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## OECD and the world economy

### Report

Committee on Economic Affairs and Development

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### Contents

|  | <b>Page</b> |
|--|-------------|
| A. Draft resolution .....  | 2           |
| Annexe .....   | 5           |
| B. Explanatory memorandum, by Ms Lilliehöök .....                          | 6           |
| 1. Background .....  | 6           |
| 2. Introduction: uncertain prospects for the world economy .....           | 6           |
| 3. A survey of key economies .....   | 8           |
| 3.1. The United States .....   | 8           |
| 3.2. Asian economies .....   | 9           |
| 3.3. The euro area .....   | 11          |
| 3.4. The United Kingdom .....  | 12          |
| 3.5. Other key economies .....   | 13          |
| 4. Key questions relating to the financial markets .....                   | 15          |
| 4.1. Regulation and supervision .....                                      | 15          |
| 4.2. Financial education .....   | 16          |
| 4.3. The rise of sovereign wealth funds .....                              | 17          |
| 4.4. Private equity firms and hedge funds .....                            | 19          |
| 5. An update on other topics of interest .....                             | 20          |
| 5.1. Prospects for the Doha Round .....                                    | 20          |
| 5.2. Towards a global energy crunch? .....                                 | 21          |
| 5.3. Solutions for a planet under pressure .....                           | 22          |
| 5.4. Innovation strategy .....   | 23          |
| 5.5. Increasing the effectiveness of development aid .....                 | 24          |
| 5.6. An international commitment to combat corruption – Ten years on ..... | 27          |
| 5.7. An update on the OECD project “Going for Growth” .....                | 28          |
| 5.8. A renewed impetus for OECD enlargement .....                          | 30          |



## A. Draft resolution

1. The enlarged Parliamentary Assembly, made up of delegations of the OECD and Council of Europe member states as well as the European Parliament, has examined and debated the ongoing activities and work programme of the OECD, notably as they relate to the world economic situation, in the light of the OECD's *Annual Report 2008*, the report by the Assembly's Committee on Economic Affairs and Development, and contributions from other Assembly committees in the fields of the environment and agriculture, education and science, migration, health and social policy.

2. In view of the difficulties that have beset most of the advanced economies in 2007 and 2008, overall performance has been better than expected so far, according to the OECD. One reason for this is that the calls for structural reforms have borne fruit and, if pursued, should continue to help maintain stability. Moreover, the interventions of central banks have helped maintain liquidity. Nevertheless, in mid 2008, the global economic situation was still characterised by financial market turbulence, the slump in housing markets and soaring commodity prices. As a result, according to the OECD's *Economic Outlook*, June 2008, most OECD economies can expect "several quarters of weak growth", while headline inflation (including food and energy) is set to remain high "for some time to come". However, the OECD is conscious of the risky nature of forecasting in a "particularly unsettled" economic climate. Policy makers are advised to take account of the possible effects of developments in non-OECD countries and in financial markets, higher energy and credit costs and other inflationary pressures.

3. The financial crisis that has continued to shake the global economy since the OECD's mid-year assessment was published shows how uncertain the outlook remains. Some of the world's most powerful financial institutions have been toppled or remain vulnerable not only to the effects of the sub-prime mortgage debacle but also to further shocks connected with the wide and complex range of financial instruments invented and marketed by these institutions in recent years. Confidence in the ability of governments to safeguard citizens' essential economic and financial interests through adequate regulation has been undermined. Moreover, although the actions of both governments and central banks in seeking to prevent systemic collapse appear to have struck the right balance so far, their increasing involvement in rescuing private financial institutions at the taxpayers' expense has been questioned. Thus there remains a pressing need for greater regulation of financial markets, and the enlarged Assembly urges the OECD, as well as other institutions such as the IMF and the European Commission, to quickly step up their work on this issue with a view to avoiding future financial turmoil.

4. In this context, the enlarged Assembly welcomes the OECD's financial education project and related development of guidelines and good practices designed to improve the quality of financial understanding among consumers faced with increasingly complex financial markets and products.

5. The OECD advises against the introduction of measures to compensate for soaring food and energy prices, arguing that supply and demand in these markets can be best balanced through "the right price signals". Rather, the impact on those with low incomes is better offset, according to the OECD, "through an appropriately designed tax and social transfer system". The enlarged Assembly urges member governments to avoid measures that lead to market distortions. In accordance with the OECD's *Economic Outlook*, June 2008 report and in the light of the current state of the world economy, it is essential to adopt measures that endeavour to stimulate food supply in the medium term and seek to improve basic infrastructure (transport, energy and irrigation) and investment in technology for the agricultural sector.

6. Nevertheless, the enlarged Assembly is conscious that economic and financial instability can in turn threaten political stability, not least in the poorest countries of the world where food shortages have led to demonstrations and even rioting. They may also increase uncontrolled migration pressures. For economic and demographic reasons, international migration is set to continue. Thus the enlarged Assembly appeals to the OECD countries to step up their assistance to the hardest hit countries in the short term; to exercise leadership offering new approaches so as to define, manage and develop migration in accordance with the interests of the sending and receiving countries; to avoid disruption to relief supplies to traditional humanitarian constituencies of conflict and disaster-affected populations; to intensify their co-ordinated technical assistance with a view to improving farm productivity in these countries as a matter of urgency; to create a better environment for agricultural investment; and to ensure that they live up to their Official Development Assistance commitments.

7. In particular, the enlarged Assembly considers that migration has played, and will play, an important role for the economies of OECD countries, as well as for economic development in the migrants' countries of origin. A precondition is, however, that migrants are well integrated in their host society and in the world of

work. To this end, migrants and members of their families must learn the language of the host country as well as its history, and they must learn to respect and take part in the promotion of its basic democratic values and laws, including with regard to human rights.

8. The enlarged Assembly once again stresses the importance of removing barriers to international trade in agricultural and industrial goods as well as in services, with a view in particular to improving access for the products of the developing countries to the markets of the developed economies. Thus, while it regrets the failure of the World Trade Organization (WTO) Ministerial negotiations in July 2008, it considers that progress achieved so far in the Doha Round should be safeguarded and that efforts should be redoubled to relaunch the negotiations with a view to reaching a positive outcome beneficial to all parties. The enlarged Assembly notes that according to the Copenhagen Consensus 2008 agreed by a group of the world's top economists, conclusion of the Doha Round could realistically increase global income by US\$3 000 billion per year, over 80% of which would go to the developing world, representing exceptionally high cost-benefit value. The enlarged Assembly also welcomes the OECD-WTO's joint efforts to promote "aid for trade" – donor projects geared to increasing the capacity of developing countries to take better advantage of trade opportunities.

9. The enlarged Assembly notes the growing impact of Sovereign Wealth Funds, government investment vehicles intended as a means of investing foreign exchange reserves. It welcomes the OECD's Declaration on Sovereign Wealth Funds and Recipient Country Policies, as well as the work of the International Monetary Fund on voluntary best practices for Sovereign Wealth Funds and that of the European Union, as important steps towards one possible manner of resolving the tension between the need for recipient country governments to maintain an open, transparent global investment climate and their legitimate concerns over national security.

10. Despite slower global growth prospects, energy prices have continued to rise, reflecting weakness of the US dollar in which oil and gas are priced, geopolitical uncertainty, security concerns, growing demand in the emerging economies, chronic underinvestment in production and distribution, and long-term demand projections. According to the International Energy Agency, if governments maintain existing policies, the world's energy needs will increase by over 50% by 2030. The key to reducing energy demand lies in increased energy efficiency, while diversification of energy sources will also be essential. The enlarged Assembly calls on governments to accelerate the development of innovative energy technologies to achieve energy efficiency and to address global challenges of energy-related issues such as clean energy, climate change, and sustainable development. At the same time, the enlarged Assembly also calls on governments systematically to take account of the environmental impact of all energy-related measures. It also urges the OECD to step up its research in particular on the economic and environmental impact of biofuels and to carefully consider all side-effects of their development. The enlarged Assembly urges member states to strengthen institutions and mechanisms for national and regional dialogue in the field of energy in order to increase international co-operation in the energy sector for sustainable development.

11. The enlarged Assembly welcomes the OECD's work on education and encourages the OECD to pursue its studies on the efficiency of teaching and learning processes in order to formulate proposals to reverse the existing trend of increased educational expenditure versus unchanged education results. Improving the efficiency of learning processes is of the essence in order to tackle the current mismatch in adult competences and to ensure the sustainability of adequate life-long learning and continuing education systems. Within the OECD studies on education specific attention should be dedicated to e-education and Internet-learning in order to avoid and reduce the ever widening digital and, in consequence, generational education gap. The enlarged Assembly encourages education authorities in Council of Europe member states to look urgently into the available means to reduce inefficiency in their national primary and secondary education systems as well as to increase investment in higher education, as addressed by the 2008 OECD report "Going for Growth".

12. The problem of climate change requires there to be the broadest possible co-operation among states and their participation in shaping an effective and appropriate international response, in accordance with their respective responsibilities, abilities and social and economic conditions. The world will be faced with an enormous economic, social and environmental cost if no progress is made in framing policies to adapt to and mitigate the effects of climate change. In this regard, the OECD countries have a historic responsibility. The enlarged Assembly welcomes the OECD's recent work on the economics of climate change and strongly encourages the OECD also to focus its science studies on the new global challenges such as world food safety, large-scale genetic technology applications and above all the potential dramatic effect of global climate change on the access to basic needs such as food, energy and specifically water. The urgent challenge today is to ensure continuing economic growth in order to sustain equitable economic and social progress while reducing to a minimum its deleterious impact on the environment. The OECD emphasises the importance of using market instruments such as carbon taxes, carbon-trading schemes, and removal of energy subsidies as

key to addressing climate change, together with other instruments such as investment in clean technologies. According to the OECD *Environmental Outlook to 2030*, released in March 2008, global greenhouse gas emissions can be stabilised at 450 parts per million at a cost of 0.5% of world GDP in 2030 and 2.5% of GDP in 2050. While new cost estimates by OECD to be released later this year are likely to be higher, estimates for the cost of inaction are also being revised up, thus it is still economically rational to act sooner than later. The world GDP is likely to double by 2030 and to triple by 2050. This will require the prevalence of existing efficient technologies and the immediate introduction of innovative technology-based efficiency policies, and a global emissions price starting at just over US\$2 per emission tonne rising to US\$150 per tonne in 2050. The enlarged Assembly urges governments to give serious consideration to the OECD's recommendations in this respect.

13. The enlarged Assembly welcomes the steady, painstaking work behind the success of the OECD's Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, to which all 30 OECD member states and seven other governments are parties. Like the Council of Europe, the OECD sees corruption as the leading contemporary threat to good governance, accountability and sustainable economic development. The enlarged Assembly therefore congratulates the OECD for having broadened the scope of its activities in this field, including the development of a range of anti-corruption tools and recommendations relating to taxation, company ethics, export credits and development aid. The enlarged Assembly calls for the adoption of preventive measures to include codes of conduct for public officials and rules on conflicts of interest, training to promote compliance and sanctions in the event of failure to comply.

14. The enlarged Assembly notes that negotiations are proceeding between OECD and the countries listed as candidates for membership (Chile, Estonia, Israel, the Russian Federation, and Slovenia) and that the OECD is strengthening its relations with Enhanced Engagement countries (Brazil, India, Indonesia, the People's Republic of China and South Africa) as well as countries of strategic interest to the OECD in South-East Asia, and would urge the OECD to reserve membership for those countries which fully respect democracy, human rights and international law.

15. Finally, the enlarged Assembly decides to modify its Rules of Procedure (as per the Appendix hereto), last amended through [Resolution 1467 \(2005\)](#), to bring them into line with the relevant provisions of the Assembly's Rules which have been updated several times since then.

## Annexe

### **Modification of the Rules of Procedure for enlarged debates of the Parliamentary Assembly on the activities of the OECD**

1. The Rules of Procedure for the enlarged debates of the Parliamentary Assembly on the activities of the OECD were adopted in 1992 and amended in 1994 and 2005. They appear on pages 218 to 231 of the 2008 edition of the Rules of Procedure of the Assembly.
2. The Rules of Procedure of the Assembly have been modified several times since 2005, with new provisions, for example on gender balance and speaking time.
3. In line with the above, the Rules of Procedure for the enlarged Assembly are modified as follows:
  - Part II.2, add “and take account as far as possible of the need for gender balance”;
  - Part V.5, in the second sentence, replace the phrase “8 minutes to introduce a debate and 4 minutes to sum it up” by the phrase “13 minutes to introduce the report and to reply to the debate”;
  - Part VI.3, in the last sentence, replace the phrase “two hours before the beginning of the debate” by the phrase “one hour before the scheduled end of the sitting preceding that in which the debate is to begin”;
  - Part VI.5, replace the words “its author” by the words “one of its authors or another member speaking in its favour”;
  - Part VI.5, replace the words “1 minute” by the words “30 seconds”;
  - Part VI.6, replace the words “its author and one speaker against” by the words “one of its authors or another member speaking in its favour, one speaker against, and the Rapporteur or Chairperson of the Committee on Economic Affairs and Development”;
  - Part VII, in the last sentence, replace the words “one minute” by the words “30 seconds”;
  - Part VIII.2, in the first sentence, replace the word “30” by the word “60”;
  - Part IX.1, in footnote 1, replace the words “prepared in good time for presentation to the enlarged meeting of the Committee on Economic Affairs and Development to be held on the eve of the enlarged debate” by the words “submitted in writing in both official languages to the Head of the Secretariat of the Committee on Economic Affairs and Development at least seventeen hours before the scheduled start of the enlarged meeting of that committee held on the eve of the enlarged debate, e.g. by 3.30 p.m. on Monday if the enlarged committee meeting is held on Tuesday at 8.30 a.m.”

## B. Explanatory memorandum, by Ms Lilliehöök

### 1. Background

1. In October 2008, in Strasbourg, the enlarged Parliamentary Assembly of the Council of Europe will hold its annual debate on the OECD and the world economy. To prepare for this, the following draft report contains a summary of the key topics and questions discussed during the rapporteur's meetings at OECD headquarters in the first half of 2008. Provisionally approved by the Committee on Economic Affairs and Development at its meeting on 20 June, it will be distributed to national delegations for comment, and submitted, after further revision, for final adoption at the formal session of the enlarged Committee on Economic Affairs and Development and the enlarged Parliamentary Assembly in October 2008.

