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Conventional signs

$	US dollar	.	Decimal point
¥	Japanese yen	I, II	Calendar half-years
£	Pound sterling	Q1, Q4	Calendar quarters
€	Euro	Billion	Thousand million
mb/d	Million barrels per day	Trillion	Thousand billion
. .	Data not available	s.a.a.r.	Seasonally adjusted at annual rates
0	Nil or negligible	n.s.a.	Not seasonally adjusted
–	Irrelevant		

EDITORIAL

THE POLICY CHALLENGE: CATALYSE THE PRIVATE SECTOR FOR STRONGER AND MORE INCLUSIVE GROWTH

Global economic growth is strengthening, with incoming data surprising on the upside. We project global GDP growth to be between 3½ and 3¾ per cent through the projection horizon, closer to long-run averages. Will this synchronised momentum finally propel the global economy to gather enough speed to raise productivity, real wages, and living standards for all?

More robust and higher quality private sector investment, including in intangibles and skills, is key for long-term productivity and real wage growth. There are positive signs: surveys indicate that businesses intend to invest, particularly in technology-embodied capital; and the now synchronous global upturn signals demand for investment, particularly given the erosion of the capital stock. But, projected investment rates remain too low to sustain the acceleration of activity. As a result, our projection for global GDP for 2019 shows a tempering of growth rather than continued strengthening.

A myriad of obstacles (different across countries) stand in the way of the more robust investment crucial for productivity growth to meet the public's expectations for higher living standards, and to fulfil the longer-term commitments of governments to provide solid career paths for the young and adequate pensions for the old. For example, services restrictions create hurdles to invest, particularly for smaller firms; judicial delays hinder the clean-up of balance sheets and capture resources in poorly performing firms; housing policies can make it difficult to hire workers with the right skills, undermining investment by both workers and firms.

Some people think that the per capita income growth enjoyed in previous decades is out of reach, and that those expectations are unrealistic or even inappropriate, given demographic and environmental considerations. On the former, OECD research shows that changes in pension policies to promote longer working careers and increased participation of women can offset much of the demographic drag on potential output. On the latter, the OECD report “Investing in Climate, Investing in Growth” shows a path to better well-being consistent with climate change commitments. More robust productivity growth is needed to raise wage prospects in advanced economies and higher investment – in social, public, human, and physical capital (with different combinations for different countries) – is needed for emerging economies to sustain catch-up in living standards.

Financial markets provide additional signals that real investment has yet to fully fire, and that incentives are misaligned. When firms invest in financial assets rather than in real capital, asset prices rise relative to long-term growth prospects. Evidence continues to build that financial asset prices are inconsistent with expectations for future growth and the policy stance, exacerbating the risks of financial corrections and growth downdrafts. Vulnerabilities appear through a number of channels: volatility measures are low even as the probability of sharp corrections is high, equity prices are high relative to expected growth rates and discount rates, credit spreads are narrow relative to risks, bond yields are low relative to probable outcomes of fiscal and monetary policies, and historically-high duration exposes bond holders to interest rate normalisation. Current global growth rates, and fiscal and monetary space are too limited to weather a financial downdraft. This puts an even greater premium on structural policy efforts.

Policymakers need to trigger deeper changes to their policies to catalyse investment, productivity, and real wage growth and make growth more inclusive. The OECD's *Going for Growth* exercise documents that many countries have focussed and made progress on policies that enhance labour market fluidity and participation by redesigning benefits and "making work pay", and by improving childcare so as to enhance labour force inclusion of women. These reforms have paid off with higher employment rates, particularly among groups that typically have been more weakly attached to the labour market. However, for these reforms to be reflected in high productivity and real wage growth, opportunities for right-skilling need to improve and productivity gains need to diffuse from the frontier to all firms. Further, competition in markets enhances competition for workers, making for better skill matching and higher real wages. Policymakers' efforts on product market reforms have been less ambitious, in particular on anti-trust/competition policy action and on trade and investment policies; indeed, threats to roll back openness permeate the policy landscape. Although progress has been made on financial market repair, zombie firms still capture too much labour and capital, taking a toll on business dynamism, productivity and real wage growth.

The financial crisis prompted structural reform and new regulation of parts of the financial system, but private sector debt remains high. The past decade has seen a growing reliance by firms on bond financing at attractive rates, with deteriorating credit quality and use of international issuance, as set out in Chapter 2 of this *Economic Outlook* on "Resilience in a Time of High Debt". While credit is needed to support economic activity and innovation, it can increase risks, lower growth and raise inequality. An integrated policy approach is needed to enhance the financial resilience of economies to shocks and to minimise the risks of sub-par growth in the medium term. Financial regulation should not focus only on risk, but also on growth.

Policy fatigue and sluggish growth in the past decade have curbed reform ambitions. And some might suggest that the global upturn means that no more policy effort is needed. In fact, the rapid pace of technological change – digitalisation, robotics, artificial intelligence, cloud computing – demands deeper and more extensive reforms, not complacency. Attention to the local challenges of global and technological changes has to ensure that opportunities will be shared. Those countries that step up policy efforts will create a better environment for their firms and public. With the global upturn putting wind under the wings of policy, now is the time to redouble the effort.

28 November 2017

Catherine L. Mann
OECD Chief Economist

OECD Economic Outlook, Volume 2017 Issue 2

Chapter 1

GENERAL ASSESSMENT OF THE MACROECONOMIC SITUATION

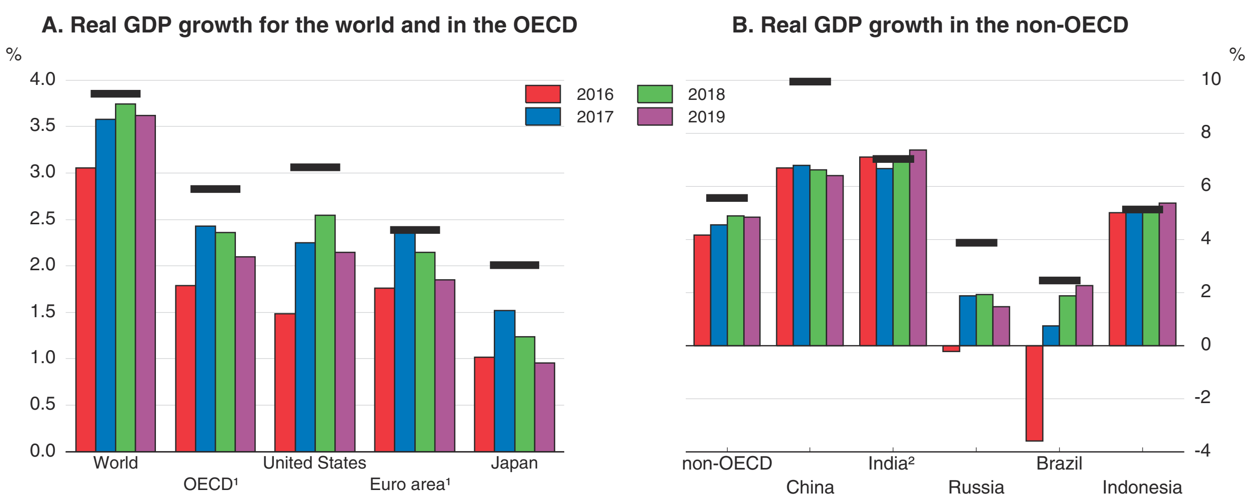
Introduction

The global economy is now growing at its fastest pace since 2010, with the upturn becoming increasingly synchronised across countries. This long awaited lift to global growth, supported by policy stimulus, is being accompanied by solid employment gains, a moderate upturn in investment and a pick-up in trade growth. Global GDP growth is projected to be just over 3½ per cent this year, strengthening further to 3¾ per cent in 2018 before easing slightly in 2019 (Figure 1.1; Table 1.1). On a per capita basis, growth is set to improve but fall short of pre-crisis norms in the majority of OECD and non-OECD economies. Inflation is currently subdued in the major economies and is set to remain moderate, although edging up gradually as resource pressures build.

Whilst the near-term cyclical improvement is welcome, it remains modest compared with the standards of past recoveries. Moreover, the prospects for continuing the global growth up-tick through 2019 and securing the foundations for higher potential output and more resilient and inclusive growth do not yet appear to be in place. The lingering effects of prolonged sub-par growth after the financial crisis are still present in investment, trade, productivity and wage developments. Some improvement is projected in 2018 and 2019, with firms making new investments to upgrade their capital stock, but this will not suffice to fully offset past shortfalls, and thus productivity gains will remain limited. Growth also remains

Figure 1.1. **GDP growth projections for the major economies**

Year-on-year percentage changes



Note: Horizontal lines show the average annual growth rate of GDP in the period 1987-2007. Data for Russia are for the average annual growth rate in the period 1994-2007.

1. With growth in Ireland in 2015 computed using gross value added at constant prices excluding foreign-owned multinational enterprise dominated sectors.
2. Fiscal years.

Source: OECD Economic Outlook 102 database; IMF World Economic database; and OECD calculations.

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Table 1.1. **The modest cyclical recovery will continue**

OECD area, unless noted otherwise

	Average 2005-2014	2015	2016	2017	2018	2019	2017 Q4	2018 Q4	2019 Q4
				Per cent					
Real GDP growth[1]									
World[2]	3.8	3.3	3.1	3.6	3.7	3.6	3.8	3.7	3.6
OECD[2,7]	1.5	2.4	1.8	2.4	2.4	2.1	2.5	2.2	1.9
United States	1.5	2.9	1.5	2.2	2.5	2.1	2.5	2.3	2.0
Euro area[7]	0.8	1.5	1.8	2.4	2.1	1.9	2.5	1.9	1.8
Japan	0.6	1.1	1.0	1.5	1.2	1.0	1.5	1.1	0.4
Non-OECD[2]	6.2	4.0	4.1	4.6	4.9	4.8	4.8	4.8	4.8
China	10.0	6.9	6.7	6.8	6.6	6.4	6.8	6.5	6.3
Output gap[3]	-0.9	-1.4	-1.2	-0.5	0.2	0.6			
Unemployment rate[4]	7.2	6.8	6.3	5.8	5.5	5.3	5.6	5.4	5.3
Inflation[1,5]	2.0	0.8	1.1	1.9	2.1	2.2	1.9	2.2	2.4
Fiscal balance[6]	-4.6	-2.9	-3.0	-2.6	-2.4	-2.2			
World real trade growth[1]	4.7	2.7	2.6	4.8	4.1	4.0	4.1	4.2	3.9

1. Percentage changes; last three columns show the increase over a year earlier.
2. Moving nominal GDP weights, using purchasing power parities.
3. Per cent of potential GDP.
4. Per cent of labour force.
5. Private consumption deflator.
6. Per cent of GDP.
7. With growth in Ireland in 2015 computed using gross value added at constant prices excluding foreign-owned multinational enterprise dominated sectors.

Source: OECD Economic Outlook 102 database.

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softer than in the past in the emerging market economies (EMEs), dimming both prospects for their catch-up and for faster global growth (given their steadily rising role in the global economy). EME growth is hampered by slowing reform efforts and financial vulnerabilities from high debt burdens, particularly in China. Financial risks are also rising in advanced economies, with the extended period of low interest rates encouraging greater risk-taking and further increases in asset valuations, including in housing markets (Chapter 2). Productive investments that would generate the wherewithal to repay the associated financial obligations (as well as make good on other commitments to citizens) appear insufficient.

