large current account deficit and capital outflows, limit the scope for lowering interest rates despite the weakening economy. In Brazil, some pause in monetary tightening would be desirable given the moderation of the inflation rate and the slowdown of the economy, but this could result in further depreciation of the exchange rate.

Despite the improved fiscal situation in the major advanced countries, fiscal consolidation remains necessary. In the United States, a credible medium-term fiscal plan is imperative. In the euro area, existing fiscal plans should be implemented and the automatic stabilisers allowed to operate fully. In Japan, the decision to increase the consumption tax in 2014 is a welcome major step forward. Any measures to compensate the near-term growth impact of such tax increase should be explicitly temporary to avoid undermining the medium-term consolidation that the tax rise will deliver.

As with monetary policy, fiscal policy requirements reflect widely differing circumstances across the emerging-market economies. China has some scope for countercyclical fiscal policy, but the importance of off-budget vehicles means that such scope is much more limited than the headline budget deficit would suggest. While India has made progress on this front - given the large budget deficit and the need to strengthen confidence in economic management in view of the sharp depreciation of the currency - further consolidation is necessary. By contrast, Brazil's fiscal position allows automatic stabilisers to operate.

Against the backdrop of necessary consolidation in many countries, it remains vital to maintain public support and to protect the most vulnerable groups, including by prioritising spending to mitigate inequality and help people get back to work.

Reforms to the global financial system

Further measures to repair the credit transmission mechanism are needed, particularly in the euro area. Progress in establishing a single supervisory mechanism and in agreeing on the design of a single bank resolution regime needs to be followed by adopting an adequate joint financial backstop and, possibly, a joint deposit guarantee. The building blocks of a full-fledged banking union need to be put in place as quickly as possible and the date for an effective single bank resolution regime should be brought forward from the current 2018 target.

At the same time, the credibility of the asset quality and stress tests planned for 2014 needs to be firmly established, which may be challenging in the absence of a common fiscal backstop. The asset quality review must properly evaluate assets acquired in the past and especially identify the true magnitude of non-performing loans in banks' balance-sheets. Thus, it is crucial to establish in advance of the tests how the identified capital shortfalls will be addressed. The reliability of the bank stress test would also benefit from improved

transparency of results (including publishing of exposure to sovereign bonds), common definitions of key indicators (notably non-performing loans), consistency checks and demanding macroeconomic assumptions. In addition, marking to market all government securities (not only those in the trading book) would be warranted.

More broadly, a stronger recovery requires higher and better targeted investment in real assets and intangibles, rather than financial assets. While huge progress has been made since the crisis on repairing the global financial system and making it more stable, reforms are still work in progress. In particular, reform of the banking system is incomplete, which holds back long-term investment financing and creates risks from highly-leveraged too-big-to-fail institutions.

OECD work shows that banks separation in Europe and in the US – as well as a proper recapitalization of the European banking system are critical to make banks safer, limit contagion, address the too-big-too-fail problem and refocus banks on lending.

Derivatives positions – the size of which is now back at pre-crisis levels – are making banks more vulnerable to volatility in financial markets because of potentially large cash margin calls. In normal times, banks borrow to meet margin calls; but in periods of volatile movements in market prices, liquidity can dry up, and banks' vulnerability increases. In this context, the OECD calls for a more comprehensive separation of banks' activities – with a ring-fencing of their traditional and most risky (derivatives) activities - through the creation of a non-operating holding company structure.

We are also recommending to assess banks' need for capital and - possibly for recapitalisation - in light of a simple leverage ratio – equity capital over total IFRS equivalent unweighted assets – set at 5% (instead of the 3% ratio set out in Basel rules).Our analysis shows that this simple capital adequacy ratio is a very reliable indicator of banks' balance

sheets health and vulnerability to episodes of volatility in financial markets. By this measure, US banks are more robust than their European counterparts: banks in the euro-area do not have enough capital, and their leverage is too high compared to US banks, even when adjusting for similar accounting standards. They also have overpriced and less liquid securities in their banking books than their US counterparts. In other words, they have important needs for fresh capital.

Creating jobs and protecting the vulnerable

Unemployment has risen sharply in some countries, bringing with it the risk of a rise in structural unemployment. The number of long-term unemployed persons in OECD countries has nearly doubled since 2007, although the rise has been far from uniform, with about one-third of OECD member countries actually experiencing a fall in the proportion of long-term unemployed. Youth unemployment continues to be a major concern in many countries, which risks compromising their long-term career prospects.

While improving labour market conditions and confidence in the short term is largely dependent upon a broader and sustained economic recovery, more effective activation and training policies, together with reforms to tax-benefit systems to improve work incentives, would also help to tackle long-term unemployment and longstanding low employment rates.

Targeted measures are needed for some groups, such as the increasing number of young people not in employment, education or training (NEETs). There is a clear role for publicly subsidised training programmes, provided they are closely coordinated with employers to assure that training meets existing skill needs. In this context, the results of the OECD Adults Skills Survey (PIAAC), launched in Brussels last October 8th, will help countries design policies to ensure their citizens have the necessary skills to participate in the 21st Century

global jobs market. Work experience programmes have also proved useful in some countries for keeping youth and the long-term unemployed connected to the labour market.

Immigrants are another group that has been severely affected by the worsening in labour market conditions. OECD-wide, the unemployment rate of the foreign-born rose by 5 percentage points between 2008 and 2012, compared with 3 percentage points for the native-born. The high unemployment rates of immigrant youths are a particular concern. OECD countries need to address this issue to avoid scarring effects and maintain social cohesion. Against this backdrop, OECD countries should avoid cutting spending for integration

In many emerging-market and developing countries, large numbers of workers are condemned to low-paid, precarious jobs with little social protection. Tax simplification and the extension of social insurance coverage are among the measures that can help tackle these high rates of informality.

Structural policies to facilitate rebalancing and raise growth rates

Many countries, both advanced and emerging, are currently facing the challenge of slower trend growth. Together with the right macroeconomic policies, reforms to boost growth, rebalance the global economy and reduce structural impediments to job creation remain vital.

Some countries, especially those hardest hit by the global crisis, have stepped up the pace of structural reform in recent years. In many other countries, however, including some advanced economies and emerging-market economies that benefitted from positive capital inflows, reform efforts have been only moderate. The slow pace of reform has hindered the needed rebalancing of the global economy and complacency has left some countries unduly exposed to low growth and financial tensions.

In the euro area, rebalancing remains incomplete; falling domestic demand in high-debt countries has been offset, only to a limited extent, by stronger exports only to a limited extent, leaving output far below pre-crisis levels. Reforms to enhance productivity, such as easing restrictions in product markets and making labour markets more dynamic, will help to improve underlying competitiveness and export performance, unlock new opportunities for growth and support job creation. At the same time, measures to create more favourable conditions for investment in the surplus economies would help to achieve more balanced growth in the euro area as a whole.

In China, trend growth will slow over time as scope for catch-up growth diminishes, and as that occurs the structure of domestic demand will have to shift from investment to consumption. Structural reforms are necessary to facilitate that transition while at the same time avoiding a resurgence of current account imbalances. Such reform measures include the on-going development of social safety nets to reduce excess saving and removing obstacles to the development of the services sector.

There are also considerable welfare gains to be reaped from further trade liberalisation. Apart from the standard benefits of freer trade, a further reduction of barriers would foster integration into global value chains, which appears to have been a significant driver of productivity growth in recent years. Adopting a flexible trade and investment regime and a pro-competitive regulatory stance in key service sectors will be essential for countries, both advanced and emerging, to maximise the benefits from the internationalisation of services markets.