2. The rapporteur wishes to thank all those at the OECD who have offered their time and expertise to this project, and have made the report possible. Against a backdrop of dramatic headlines and rapidly changing economic indicators, the rapporteur found her wide-ranging sessions with OECD officials particularly stimulating and useful. So it is hoped that this report will offer a clear, if inevitably cautious, perspective. It begins with an overview of the critical factors that are driving economic prospects, and then provides a summary of developments in some OECD member countries, and some key emerging economies.<sup>1</sup>

3. This year, the report also pays special attention to developments in the financial markets, examining in particular the need for improved financial regulation and education, and assessing the rise of sovereign wealth funds. In conclusion, it will provide updates on subjects reviewed in recent reports, including the prospects for a successful conclusion to the Doha Trade Round, progress in delivering international aid more effectively, an update on the OECD's anti-corruption work, and plans for an expansion of the OECD's membership.

### 2. Introduction: uncertain prospects for the world economy

4. Much has changed in the world economy since last year, when the rapporteur's predecessor offered an upbeat view of continuing, non-inflationary growth. At that point, it seemed that the impact of rising energy prices would be limited and that, rather than stalling, global economic growth was rebalancing. But 2007-08 brought a series of distinct, though interrelated shocks: a sharp correction in United States housing markets, triggering a global credit crunch and a continuing loss of confidence in the financial markets, alongside a growing inflationary threat, with rising oil and commodity prices, spurred on by a weakened United States dollar, and their effect compounded by sudden increases in global food costs.

5. The impact and duration of these shocks remain unclear. Given the conflicting pressures they place upon policy makers, some commentators viewed them as a "perfect storm", making economic recession difficult to avoid. Indeed, in March many were convinced that the United States was already in recession, although the formal criterion of two quarters of negative growth had not yet been fulfilled. On 3 March, the legendary financier Warren Buffett said that, while conditions were nothing like those of the 1970s, "from a commonsense standpoint we're in recession",<sup>2</sup> and a poll undertaken shortly afterwards by the *Wall Street Journal* found that 71% of US businessmen agreed with him.<sup>3</sup>

6. In its interim update, issued on 20 March, the OECD agreed that there was already a "recessionary effect" in the worst-hit sectors of the economy. It revised its short-term growth forecasts downward for most major economies, saying that "prospects have weakened more than was projected" in its half-yearly report, published in January. In particular, it said that inflation measures were trending upward and "exceed comfort levels in many economies", and noted that the US economy was "now essentially moving sideways, if not contracting outright". The OECD's chief economist suggested that there was a "relatively high" risk that a recession in the US would actually occur, noting that the perception of one was already shaping economic and consumer sentiment.

7. Although the OECD had already lowered growth forecasts by the time of its December 2007 report, it was still able to express cautious confidence in March. It pointed out that, overall, world trade growth remained exceptionally strong, with 7.1% for last year, and 8% expected during 2008 (revised to 6.3% in June). Amongst OECD members, GDP growth in 2007 had been 2.7% (equal to average growth in the years

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1. The rapporteur has largely relied on data contained in the OECD's *Economic Outlook* published in December 2007 and June 2008, together with its interim assessments of March and September 2008. Any errors or misinterpretations in the text are her own responsibility.

2. [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article3476265.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3476265.ece).

3. <http://money.cnn.com/2008/03/13/news/economy/recession/index.htm?postversion=2008031315>.

between 1995 and 2004), and was expected to reach 2.3% in 2008. In January OECD-wide inflation had been thought likely to remain around 2.3%, while unemployment had been expected to continue falling, to reach 5.3% by 2009.

8. The OECD's *Economic Outlook*, June 2008, predicted that "several quarters of weak growth" lay ahead for most OECD economies. Growth for the area was scaled down to 1.8% for 2008, and 1.7% in 2009. Moreover, headline inflation "could remain high for some time to come". Its projection for the OECD area in 2008 was revised upwards to 3%, though falling to 2.1% in 2009. This average of course reflected lower levels in Japan than in the United States and particularly the euro area. The previously predicted fall in unemployment was not set to materialise: the OECD estimate was revised to 5.7% of the labour force unemployed in 2008 and 6% in 2009. Growth in world trade was also expected to slow to 6.3% in 2008, but to recover slightly to 6.6% in 2009. The OECD's June Outlook acknowledged that the "current economic situation is particularly unsettled and the distribution of risk around the projections is wide. In this environment, economic policy in OECD countries needs to take into account the growing importance of developments in non-OECD economies; the influences of higher energy and credit costs on the supply side of OECD economies; the possibility of upward drift in inflation expectations; and the uncertainty as to the effects of financial market developments on growth and inflation".

9. On 4 and 5 June 2008, OECD ministers nevertheless agreed at their annual council that "the overall performance has been better than expected", and called for "continued close policy co-ordination to facilitate the expected upturn". As for financial markets, "the situation has improved since March but current credit conditions are restraining investment". They noted that commodity prices "have risen tremendously and driven up headline inflation but may not rise further in the near term". However, they remained "concerned about inflationary pressures and indications that inflationary expectations may be drifting upwards". They agreed that "attention needs to be paid to fiscal balances, especially where inflationary pressures persist", and that structural reforms should be pursued. Regarding housing markets, "continued cooling is expected in most OECD countries".

10. According to OECD's latest interim economic assessment, dated 2 September 2008:

*"1. Financial market turmoil, housing market downturns and high commodity prices continue to bear down on global growth while at the same time evolving rapidly:*

*– banks appear to have recognised most of the losses and write-downs related to sub-prime based securities. Continued financial turmoil appears to reflect increasingly signs of weakness in the real economy, itself partly a product of lower credit supply and asset prices. The eventual depth and extent of financial disruption is still uncertain, however, with potential further losses on housing and construction finance being one source of concern;*

*– the downturn in housing markets is still unfolding, with reduced credit supply likely adding to pressures. US house prices continue to fall, threatening further defaults and foreclosures that may again depress prices and boost credit losses. As regards construction, however, there are some hints of eventual stabilisation with permits and sales of new homes having ceased to fall and inventories of unsold houses coming down. In Europe, downturns in prices and construction activity appear to be spreading beyond Denmark, Ireland, Spain and the United Kingdom, with sharply lower transaction volumes likely a precursor of downturns elsewhere;*

*– the price of oil has fallen from peaks reached around the middle of the year in response to slower demand growth and record production from OPEC. Oil supply conditions remain tight, however, contributing to volatile prices. Prices of other commodities – notably food – appear to have steadied at high levels. Food commodity prices may ease in the period ahead as droughts end in some food-exporting countries and as higher food production comes on stream.*

*2. Based on incoming high-frequency indicators, OECD short-term forecasting models point to weak activity through the end of the year. However, limited experience with some of the main drivers of the current conjuncture as well as uncertainty about some specific influences make for a particularly unclear picture. In the United States, uncertainty as to the extent of weakness hinges importantly on how rapidly the effects of temporary fiscal stimulus will fade. In the euro area and its three largest economies, as well as in the United Kingdom, activity is foreseen to remain broadly flat. And in Japan only a partial bounce-back from the 2nd quarter fall in GDP is expected.*

*3. Sharp increases in energy and food prices have boosted headline inflation and sapped real incomes of consumers across the OECD area. Statistical measures of underlying inflation have also drifted up in most large OECD economies, partly reflecting the ongoing feed through of higher commodity prices. So*

*far, wage increases appear to have been broadly contained. If commodity prices are sustained at their recent, and in cases such as oil, lower levels some moderation of both headline and underlying inflation is to be expected.*

*4. The G7 economies face different policy environments. In the United States, underlying inflation is high but appears not to have drifted up further and widening slack will be a disinflationary force. With headwinds from financial constraints, this appears to vindicate existing expansionary policies. Underlying inflation has been rising steadily in the euro area for some time, suggesting that capacity pressures need to be reduced. Hence, at this moment, there is little need to change existing policy stances. Should a need to tighten or loosen the macro policy stance become apparent, monetary policy would be the preferred instrument. In Japan, different indicators of underlying inflation send mixed signals and deteriorating business sentiment, as well as the need for a buffer against the risk of deflation, argue for keeping monetary policy on hold.”*

11. In the rapporteur's view, the financial crisis that has shaken the global economy since this interim assessment was published shows how uncertain the outlook remains. Some of the world's most powerful financial institutions have been toppled or shaken to the core and remain vulnerable not only to the effects of the sub-prime mortgage debacle but perhaps also to further shocks connected with the wide and complex range of financial instruments dreamed up and marketed by these institutions in recent years. The policy response to this evolving crisis has been to seek to restore confidence, treading a narrow path between, on the one hand, loosening credit and liquidity as well as stimulating demand through tax reductions so as to minimise the threat of recession and further bankruptcies and, on the other hand, tightening monetary conditions in order to contain runaway borrowing and resurgent inflationary pressures. The actions of both governments and central banks in seeking to prevent systemic collapse appear to have struck the right balance so far. One may, however, question their increasing involvement in rescuing private financial institutions at the taxpayers' expense, in consideration also of the growing wish that the perceived need for urgent action may increase with further losses and devalued assets. There remains a pressing need for greater regulation of financial markets, and it is to be hoped that the OECD, as well as other institutions like the IMF, will quickly step up their work on this issue with a view to avoiding in the future the financial turmoil that has characterised the past year.

### **3. A survey of key economies**

#### **3.1. The United States**

12. In the last few years private consumption has made a greater and greater contribution to sustaining US GDP growth, and this helped to offset the impact of a housing market in rapid decline. During 2006 and 2007, disposable incomes rose strongly, partly through bonus and stock-option payments and property loans, and this underpinned domestic spending, even with the onset of the financial crisis last summer. Foreign trade has also contributed to growth, with exports benefiting from emerging country demand and a weak dollar. This led to a decline in the US current account deficit, to 5.3% of GDP in 2007 and an estimated 5% in 2008.

13. Overall, growth in the US during 2007 was at 2.2%, having been at 2.9% in 2006. In its June 2008 forecast, the OECD projected growth to be around 1.2% during this year, and 1.1% in 2009, as the effects of the housing crisis, credit squeeze and higher commodity prices deepen.

14. A key indicator of US economic prospects is the housing market. During 2007 and 2008, prices decelerated sharply, with falls in many areas – and this trend has continued. As the OECD noted in its September 2008 interim assessment, however (see above paragraph 10), the increase in inventories of unsold houses and the decline in new construction may have levelled off. The knock-on effects of the mortgage crisis are well known; the financial markets have remained agitated, with banks hesitating to lend to each other, causing crises of confidence in specific institutions, causing spill-over effects in the insurance industry, and equities in general. All this is restricting the supply of credit to private and corporate consumers, but strenuous efforts by the Federal Reserve appear to have succeeded in staving off a full-blown recession.

15. Consumer spending and employment have declined. Private consumption growth is likely to slow from 2.9% last year to 1.2% in 2008, and to fall to 0.4% next year. Private sector employment growth slowed markedly during 2007, with heavy losses in manufacturing, construction and financial services, and in the first half of 2008 private sector employment fell for five consecutive months. From January to August a total of 605 000 jobs were lost. Overall, unemployment edged up during 2007, and is expected to reach at least 5.4% this year and 6.1% next year.

16. Underlying inflation, as noted in the OECD's September interim assessment, is high but has not drifted higher – in part, because of decrease in activity and the downward pressure on labour markets, and partly because, despite the weak dollar, many imports come from low-cost countries. Although headline inflation passed 3% in 2007, driven by oil and food prices, core inflation was stable at around 2%. In March 2008, the Federal Reserve reduced its target interest rate to 2.25% (and to 2% in April, where it has remained) – a full 3% fall in six months – which the OECD suggested should be regarded as a temporary policy response to reassure markets and improve the distribution of credit across the economy. Should the reductions be too deep or long lasting, however, there could be an inflationary risk – and the August 2008 figures, showing US headline inflation at around 5.4%, suggest a need for caution. In its *Economic Outlook*, June 2008, the OECD recommends that US “monetary policy should be maintained at the current accommodative stance until the recovery has taken hold, but interest rates should be raised promptly when conditions normalise”.

17. The US Government deficit is likely to rise from 3% of GDP in 2007 to 5.5% in 2008, in part because of lower tax revenues. The government's room for fiscal manoeuvre is thus limited. This is all the more true as social security comes under unprecedented strain from the first wave of retiring baby-boomers, without any significant reforms in the system having been enacted.

18. The US fiscal package consisting of temporary tax rebate cheques posted out in May 2008 as well as temporary investment incentives will have a short-term impact on economic activity likely to be felt mainly in the second and third quarters of 2008. And although the weaker dollar means that export growth is likely to slow only moderately, while lower domestic spending should restrain the inflationary effect of more expensive imports, the implied improvement in the current account balance will be limited, because of declining inward investment – the US is expected to have a net investment deficit by early 2009.

19. Overall, the OECD expects that despite a continued positive contribution from US exports, growth will virtually stagnate over the rest of 2008. Activity should gradually recover in 2009. Assuming flatter commodity prices, inflationary pressures should eventually ease as a result of the output gap and the higher (above 6%) unemployment rate. However, recovery could be jeopardised if financial turmoil is prolonged.

### 3.2. Asian economies

20. There has been some slowing in Japan's growth – from 2.4% in 2006 to 2.1% last year – but the longest recovery in its post-war history continues, and growth of 1.7% is expected in 2008. Exports continue to play a powerful role, despite an appreciated yen, with regional demand offsetting the slower US market, and unemployment has fallen to its lowest level since 1998.

21. The decline in real wages recorded during 2007 has been reversed this year, reflecting higher compensation for full-time workers and an end to the shift towards lower-paid part-time work. However, consumer prices have risen, in line with more costly energy and food. Headline inflation accelerated from 0.1% in 2007 to over 1% in the first quarter of 2008, although core inflation(excluding volatile energy and food prices) remained around zero and is expected to rise only slowly.

22. With the persistence of low underlying inflation, Japan's short-term policy interest rate has remained at 0.5% since early 2007. The OECD believes that this is sensible, and suggests that rates should be held in this context.

23. In June, Japan was thought likely to see the GDP growth rate slow to about 1.25% during the rest of this year and then increase in 2009 to just over 1.5%. The key risk to this outlook is the likely weakness in exports owing to slower world growth and an appreciated yen. However, domestic demand seems likely to have enough momentum to avoid recession, buoyed by a rebound in residential investment, strong underlying corporate profitability leading to increased business investment, and continuation of the positive trend in wage growth.