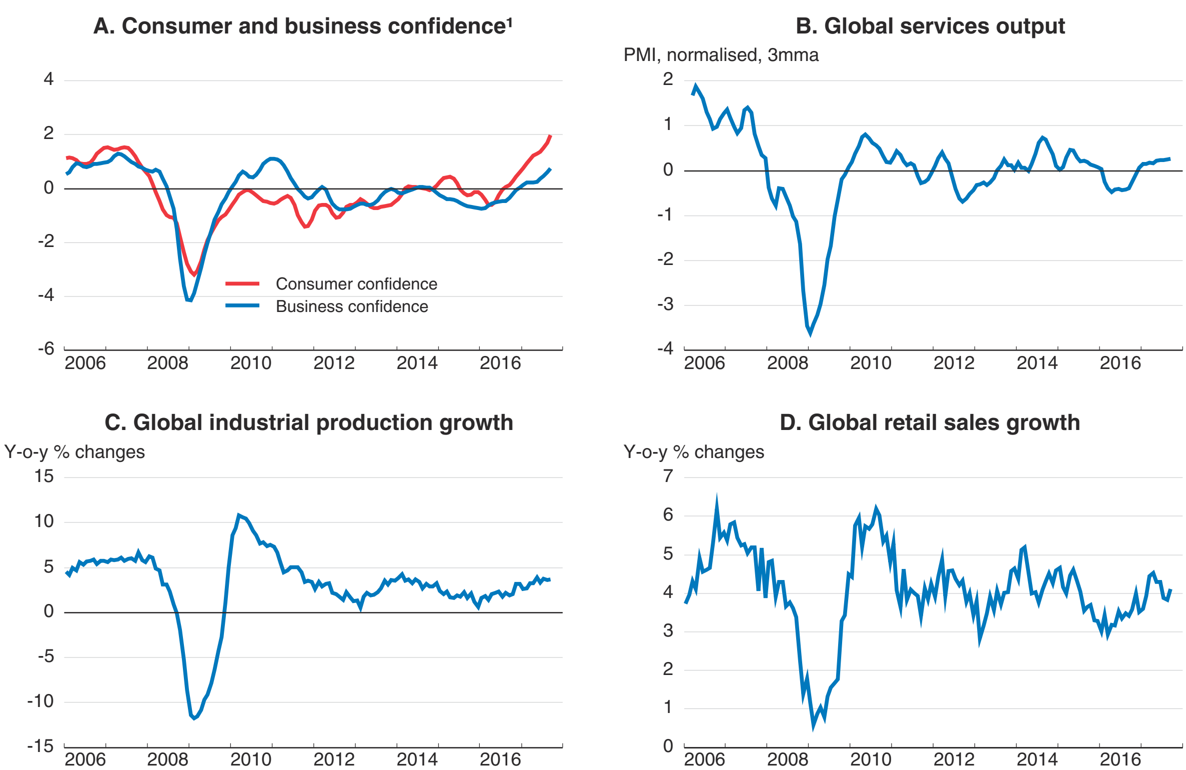
Improved short-term momentum and the fiscal room created by the current accommodative monetary policy environment provide an opportune moment for further rebalancing policy to address the structural impediments to stronger and more inclusive medium-term growth, and to increase resilience against possible risks. Monetary policy will be differentiated according to the need to support growth but with greater attention to financial stability and the potential for cross-border turbulence from rising differences in policy settings across countries. The fiscal easing underway in many economies should be delivered as planned in 2018, alongside redoubled efforts to focus tax and spending policies and structural policy efforts on the country-specific measures required to support inclusive and sustainable growth. Active and timely deployment of prudential and supervisory policies in both advanced and emerging market economies would help to address financial vulnerabilities (Chapter 2). Better integrated policy packages that address domestic and international weaknesses are necessary to ensure that the gains from technological change and cross-border trade and investment are more widely shared by workers, households and regions.

Prospects for the medium term depend on the responses of market actors to policy settings, including the monetary policy stance, the effective deployment of fiscal space and associated changes in the quality of the public finances. Further structural policy reforms focusing on measures to promote greater business dynamism, trade and investment, encourage increased labour force participation, and improve the functioning of financial institutions would strengthen growth potential and complement the productivity gains that could be achieved through corporate spending on knowledge-based capital. The upside potential for productivity and wages to support inclusive growth – the avenue by which countries can meet the expectations of citizens – depends on the packages of policies appropriate for each country. Given high debt, financial turbulence from unexpected macroeconomic policies, or a materialisation of downside risks in key economies or financial markets, would result in weaker growth outcomes, larger shortfalls from past performance, and a further diminishing of trust in the capabilities of policymakers.

Global growth momentum will stay strong, but only for a while

Global GDP growth is set to be just over 3½ per cent this year, the fastest for seven years, with improved outcomes in both advanced economies and the EMEs. Confidence measures and levels of new orders for businesses remain strong (Figure 1.2, Panel A),

Figure 1.2. **The cyclical upturn has gathered pace this year**



Note: 3mma stands for 3-month moving average.
1. Based on OECD member countries, Brazil, China, India, Indonesia, Russia and South Africa.
Source: OECD Main Economic Indicators database; Markit; Thomson Reuters; and OECD calculations.

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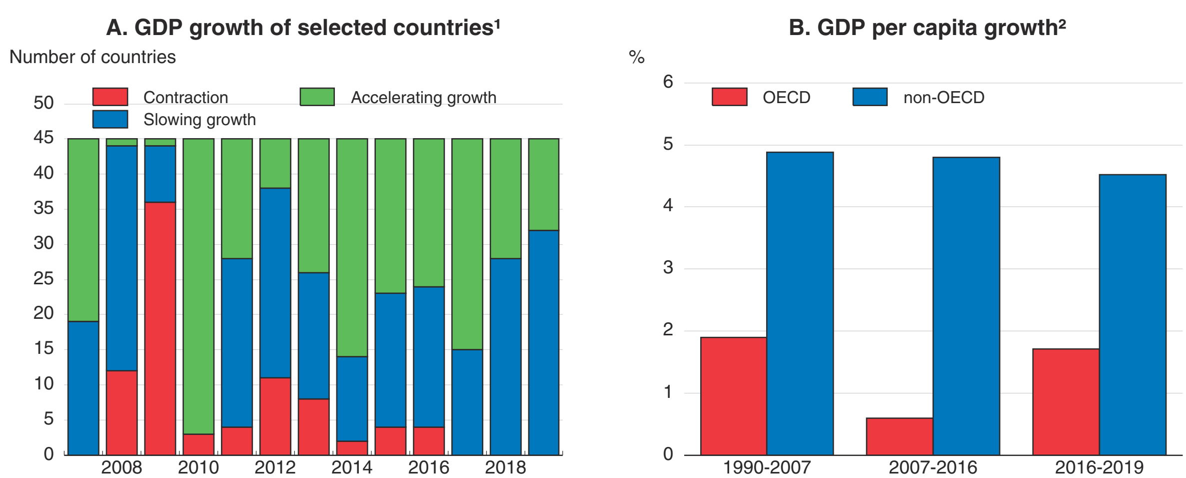
pointing to improved short-term growth prospects, although they have run ahead of activity data in some countries and sectors (Figure 1.2, Panel B). Industrial production and retail sales growth have also both strengthened this year (Figure 1.2, Panels C and D). Amongst the advanced economies, policy easing (both fiscal and monetary) is helping growth to remain stronger than anticipated in the euro area, and also in many other small open economies strongly connected to the euro area via value-chain linkages. Strong infrastructure investment in China in 2016 and 2017 is a key driver of the upturn in the EMEs, boosting external demand elsewhere, especially in Asia, and contributing to the recovery now underway in many commodity-exporting economies. By some measures, financial conditions remain supportive in the major economies (see below), although further increases in asset prices and the compression of risk spreads are adding to potential financial vulnerabilities. Commodity prices have risen, partly reflecting strong industrial demand as well as geopolitical risks and supply constraints from the agreement amongst OPEC and select non-OPEC members to restrict oil production through to March 2018. Nonetheless, prices remain below the peaks seen in 2010-11, suggesting that the impact on growth prospects may be modest, although they will push up headline inflation.

The broad-based cyclical upturn (Figure 1.3, Panel A) is set to persist into 2018, with global GDP growth projected to strengthen to 3.7%.[1] Over 2017-19 as a whole, global growth is projected to average 3.6% per annum, which is comparatively modest for a cyclical upswing. In the advanced economies, supportive macroeconomic policies, steady labour market improvements and accommodative financial conditions should help to underpin demand, with GDP growth averaging close to 2¼ per cent over the projection period. On a per capita basis, GDP growth is also projected to improve over 2017-19 in the advanced

Figure 1.3. **The upturn is broad-based, but remains modest by past standards**



1. Accelerating/slowing growth refers to a comparison with the previous year at annual frequency.
2. The OECD and non-OECD aggregates are calculated with moving nominal GDP per capita weights using purchasing power parities. The non-OECD aggregate is based on data for Argentina, Brazil, China, Colombia, Costa Rica, India, Indonesia, Lithuania, Russia, Saudi Arabia, South Africa and the Dynamic Asian Economies (Chinese Taipei, Hong Kong - China, Malaysia, the Philippines, Singapore, Thailand and Vietnam).

Source: OECD Economic Outlook 102 database; UN database; and OECD calculations.

StatLink *http://dx.doi.org/10.1787/888933630525*

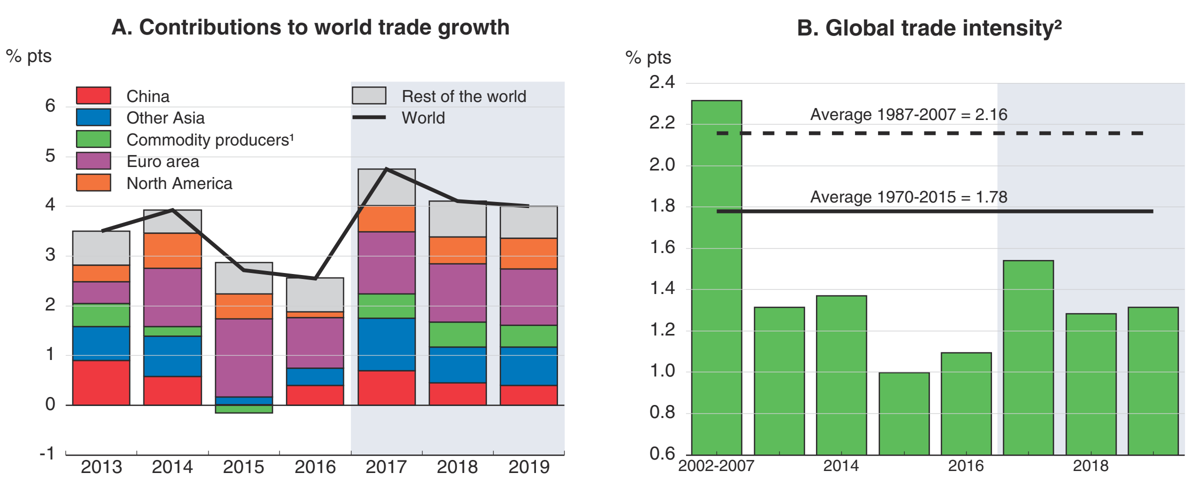
1. Key technical assumptions underlying the projections are set out in Annex A1.

economies, but not at a pace sufficient to offset the decade of sub-par growth after 2007 (Figure 1.3, Panel B). Monetary policy is set to remain accommodative in the major economies in 2018-19 and fiscal policy easing will offer more support to activity than in the three years prior to 2017. In the median OECD economy, a fiscal easing of around 0.6% of GDP is projected to occur over 2017-19, with the main boost in 2017 and 2018, after consolidation of around 0.4% of GDP over 2015-16. By 2019, GDP growth is projected to ease mildly in the majority of major economies as capacity constraints begin to emerge, in part because the upturn in productive investment is projected to remain weaker than is necessary to strengthen potential output growth.

In the EMEs, an upturn in investment is projected to support growth in India and the Dynamic Asian Economies in 2018-19, and a continued recovery is projected in Brazil and Russia, helped by the higher level of commodity prices and more accommodative monetary policy. However, a projected gradual slowdown in domestic demand growth in China, as stimulus measures in 2016-17 ease and necessary efforts continue to stabilise corporate debt and reduce excess capacity, will check the overall pace of trade and output growth in key trading partners in 2018-19. On a per capita basis, GDP growth in the non-OECD economies as a whole is set to ease over 2017-19 (Figure 1.3, Panel B).

Global trade growth has rebounded since the first half of 2016 and become increasingly broad-based across economies. Key factors underlying this include the recovery in Europe (a relatively trade intensive part of the world economy), the strong pick-up in electronics trade in Asia, and a shift in the composition of demand towards investment, which is more import intensive (Figure 1.4, Panel A). Nonetheless, trade intensity is set to remain mild by pre-crisis standards (Figure 1.4, Panel B). In part, this reflects structural factors, including a slowdown (OECD-WTO, 2017), or possibly even a reversal (Haugh et al., 2016), in the deepening of global value chains. The number of new trade restrictions in the

Figure 1.4. **The trade upturn is being driven from Asia, but global trade intensity growth remains low**



1. Commodity producers includes Argentina, Australia, Brazil, Chile, Colombia, Indonesia, Norway, New Zealand, Russia, Saudi Arabia, South Africa and other oil producing countries.
2. World trade volumes for goods plus services; global GDP at constant prices and market exchange rates. Period averages are the ratio of average annual world trade growth to average annual GDP growth in the period shown.

Source: OECD Economic Outlook 102 database; and OECD calculations.

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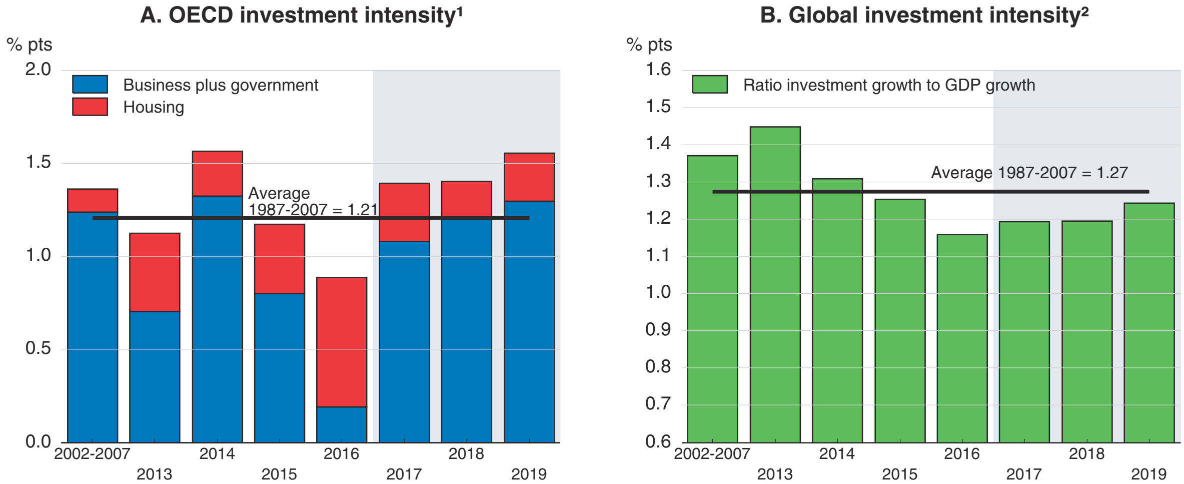
Figure 1.5. **Global investment intensity remains below past norms**



Note: Period averages are the ratio of average annual gross investment growth to average annual GDP growth in the period shown.

1. Ratio of OECD investment growth to OECD GDP growth in period shown.
2. Fixed capital investment and GDP growth in the OECD, Brazil, China, Chinese Taipei, Hong Kong - China, India, Indonesia, Malaysia, the Philippines, Russia, Singapore, South Africa, Thailand and Vietnam, at constant prices.

Source: OECD Economic Outlook 102 database; IMF World Economic Outlook database; Consensus Economics; and OECD calculations.

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major economies has also built up over the past decade, though the rate of increase is now easing (WTO, 2017). The cyclical upturn in investment intensity is also projected to be weaker than seen in the past at the global level (Figure 1.5).[2]

Strong and sustained medium-term growth is not yet secured

A more robust investment upturn is required for a sustained recovery in the advanced economies

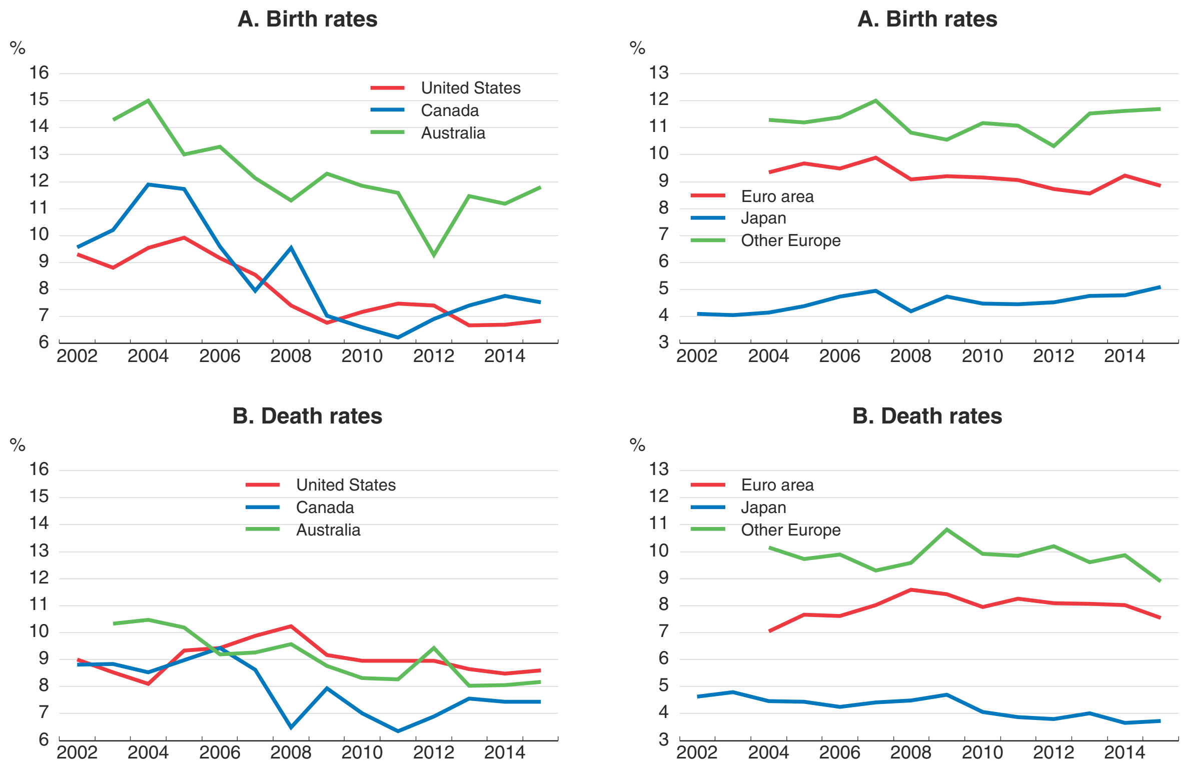
Investment is now rising in most advanced economies, but the upturn remains weaker than the average of past recoveries, implying slow growth of productive capital and limiting prospects for productivity growth and potential output. Since the financial crisis, weak global demand growth and heightened policy and regulatory uncertainty have driven the persistent weakness of investment (OECD, 2015; Égert and Gal, 2017). Financial constraints arising from impaired banking sectors in some economies, resources trapped in unproductive "zombie" firms (Adalet McGowan et al., 2017) and the slowdown in reform efforts to tackle regulations that impede product market competition (OECD, 2017b) have also helped to weaken incentives to invest.

Some of these constraints have begun to ease, with signals about prospects for investment generally improving over the past year. After stagnating in 2016, business investment has risen by just under 3¾ per cent in the advanced economies this year, and capital goods production has strengthened through 2017. Corporate surveys also point to improving investment intentions in the euro area and the United States and emerging capacity shortages in Japan. The current broad-based improvement in near-term growth prospects should also help to stimulate investment, given empirical and survey indications

2. Trade growth in Europe in 2019 will depend in part on the new economic relationship between the United Kingdom and the European Union (EU). The projections use a technical assumption that the United Kingdom has a transition arrangement with the EU after formal exit in 2019, which minimises potential short-term disruptions to trade in 2019.

that global demand matters as a distinct driver beyond domestic demand for many investment decisions (OECD, 2015). However, questions remain about how strong and long-lasting the investment rebound will be. Potential obstacles to a sustained recovery include a step-down since the financial crisis in expectations over the longer-term for global GDP growth;[3] a decline in business dynamism in several countries (Figure 1.6; Carey et al., 2016; Millar and Sutherland, 2016),[4,5] with potentially adverse effects on competitive innovation, investment and productivity diffusion; and still high global policy uncertainty, including about trade policy developments. These all suggest that policy choices will have an important bearing on medium-term investment prospects.

Figure 1.6. **Business dynamism has declined in several advanced economies**



Note: Number of enterprise births and deaths in year t over number of active enterprises in year t. Data for the United States and Canada are estimated in 2013-15 and 2014-15 respectively, using separate data from the US Census Bureau and Statistics Canada. The euro area estimates are an unweighted average of birth and death rates in member states. The estimates for "other Europe" are unweighted averages of birth and death rates in the Czech Republic, Denmark, Hungary, Norway, Poland, Sweden and the United Kingdom.
Source: OECD Structural and Demographic Business Statistics Database; Japanese Ministry of Health, Labour, and Welfare; and OECD calculations.

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3. Consensus growth projections suggest that PPP-weighted global GDP growth is now expected to average only 3¼ per cent per annum over the next decade, compared with expectations prior to the crisis and its immediate aftermath that future annual global growth would average around 4% per annum.
4. More timely quarterly data show a rise in the number of new enterprises created in 2016 and early 2017 in some OECD countries (OECD, 2017h).
5. Information over a longer time period is available for the United States and Canada using national definitions of entry and exit rates. On average, over 2003-15 entry and exit rates in the United States were 3 and 2 percentage points lower, respectively, than in the previous two decades (Millar and Sutherland, 2016). In Canada, the equivalent gaps were around 4 percentage points (Carey et al., 2016).

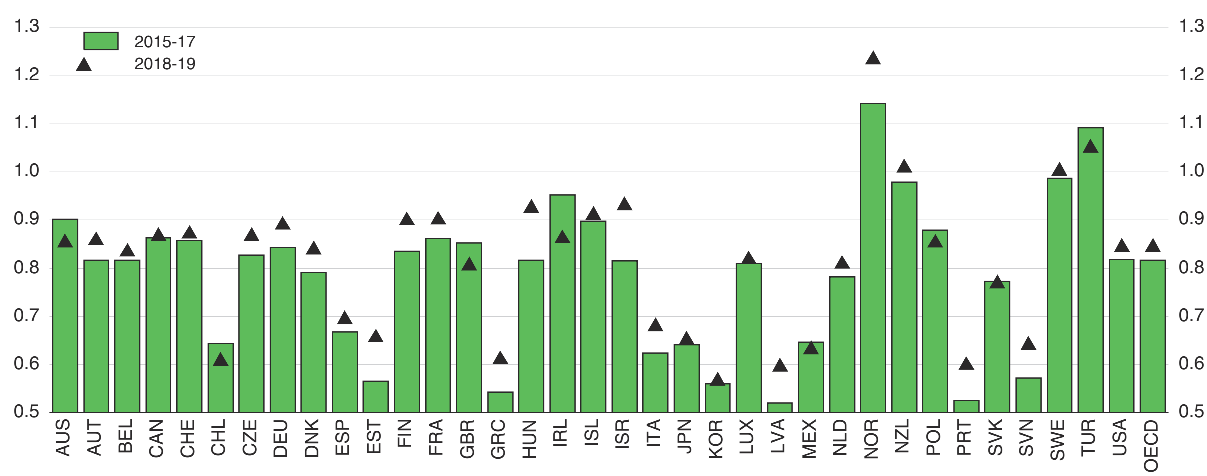
The pace of business investment growth in the advanced economies is projected to average around 3½ per cent per annum over 2018-19, suggesting that longer-term structural impediments outweigh more favourable cyclical conditions and leaving growth of the productive capital stock (which includes government as well as business investment) well below pre-crisis norms in most countries. In the median OECD economy, investment spending in 2018-19 is projected to be around 15% below the level required to ensure the productive net capital stock rises at the same average annual pace as over 1990-2007 (Figure 1.7).[6] With depreciation rates having risen over time by over 1¼ percentage points in the median OECD economy between the 1997-07 average and 2016 (in part due to the shorter lifespans of technology investments), much stronger gross investment is now required to achieve the same net capital stock growth (Figure 1.8).