24. Growth in Korea, which rebounded after a difficult period to 5.1% in 2006, remained steady at 5% in 2007 but is expected to fall to around 4.3% this year, with export growth declining from 12.1% in 2007 to 8.6% in 2008. Employment growth has slowed and gains in household income are being eroded by higher consumer price inflation, 3.8% in the first quarter of 2008 over 2.5% in 2007, reflecting the spike in oil prices and depreciation of the won. But the inflation rate is projected to ease back to within target range.

25. The housing market continues to stagnate, with lower construction orders and the largest stock of unsold apartments since 1996. In August 2008 the government announced measures to boost the housing market, but there is worry about real estate financing operations and mortgage defaults impacting on banks.

26. Korea's growth is expected to rebound to 5% in 2009, close to potential, fuelled by planned tax cuts expected to boost business investment and stronger exports on the back of higher overseas demand and a weaker exchange rate. Korea stands to benefit from improved prospects for economic co-operation on the Korean peninsula, and the implementation of its free trade agreement with the US. The OECD has advised that prospects for a return to growth should be maximised by regulatory and reform measures to reverse the declining trend in foreign direct investment, steps to avoid any severe slowdown in the housing market, and the adoption of reforms to boost productivity, especially in the service sector.

27. After a brief slowdown in 2006, China's growth has once more accelerated to reach 11.9% in 2007, and robust domestic demand has partly offset moderating export growth and investment. GDP growth is likely to be around 10% during this year and 9.5% next. The current account surplus continues to increase, although not at the same pace given the boom in imports, recorded at US\$354.7 billion in 2007 and likely to reach US \$435.8 billion by 2009.

28. Consumer prices have increased sharply, at 5% in 2007, reaching 8.7% in February 2008 and expected to average 6.4% this year, its highest level in a decade and more than double the official target. While much of this can be attributed to food prices, official oil-product prices are being adjusted upwards, and other costs are also growing. In response, urban wage increases were running at around 20% in the first part of 2007. In mid-2008, labour income was at a twelve-year high, with wages continuing to grow faster than national income.

29. The government is making some efforts to slow the economy down. There have been several interest rate rises, and an upward adjustment of the currency – by a cumulative 4.5% against the US dollar in the first five months of 2008, which the OECD points out has been too little to ensure an effective appreciation. Efforts have been made to restrict the money supply through commercial banks and to sterilise the continued rise in China's foreign exchange reserves.

30. Tighter fiscal policies are also being pursued. Last year, the government's revenues grew significantly faster than spending, and the national budget moved to a surplus of 0.7% of GDP; the social security system's surplus has increased, reflecting buoyant wages, and taxes have been imposed on some energy-intensive exports, while VAT rebates on some other exports have been removed. Altogether, the combined fiscal surplus is estimated to have exceeded 2% of GDP in 2007. Higher wages and inflation should provide a further brake on the economy, denting export competitiveness. Even so, the OECD thinks macroeconomic policies need to continue working to combat the danger of overheating.

31. China's economy therefore faces two opposing risks: if the world economy slows significantly, this should help to address domestic imbalances, but will challenge the progress of development, and the job creation needed to overcome poverty and spur rural emigration. But on the other hand, if the economy withstands the current slowdown, China may be subject to significant inflationary overheating, which would encourage short-term speculation, threaten asset prices and undermine the balance sheets of its banks.

32. In the three decades after independence, India's growth averaged 1.75% per year. In early 2007, it topped 10%, supported by surging foreign investment, strong industrial output and a recovery in the agricultural sector. Perhaps the most striking feature has been the attitude of foreign investors, with surveys suggesting India is now the second most-favoured FDI destination – and in the electronics and telecommunications sectors, investment has doubled. Overall, FDI levels have reached 20% of India's GDP, confirming the OECD's view that "reforms have progressively moved the Indian economy towards a market-based system". However, growth slowed during 2007 to 8.5% in the last quarter, partly in response to tighter monetary policy.

33. Nevertheless, consumer and wholesale price inflation picked up, both reaching 8% by the spring of 2008 while the latter reached an estimated 12.4% in August. Higher oil and commodity prices seem likely to push the current account deficit up to 2% of GDP in 2008. The strength of investment helped to offset a slight slackening in consumer demand in 2007, particularly in areas reliant on credit, as steps were taken to combat this. But as 2008 began, it was notable that industrial production had weakened, although farm output was buoyant.

34. India's progress in fiscal consolidation in 2006 continued in 2007, with the combined central/state deficit falling back from 6.4% to 5.4% of GDP, with government foreseeing a further reduction this year to 4.5%. This is a notable performance, though it should be remembered that off-budget subsidies to oil refiners, food distributors and fertiliser companies are not included, nor a pay award to public sector workers due in fiscal 2008 amounting to 0.9% of GDP. The OECD warns that the pay award, as well as debt write-offs for small farmers, should be introduced gradually to avoid fiscal shock. Moreover, a national value-added tax should replace current state and union indirect taxes.

35. Meanwhile, monetary conditions have tightened during 2008, while the exchange rate has been relatively stable against the dollar following a 12% appreciation of the rupee in 2007. This, together with rising inflation, is helping to widen the trade deficit. Domestic monetary policy has aimed to neutralise the effects of ever-increasing capital inflows and resurgent inflation, with the Reserve Bank of India raising its benchmark interest rate three times in the summer of 2008, to reach a seven-year high of 9% on 29 July. Even so, India's growth is expected to fall only slightly, to around 7.8% in 2008.

36. To improve the economy's long-term strength, the OECD has encouraged deficit reduction, making more room for private investment, while tariffs should continue to be lowered and the bureaucratic burden on business reduced. In addition, restrictive labour practices should be addressed, promoting long-term employment, and special emphasis should be placed upon enhancing public services, particularly in education and national infrastructure. The OECD says that the economy's impressive reaction to reforms already enacted should give policy makers confidence that further liberalisation will deliver further growth, and speed the progress of poverty reduction.

### 3.3. The euro area

37. The economic recovery described in last year's report has slowed in 2008. From 2.9% in 2006, growth fell back to 2.6% last year, and is expected to be around 1.7% this year, and 1.4% next year. The June Outlook indicates a sharp fall in GDP growth from a surprisingly high 3.1% in the first quarter of 2008, reflecting temporary factors in Germany, to 0.2% in the second, then rising from 1.1% in the third and 1.2% in the fourth quarters and slowly but steadily upwards thereafter.

38. Higher interest rates, a strong currency, tighter credit markets and rising prices had already reduced the pace of growth in 2007 and hampered retail sales in the euro area. Consumption tax increases, particularly in Germany, also had an effect. This combination slowed housing markets where they had been active, and exacerbated problems in countries where the housing market had already peaked. In Ireland, house prices have been falling since the second half of 2006, and housing investment levels have fallen sharply; in Spain, too, the slowdown has been severe, and accompanied by a plunge in residential building permits. In Denmark, the Netherlands, and to a lesser extent in France, spectacular gains of a few years ago have been replaced by markets that are flat.

39. Investment and exports have been central to the euro area's recent growth. In general, these have held up well against international uncertainty, and there have been gains in competitiveness. Investment in Germany was particularly strong in the first quarter of 2008 and German export growth has held up well in the face of euro appreciation and slower demand in the United States, in part because the slack has been taken up by oil-producing countries and because of sustained demand from the rest of Europe. Germany accounts for about a third of all euro area exports and thus its consistent trade surpluses help to balance the often sizeable deficits of other eurozone members such as Greece, Portugal and Spain.

40. Additional growth for the eurozone will depend on the resilience of domestic demand. Although demand has been dampened by tighter credit, higher inflation and the slump in the housing market, it will be buoyed as some (albeit slower) job creation and modest wage-growth continue. Overall, unemployment in 2007 was at 7.4%, having fallen from 8.2% in 2006. However, cost pressures have now increased and growth in productivity has declined, and unit labour costs are increasing at around 2% annually. Thus the OECD predicts that unemployment will begin to edge up this year and next.

41. Demographic trends have been at work, however, with a decline in workers joining the labour force. In Italy, for instance, growth in the working age population is almost entirely due to immigration, while in France, moderate private sector employment growth has been sufficient to offset slower state recruitment. At the same time, labour market participation has risen particularly strongly amongst women and older workers, but there is evidence that a "two-speed" labour market is still in place, with unemployment among the young and low-skilled still very high by international standards. Therefore, despite the overall improvement, the OECD says that further reforms are needed, both in countries where restrictive practices are hindering access to employment, and in those countries where tight labour markets have begun to restrain growth.

42. Rising oil and food prices have pushed up euro area inflation. In the OECD's *Economic Outlook*, June 2008, it was expected to reach 3.4% in 2008, before beginning to fall back to the ECB's 2% target, with 2.4% predicted for 2009. The OECD sees present policy stances as appropriate, with the ECB's current policy interest rate at a seven-year high of 4.25%. There is, however, an obvious need for caution in the light of the potential effects of the September financial crisis on growth prospects, with pressure building for a downward move on rates as inflation eases.

43. Over the period 2005-07 the recovery saw a noticeable improvement in fiscal positions, with the structural budget deficit reduced by 1.5%. The OECD judges that although some of the improvement was due to structural reform, much could be attributed to cyclical revenue increases, and warns that efforts toward fiscal consolidation need to continue. In any event, in the cyclical downturn, the so-called automatic stabilisers (for example, lower tax revenue, greater transfer payments and lower imports tending to cushion demand) should be allowed to do their work.

44. The OECD underlines that despite some improvements, many European countries still carry high levels of structural debt – in France, for instance, the debt ratio is at least two thirds of GDP – and that more needs to be done if countries are to successfully confront the demographic trend of ageing populations, a challenge that faces Italy in particular. In this regard, it calls for rigorous implementation of the recent pension reform in Greece, as well as comprehensive reform of its health care system, and commends the progress made by Portugal – where a comprehensive reform of civil servant contracts, health and pension systems should enhance growth prospects.

45. During the remainder of 2008, the key risk for the euro area lies in the depth and duration of the slowdown in the external environment, particularly the US, its effect on the strength of the euro, and on exports. These effects could be particularly serious to the extent that they feed through into global markets and reduce demand in emerging markets, where European exporters are particularly strong. There is also a danger that further financial market turmoil, inflation and credit restrictions may lead to general difficulties in obtaining bank lending, with a knock-on effect on consumer spending and a further deterioration in some housing markets. In response, the OECD has suggested that euro area countries should act to strengthen the working of the internal market, which would enhance growth prospects and improve the working of monetary union; in addition, it would certainly be worthwhile to review the current, fragmented, system of financial supervision.

### **3.4. The United Kingdom**

46. In 2007, growth was above trend levels, rising from 2.8% to 3.1%, but there has been a sharp slowdown this year, with the OECD revising its June prediction of 1.8% for 2008 to 1.2% in September. Indeed, the OECD forecast that GDP would actually shrink by 0.3% in the third quarter and by 0.4% in the fourth, making it the only OECD member state to sink into recession, technically defined as two consecutive quarters of negative growth.

47. Strength in the service sector, and resilient domestic demand, helped to maintain momentum during much of last year, and offset a decline in investment and a gathering slowdown on the housing market. But housing market activity has continued to weaken in 2008: with tightening credit, mortgage approvals have fallen substantially, and overall price levels have dropped, leading to a dissipation of the house value collateral and wealth effects, and a significant slowing in consumption growth and residential investment.

48. Despite this context, and the fact that wage increases remain moderate, consumer price inflation has accelerated in 2008, reaching 4.7% in August, due to upward pressure from energy and food. Further contributing factors have been the 16% fall in the effective exchange rate from July 2007 to August 2008 and tight profit margins in the retail sector, leading retailers to pass on higher costs to consumers. Nevertheless, the OECD sees inflation falling back to close to target during 2009, with the unemployment rate set to rise from 5.5% to 5.8%. To avoid inflation expectations becoming entrenched, it recommends holding policy interest rates steady (the Bank of England maintained its 5% rate on 4 September), although further cuts are likely to be necessary as the economy slows.

49. The United Kingdom fiscal deficit is likely to reach 3.8% for 2008, given a substantial slowing in tax revenues, declining very slightly to 3.7% in the following year. With net debt perhaps approaching 40%, the OECD warns that the government may need a much tighter fiscal policy, so that its “golden rule” and medium-term goals for sustainable investment can be met. To assist the housing market, it suggests that the government should aim to streamline planning regulations, and consider better incentives for land development. In particular, it recommends a redefinition of “green belt” planning boundaries, as recently recommended by the Barker Review.

### 3.5. Other key economies

50. The Canadian economy, having grown for several years above potential, decelerated sharply in late 2007 as a result of slower exports and manufacturing output. Lower external demand, especially in the US, and a strong appreciation in the Canadian dollar have dampened activity, and growth in 2008 should fall back from 2.7% in 2007 to around 1.2% this year. But it is likely to bounce back next spring to reach an annual rate of 2%, as external factors improve and credit market difficulties are overcome.

51. Canada's economic fundamentals in 2007 were sound, with both employment and domestic demand strong, and income growth boosted by sharply improved terms of trade on account of higher commodity prices. The housing market has been in fairly good shape, with relatively few defaults on mortgages. Tight labour markets and low unemployment levels also boosted incomes and supported consumption – despite a poor productivity performance and rapidly rising unit labour costs. Inflation pressures, however, have been moderate – with sales-tax cuts and the strengthening Canadian dollar helping to keep inflation expectations within the central bank's target range.

52. With the cooling economy maintaining a benign inflation environment, the OECD believes the Bank of Canada can pursue an easing monetary policy stance into 2009. Overall fiscal policy needs to remain prudent at all levels of government, the OECD believes, while provision should be made for future increased spending, as the population ages, by setting aside windfall commodity gains.

53. Key risks to Canada's outlook would be a prolonged US credit crisis and slowdown, or a sustained appreciation in the value of the Canadian dollar and a resulting decline in the external balance.

54. Mexico, too, has been affected by slowing US demand, with growth reaching only 3.3% in 2007, compared to 4.8% the year before. This is expected to dip further to 2.8% in 2008, before returning to 3.3% in 2009. Domestic demand grew relatively strongly in 2007, but the negative impact of foreign trade upon growth increased, as imports remained strong while export growth declined, and oil production suffered technical constraints. As a result, the current account deficit is widening, from 0.8% of GDP in 2007 to an estimated 1% in 2008 and 2% in 2009.