However, there could still be improvements to growth prospects even if companies seek only to upgrade their existing capital assets. The improving momentum in the global IT cycle, driven by production in the Asian economies (Figure 1.9), signals that a key part of any capital stock upgrade could be the replacement of old equipment and software with new enhanced digital technologies, with associated benefits for productivity growth.

Broad structural policy packages, supported by supply-side fiscal measures, would support demand and, even more importantly, improve longer-term growth prospects, thereby helping to catalyse a stronger upturn in business investment (Box 1.1). In particular, a stronger pace of progress towards competition-friendly regulations would help to strengthen product market dynamism and competitive pressures and investment (Döttling et al., 2017). More competitive product markets would raise the prospective rate

Figure 1.7. **Investment shortfalls are set to persist**

Ratio of actual investment to gross investment required for net productive capital stock growth at the 1990-2007 annual average rate



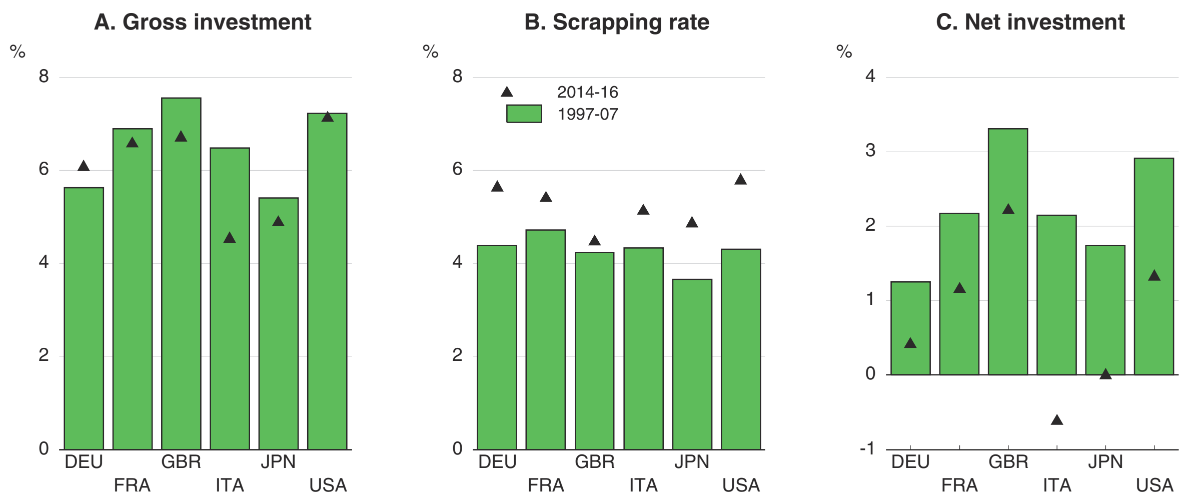
Note: Estimates for the OECD are for the median country. Investment comprises business and government gross fixed capital investment.
Source: OECD Economic Outlook 102 database; and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933630601

6. The extent of the shortfall for each country depends on the pre-crisis period that is chosen for the target growth of the capital stock. Choosing a shorter sample from 1997-2007 does not alter the findings for the typical OECD economy, with the investment shortfall in the median OECD economy remaining at 15% and the unweighted average shortfall being 17% (down from 18% for 1990-2007).

Figure 1.8. **Rising depreciation rates are helping to hold down net investment in productive capital**

Per cent of productive capital stock

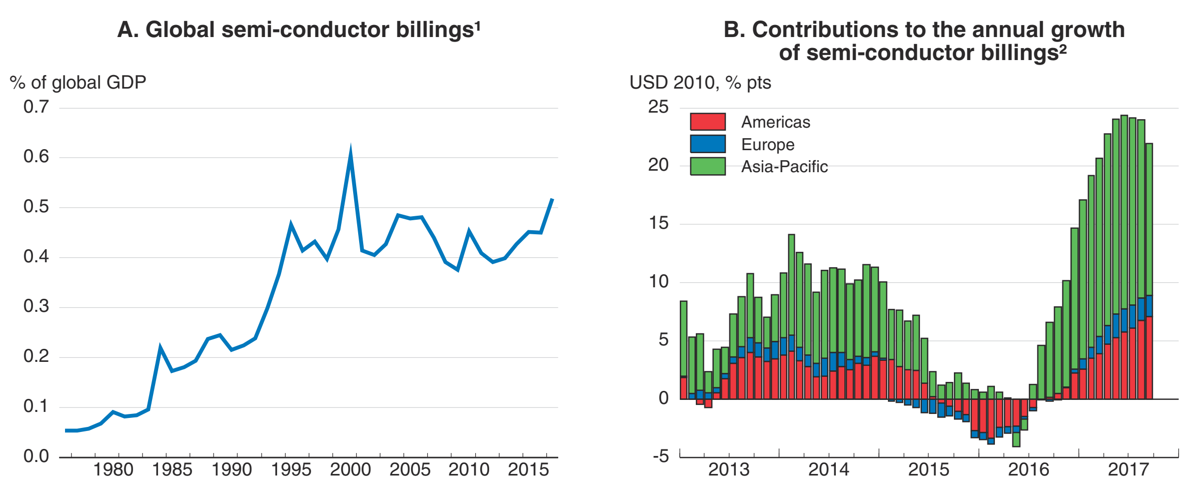


Note: Business plus government investment. The series are annual averages for the period shown.
Source: OECD Economic Outlook 102 database; and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933630620

of return on new investments and provide a better environment to revive the stalled diffusion of innovation between frontier firms and the rest of the economy (Alesina et al., 2005; Gal and Hijzen, 2016; Égert and Gal, 2017). Moves towards more reallocation-friendly insolvency regimes would also reduce resources trapped in "zombie" firms and improve the ability of more productive firms to attract additional capital (Adalet McGowan et al., 2017; Chapter 2). Relatively favourable cyclical conditions provide a propitious opportunity

Figure 1.9. **The upturn in the global IT cycle points to improving prospects for high-tech investment**



1. Estimate for total semi-conductor billings 2017 based on data up to September. Global GDP is expressed in USD at market exchange rates.
2. Nominal billings in Europe and Asia-Pacific deflated using US semi-conductor import prices. Nominal billings in the Americas deflated by US semiconductor export prices.

Source: World Semi-Conductor Statistics; Bureau of Labor Statistics; and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933630639

Box 1.1. **Deeper reforms would strengthen growth prospects**

Renewed structural policy efforts, including further liberalisation of trade and regulation, especially in services, would help to improve the diffusion of new ideas and technologies between firms and across countries and boost total factor productivity (TFP) growth. In turn, this could push the anticipated internal rate of return on investment above current hurdle rates and encourage firms to upgrade their capital stock, and thereby help to sustain the momentum of the current recovery. Technological upgrading that improves capital quality would provide an additional boost to potential output.

In the OECD as a whole, the annual average contribution of TFP to potential output growth in the decade from 2007 to 2017 was just over 0.2 percentage point weaker than in the pre-crisis decade. Undertaking policies to close this gap would boost output growth in the medium term. Additional easing of regulatory barriers in product markets, reductions of trade restrictions and more open economies, and stronger R&D spending are key policies in this respect (OECD, 2017b; Égert and Gal, 2017; Haugh et al., 2016). Identified policy priorities differ across countries (table below), but frequently include steps to: streamline permits and licenses; improve the transparency of regulation; reduce barriers to entry in network industries, professional services and retail sectors; lower barriers to trade and FDI; and strengthen collaboration between research institutes, universities and industry.

Reform recommendations to help strengthen business dynamism and knowledge diffusion

Policy	Countries with scope for gains and recommended actions
Reforms to ease economy-wide regulatory barriers	AUS, BEL, CAN, CHL, CZE, DEU, DNK, GRC, HUN, IRL, ISL, ISR, ITA, JPN, KOR, LVA, MEX, NOR, NZL, POL, PRT, SVN
Reforms to ease network industry regulatory barriers	BEL, CAN, CZE, DEU, ESP, EST, GRC, HUN, IRL, ISR, JPN, LVA, MEX, NOR, NZL, TUR
Reforms to ease service-sector regulatory barriers	AUT, BEL, CAN, CZE, DEU, DNK, ESP, FIN, FRA, HUN, IRL, ISL, JPN, KOR, LVA, LUX, MEX, NOR, PRT, SVN
Lowering barriers to trade and FDI	CAN, CHE, ISL, ISR, JPN, KOR, MEX, NOR, NZL
Improving physical and legal infrastructure	AUS, CZE, EST, FIN, GBR, GRC, HUN, ISR, ITA, LVA, POL, USA
Reductions in corporation tax rates	CAN, JPN, NOR, USA
Reforms to improve innovation capacity	AUS, CAN, CHL, CZE, EST, GBR, ISL, IRL, ITA, LUX, MEX, NLD, NZL, POL, PRT, SVN, USA

Note : The countries identified are those in which the reform is identified as a priority for the country in 2017.
Source: OECD (2017), *Economic Policy Reforms 2017: Going for Growth*, OECD Publishing, Paris.

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A stylised scenario using the NiGEM global macroeconomic model serves to illustrate the possible short and medium-term growth effects that might be achieved if the rate of technical progress were to be stronger. The scenario considers the effects of raising labour-augmenting technical progress by 0.2 percentage point per annum in all of the advanced economies for five years, beginning in the latter half of 2017, with the 1% higher level of technical progress being maintained permanently thereafter.

There are a number of ways in which an increase of 1% in the level of TFP over five years can be achieved, based on the analysis in Égert and Gal (2017), especially if a collection of reforms are undertaken simultaneously in a number of different policy areas. Alternatively, the increase could be separately obtained from a large reform that raised trade openness by 5 percentage points (which is around twice the increase projected in 2017-19 in the OECD economies compared with 2014-16), or a beneficial two-year reform to product market regulation of a size that is somewhat larger than has been typically observed in

Box 1.1. **Deeper reforms would strengthen growth prospects** *(cont.)*

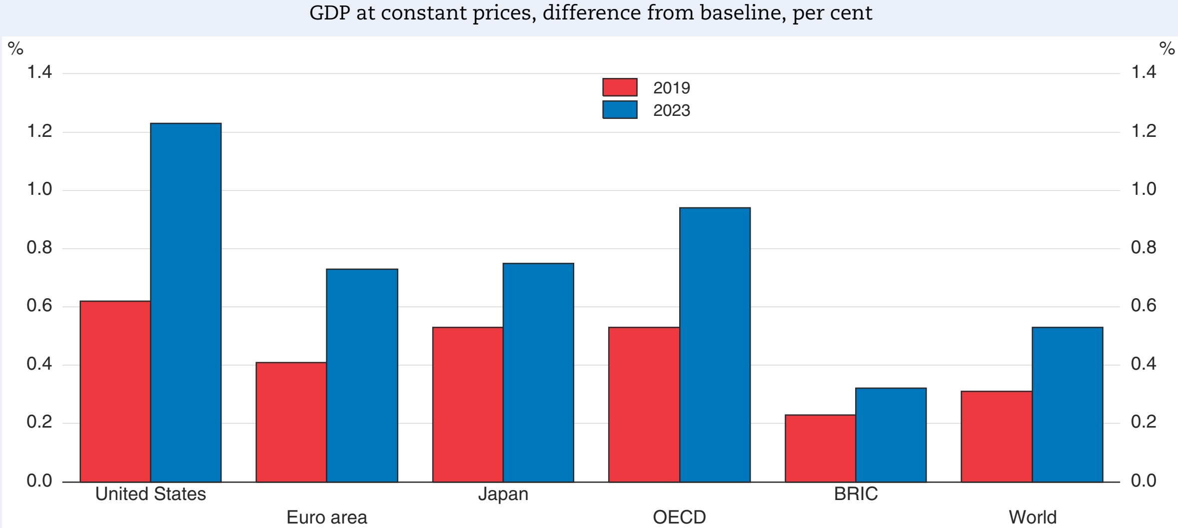
the past. A rise in the share of business R&D spending in GDP can also boost TFP, but the effects are comparatively small, with an increase of 0.1 percentage point (which is roughly the difference between spending per annum in the OECD economies in 2014-15 and that in the previous decade) raising TFP by 0.1% after five years.