55. Employment continued to expand in the formal sector until the end of 2007, particularly in construction and services, while the value of the peso in relation to the US dollar has been broadly stable. On the back of soaring food prices, inflation, though, is strongly up, at 4.6% annual rate in April 2008, above the upper end of Mexico's target range. The central bank therefore raised interest rates in 2007, but has eased them in 2008, and inflation may well surpass 4% for this year before falling back in 2009. Both FDI and domestic investment have been performing strongly, and recent fiscal reforms are expected to encourage this still further.

56. The key change to the tax structure has been a minimum business tax introduced in September 2007 that is estimated to raise revenue by about 1.2% of GDP; together with oil industry regulation changes, this will mean an appropriate rebalancing of revenues, with the non-oil component up substantially. A balanced budget was achieved in 2007 and is targeted for 2008, with both revenue and spending rising, and increased funding for infrastructure, education and health. An infrastructure fund was established in February 2008 to encourage investment programmes beginning this year, and in March reductions were granted in taxes and social security contributions.

57. Looking ahead, the main risk is delay in a US recovery resulting in a durable slowdown in Mexican exports.

58. In Brazil, the rebound in growth from an earlier slowdown continued strongly in 2007, with growth reaching 5.4%. This has been driven by strong private demand, with increases in credit, falling unemployment and rising wages. There has also been a notable expansion in investment, helping to alleviate emerging capacity constraints. As a result of higher demand, imports are now surging, especially of capital goods and intermediate inputs, but this has been offset by a strong export performance. Encouragingly, capacity utilisation data and industrial production indicators have risen substantially, suggesting structural improvements in the economy. In line with the global outlook, however, GDP growth is likely to slow down to 4.8% in 2008 and 4.5% in 2009.

59. Inflation has risen substantially since mid-2007 on the back of food and energy prices. Late in 2007, a process of interest rate cuts was reversed because of continuing demand growth, and in April 2008 the central bank pushed up its policy rate by 50 basis points to 11.75%. Overall conditions are strong, with the currency gathering further strength and the central bank continuing to accumulate reserves which, at around US\$200 billion, now exceed the country's external commitments. Measures have been taken to reduce pressure on the exchange rate.

60. Brazil's 2008 budget has sought to raise taxes and spending and increase payrolls. In fact, government expenditure has been rising strongly for some time, particularly to support increased federal payrolls, supported by buoyant revenues. There have been some measures to reduce the tax burden, particularly on investment, but Brazil's revenue-to-GDP ratio has been increasing, and restraining public expenditure growth remains one of the country's most pressing challenges over the medium term.

61. Poland's economic growth has continued to surge, reaching 6.6% in 2007, with a robust 5.9% expected this year. Growth has been driven by strong domestic demand and foreign investment, high government spending and falling unemployment. In fact, there have been growing labour shortages; and with high capacity utilisation in the economy, and increases in unit labour costs, inflation has begun to rise. Consumer price inflation was expected to reach 4.5% in 2008 and 5.5% in 2009. Poland's growth may slacken in 2009, but is likely to remain above its long-term potential, at around 5%, with the present deterioration in the current account expected to continue.

62. Despite recent improvements in its fiscal position, current plans to increase spending and cut taxes put at risk the government's plans to bring the budget deficit down to 2.8% by 2009. In the OECD's view, a strict implementation of the budget plans will be essential. It approves the government's "50+" scheme, which aims at increasing the participation of older workers, notably by limiting access to early retirement schemes. Since interest rates will be the main instrument for containing both the deficit and inflation, the main interest policy rate is likely to reach 7% during 2008, which may threaten the sustainability of Poland's high growth rate, and call into question its objective of joining the euro.

63. In the Czech Republic, growth is likely to fall back from 6.5% to 4.5% this year, as a result of higher inflation, at 7.5% year-on-year in the first quarter of 2008, which has squeezed real household disposable incomes. Unemployment, which was 7.9% in 2005, is expected to be 4.6% in 2008, and 4.4% in 2009. The tightening labour market is exerting further inflationary pressure, but other factors have been rises in indirect taxation and the relaxation of regulated prices. With increasing food costs, and a series of EU-inspired tax rises being implemented, interest rates began to rise in the later part of 2007.

64. Monetary policy is expected to contain inflation in this case, and the rate is expected to be much lower at 2.9% in 2009, with economic growth regaining its potential rate of around 5% in that year. The government deficit for 2007 was lower than expected at 1.6% of GDP, despite welfare spending increases. For 2008, reforms are bringing some uncertainty in revenues and spending, but the government deficit is predicted at 1.5% for this year and 1.3% in 2009. The planned 2010 entry to the euro has been postponed, and no new date has been set. In the OECD's view, the key challenges are to ensure full implementation of reform plans, ensure fiscal sustainability in the face of future population pressures and to expand labour supply and improve education in order to prevent labour and skills shortages from hampering growth potential.

65. Hungary has faced a series of difficult challenges, particularly over levels of public expenditure. Spending cuts, tax increases and falling private consumption saw growth slump to 1.3% in 2007, against 3.9% the year before, while consumer prices surged by 8%. Manufacturing remained healthy, though, with exports up by more than 14%, and overall economic growth is expected to pick up during 2008 to 2%, reaching 3.1% in 2009, while inflation falls back to 6.3% this year and 3.7% next, partly in response to higher policy interest rates.

66. Indicators suggest that exports will continue to be the main engine of growth, stimulating investment. The main challenge remains a successful restoration of public finances, so as to provide more room for lowering taxes and social security payments. This would also increase the room for manoeuvre of the monetary authorities. The government's current plans foresee the budget deficit falling from 9.3% in 2006 to 3.5% by 2009. Along with measures to reform the labour market, which should reduce the grey sector of the economy, all this should help stabilise growth in the longer term. The OECD has warned against any rapid spending increases in the run-up to the next elections, due in 2010.

67. Growth in Russia, which had been expected to moderate in 2007, accelerated on the back of strong investment and high commodity prices, reaching 8.1%. While uncertainty about energy pricing makes forecasts difficult, the OECD expects growth to slow slightly, to 7.5% this year, and 6.5% in 2009. A crucial part of Russia's recent performance has been a boom in investment, which was up by 22% in the first half of 2007, especially in the energy and construction sectors – and while investment will remain buoyant, this level of growth is not likely to be maintained.

68. Domestic demand, which has been boosted by rising wages and expanding credit, is expected to advance strongly. In the last few years, private consumption has been growing at double-digit rates – and so, while export volumes grew at 6.4% last year, import volumes increased by 27.3%. Unfortunately, inflation has

also risen sharply, to 11.9% in 2007, and is predicted to reach 13% this year, well above the Central Bank's target of 8%. Rapid money supply growth, fiscal loosening as well as sharp rises in food prices are contributory factors.

69. The OECD says that conflict within the government over economic policy has sharpened, some agencies favouring the intensification of industrial policies including the creation of further state entities. There are also pressures for greater domestic investment by the National Welfare Fund, a sovereign wealth fund originally designed to invest only in foreign assets, and the Ministry of the Economy has sought a value added tax cut to boost growth. The Ministry of Finance, however, is anxious to limit the budgetary cost of new initiatives. The OECD sees attempts to modernise and diversify the Russian economy as understandable, given the high volatility and lower growth stability that often characterise resource-dependent economies. But it warns against any "proliferation of expensive interventions which do little more than distort markets and waste resources, while undermining fiscal sustainability and exacerbating overheating and pressures for real appreciation of the rouble".<sup>4</sup> Thus, long-term investor confidence will critically depend on procompetitive market regulations and a reduction in state intervention.

70. The OECD sees the prices of export commodities in general, and of oil and gas in particular, together with net capital inflows, as the key to the momentum of domestic demand. But these are also the main areas of uncertainty looking forward. The OECD considers that Russia would be best advised to combine neutral fiscal policy with a monetary policy more firmly directed towards price stability and structural reform to increase growth potential.

#### 4. Key questions relating to the financial markets

##### 4.1. Regulation and supervision

71. Although the credit crisis emerged in the US, stemming in the first instance from sub-prime lending, its effects have spread rapidly – throughout the financial markets, and to markets all over the world. This has highlighted the interconnectedness of today's markets, and shows how a chain of unexpected events can expose weaknesses or shortcomings in the system, in this case triggering the collapse of a regional bank in Germany, a bank in the United Kingdom, investment banks, mortgage lenders and a global insurance company in the US, and multi-billion dollar write-offs by major banks all over the world. Understandably there have been widespread calls for action – but what should be done?

72. Looking specifically at the origin of the turmoil, the OECD says that while the "securitisation", or bundling, of risk has increased access to credit, it has proved to have some serious flaws. For one thing, it may have encouraged the mis-selling of mortgages and other credit – a problem which can be addressed by general regulation. But subsequently, there is a lack of information as to where in the system such risk is concentrated, and therefore who holds it, plus a serious difficulty in valuing it, and therefore re-pricing the assets involved. That combination has made the current situation prolonged, and full of uncertainty. Even now, it is hard to tell how long it will take, or how much will need to be written off (the OECD has estimated this at between US\$350 billion and US\$420 billion; the IMF at US\$500 billion). And since it remains unclear who holds how much debt, mutual trust and confidence have been undermined. This restricts general credit availability, causes rumours and speculation, and threatens even institutions which are credit worthy.

73. The OECD suggests that, as the problems encountered are fully understood, the regulatory framework surrounding securitisation will need to be thoroughly reviewed with a view to improving risk management and enhancing transparency, to see whether and how it can be prevented from failing in the future.

74. Looking forward, the OECD feels that a clear decision may be needed on the extent to which "off balance-sheet" activities, such as the bundling of sub-prime debt, is to be permitted. But more broadly, how can we ensure better regulation of markets, and more effective supervision? The OECD has a range of suggestions:

- first, it cites the need for constant updating and revision of financial regulations, given the speed with which markets are evolving, and new products being introduced. This should include a continuing effort to streamline the system of supervision itself, so that it remains integrated, connected with regulators in other countries, and adapted to the market itself. It notes that Canada stages a regulatory review of its entire financial system, every five years. In conducting regulatory reviews, it suggests that policy

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4. OECD *Economic Outlook*, June 2008.

makers should look to the Basel Framework, which provides accepted standards that banking regulators can use, particularly when creating regulations about how much capital banks need to put aside to guard against financial and operational risks;

- in some countries, specific regulations may need to be introduced to prevent predatory lending practices, and to improve the quality of disclosure to borrowers. Moreover, the level of charges and fees that can be levied should be examined – as well as steps to make them more transparent, to ensure that they are understood;
- customer compensation schemes are in general need of updating; in many OECD countries, the guaranteed sums available are nowadays too little to maintain consumer confidence when an institution is in difficulties, and six OECD members have no scheme in place at all. The consequences of this were all too clear recently in the United Kingdom, where a small compensation scheme is in place, and a string of emergency announcements had to be made, in an attempt to shore up confidence in the Northern Rock bank;
- the role of credit rating agencies should be reviewed; the current turmoil has raised many questions about their effectiveness in assessing risk, and whether there is sufficient competition between them.

75. It is in the interests of everyone that good regulation is achieved. Certainly, it is in the interests of the financial sector itself; and careful supervision is more important for governments than ever, in an age where policy makers must steer between “moral hazard” – the need not to reward failed institutions, in a way that could debilitate the entire sector by removing all risk – and the threat of disaster for distressed consumers. The political pressures involved in such a case are acute, which leads some observers to wonder: in an age where consumers have substantial private investments, often made with encouragement from government, can a bank or institution be allowed to fail at all? Judging by recent US experience, with bailouts of Bear Stearns, Fannie Mae, Freddie Mac and AIG, together with plans for a massive US\$700 billion scheme to allow the Treasury to buy up the financial sector’s risky and illiquid mortgage-backed assets, the answer seems to be no, at least where there appears to be a risk of systemic collapse and damage to the real economy.

#### **4.2. Financial education**

76. As this situation suggests, improving the quality of financial understanding among consumers is an ever more important topic, and it is a priority for the OECD. Market developments on the one hand, and demographic and social changes on the other, mean that individuals are becoming increasingly exposed to complex financial markets and products – through home ownership, personal savings, private pensions, etc. Yet studies across OECD countries consistently demonstrate a low level of financial awareness and literacy – from a lack of awareness of the need to save, to a poor understanding of the products in which individuals invest. Also worrying is the evidence that individuals tend to overestimate their financial literacy, whilst the most vulnerable (lower income and education groups) often display the lowest levels of understanding.

77. These developments raise important policy challenges: from ensuring that even theoretically sophisticated investors really understand the financial risks to which they are exposed, to finding ways to ensure that the most vulnerable consumers have access to a bank account (which is still not the case for 3%-10% of OECD populations). The challenges are only greater for those managing developing economies.

78. The OECD’s financial education project was launched in 2003 to look at financial education programmes across OECD and selected non-member countries, analyse their effectiveness and provide policy support for governments and other players launching such programmes. In 2005 the first major international survey on financial education was published – *Improving Financial Literacy* – along with a set of guidelines for financial education and awareness drawing on international good practice. These guidelines promote the role of major stakeholders (governments, trade unions, financial institutions, employers, etc.) and recommend action in a number of areas, from savings and debt management to private pensions.

79. In 2006 the G8 finance ministers recognised the importance of financial education and called on the OECD to develop further guidance on the topic. Good practices for financial education in the field of private pensions and insurance were published in the spring of 2008. Further work is also being carried out on consumer protection regulation in the financial markets area, with a specific focus on private pensions. The main output from this work is the OECD’s regulatory guidelines on the protection of the rights of members and beneficiaries, approved in 2004. The organisation is currently focusing on policy issues related to financial education in the area of credit. The urgent need for such education has recently been emphasised through developments in the mortgage and credit markets and, most notably, the sub-prime crisis. A set of OECD good practices on financial education and awareness relating to credit will be completed by the end of 2008.

80. As in previous years, the OECD continues to promote international co-operation on financial education. In 2008, the organisation has been particularly active on that front, organising three high level conferences highlighting the importance of and developments in the financial education field (in the US in May, Mexico in July and Indonesia in October). To enhance information exchange and further co-operation amongst key international financial education stakeholders, the OECD also recently set up the International Network on Financial Education, a platform for exchange of information, including on emerging good practices, as well as the International Gateway for Financial Education, which serves as the international clearing house for financial education programmes and issues around the globe.