The NiGEM model simulations are run in forward-looking mode, so that private actors and financial markets start to adjust their behaviour in anticipation of the higher level of output in the future. Monetary and fiscal policies are allowed to remain endogenous.

All told, the positive supply shock would raise OECD GDP growth by around ¼ percentage point per annum over 2018-19, and by a further 0.1 percentage point per annum on average over 2020-23, so that the level of GDP in the OECD economies is 0.9% higher than otherwise by 2023. The output gains are larger in the United States than in the euro area or Japan (figure below), reflecting a more dynamic investment response and a faster response of real wages to the improvement in labour efficiency. Business investment growth is between 1 and 2 percentage points stronger in 2018 in the advanced economies than in the baseline, and by 2023 the capital stock is around 1% higher than the baseline in the United States (and also the United Kingdom and Canada) and around 0.7% above the baseline in Japan and the euro area. Real wages also rise gradually over time, as they adjust towards the higher level of productivity, by 0.1-0.3% relative to baseline in the major advanced economies in 2019 and by 0.5% on average in these economies by 2023, with somewhat stronger effects in the United States than elsewhere. In turn, this helps to strengthen consumer spending. The collective boost to output in the advanced economies also has mild positive spillovers to the EMEs and to world trade. Overall, global GDP growth is boosted by around 0.1 percentage point per annum on average out to 2023, and world trade growth by around 0.2 percentage point per annum over the same period.

The output gains from faster technical progress growth in the advanced economies

GDP at constant prices, difference from baseline, per cent



Source: OECD calculations.

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to undertake such reforms, as any potential short-term costs from weaker firms exiting the market are likely to be lower and shorter-lived when demand and job creation are stronger. More could also be done to tackle regulatory divergences in network industries to encourage cross-border investment, especially in Europe (Fournier, 2015).

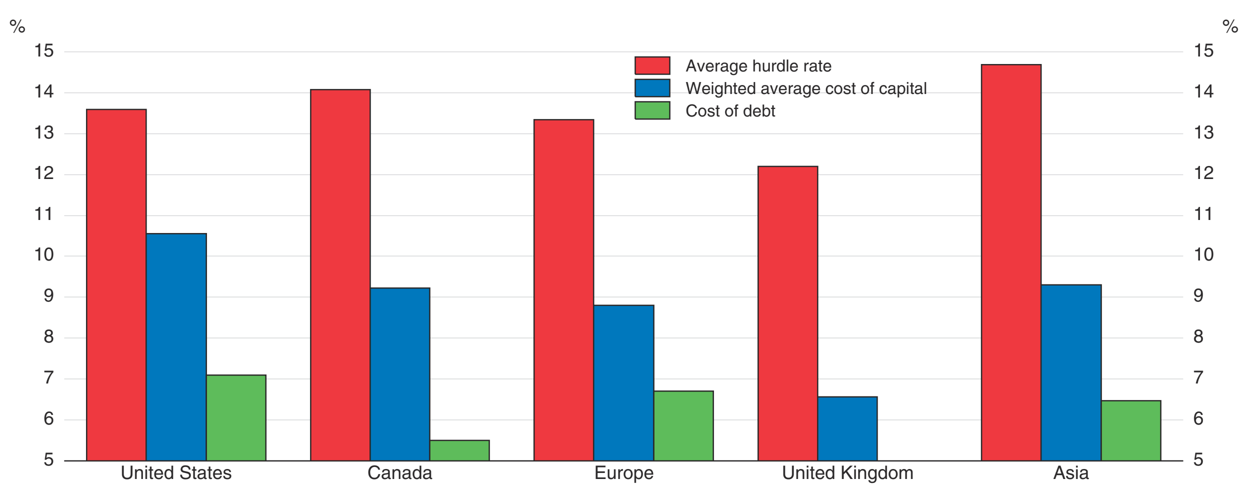
The onset of monetary policy normalisation in the major advanced economies might have little direct effect on aggregate incentives to invest in productive assets. Corporate hurdle rates for investment remain well above the cost of capital (Figure 1.10) and the available survey evidence, though limited, suggests that hurdle rates have been high and relatively sticky over time despite underlying fluctuations in the cost of finance (Sharpe and Suarez, 2014; Deloitte, 2014; Norman, 2016).[7] This is one reason why business investment has remained weak despite the decline in policy and market interest rates over the past decade. For the same reason, changes in tax rates (which affect the cost of capital) may yield less impetus for investment than theory or historical evidence might suggest. Changes in interest rates and taxes could still have a broader effect on corporate balance sheets by affecting decisions to issue debt and undertake financial transactions, adding to the growing disconnect between debt issuance and investment seen in recent years (Chapter 2).

Reforms are needed to improve growth prospects in emerging market economies

A durable strengthening of growth in EMEs is central if global growth is to return to higher long-term norms, given their rising share of global output and trade. However, GDP growth has eased overall in these countries since the 2000s, progress in enacting structural policies has slowed and demographic headwinds are now appearing in some countries. Progress on catch-up in terms of GDP per capita has thus slowed in many EMEs.

In recent years, weaker growth outcomes in the major EMEs were largely accounted for by a gradual moderation of growth in China, and a more substantial slowdown in commodity exporting economies (Figure 1.11, Panel A). Domestic demand was especially weak in many of the latter economies (Figure 1.11, Panel B). Growth in the major EME commodity importers (excluding China) did also ease, but to a much smaller extent. Going forward, as discussed above, growth in the non-China EMEs is now improving, helped by a

Figure 1.10. **Hurdle rates for corporate investment are well above the cost of capital**



Source: Duke CFO Global Business Outlook Survey, June 2017; and Bank of England Finance and Investment Decisions Survey.

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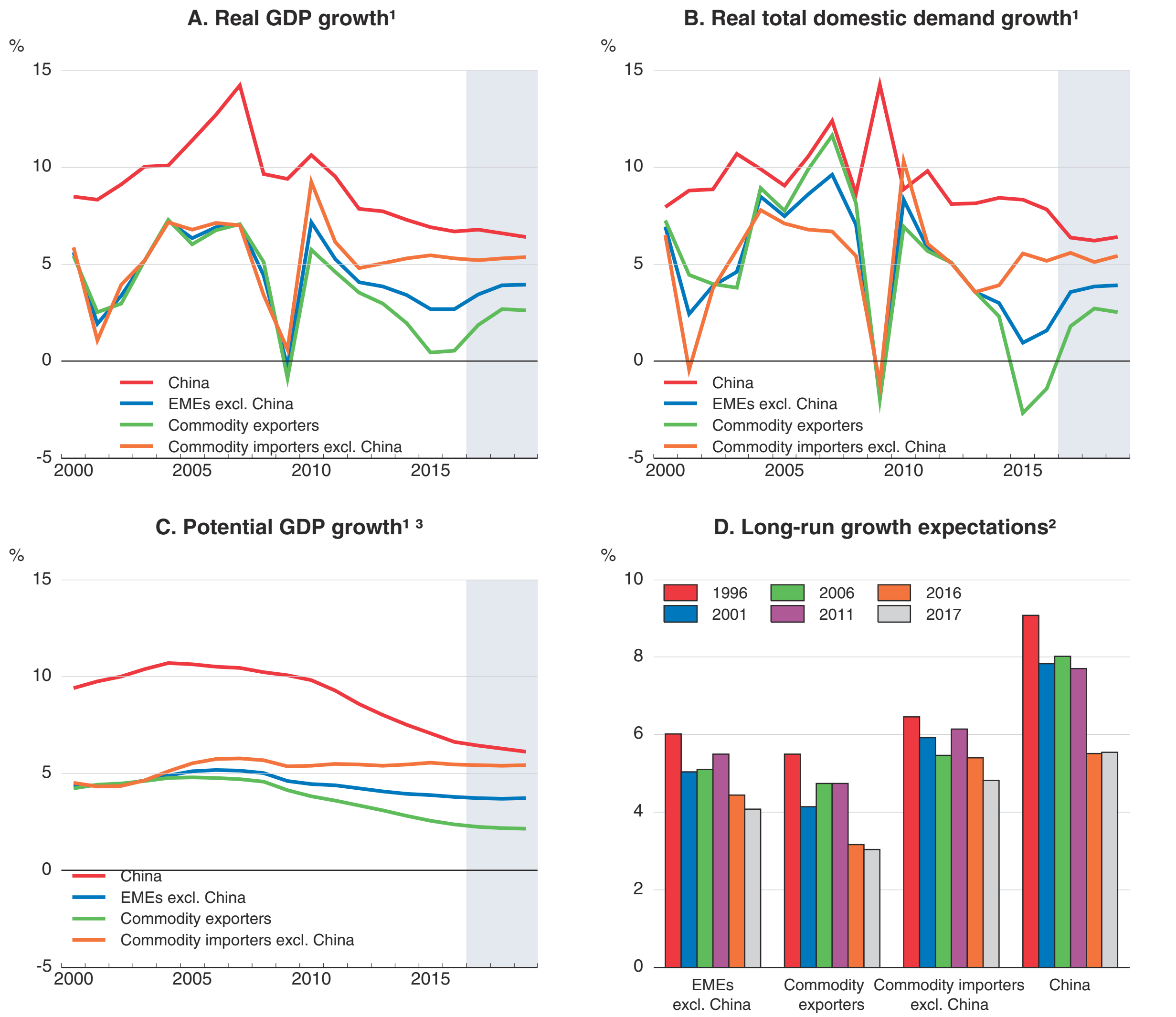
7. The average hurdle rate amongst the US companies responding to the Duke CFO Global Business Outlook Survey was 14.7% in 2007, 14.8% in 2011 and 13.6% in 2017.

Figure 1.11. **GDP growth is subdued in the emerging market economies and medium-term prospects have declined**



1. Commodity exporters include Argentina, Brazil, Chile, Colombia, Indonesia, Russia, Saudi Arabia, South Africa and other non-OECD oil producers. Commodity importers (ex. China) include India, Mexico, Turkey and the Dynamic Asian Economies (Chinese Taipei, Hong Kong - China, Malaysia, the Philippines, Singapore, Thailand and Vietnam). Emerging markets economies (ex. China) include the countries in the commodity exporters group and commodity importers group. Countries are aggregated based on PPP GDP weights.
2. Average annual GDP growth expected over the following ten years in long-term consensus forecasts from the years shown. Commodity exporters include Argentina, Brazil, Chile, Colombia, Indonesia, Peru, Russia, Ukraine and Venezuela. Commodity importers (ex. China) include Bulgaria, Chinese Taipei, Hong Kong – China, India, Malaysia, Mexico, Philippines, Romania, Singapore, Thailand and Turkey. Countries are aggregated based on PPP GDP weights.
3. Production function based estimates of potential output in Argentina, Brazil, Chile, China, Colombia, India, Indonesia, Mexico, Russia, Turkey and South Africa. HP-filter based estimates of potential output in Saudi Arabia, the Dynamic Asian Economies and other non-OECD oil producers.

Source: OECD Economic Outlook 102 database; Consensus Economics; and OECD calculations.

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rebound in Brazil and Russia, two of the major commodity producers, and spillover effects from policy stimulus in China. However, this upturn is set to be moderate by pre-crisis standards, reflecting relatively modest external demand growth and the need for further reforms to strengthen domestic demand.