#### **4.3. The rise of sovereign wealth funds**

81. So-called sovereign wealth funds (SWFs) are, in essence, government-owned or controlled investment vehicles that are funded by foreign exchange or other assets such as natural resources. While this concept is not new (the first such entity was the Kuwait Investment Authority established in 1953, although Kuwait became a sovereign state only in 1961), their number and size is growing rapidly. Six have been established over the last five years (by Russia, China, Qatar, Australia, Korea and Venezuela). Total reserves amongst the funds are estimated at around US\$3 trillion. Around half of this total is held by countries that are substantial exporters of oil and gas. With global reserve accumulation running at around US\$1 trillion every year, and more funds likely to be established in the near future, their importance in financial markets will continue to grow.

82. According to data from the Peterson Institute for International Economics (end 2007 or most recent available),<sup>5</sup> the 10 largest SWFs are:

- 82.1. Abu Dhabi Investment Authority and Council, Abu Dhabi, UAE (1976): US\$500-875 billion (est.);
- 82.2. Government Pension Fund Global, Norway (1990): US\$375 billion;
- 82.3. Government Investment Corporation, Singapore (1981): US\$200-330 billion (est.);
- 82.4. Kuwait Investment Authority (1953): US\$213 billion;
- 82.5. China Investment Corporation (2007): US\$200 billion;
- 82.6. Reserve Fund, Russia (2008): US\$128 billion;
- 82.7. Temasek Holdings, Singapore (1974): US\$110 billion;
- 82.8. Investment Corporation of Dubai, UAE (2006): US\$82 billion;
- 82.9. Qatar Investment Authority (2005): US\$60 billion;
- 82.10. Libyan Investment Authority (2006): US\$50 billion.

83. It is difficult to evaluate the exact holdings of such funds. Each is managed according to its own rules, and some have a portion of their holdings in domestic assets or dedicated to domestic investment, while others have assets that are included in government reserves. The largest, though, is clearly that of the Abu Dhabi Investment Authority, with around a third of all funds held, followed by that of Norway, and that of Singapore. The largest of the recent funds is China's CIC. Russia's Stabilisation Fund has been split into a National Welfare Fund and a Reserve Fund, with holdings of US\$32 and US\$128 billion respectively. Although China's fund is designed to manage assets of around US\$200 billion, most of this total is to be invested to recapitalise domestic banks, and only around US\$66 billion is available for international investment.

84. Over the last few years, as these funds have grown, and been more actively managed, their effects have become more visible. SWFs have tended to favour high-quality, fixed-income types of investment, which is thought to have had a general lowering effect on long-term interest rates. Now, with signs that their focus is shifting, these rates may tend to rise. A conservative approach has been pursued by SWFs domiciled in OECD countries – but one involving widely dispersed portfolios of stock as well as fixed-income paper. SWFs in emerging countries have for some time invested part of their portfolios in alternative investment vehicles, including real estate and private equity (PE). If their investments move towards the stock market, this is likely to drive up equity prices. Any such movements will be particularly pronounced in emerging markets, where the SWFs are currently thought to have much of their assets, and where there is a relative lack of other investors.

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5. Edwin M. Truman, *The Rise of Sovereign Wealth Funds: Impacts on US Foreign Policy and Economic Interests*, testimony before the Committee on Foreign Affairs, US House of Representatives, Washington, 21 May 2008.

85. In developed markets, SWFs have begun to make the headlines with a series of investments announced, or under discussion, in high-profile businesses. In particular, they have taken stakes in those banks most in need of liquidity: by late January, these investments had reached more than US\$60 billion, with US\$20 billion being invested into Citigroup and Merrill Lynch alone. They are also focusing on private equity, with the Abu Dhabi fund investing in the Carlyle Group, and the UK group Apax selling a 10% stake to a collection of SWFs. Moreover, there are indications that such private equity firms will increasingly turn to them as sources of finance. In February, Guy Hands of the Terra Firma group said that “as banks ... are unable to underwrite mega-deals, we will start having to raise money from pension funds, Sovereign Wealth Funds and even the global money markets”.<sup>6</sup> SWFs and pension funds have long been the main investors into private equity. The new development is that they appear to be moving up the value chain, taking shares in the management companies and, increasingly, pursuing PE strategies themselves.

86. The commercial logic of these developments is undeniable, and SWFs can provide great benefits to international markets; indeed, they have been a source of stability in recently volatile times, providing much needed sources of foreign investment to many OECD countries. According to the OECD’s April 2008 report on SWFs and recipient country policies, SWFs “help to recycle savings internationally and generally have a good track record as long-term investors”, contribute to the economic development of their home countries, and, in the recipient countries, “bring the benefits normally associated with foreign investment such as stimulating business activity and creating jobs”. However, the OECD acknowledges that “the growing role of SWFs raises issues”, including “the smooth functioning of financial markets” and “legitimate concerns in recipient countries about protecting national security”. The OECD recognises that the problem is aggravated by lack of transparency, and insists that “when new actors emerge on the international financial scene, the players need to become better acquainted”.

87. Such a situation is clearly incompatible with a commercial environment in which the practice of good governance is a crucial part of social development. Norway’s fund is widely seen as a successful model of transparency; it has public codes of conduct, publishes both its governance process and investment strategy, and guarantees to maintain open and accessible reporting on its operations. The highest level of transparency in a large SWF outside the OECD area is arguably to be found in Temasek Holdings. The Kuwaiti Fund, too, makes a significant effort to achieve transparency, and there is evidence that other funds are responding to concerns.

88. Expectations regarding SWF disclosure need to be fair. That is, disclosure norms need to embody comparable expectations for comparable investors and they need to respond to the various (possibly conflicting needs) of the individuals and organisations affected by SWF operations (for example, host governments, investors, other stakeholders, and home country citizens). There is certainly a case for making SWFs subject to the same disclosure requirements as other commercial entities, for instance in terms of revealing partners and co-investors. But the OECD points out that any moves toward investment protectionism are likely to be counter-productive, especially at the present time. It is therefore in the best interests of both SWFs and potential investment recipients to reach a level of agreement on working practices and standards – and the OECD is one of the international bodies now addressing this.

89. Following a request from the G7 Finance Ministers and other OECD members in October 2007, the OECD countries and their partners are looking at how to address these concerns without imposing unnecessary restrictions on international investments.

90. The OECD wishes to avoid any discriminatory reaction towards foreign government controlled investments, and maintains its long-standing commitment to promote the freedom of investment (for example, through its Codes of Liberalisation and the National Treatment instrument in the Declaration on International Investment and Multinational Enterprises).

91. Representatives of the OECD countries and their non-member partners are therefore working on ensuring that policy responses to national security concerns are consistent with existing national agreements, and that any restrictions on investments are guided by the principles of proportionality, transparency, predictability and accountability. So far, the OECD has examined investment measures currently in use by governments, and identified a set of core principles to minimise their impact on legitimate activity.

92. Meanwhile, the SWFs themselves are being encouraged to improve their governance and transparency in order to improve acceptance of their activities. This should help to address suspicions that their investment strategies might be as much political as they are commercial – and that their activities might be damaging not just in terms of external control but also to the functioning of effective local markets.

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6. [http://business.timesonline.co.uk/tol/business/industry\\_sectors/banking\\_and\\_finance/article3446062.ece](http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article3446062.ece).

93. There is evidence that this public debate is indeed changing the attitudes of the SWFs. China Investment Corporation recently confirmed that it is drafting a charter of principles, indicating that it will be run on commercial lines and at arm's length from the government. In March, the US Treasury Secretary met with representatives of Abu Dhabi and Singapore, who confirmed that their funds would disavow "geopolitical goals". They agreed to greater disclosure in areas such as their purpose, objectives and returns – and to put in place strong risk controls, and comply with the regulatory and disclosure requirements of the countries in which they invest. The US Treasury Secretary commented: "The US welcomes Sovereign Wealth Fund investment and looks forward to continuing to work with these two countries and others to support the initiatives underway at the IMF and OECD to develop best practices for Sovereign Wealth Funds and recipient countries."

94. The European Commission, too, is proposing a set of principles for transparency, predictability and accountability that would apply to the funds as well as to donor and recipient nations. In practical terms, these could include an annual statement of a fund's investments and assets, details on the size of its resources and information on any voting rights it exercises. The President of the Commission underlined that "we cannot allow non-European funds to be run in an opaque manner or used as an implement of geopolitical strategy," though he emphasised that SWFs provide welcome investment, and should not be seen as "a big bad wolf at the door". Speaking in Oslo, he described Norway's fund as "the gold standard ... we would like others to look at your example and follow the rigorous standards you are applying".

95. The OECD indicates that through its Investment Committee, member countries and other participating governments will, through ongoing dialogue and strengthened peer surveillance, seek to help all governments keep markets open for international investors while also safeguarding national security. The OECD will also continue to co-ordinate its work with that of the International Monetary Fund and the European Commission. So at this stage, there seems to be a good prospect that reasonable working practices can be agreed for SWFs, without the need for draconian legislation – this is certainly in the interests of all, and the OECD is playing an important role in ensuring that this is possible. And it is interesting to note that London's private equity industry, which has recently faced some similar concerns, moved last year to introduce a voluntary code of conduct.

#### **4.4. Private equity firms and hedge funds**

96. There are, of course, significant differences between the workings of private equity and sovereign wealth: private equity is, for instance, overtly commercial in its activities, with registered partners, and its investors are mostly wealthy individuals, pension funds and other institutional investors. It is also very much subject to the trends in the financial markets. But there have been questions about the transparency of the funds themselves, and the level of disclosure about the deals they transact.

97. In fact, pools of private capital, such as private equity and hedge funds, have greatly increased in size in recent years – though they remain very small in comparison to the global mutual funds industry, and the vast majority of acquisitions are still made between public companies. The OECD's Corporate Affairs Division has investigated the role which these activist investors can play in promoting good corporate governance, and whether there is effective oversight to ensure that company boards and management pursue objectives which are in the interests of shareholders and other stakeholders.

98. The OECD believes that their role is generally positive. Through engaged and informed ownership (for example scrutinising corporate management and strategies, dividend policies and acquisition plans), capital can be allocated more efficiently throughout the economy, offsetting the increasing number of "passive" institutional investors. The OECD says that company performance does appear to improve after acquisition, and that the impact on employment is not inherently negative, though this aspect could be further examined. It is worth noting, too, that hedge funds have recently played a positive role in stabilising world markets, by buying up debt that they believe has depreciated too sharply.

99. Such investors are often accused of being short term in outlook, driving for quick returns rather than focusing on long-term, value-creating strategies. But the OECD points out that it is the very lack of such strategic direction that often makes companies targets for these groups, so that, even if they have a limited investment horizon, their aims are likely to be compatible with good corporate governance. The OECD's Steering Group on Corporate Governance feels that the corporate governance issues surrounding these investors are best addressed within the existing OECD principles so that a separate international code focused on them is not necessary. The principles already cover transparency by institutional investors and the need for a transparent market for corporate control, issues which are frequently raised by the actions of activist hedge funds and private equity buyouts. Effective implementation might well require regulatory changes in some jurisdictions.

100. There is also a place for industry codes such as the Walker Committees in the United Kingdom, which calls for semi-annual disclosure for portfolio companies held by private equity along the lines of that required for public companies. In addition, private equity partnerships are also recommended to disclose more information about themselves to the public rather than only to their investors. There is also a set of principles covering hedge fund behaviour, including standards for activist hedge funds regarding voting borrowed shares.

101. There is some disagreement about whether these steps go far enough to satisfy critics, and the debate is likely to continue. In the OECD's view the key to policy in this area is to ensure that the regulatory framework is up to date in areas such as ownership disclosure and market integrity rules. Greater transparency by these activist investors about their operations can only assist with this.

## **5. An update on other topics of interest**

### **5.1. Prospects for the Doha Round**

102. Like the world's financial markets, the global trading system has expanded hugely in recent years. Thanks in large part to the efforts of the General Agreement on Tariffs and Trade (GATT), and subsequently the World Trade Organization (WTO), the expansion of world trade has provided an engine of growth that has benefited both developed and developing countries. And as the OECD points out, at a time of global uncertainty it is more important than ever that free trade is adhered to and, as far as possible, expanded. But can it be done?

103. The stakes are high. According to one analysis presented for discussion by some of the world's top economists in the framework of the Copenhagen Consensus 2008, conclusion of the Doha Round could realistically increase global income by US\$3 trillion per year, over 80% of which would go to the developing world, representing exceptionally high cost-benefit value. The OECD has estimated gains in the service sector, excluded from trade talks for many years, but now the fastest-growing sector of the world economy, of up to US\$500 billion. Moreover, it sees gains of around US\$100 billion, if there were full tariff liberalisation for industrial and agricultural goods – and the same amount again, if there were agreement on trade facilitation. Developing countries would benefit particularly from this, reaping up to two thirds of the benefit. And specifically, Doha offers an opportunity to address distortions that hinder growth in the poorest countries. Partly because they were not represented in earlier trade rounds, tariffs are much higher on goods primarily produced by developing countries than on those produced by wealthy countries.

104. The WTO Doha Development Round has been in difficulties for several years. Discussions between the US and the EU have captured the headlines, especially over agriculture, but there are many areas of concern within the group of emerging economies too, particularly on tariff reduction. For instance, Brazil is concerned about the prospect of cheap manufactured imports, in particular from China.

105. Towards the beginning of 2008, there were some positive signals. Following intensive negotiations, WTO Director General Pascal Lamy reported to the organisation's General Council on 5 February that "we are on the last lap and we have now started the final sprint towards establishing modalities. I think we have a broad agreement on the urgency of what we are doing, and on the basic steps we need to take to reach a deal."

106. Draft positions were circulated, representing a measured assessment of what tariff and subsidy reductions might be agreed, and the provisions necessary to make them happen, forming the basis of a possible agreement. The OECD thought that a deal was possible, noting that higher food prices should help to reduce the arguments over agricultural subsidies. But they emphasised that no trade round had ever been so complex, and that concessions would be needed on all sides.

107. But while gathering economic difficulties made an agreement more important, they also made concessions harder to accept, and the US presidential handover was expected to delay a deal, unless done very soon. Unfortunately, participants at the ministerial meeting the WTO called in July failed to strike a deal. The main problem was the insistence of India and China that they and other emerging and developing countries should be allowed to impose prohibitively high safeguard tariffs if a surge of agricultural imports from developed countries threatened to overwhelm their producers. This position was rejected by the United States and other food producing countries, so the talks broke down.

108. In the absence of an agreement, there is a risk that the world will increasingly proceed via bilateral and regional agreements which, by their exclusions, will foster subtle protectionism. The US, for instance, is making a range of bilateral deals, particularly in Latin America, while in Asia there is talk of an "APEC only"

Free Trade Agreement (FTAAP). This would leave the WTO acting increasingly as a centre of disputes, with global trade proceeding by litigation, rather than legislation. The OECD therefore regards the Doha Round as a low-cost insurance policy against the revival of protectionism and trade wars, and urges that the key players grasp what it describes as the “low hanging fruit” of the world’s trading architecture. After the collapse of the July WTO ministerial negotiations, which he said had “added significant elements to a package of potential final results”, the OECD’s Secretary-General, Angel Gurría, urged negotiators to “go the last mile” to a successful conclusion of a multilateral trade agreement, “particularly at a time when the global economy is showing signs of weakness”.

## **5.2. Towards a global energy crunch?**

109. In recent years, many have predicted that energy costs would moderate, or decline; instead, they have continued to rise relentlessly, even as the outlook for global growth has diminished. As we have seen, this is itself one of the key factors depressing economic prospects, and a major cause of inflationary pressure. But it is difficult to address, since there are a myriad of reasons for continuing price rises: in part, they are an inevitable offsetting of the weak dollar, in which oil and gas are priced, and in part they reflect notable geopolitical uncertainty and security concerns in the regions of the world where much of the current, and most of the future, production will occur.

110. On top of this, as the International Energy Agency (IEA), the OECD’s energy agency, points out, there are long-standing problems of underinvestment. Low prices in the 1990s, political issues for investors in producer countries and the difficulty of tapping more remote and inaccessible fields means there is a dearth of new supply – while despite some improvements in distribution, there is still a lack of transport and facilities to handle the new geographical pattern of economic activity, and environmental concerns have contributed to a shortage of new extraction, refining and generation capacity in developed countries. But perhaps more than anything else, it is the long-term projection of supply and demand that is keeping prices high: on current terms, the global energy market is likely to remain tight for the foreseeable future. This could represent a considerable constraint to the world economy and to the development of emerging economies, as well as an environmental disaster.

111. According to the IEA, if governments around the world stay with their existing policies, the world’s energy needs will increase by more than 50% by 2030. Their latest “World Energy Outlook” points out that, far from declining, this growth trend has actually risen in the last year. And while energy consumption continues to increase worldwide, the growth is most apparent in China and India, to which the IEA report pays particular attention. In these countries, energy use is set to more than double between 2005 and 2030. This is more than offsetting any global trend away from fossil fuels, with coal consumption likely to grow most rapidly, driven largely by power-generating demand. Indeed, world coal prices have almost doubled recently.

112. On this basis, global energy-related emissions of CO<sub>2</sub> will rise by 57% between 2005 and 2030, with China likely to have become the world’s largest carbon emitter during 2007, and India becoming the third largest by around 2015. By 2030, China’s per-capita emissions will almost reach those of the OECD’s European members.

113. At the same time, supply is likely to remain constrained. Consuming countries will increasingly rely on oil and gas imports, much of them from the Middle East and Russia, while net oil imports by China and India will almost quadruple by 2030, and will exceed the current imports of the US and Japan combined. World oil output is expected to become more concentrated in a few Middle Eastern countries, though further investment will be needed to secure this. And although production capacity at new fields is expected to increase over the next five years, it is very uncertain whether it will compensate for the decline in output at existing fields. So the IEA believes that in the period to 2015 a “supply-side crunch”, involving an abrupt escalation in oil prices, cannot be ruled out.

114. What can be done to address this alarming scenario? The IEA says that if world governments were to implement policies they are considering today, the increase in oil demand by 2030 could be reduced by 14 million barrels per day, equivalent to the entire current production of the US, Canada and Mexico. Meanwhile, energy-related CO<sub>2</sub> emissions would level off in the 2020s and could be around 20% lower than predicted by 2030. The key to achieving this, in their view, is energy efficiency, which they see as the cheapest and fastest way to curb demand and emissions, particularly in China and India. For example, tougher efficiency standards for air conditioners and refrigerators in China would, by 2020, save the amount of power produced by the Three Gorges dam. Emissions of local pollutants in both countries, including sulphur dioxide and nitrous oxides, would also be reduced sharply.

115. But even in this case, global CO<sub>2</sub> emissions will have increased 25% by 2030. In its “450 Stabilisation Case”, which projects a potential long-term stabilisation of greenhouse gases at around 450 parts per million, the IEA sees a possibility that global emissions could peak in 2012 and then fall sharply, declining below 2005 levels, by 2030. Savings would come from improvements in industrial efficiency, in buildings and transport, and by switching to nuclear power and to renewable energy sources, as well as widespread use of CO<sub>2</sub> capture and storage. But they warn that exceptionally quick and vigorous policy action by all countries – and unprecedented technological advances, with substantial costs attached – would be needed to make this case a reality. And even this model would be jeopardised if economic growth were faster than expected.

116. Over the last generation, the developed world – and in particular, Japan – has made rapid progress in becoming more energy-efficient, and in diversifying its energy sources. To meet the challenges outlined by the IEA, this will clearly need to continue: but in addition, there will be a need for enhanced technology, which offers new market opportunities, and for new forms of technology transfer, which can perhaps be seen as enlightened generosity. For the governments of Europe, many of whom have shown leadership on these issues so far, this should be a natural formula.

117. Launching the latest report, Nobuo Tanaka, the IEA’s new director, said that “the next ten years will be crucial for all countries, including China and India, because of the rapid expansion of energy-supply infrastructure. We need to act now to bring about a radical shift in investment in favour of cleaner, more efficient and more secure energy technologies.” He emphasised the importance of the agency’s links with both countries, and set further improved co-operation as one of his priorities – and he held out the possibility of their ultimately becoming IEA members.

### **5.3. Solutions for a planet under pressure**

118. More than ever before, the issues of energy supply and environmental protection are inextricably linked, and difficult to reconcile. To meet, on the one hand, the needs of poverty reduction and the expectation of growing populations in developing countries for a better lifestyle, while on the other hand protecting the environment that everyone depends on, is perhaps the greatest challenge of this generation.

119. In March, the OECD released its *Environmental Outlook to 2030*, offering an analysis of economic and environmental trends, and exploring a range of policy initiatives to address the key problems. “Without new policies,” it says, “we risk irreversibly damaging the environment and the natural resource base needed to support economic growth and well-being.” However, the report makes clear that there are solutions, and that these are both affordable and achievable.

120. On climate change, the environmental outlook report echoes the findings of the IEA. The situation is increasingly urgent; some level of global warming is already under way, and further increases are generally agreed to be inevitable – but there is still time to avoid the worst effects, projected to take place in the second half of the century. The OECD *Environmental Outlook to 2030* emphasises the importance of using market instruments such as carbon taxes, carbon-trading schemes, and removal of energy subsidies as key to addressing climate change, together with other instruments such as investment in clean technologies. It points out that world GDP is likely to double by 2030, and to triple by 2050 – and that it would only cost about 0.5% of that GDP in 2030, and 2.5% in 2050, to achieve the goal of stabilising greenhouse gas (GHG) concentrations at 450 parts per million. While new cost estimates in a forthcoming OECD report are likely to be higher, it is still economically rational to take action sooner as estimates for the cost of inaction are also being revised upwards. Underlining that technology-based efficiency policies are the least-cost approach, and will be most effective if started immediately and with all countries participating, the OECD *Environmental Outlook to 2030* advocates using the incentive of a global emissions price, which would start at just over US\$2 per emission tonne, and rise to over US\$150 per tonne in 2050.

121. The report looks at several areas where environmental and energy policies have, in recent years, come into conflict. To take one particularly hotly debated example, the report examines biofuels, which received some US\$15 billion of subsidy in OECD countries during 2007, but whose use is increasingly controversial, given pressure upon rainforests and agricultural land. In a recent policy brief, the OECD and IEA jointly suggested that the assumed benefits of biofuels are actually smaller than expected, and that even these are not being widely achieved, given the lack of regulatory and policy frameworks. It says that further research on the economics of biofuels, and on their wider impact, is needed; in particular, it calls for better certification and carbon-intensity measurement systems. Looking ahead, it calls for careful study of the potential of the second-generation biofuels now becoming available, particularly those that can be made from sources other than crops, such as animal waste. In the meantime, it offers policy-reform recommendations for governments seeking to balance these issues, particularly in the transport sector.

122. In addition, the report addresses measures necessary to tackle coastal flooding, and the consequent threat to major cities, and the infrastructure on which they depend, and turns to a sequence of environmental issues that, while often associated with climate change, pose quite distinct challenges to policy makers. For instance:

- as the world's population expands, and becomes more affluent, agricultural land use will need to expand by around 10% by 2030 under policies in place as of 2005. Therefore agriculture will continue to be the source of greatest pressure on biodiversity – particularly given the increasing problems of drought and soil erosion from previous deforestation. The OECD says that, given current policies, this will result in the loss of two thirds of the mature forests in South Asia, a quarter of those in China and Africa, and nearly as much in eastern Europe and Australia. Apart from the other implications of deforestation, this will accelerate the global loss of biodiversity, which some are already calling an “extinction epidemic”. This has grave long-term implications for agriculture and the pharmaceutical business, amongst others, and runs parallel to a threatened collapse in global fish stocks, raising fears of severe food shortages in the future;
- even as life expectancies have been rising through poverty reduction, the negative health impacts of environmental degradation are becoming increasingly pronounced. Air pollution, for example, is an ever-increasing problem; on current terms, the number of premature deaths per million inhabitants caused by “ground-level ozone” is likely to quadruple by 2030, while premature deaths per million linked to “fine particulates” could more than double, to reach over 3 million per year;
- by 2030, with current policies, almost half the world's population will be living under severe water stress – that is, 3.9 billion people, compared to 2.8 billion today. Most of these will be living in developing countries – and while around two thirds of the population in Brazil, Russia, India and China are currently under medium-to-severe water stress, this will increase to 80% unless better resource management systems are introduced.

123. The OECD accepts that there are no simple solutions to such immense challenges. However, it believes that the application of a mix of policies can make a significant impact, particularly if costs are kept low by basing policy upon economic and market-based instruments. For instance, it believes that airborne pollution could be reduced by a third if the greenhouse gas (GHG) reduction investments described earlier were made. As components of its favoured policy mix, the OECD especially advocates green taxes, efficient water pricing, emissions-trading and polluter-pay systems, realistic waste charges, and the elimination of environmentally destructive subsidies, such as those which support fossil fuels and agriculture. Such initiatives must, of course, be based upon sound infrastructure investment, to improve service and delivery, and will need to be buttressed by technological advances. This, in turn, will make stringent regulations and standards more meaningful, especially in the transport and construction sectors, and will encourage investment in research and development – although this will require that some key questions in the area of intellectual property rights are confronted.

124. Moreover, the OECD report identifies ways to share the cost of policy action globally. It points out that developed nations have been responsible for the majority of GHG emissions so far, but that by 2030 the annual emissions of Brazil, Russia, India and China will together exceed those of all the OECD member countries. Speaking at the report's launch, the OECD Secretary-General said: “We must be aware that getting it right in the field of the environment is not only about what to do and how to do it. We also need to address the question of who will pay for what. The global cost of action will be much lower if all countries work together.”

125. The 2008 environmental outlook report is part of a wider focus in this area by the OECD, which includes this year's annual ministerial meeting of the OECD Council, where the main topic of analysis was the economics of climate change, and the OECD 2008 forum. As the Secretary-General has said, “We aim to develop a sound economic footing for the post-Kyoto architecture.” Ongoing OECD work on the economics of climate change is to provide an input to the United Nations Framework Convention on Climate Change (UNFCCC) Conference of Parties (COP) 14 hosted by Poland in December 2008, and COP15 hosted by Denmark in December 2009.

#### **5.4. Innovation strategy**

126. The 2008 OECD Ministerial Council discussed progress on the OECD Innovation Strategy launched in 2007. The overarching objective of the Innovation Strategy is to improve economic performance and social welfare. Innovation is recognised as a critical means for achieving these ends. An improved understanding is needed of precisely how innovation is contributing to this and how modern innovation systems work in practice. The Innovation Strategy is designed to assist policy makers in harnessing innovation to achieve

sustainable growth and development. It aims to provide sound evidence on the changing nature of innovation, innovation ecosystems and innovation performance as well as analysis and best practices for the effective promotion, reporting, measurement, and assessment of innovation. The outcome should be coherent, government policy approaches; better targeted innovation to help meet global challenges (for example, climate change, health and economic development); and effective ways to encourage the creation and strengthening of human capital. A final report on the OECD Innovation Strategy will be provided to the OECD Ministerial Council in 2010.

127. An OECD ministerial meeting on the Future of the Internet took place on 17 and 18 June 2008 in Seoul, Korea. This meeting, addressed by Council of Europe Deputy Secretary General Maud de Boer-Buquicchio, called attention to the growing importance of the Internet for economic growth and prosperity and resulted in the Seoul Declaration for the Future of the Internet Economy endorsed by 39 countries and the European Commission.<sup>7</sup>

128. The key messages from the Seoul ministerial meeting on the future of the Internet economy included the following:

- policies affecting the Internet can no longer be seen as narrow sectoral policies having to do with telecommunications, but as mainstream economic policies reflecting the fact that the Internet has become a fundamental economic infrastructure;
- the Internet plays a critical role in the creativity and innovation process (for example, lowering barriers, broadening collaboration and the exchange of ideas – the essence of innovation). The OECD will work to better understand this as a key element of its Innovation Strategy;
- the Internet offers a huge potential to address pressing societal challenges (for example, ICT and environment). A high-level OECD conference on this issue will be hosted in 2009 by Denmark in support of the UN Conference on Climate Change (COP15).

### **5.5. Increasing the effectiveness of development aid**

129. In the Paris Declaration on Aid Effectiveness, agreed in March 2005, the world's key donor and recipient countries agreed "to reform the ways we deliver and manage aid". The declaration made commitments to harmonise aid delivery, by strengthening national development strategies, eliminating duplication of effort, simplifying donor policies and agreeing common criteria and measures of performance. Overall, it is designed to tackle what may be the critical challenge to the delivery of the Millennium Goals, increasing the capacity of recipients to make best use of new resources, through a process of "country-owned change".