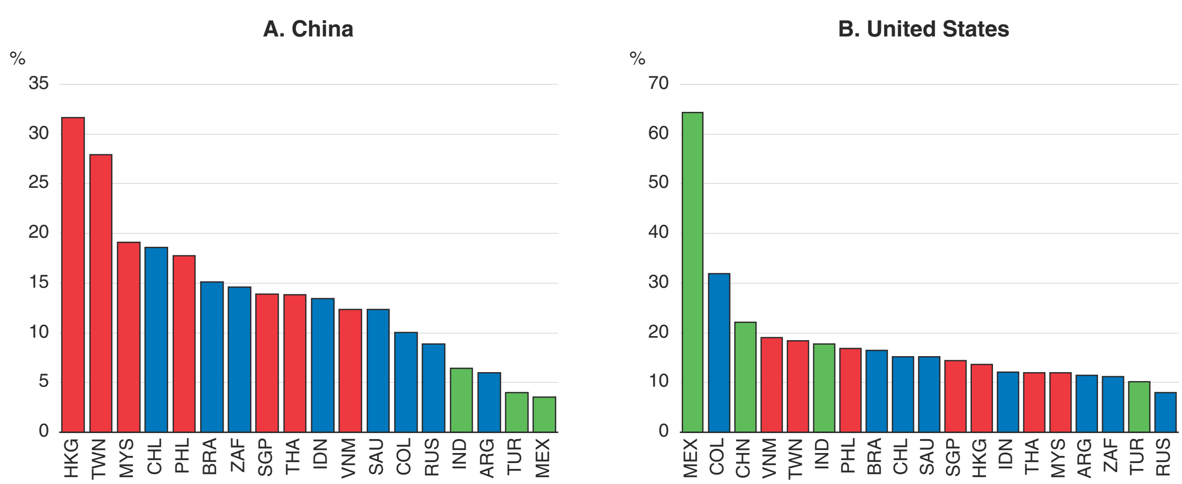
A risk is that the cyclical rebound in growth outcomes could disappoint if there were to be a sharper slowdown in China than currently projected, given the strong linkages of the smaller Asian economies and commodity exporters with China through global value chains (Figure 1.12). Financial vulnerabilities, such as high debt, currency mismatch between debts and revenues, and rising non-performing loans in some EMEs could also cloud the near-term growth outlook (Chapter 2). Capital flows may also become more volatile if steps to normalise monetary policy in some advanced economies gather pace.

Further ahead, prospects for stronger output and per capita growth in EMEs will depend on the extent to which supply-side developments improve and, in particular, on whether investment and productivity growth can strengthen sufficiently to outweigh demographic headwinds in some countries and a further moderation of growth in China. In the EMEs as a whole, estimates of underlying growth potential have declined over the past decade, especially in China and many commodity exporters (Figure 1.11, Panel C). Excluding China, potential output growth for the commodity importing EMEs has remained broadly unchanged. An underlying slowdown is also reflected in the steady decline in long-term consensus expectations of average annual growth over the next decade in the EMEs (Figure 1.11, Panel D), likely damping incentives to invest.[8] Key factors behind the slowdown in potential growth include:

- The contribution from capital per worker in the commodity exporters has been particularly soft in recent years (Figure 1.13; World Bank, 2017). Despite their recent rises, most commodity prices remain well below their peaks in 2008 and 2011-14, holding back capital spending (Deutsche Bundesbank, 2015). In China, investment remains a key

Figure 1.12. **China is an important trading partner for smaller Asian economies and commodity exporters**

Per cent of total domestic value-added in foreign final demand in 2014



Note: OECD TiVA Nowcast Estimates. Red is for the Dynamic Asian Economies, blue is for the commodity exporters and green for the commodity importers.
Source: OECD calculations.

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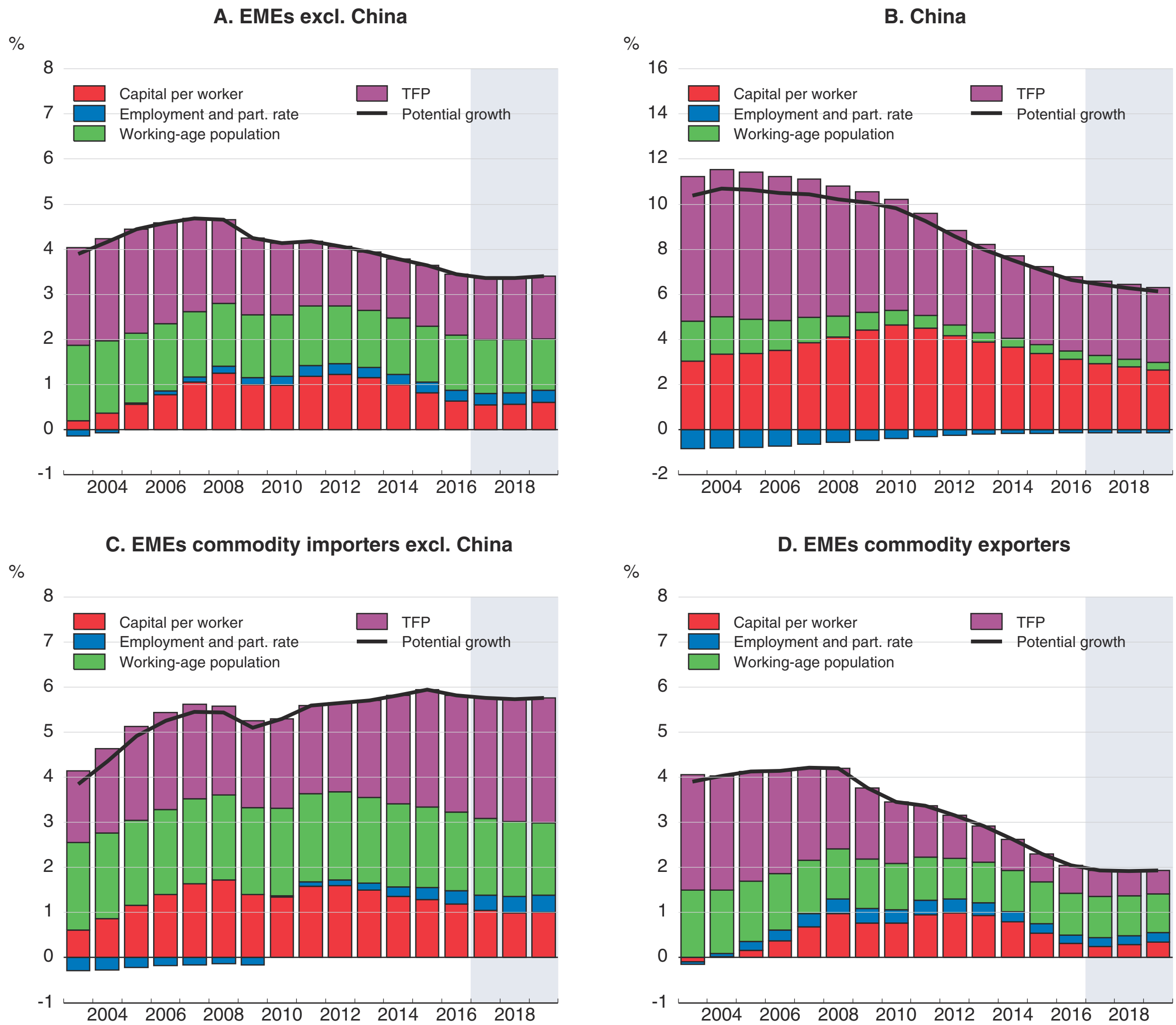
8. Since 2011, expectations of average annual growth over the next decade have declined by 2 percentage points in China and by close to 1½ percentage points in the other major EMEs.

Figure 1.13. **Potential GDP growth has fallen in many EMEs**



Note: Contributions to potential output growth are expressed in percentage points. Commodity exporters include Argentina, Brazil, Chile, Colombia, Indonesia, Russia and South Africa. Commodity importers (ex. China) include India, Mexico and Turkey. Countries are aggregated based on PPP GDP weights.

Source: OECD Economic Outlook 102 database; and OECD calculations.

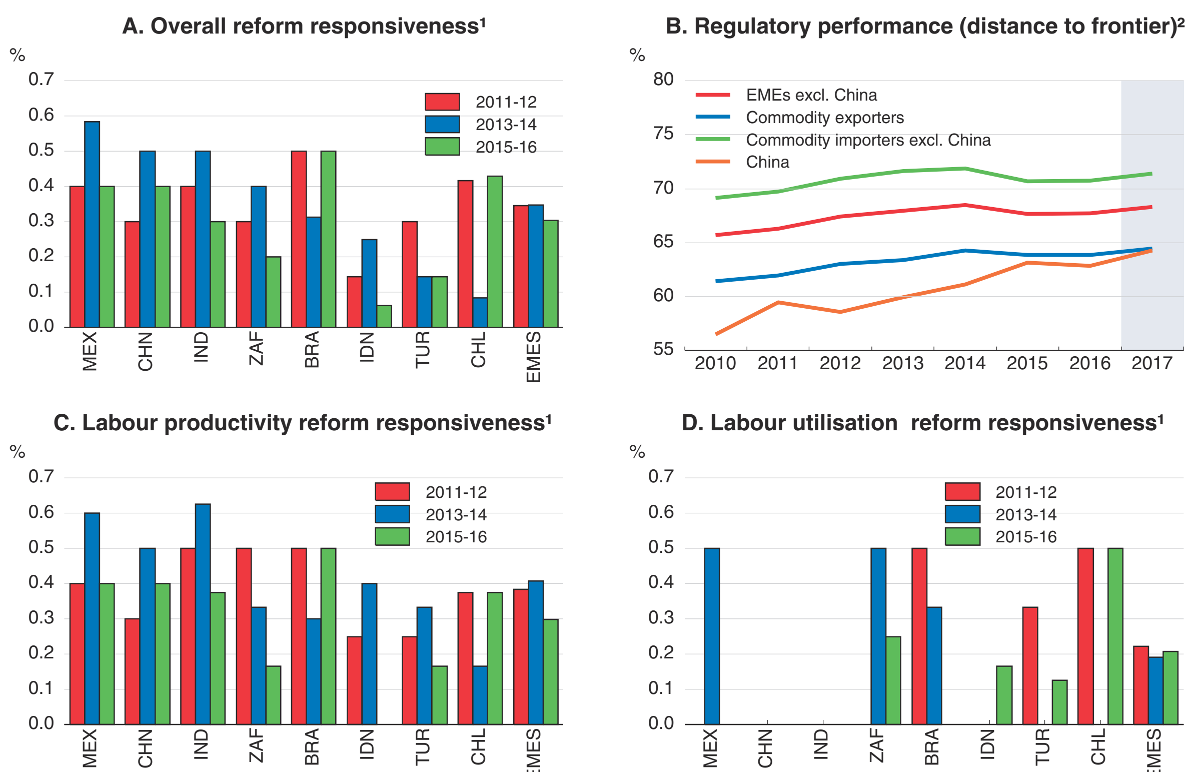
StatLink http://dx.doi.org/10.1787/888933630715

factor underpinning growth (OECD, 2017d), but its pace has moderated, partly reflecting necessary adjustments to reduce over-capacity in some sectors.

- Total factor productivity (TFP) growth has also slowed, especially in the commodity exporters and China, partly due to weaker investment and trade growth since the crisis. However, TFP growth has held up relatively well in the other major commodity importers. In part this reflects a stronger pace of structural reforms in India since 2014 (OECD, 2017e), and major growth-enhancing reforms in Mexico (OECD, 2017f).
- Demographic developments in some EMEs have become less favourable, especially in China and, to lesser extent, in many commodity exporters.

Stepping up the pace of structural policies to boost productivity growth, including through more competition-friendly regulations and efforts to raise labour utilisation rates, is essential to improve medium-term growth prospects in the EMEs and to provide avenues to tackle challenges of inclusiveness. In recent years, progress in enacting structural reforms has slowed in many EMEs based on OECD indicators, especially for policies aimed at boosting labour productivity (OECD, 2017b; Figure 1.14). Other measures of regulatory performance, such as the World Bank Doing Business survey, suggest that regulatory quality relative to frontier countries has remained largely unchanged in most EMEs since 2014 (Figure 1.14, Panel B). Lowering barriers to foreign trade, investment and firm entry, and reducing the state control of businesses would improve the efficiency of capital allocation and boost job growth. Further, these kinds of regulations bear most heavily on SMEs which are a key source of job creation (OECD, 2017g). Measures to boost investment directly by tackling structural bottlenecks and expanding public investment in infrastructure and human capital, where fiscal space exists, would also support stronger underlying growth. Addressing potential financial vulnerabilities and improving risk-management practices could also strengthen resilience in many EMEs, providing a more stable environment to foster long-term investments (Chapter 2). Deeper capital markets would also improve the efficiency of capital allocation and support job growth.