130. The OECD is supporting these aims through the Development Assistance Committee (DAC) – which brings together those countries responsible for the overwhelming proportion of foreign aid and the major recipients, and works in partnership with international institutions such as the World Bank. On 14 February, the DAC launched the most recent edition of its annual Development Co-operation Report. In this, Richard Manning (DAC Chair from June 2003 to January 2008) looked at the 12 measures of success that he established in 2003. The resulting "scorecard" shows progress is being made, but there is still a long way to go to improve the effectiveness of aid and, in particular, the official development assistance (ODA) provided by the members of the DAC.

131. In 2007, total ODA provided by the members of the DAC fell to US\$103.7 billion, 8.4% lower than in 2006. The fall was expected. ODA had been exceptionally high in 2005 (\$107.1 billion) and 2006 (US\$104.4 billion) due to large debt relief operations for Iraq and Nigeria. Excluding debt relief grants, ODA by DAC members rose by 2.4%. This means that DAC members are well behind on their commitment to reach aid levels of US\$130 billion by 2010 (at constant 2004 prices). Though EU commitments are impressive, the OECD has criticised the bureaucracy of their efforts and consequent slow rate of spending.

132. But as noted in the 2007 Development Co-operation Report, when measured in 2002 dollars, total delivered aid has reached US\$77.8 billion. Although some US\$7 billion of this went to Iraq, the report regards this total as a significant achievement, fulfilling the first of the benchmarks set in 2002, since for many years the figure was around US\$50 billion. There is evidence of better targeting too, with the proportion of aid going to the world's poorest countries rising significantly, from 40% in 2002 to 46% in 2006 for bilateral aid, and from 47% to 49% when multilateral aid is included. Overall, the report believes that both donors and recipient countries have made considerable efforts to improve the quality and effectiveness of ODA.

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7. [www.oecd.org/dataoecd/49/28/40839436.pdf](http://www.oecd.org/dataoecd/49/28/40839436.pdf).

133. A higher proportion of aid than previously is “untied”, and so not restricted to purchasing products and services from the donor. Correspondingly, recipient countries have gained greater independence by increasing their expenditure on public services, such as health and education, and raising their own share of revenue contribution to development projects. In these sectors, in particular, management has improved and better results are being achieved.

134. However, as last year’s rapporteur pointed out, the bulk of the recent aid increases have not been “programmable aid” – rather, much of it has been in the form of debt relief. The proportion of aid going to countries that have been good performers has declined. While this could raise questions as to how well current strategies are rewarding successful project management, much of the decline is due to donors engaging more with states in fragility or coming out of conflict. It should also be noted that while the need for humanitarian aid – in particular in response to natural disaster emergencies – has increased in recent years, there have been signs of “donor fatigue”.

135. Moreover, despite the efforts of the DAC and other bodies, the aid sector remains fragmented. With more than 280 donors (from the Desert Locust Control Organisation for Eastern Africa to the International Potato Centre), and emerging economies increasingly becoming donors themselves, international efforts often threaten to become confused. On average, a recipient country has to deal with 18 different donors; for example, Tanzania received 542 donor visits in 2005, and Vietnam had 791, while India has recently restricted to six the number of aid partners it works with. There are signs, though, that donor countries are taking this challenge seriously: Sweden, for instance, has recently moved to sharpen its aid focus, with a system of “delegated co-operation”, providing greater autonomy for field management.

136. The DAC points out that such fragmentation is expensive; efforts to reduce the “transaction costs” involved by working together – for instance, in joint analytical studies – are currently uneven, and thought to be saving between 12% and 80%. More can be done here, and progress is also needed in project definition: for instance, what is reported as “technical co-operation” still varies widely among donors, making it difficult to measure whether there has been progress in making efforts more co-ordinated and country-owned. But certainly, further work is needed to align aid with local country systems, ensure equity, and provide aid priorities and processes that are appropriate to the context.

137. Assessing progress towards the Millennium Development Goals, the Development Co-operation Report says that we are still awaiting much of the definitive statistical data that we need to make positive conclusions. The progress on the poverty goal is encouraging, though, and if present trends continue it will be reached before 2015, thanks particularly to the performance of China and India. Both, however, still have hundreds of millions of people below the poverty line. And while there are indications of accelerating and encouraging progress on the other goals, it is still unlikely that the MDGs will be reached by 2015 in many countries and regions. Sub-Saharan Africa, followed by the Pacific, stand out as the regions where least progress is visible.

138. In addition, the Development Co-operation Report sets out a series of lessons learned from the experience of DAC peer reviews. The DAC has also published a synthesis report, *Effective Aid Management: Twelve Lessons from DAC Peer Reviews*, which identifies common measures that appear necessary to improve the management and delivery of development assistance by DAC members. By looking at what has, and has not, worked in the past, these publications offer practical, first-hand guidance, both for donor and recipient countries.

139. Since the publication of the Development Co-operation Report, a broad alliance of development partners – developing and donor countries, emerging economies, UN and multilateral institutions, global funds and civil society organisations – have met at the Third High Level Forum on Aid Effectiveness, hosted by the Government of Ghana and organised by OECD and the World Bank, in Accra, Ghana (2 to 4 September 2008). Participants at the High Level Forum endorsed the Accra Agenda for Action (AAA) – a set of measures to accelerate progress towards the Paris Declaration commitments on aid effectiveness. Under the AAA, developing countries have committed to take control of their own futures, donors to co-ordinate better amongst themselves, and both parties to the agenda have pledged to account to each other and their citizens. Key actions include:

- predictability – donors will provide three- to five-year forward information on their planned aid to partner countries;
- country systems – partner country systems will be used to deliver aid as the first option, rather than donor systems;
- conditionality – donors will switch from reliance on prescriptive conditions about how and when aid money is spent to conditions based on the developing country’s own development objectives;

- untying – donors will relax restrictions that prevent developing countries from buying the goods and services they need from whomever and wherever they can get the best quality at the lowest price.

*“Aid for trade”*

140. The Paris Declaration emphasises that aid effectiveness relies on encouraging local ownership, integrating projects within national systems and strategies, and harmonising donor efforts. This approach is encapsulated in the idea of “aid for trade”, whereby projects are developed with the particular aim of helping countries to expand trade so as to enhance growth prospects and reduce poverty, and to benefit from opportunities created by WTO agreements. Broadly, this involves projects that provide support for trade policy, regulation and development, trade-related infrastructure, production capacity and trade-related adjustment. This approach has assumed growing importance in most donor programmes, and was reaffirmed by the 2005 Hong Kong WTO ministerial declaration. Most major donors have developed or are developing institutional remits, dedicated teams and guidelines in place to improve “aid for trade” effectiveness.

141. In 2006, the OECD and the WTO initiated a joint monitoring system which consists of: global monitoring of aid-for-trade flows based on the OECD Creditor Reporting System data; and donor and partner country monitoring, in the form of self-assessments. Last year, the two institutions published the first global review of aid for trade, containing data on global flows of aid for trade, and feedback from both donor and recipient countries. The value of this monitoring system lies in creating incentives, through enhanced transparency, scrutiny and dialogue (that is, putting a “spotlight” on progress), to foster synergies between trade and other economic policy areas in developing countries, as well as improve the coherence of aid for trade with overall aid strategies – both essential components of an effective aid-for-trade partnership between partner countries and donors. One of, if not the most, significant achievements of this initiative so far is the strengthened dialogue around trade. That is, the initiative has brought together the aid and trade policy communities to work more closely and coherently, so as to help developing countries benefit from enhanced growth and poverty reduction through participating in global trade.

142. Between 2002 and 2005, donors committed on average US\$21.6 billion per year on the aid categories most closely associated with aid for trade. In 2006, total aid-for-trade commitments from bilateral and multilateral donors rose by more than 10% in real terms, from an average annual flow of US\$20.8 billion during the 2002-05 baseline period to US\$23 billion in 2006. A large share of this increase was spent on the funding of regional aid-for-trade programmes. Given the large size of typical infrastructure projects, aid to support the developments of economic infrastructure naturally dominates overall aid for trade at US\$12.2 billion in 2006; an increase by 8.6% in real terms compared to the 2002-05 baseline period. Activities to enhance productive capacities also increased in 2006 by 8.7% to US\$9.7 billion. Technical assistance in the field of trade policy and regulations rose by almost 60%, reaching nearly US\$1 billion in 2006. It is worth noting that, while the total volume of aid for trade amount is rising, its share of the total aid budget is actually declining slightly, as donors place priority on social projects. But if the recent rate of increase continues, it will deliver an extra US\$8 billion a year by 2010, with total commitments reaching US\$30 billion.

143. Large multinational and regional institutions, such as the World Bank and the European Commission, are the largest aid for trade donors, generally providing around 50% of their sector support to “aid for trade” activities. Amongst donor countries, Japan, Italy and Denmark have similar proportions. The regional breakdown of bilateral and multilateral aid-for-trade commitments shows that Asia and Africa receive the largest share of total aid-for-trade flows. This is not surprising because both Asia and Africa are home to the highest concentration of poor people.

144. The feedback provided by the report, both from donors and recipients, suggests that aid for trade is an extremely useful way of focusing development resources. Increasingly developing countries are choosing to make trade a part of their development strategies. And while many of the challenges encountered are seen generally in the development sector, one stands out: the regional dimension. Constraints such as poor cross-border infrastructure and bureaucracy were frequently cited, and there were suggestions that specific use should be made of regional bodies such as the Association of Southeast Asian Nations (ASEAN), as frameworks for members to reach international technical standards and establish market information systems. There is also a general need for resources to modernise customs facilities, and for training and skills improvement.

145. At this stage, there is little evidence on results that can yet be translated into policy improvements, but the OECD/WTO report is set to be updated regularly, and will provide both data and feedback from the projects now under way. It is hoped that this report will act as a stimulus for development, and over time will allow the establishment of a specific set of best-practice criteria. In addition, it is expected that the next report

will focus on improving the quality and the presentation of the global numbers by containing not only the funding commitments made by donor countries, but also the actual level of disbursement, developing better performance indicators to benchmark countries' progress, and ensuring greater partner country involvement.

### **5.6. An international commitment to combat corruption – Ten years on**

146. In November 2007, the OECD celebrated the tenth anniversary of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, also known as the OECD Anti-Bribery Convention. Its signatories – currently all 30 OECD members and seven other governments – are bound to implement a comprehensive series of legal, regulatory and policy measures designed to prevent, and to detect and prosecute, the bribery of foreign officials. It also requires the confiscation of bribes and any profits involved. All parties also agree to work together to ensure that the convention's objectives are met, for instance through the gathering and sharing of evidence, and by facilitating extradition.

147. This convention has proved to be a landmark event, helping to mobilise world opinion, and putting the OECD at the forefront of developing anti-corruption instruments and protocols. Like the Council of Europe, a close partner in this field, the OECD sees corruption as the leading contemporary threat to good governance, accountability and sustainable economic development.

148. And more than ever, it is the world's emerging economies that have most to lose from corruption, since they often have to work through weak judicial structures, incomplete criminal legislation and poor administrative-control mechanisms. In addition, many now have to cope with a rapidly rising volume of international transactions, as globalisation and high commodity prices bring strong growth, and international development efforts increase in scale and complexity.

149. Indeed, the OECD's Secretary-General has described corruption as the "cancer of globalisation". Speaking at the anniversary celebrations, he paid tribute to the new anti-bribery laws and tougher sanctions introduced by many countries over the last decade, and praised the improved level of international co-ordination and co-operation. But he warned that "some countries are still holding back", and that pressure on governments to return to "business as usual" was an ever-present danger. "The only way to prevent this is to ensure that everyone plays by the same rules", he said. "We need practical measures, and, more importantly, we need political commitment."

150. Mark Pieth, the Chair of the OECD's working group on bribery, underlines that although international efforts to tackle bribery have intensified, the problem itself is growing. In part, he thinks, this is because of the greater sums being transacted across borders, and in part because greater vigilance is uncovering more cases. The convention, though, has already had a huge impact, and can continue to do so, since its signatories are major exporters. He points out that, not long ago, writing off bribes against tax was even allowed in several OECD countries!

151. Strict monitoring of performance and peer review is used to ensure that all participants implement the convention seriously. In the first review phase, legislation is examined, and in the second, enforcement procedures are assessed. When the working group on bribery considers that there are weaknesses in the legislation or its enforcement, it makes recommendations for improvements. By the end of 2006, some 27 countries had been examined, including all of the G7. Reviews will be completed for all the remaining nine countries during 2008, and the resulting reports are made available online.

152. The impact of such transparency is obvious: today, over 100 foreign bribery investigations are being conducted by signatories to the convention. As Mark Pieth says, "Never underestimate the power of peer pressure. People care. Colleagues care. Countries attempting to justify bribery are likely to find themselves in a minority, if not completely isolated."

153. To increase the coverage of the convention, the OECD is urging other countries to become signatories, with a particular focus on emerging economies, and candidates for OECD membership are being encouraged to take the first phase of assessment that the convention sets out. And to mark the tenth anniversary a review of the convention guidelines, and the experiences of those who implement them, is being conducted, with comments invited from all stakeholders in the process.

154. Over the last decade, the OECD has broadened the scope of its work in this field. It has developed a range of anti-corruption tools and expertise, particularly relating to taxation, public sector governance and integrity, commercial governance, export credits and development aid. But crucially, it has maintained its focus on building participation amongst governments, since fostering genuine political will is crucial to success in combating corruption.

155. Amongst its chief initiatives are the 2006 OECD Council Recommendation on Bribery and Officially Supported Export Credits, the production of a bribery awareness handbook for tax examiners, the Guidelines for Managing Conflict of Interest in the Public Service and Guidelines for Multinational Enterprises. This latter publication covers issues of business ethics, international information disclosure and transparency, and involves 39 participating governments who encourage local companies to take part. It also includes a mediation facility (that has now been used nearly 100 times). Most recently, the Principles for Enhancing Integrity in Public Procurement were agreed upon to prevent corruption in government contracts.

156. In December, the OECD was honoured by Transparency International, the leading international NGO campaigning against corruption. Mark Pieth was named as one of two recipients of its annual Integrity Awards, while the OECD's Anti-Corruption Division was "Highly Commended" for its recent work with South Africa. Earlier in the year, South Africa had become the first African country to sign the OECD Anti-Bribery Convention, joining the OECD working group on bribery as its 37th member.

### **5.7. An update on the OECD project "Going for Growth"**

157. "Going for Growth" is an annual OECD publication that uses comparative benchmarking to test the position of individual member countries against a range of economic policy and performance indicators. It was introduced in 2005, as a response to the increasing divergence in growth rates and living standards apparent amongst OECD members, and was designed to offer practical recommendations that are relevant to specific individual countries, rather than to form a competitive index.