Figure 1.14. **Reform responsiveness and improvements in regulatory quality have slowed in many EMEs**



1. Responsiveness to OECD Going for Growth recommendations across EMEs. The EME aggregate is the simple average of EMEs shown in the chart.
2. Commodity exporters include Argentina, Brazil, Chile, Colombia, Indonesia, Russia, Saudi Arabia and South Africa. Commodity importers (ex. China) include Chinese Taipei, Hong Kong – China, India, Malaysia, Mexico, Philippines, Singapore, Thailand, Turkey and Vietnam. Aggregates are based on simple averages.

Source: OECD (2017), *Economic Policy Reforms 2017, Going for Growth*, OECD Publishing, Paris; World Bank Doing Business database; and OECD calculations.

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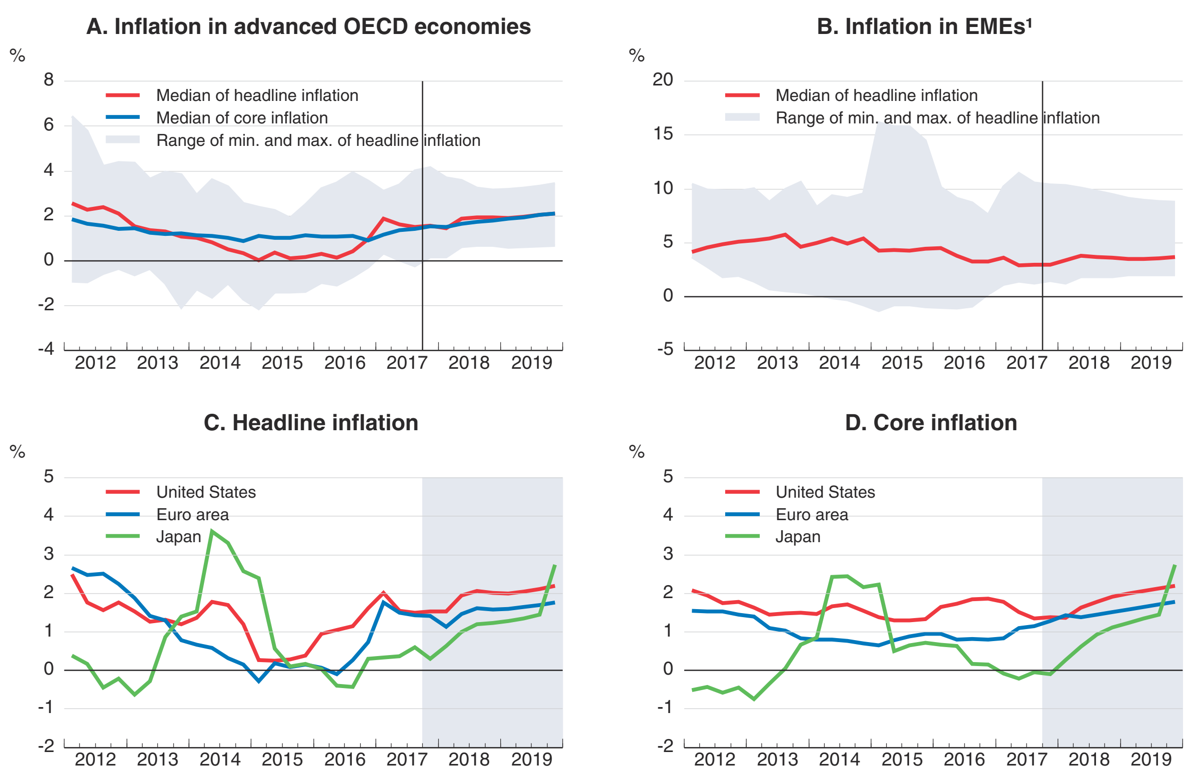
Inflation pressures are projected to be moderate

Headline consumer price inflation eased in mid-2017 in most major advanced and emerging market economies, helped by the moderation in energy prices (Figure 1.15). Meanwhile, underlying inflation across the advanced economies is currently subdued in aggregate despite the broad-based cyclical upturn and the continued absorption of slack. Apart from sluggish wage growth (discussed below), this leaves puzzles about the extent of spare capacity, and the possible extent to which global or particular domestic factors are helping to constrain inflationary pressures in the advanced economies (Figure 1.16):

- International and domestic competition and technological progress are holding down prices of goods excluding energy and food, with falling price levels in the United States and Japan and very muted increases in the euro area, and some services (Auer and Fischer, 2010). These developments are also particularly notable in communication services, with the persistent negative contributions of communication prices having recently intensified in the main OECD areas.

Figure 1.15. **Inflation is projected to remain moderate in the major economies**

Year-on-year percentage changes



Note: Inflation is based on the harmonised consumer price index for the euro area countries and the United Kingdom, on the national headline consumer price series for Canada and Japan and the EMEs, and on the personal consumption deflator for the United States. Inflation rates in Japan in 2014 and 2019Q4 are affected by the realised and expected increase in the consumption tax rate. Core inflation excludes prices of food and energy.

1. EMEs include Brazil, China, Costa Rica, Hungary, India, Indonesia, Mexico, Poland, Russia, South Africa and Turkey.

Source: OECD Economic Outlook 102 database; and OECD calculations.

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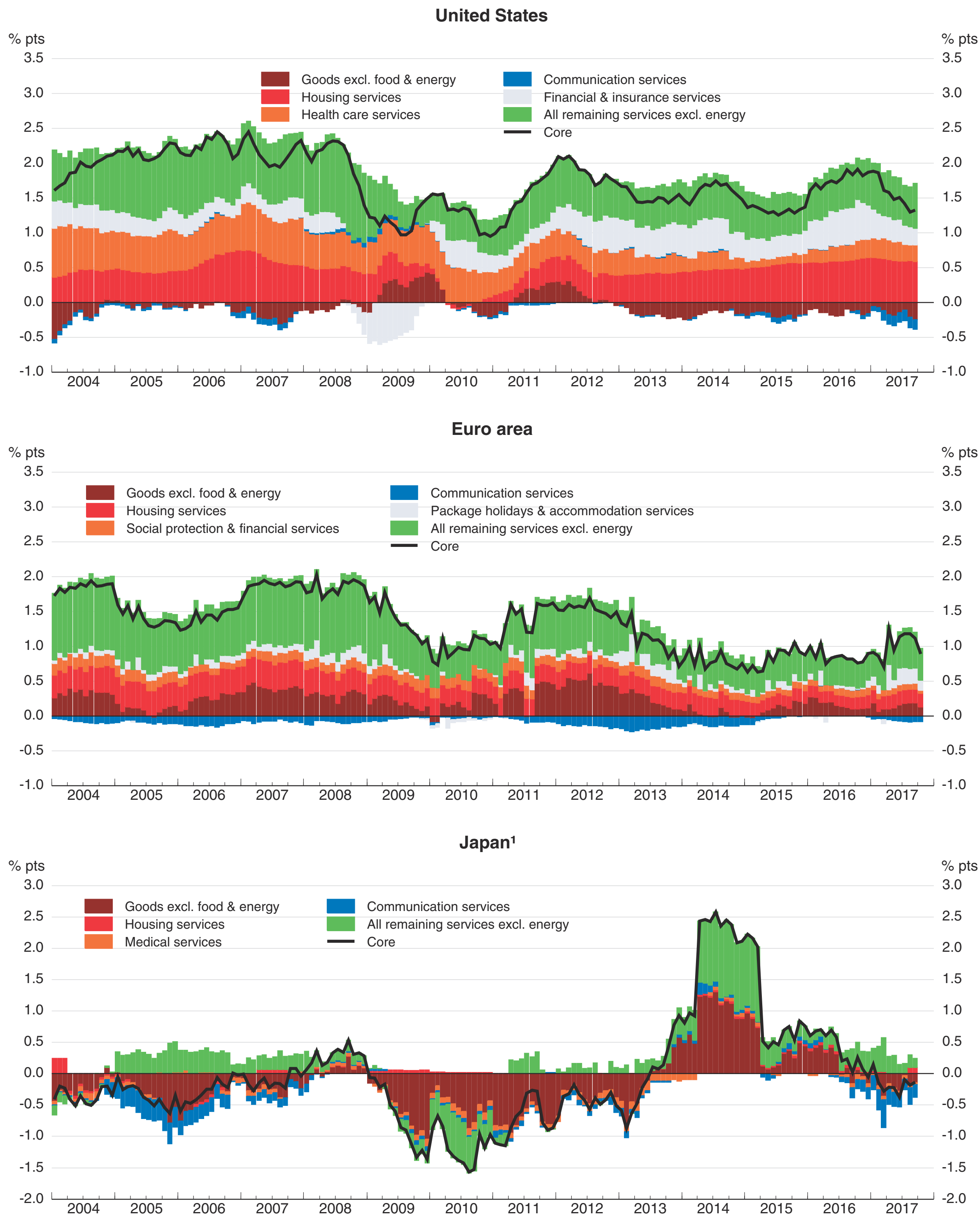
Figure 1.16. **Recent low core inflation has been driven by a mixture of idiosyncratic factors and longer-term trends**

Contributions to year-on-year core consumer price inflation in percentage points



1. Core inflation differs from the domestic definition and it excludes prices of energy and food. The spike in core inflation in Japan in 2014 is due the increase in the consumption tax rate.

Source: Ministry of Internal Affairs and Communications, Japan; Bureau of Economic Analysis; Eurostat; and OECD calculations.

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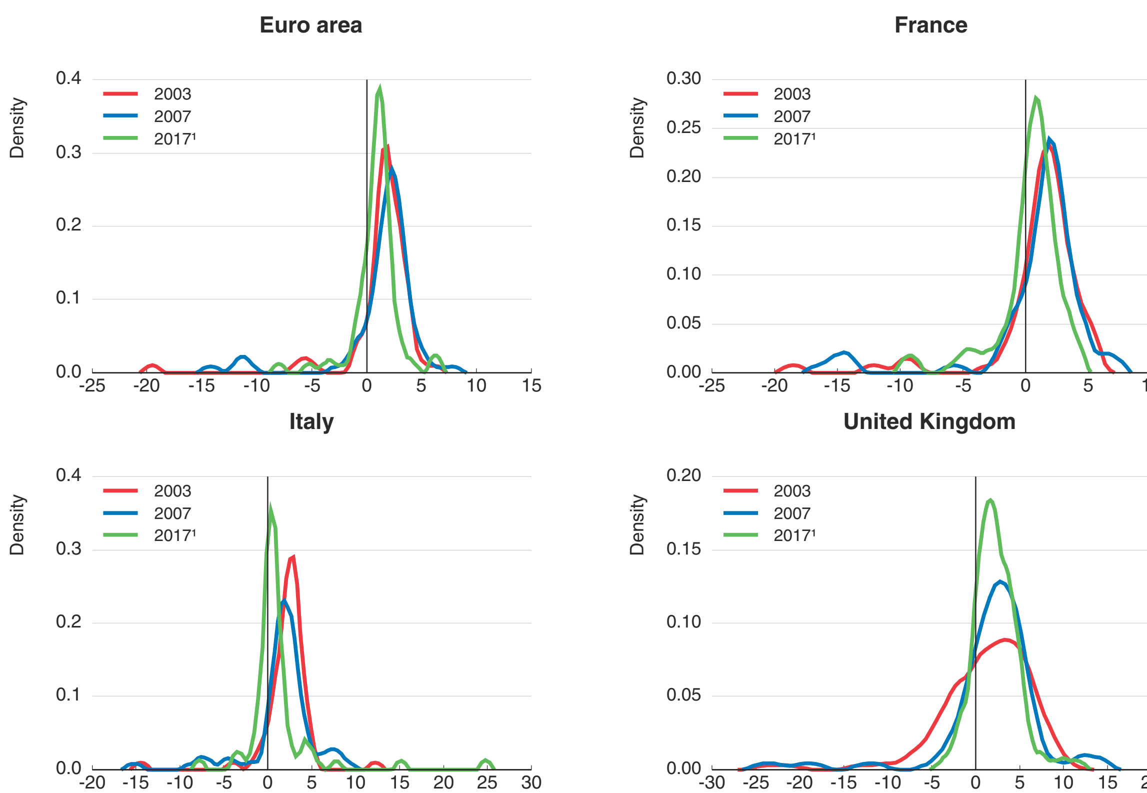
- Inflation expectations may have been weakened by the long period of low inflation in the past. In particular in Japan, continued core price inflation at around zero possibly reflects backward-looking inflation expectations of producers. Moreover, in several European economies, the mode of the distribution of price changes for disaggregated core inflation components has started to shift to the left since 2014-15 and become somewhat less dispersed compared to the pre-crisis period, possibly suggesting a convergence of price setting behaviour around a low level of inflation (Figure 1.17).[9]
- Country-specific factors are also pushing down inflation in the main advanced economies. The particularly striking recent moderation of inflation in the United States has been driven by the declining contribution of prices of financial services and low price increases in healthcare services, with the latter reflecting longer-term changes in regulation (Lorenzoni et al., 2017). In the euro area, although services price inflation has strengthened recently (largely due to one-off changes in prices related to tourism), it

Figure 1.17. **The distributions of disaggregated core inflation price changes have shifted and become less dispersed**



Note: Estimated distributions for price changes of core inflation components, i.e. excluding prices of food and energy, at 4-digit level of disaggregation at annual frequency.
1. 2017 figures are computed as the average changes from January to October 2017.
Source: Eurostat; and OECD calculations.