158. Last year, the report set out five structural priorities for each member country, and for the European Union, to improve GDP per head – which, as discussed in a previous year's report, the authors regard as a good proxy for material well-being. These priorities aim to address policies that discourage efficiency and productivity – particularly in terms of labour and product markets, but also relating to education, health and welfare services.

159. Overall, the report concludes that progress has been, at best, moderate. It suggests that the economic upswing of the last few years has generally dampened the impetus for reform, and while some progress was made on most of the priorities, the changes continued to be incremental. The greatest activity was seen in the area of labour productivity, where many countries took steps to improve education and training, to ease entry and operational controls on business, and reduce market distortions – though agriculture remains a difficulty. But in respect of labour utilisation, much less was done or is, it seems, intended. Reforms of employment law to, for instance, encourage older workers, offer flexible work or liberalise wage-bargaining have been lacking. Only in the areas of disability and welfare reform was much progress made, along with some measures to encourage women to re-enter the workplace. Labour taxation is one area where the rate of progress has been high.

160. Therefore, in the author's opinion, the vast majority of the priorities set out in last year's report remain valid. In continental Europe, where measures to improve the labour market account for most of the policy priorities, there has been modest progress: Germany, for instance, has reduced social charges, and is introducing health-care reforms that will promote efficiency; in France a package of employment reforms has been agreed between employers and unions, and Italy has reduced the tax burden on low-skilled workers. But employment regulation remains a challenge to growth, and the report points out that in Spain, Greece, the Czech Republic, Luxembourg and Portugal there has been no significant action in this area. In other regions, and particularly in low-income countries, raising productivity remains the key challenge, and so there the focus is on liberalising of product markets and services (interestingly, this is also true for Japan and Switzerland). English-speaking countries, meanwhile, tend to have good labour market performance, but share in common the need to raise their skills levels.

161. Specifically, it is worth revisiting some of the key topics raised by last year's rapporteur, and looking at the progress achieved in a selection of the countries mentioned at that time:

- the ageing demographic profile of many OECD members requires reforms to improve the prospects for older workers, and to overhaul welfare and benefit systems. In Greece and Austria, the government is consulting on some of the pension issues raised in last year's report, while Belgium has taken no new measures beyond the implementation of the 2005 Solidarity Pact, and the Netherlands has decided not to extend work capacity reassessment to disability claimants aged over 50. Meanwhile, Norway is moving towards more flexible retirement, from the age of 62 onwards, while Sweden has announced measures to tighten sickness and disability rules;

- improving the opportunities for education is also a widely shared priority: in Germany, secondary school exams are now almost universal, while Australia has increased secondary funding and established new technical colleges, and the United Kingdom is raising the school-leaving age, and developing new vocational diplomas. While no specific action has been taken in Italy, the Greek Government has enacted a comprehensive university reform bill, as in France, where university funding has been raised and autonomy increased, though student fees have not been increased. Austria has not moved to increase tertiary education fees, instead planning exemptions for those undertaking social work;
- many countries were advised to raise the level of competition and access to services in network industries such as energy and telecommunications. Australia has announced a new national operator for electricity and gas, while encouraging the privatisation of local providers; in Greece, too, the energy regulator has been strengthened, while liberalisation of the electricity and gas markets is under way. In the Netherlands, full ownership separation of the energy distribution networks and supply companies will be implemented this year, and competitive tenders are being introduced for public transport.

162. In addition to its benchmarking exercise, this year's "Going for Growth" report contains a series of special studies:

- the first of these has involved the creation of a standardised database to measure working hours, so as to examine the wide variation in hours worked across the OECD, from nearly 2 400 per year in Korea, to less than 1 400 hours in the Netherlands. In particular, the study suggests that such variations account for a "sizeable fraction" of the gap in per capita income levels between the US and Europe.

The average employed person in the US works 41 hours per week, says the study, and has two weeks off per year, while the average European works 38 hours per week, with four weeks off. About half of this difference is accounted for by a shorter working week in Europe, and by statutory caps and regulations, which have a particular impact on men. In addition, it observes that marginal tax rates are higher in Europe on average than in the US, and finds that differences in marginal tax rates account for part of the difference between the US and European countries in the number of hours worked. In particular, the higher marginal tax rates have an especial disincentive effect on second-earners in a family, most often women. Greater union power, it says, is associated with fewer hours worked for men, but more hours worked for women. Of course, the average figures given hide wide variations between European countries, though it seems that much of this is explained by the level of part-time working: the Netherlands has the highest part-time workforce on the continent, at some 45%.

Taken overall, it is striking that the position has changed dramatically since the 1970s, when Europeans worked much longer hours than in the US. While US figures have remained relatively stable over time, there has been a fall of around 25% in the western European average, so that US workers have been working longer hours since the early 1990s. Interestingly, the OECD thinks that much of this change can be attributed to shorter hours worked by part-time employees, since the hours worked by full-time employees, conventionally seen as the core of the workforce, have not fallen to nearly this extent.

This analysis suggests that European countries have two mechanisms available in order to raise the number of hours worked. On the one hand, working could be encouraged among part-timers, particularly women, if some countries (for example, the Netherlands and Germany) were to lower effective marginal tax rates – although the report accepts that specific social implications would need to be taken into account. And on the other hand, reducing the regulations and caps upon fulltime employment, which particularly applies to men, would also have a significant impact. "Policy setting in these areas may in many cases have gone too far from a welfare perspective," the study concludes, "and where this is the case, reforms may raise not only GDP per head but also overall welfare."

- in addition, the report examines means for improving investment in higher education. It points out that this sector is widely under pressure, due to rapidly expanding numbers of students, and that the justification for "near-free" public funding is not clear cut. It points out that students come disproportionately from affluent backgrounds, are increasingly internationally mobile, and stand to enjoy an income premium, across OECD countries, of between 30% and 100%. The report suggests mechanisms for increasing investment, including higher student contributions and the provision of a mix of loans and grants, while preserving or enhancing equality of access. It also offers further possible directions for reform, involving more autonomy in student selection and staff policy, more reliance on independent evaluation, and funding based on outputs rather than inputs. In addition, it sees potential for shorter and more diversified courses, to provide a more flexible response to individual learning needs;

- a further study looks at the impact of economic geography, and the so-called “death of distance” that some see as having resulted from new technology and globalisation. The report finds that, while telecommunications costs have fallen sharply and the Internet has had some impact, there is little evidence that the cost of transporting goods has fallen relative to their price. Overall, it says, the impact of distance on the structure of trade has not declined over time. Indeed, “distance to market” continues to significantly affect the GDP per head of a country – with an adverse effect of perhaps 10% to countries such as Australia and New Zealand, and a beneficial effect of perhaps 6% to countries such as Belgium and the Netherlands. At the same time, it notes that large natural resource endowments can have a strong positive impact on GDP per capita, estimating this at around 8% in the case of Norway, and 2% in Australia;
- in its final study, “Going for Growth” reviews the nature of international trade in services, and current levels of domestic regulation. It points out that services are often sheltered from competition in OECD economies and that, despite attempts to liberalise this sector, international trade in services has, in recent decades, barely increased relative to trade in goods. Although formal barriers to services are rare in OECD countries, the report points to a wide array of local regulations, which restrict the entry of foreign suppliers and make it harder, and sometimes prohibitively expensive, for domestic suppliers to compete in markets abroad.

163. The report contends that if all OECD countries were to move to the lowest levels of trade-impeding regulation currently seen amongst members – such as those in Australia, Canada and the United Kingdom – the overall trade in services could rise by around 90% on average, and by 140% in those countries that are currently most regulated, such as Italy, Hungary and Turkey. The increase in GDP per head as a result of these gains could be around 2% on average and around 3% in those countries that are currently most restrictive. And the report says that there is perhaps still more potential than that, since “heightened competition could strengthen these gains dynamically by encouraging innovation”.

164. At their Ministerial Council in Paris on 4 and 5 June, OECD ministers reaffirmed their appreciation for the OECD’s work on the political economy of reform, based on methods of evidence-based comparative analysis and peer review. They expressed the wish that the OECD continue to provide analysis and increase support to governments in the domestic reform process.

165. To quote from the summary drawn up by the Chair, French Economy Minister Christine Lagarde: “The Chair began by presenting the reform strategies she deemed effective in the light of her own experience, emphasising the timetable and simultaneous implementation of reforms. Mexico, Slovenia and Sweden offered lessons on the political economy of fiscal and labour market reforms. In the informal discussions, Ministers found that presenting a balanced ‘package’ of reforms was often helpful in gaining public acceptance and overcoming resistance from special interest groups. They agreed that advisory mechanisms, such as ad hoc commissions, were particularly useful in designing an ambitious reform programme. Ministers highlighted the importance of conveying a clear message speaking directly to citizens, in order to increase understanding of the case for reform. They pointed out that the approach to reform depended on country contexts. In many cases, building broad coalitions transcending political majorities can be instrumental for successful implementation.”

### **5.8. A renewed impetus for OECD enlargement**

166. Global involvement and outreach to non-member countries has been an integral role of the OECD since its foundation. At that time, OECD member countries made up the overwhelming share of global trade and GDP, but in an era of globalisation this position is, of course, shifting – though its 30 members still produce nearly 60% of the world’s goods and services. For some time, the OECD has been engaged in an enlargement process, and since the mid-1990s, six new members have joined. In May 2007, this process entered a new phase when the organisation decided to invite Chile, Estonia, Israel, Russia and Slovenia to open discussions for membership, and to offer “enhanced engagement”, with a view to possible membership, to Brazil, China, India, Indonesia and South Africa and to expand the OECD’s relations, including through enhanced engagement, with selected countries and regions of strategic interest to the OECD, with priority given to South-East Asia.

167. The accession process is complicated, and can be time-consuming, since it involves detailed assessments of a candidate’s policies and governmental framework, and their adherence to OECD standards and benchmarks. The accession discussions with the candidates have been launched in accordance with the accession road maps established by the OECD Council. The rapporteur would urge the OECD to reserve membership for those countries which fully respect democracy, human rights and international law.

168. “Enhanced engagement”, meanwhile, is intended to achieve the direct and active participation of each partner in the work of the organisation. It provides a mix of several elements, tailored to the country itself, and including committee participation, economic surveys, adherence to instruments, integration into the statistical reporting and information systems, sector-specific peer reviews and other policy dialogue initiatives. This is intended to be mutually beneficial, providing assistance to the enhanced engagement partner in its policy reform efforts, while also strengthening the OECD’s work. It builds on the substantial co-operation efforts that the OECD has made in recent years, such as the OECD-China programme, launched in 1995; in fact, today there are 25 non-member countries and economies participating regularly in a wide range of main committees and working groups.

Reporting committee: Committee on Economic Affairs and Development.

Reference to committee: standing mandate.

Draft resolution adopted by the enlarged committee on 30 September 2008.

Members of the committee: Mr Márton Braun (Chairperson), **Mr Robert Walter** (Vice-Chairperson), **Mrs Doris Barnett** (Vice-Chairperson), **Mrs Antigoni Papadopoulos** (Vice-Chairperson), MM. Ruhi Açıkgöz, Ulrich Adam, Roberto Antonione, Robert Arrigo (alternate: **Mrs Marie-Louise Coleiro Preca**), Mrs Veronika Bellmann, MM. Radu Mircea Berceanu, Vidar Bjørnstad, Luuk Blom (alternate: **Mr Tuur Elzinga**), Predrag Bošković, **Patrick Breen**, Mrs Anna Maria Carloni, Mr Erol Aslan Cebeci, **Mrs Elvira Cortajarena Iturrioz**, MM. Valeriu Cosarciuc, David Darchiashvili, **Joan Albert Farré Santuré**, Relu Fenechiu, Zahari Georgiev, **Francis Grignon**, Mrs Arlette Grosskost (alternate: **Mr Alain Cousin**), Mrs Azra Hadžiahmetović, MM. Norbert Hauptert, **Stanislaw Huskowski**, **Ivan Ivanov**, Igor Ivanovski, Jan Jambon, Miloš Jevtić, Ms Nataša Jovanović, MM. **Antti Kaikkonen**, Serhiy Klyuev, Albrecht Konečný, **Bronisław Korfanty**, **Anatoliy Korobeynikov**, **Ertuğrul Kumcuoğlu**, Bob Laxton, Harald Leibrecht, **Ms Anna Lilliehöök**, MM. Arthur Loepfe, Denis MacShane, **Yevhen Marmazov**, Jean-Pierre Masseret, **Miloš Melčák**, José Mendes Bota (alternate: **Mr Maximiano Martins**), Mircea Mereuță, Attila Mesterházy, Alejandro Muñoz Alonso, **Mrs Olga Nachtmannová**, Mrs Hermine Naghdalyan, Mr **Gebhard Negele**, Mrs Mirosława Nykiel (alternate: **Mrs Danuta Jazłowiecka**), Mr Mark Oaten, Mrs Ganira Pashayeva (alternate: **Mr Sabir Hajiyev**), **Mrs Marija Pejčinović-Burić**, MM. Viktor Pleskachevskiy (alternate: **Mr Nikolay Tulaev**), Claudio Podeschi, Jakob Presečnik, Maximilian Reimann, Roland Ries (alternate: **Mrs Josette Durrieu**), Andrea Rigoni, **Mrs Maria de Belém Roseira**, MM. Rafael Salas Machuca (alternate: **Mrs Maria del Carmen Quintanilla Barba**), Giuseppe Saro, Mrs Gitte Seeberg, MM. Samad Seyidov, Steingrímur J. Sigfússon, Leonid Slutsky, **Serhiy Sobolev**, Mrs Aldona Staponkienė, MM. Christophe Steiner, Vjačeslavs Stepanenko, Vyacheslav Timchenko, Mrs Arenca Trashani, Ms Ester Tuiksoo, MM. Miltiadis Varvitsiotis (alternate: **Mr Aristotelis Pavlidis**), Oldřich Vojří, **Konstantinos Vrettos**, Harm Evert Waalkens, Paul Wille, Mrs Gisela Wurm, **Mrs Maryam Yazdanfar**.

Canada: Senator Prud’homme

Japan: Ms Kaneko

Korea: Ms Song, Ms Bae

Mexico: Mr Bugarza Salmerón, Senator Jiménez Macías, Mr Soto Sánchez

NB: The names of the members present at the meeting are printed in bold.

See 33rd Sitting, 1 October 2008 (adoption of the draft resolution, as amended); and [Resolution 1629](#).