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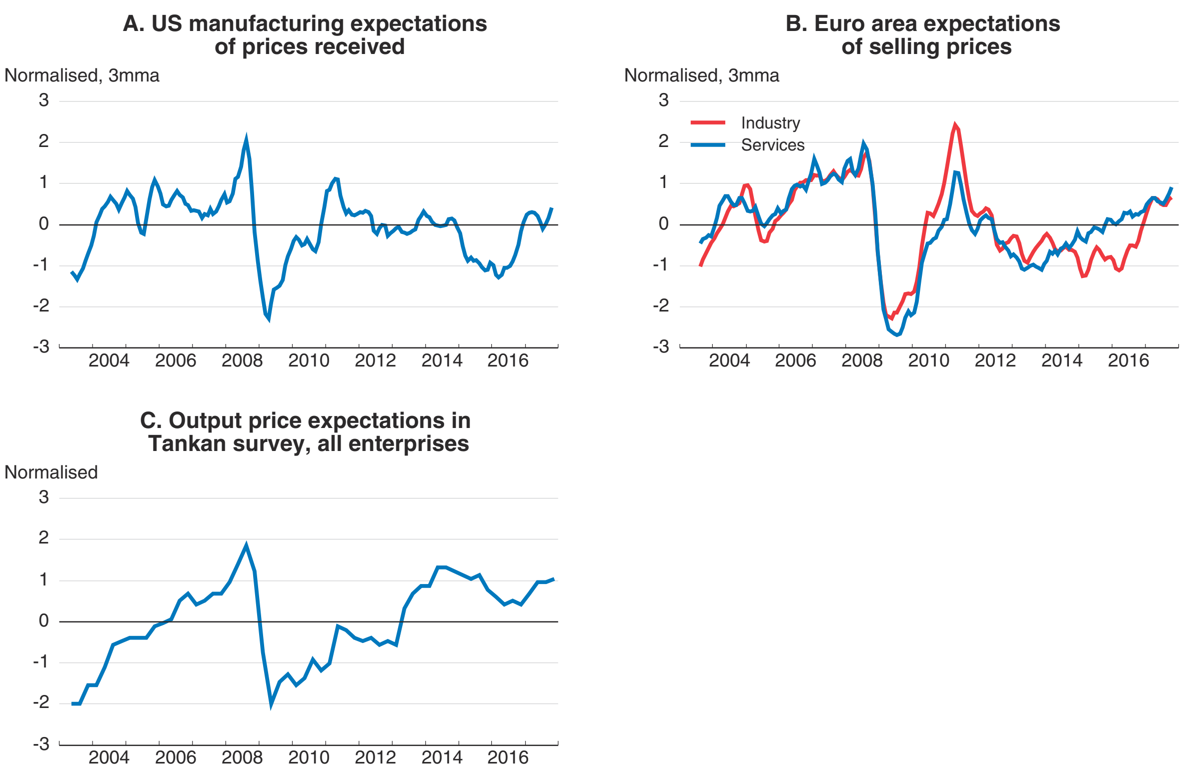
9. No similar shifts have been observed in Germany and the United States. The shifts have resulted also in a significant narrowing of the distribution of price changes weighted by their respective core inflation weights.

remains below pre-crisis levels, reflecting weaker dynamics of prices of services related to housing and a number of diverse categories of services.

In the large EMEs, inflation has generally eased this year, particularly in Brazil and Russia helped by past currency appreciation. In India, headline CPI inflation has also dipped below target, reflecting in part transitory factors including demonetisation, a good monsoon, large rebates before the rollout of the Goods and Services Tax and a strong rupee.

Median inflation in the advanced economies is projected to rise slightly to just below 2% by end-2019, increasing above the inflation objective in the United States but still remaining below target in the euro area and Japan (Figure 1.15).[10] Headline inflation will be driven by the recent increase in oil prices in the short term and then by somewhat stronger wage cost pressures stemming from improvements in the labour markets, although such wage pressure has been mostly modest so far. The rise in price inflation is consistent with the recent strengthening of corporate expectations about selling prices in the main OECD areas (Figure 1.18). However, inflation projections are subject to a high degree of uncertainty, given the tenuous relationship between prices and measures of economic

Figure 1.18. **Corporate expectations of selling prices have strengthened**



Note: 3mma stands for 3-month moving average.
Source: US Federal Reserve; European Commission; Bank of Japan; and OECD calculations.

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10. In Japan, the planned consumption tax increase in the last quarter of 2019 is estimated to boost year-on-year inflation by 1.1 percentage points.

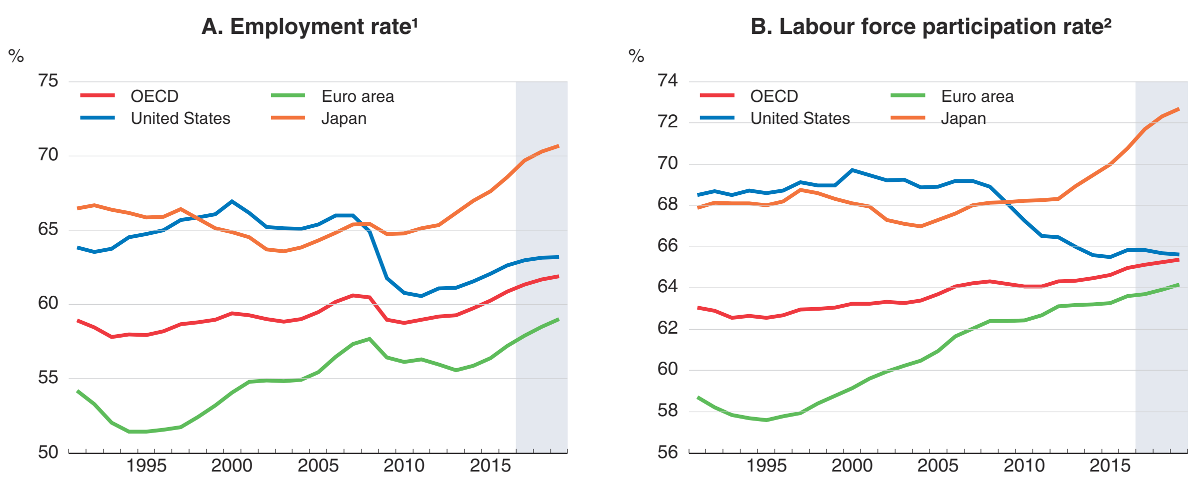
slack, and the over-predictions of inflation in the past two years.[11] In most EMEs, assuming unchanged exchange rates, inflation is expected to stabilise at low levels, reflecting the dissipation of recent price shocks and better-anchored inflation expectations. However, if monetary policy in advanced countries is normalised faster than projected, the ensuing depreciation of EMEs' currencies, unless there is complementary domestic policy tightening, could add to inflationary pressures.

Labour market outcomes remain uneven

Labour market performance continues to improve in the advanced economies but remains uneven. Employment and labour force participation rates in many countries are now above the levels prior to the crisis (Figure 1.19), helped by reforms that have raised activation, reduced pathways to early retirement, enhanced job creation and lowered barriers to female labour force participation. Outcomes in the United States are a notable exception amongst the major advanced economies, possibly associated in part with an increased incidence of poor health and disability, including rising opioid prescriptions (Krueger, 2017). In the OECD economies as a whole, the employment rates of older workers (aged 55 and above) have risen sharply, but prime-age and youth employment rates are only at, or still below, their immediate pre-crisis levels.[12]

Wage growth also remains modest in most major economies, despite higher employment rates and lower unemployment (Figure 1.20, Panel A). In the OECD economies overall, real wage growth is projected to remain moderate over 2017-19, at just over 0.6% per annum on average, up from 0.4% per annum on average in 2014-16

Figure 1.19. **Employment and participation rates are now rising in the advanced economies**



1. Employment as a percentage of the population aged 15-74.
2. Labour force as a percentage of the population aged 15-74.
Source: OECD Economic Outlook 102 database; and OECD calculations.

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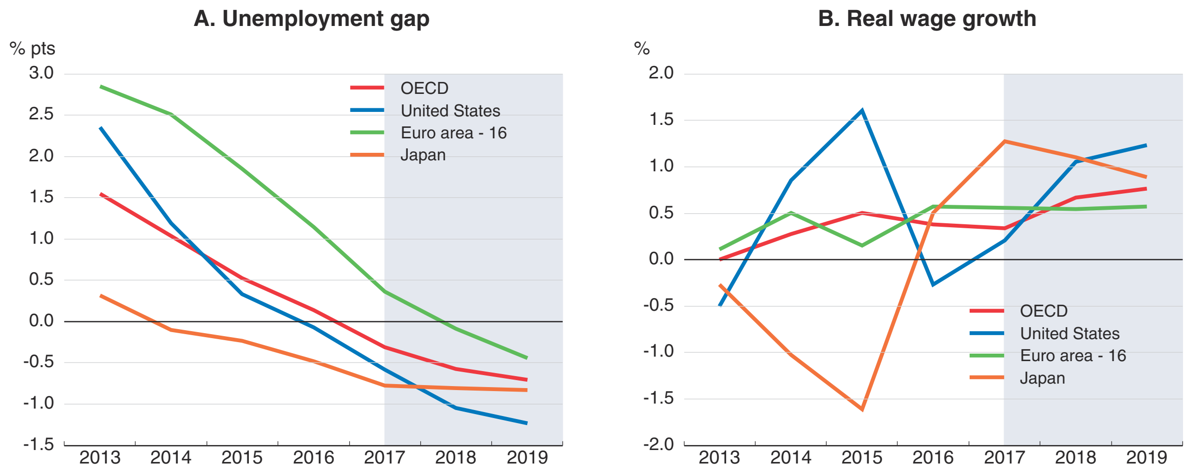
11. Two-year ahead consensus forecasts of headline inflation in 2015-16 were overestimated, on average by between 1 and 1¼ percentage points in the euro area, Japan and the United States.
12. The harmonised youth unemployment rate has however now declined to its pre-crisis level.

Figure 1.20. **Wage growth remains moderate despite declining unemployment**



Note: The unemployment gap is the difference between the unemployment rate (national definition) and the estimated structural unemployment rate. Nominal wages are measured as labour compensation per employee. Real wages are measured as nominal wages adjusted for the GDP deflator.
Source: OECD Economic Outlook 102 database.

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(Figure 1.20, Panel B).[13] This has contributed to popular dissatisfaction with economic performance, with many households having seen little growth in disposable incomes over the past decade, particularly at the lower end of the income distribution. In part, weak nominal wage growth can be accounted for by soft productivity growth and low inflation. Conventional headline measures of unemployment may also understate the extent of remaining cyclical slack in OECD labour markets (Cœuré, 2017; OECD, 2017c). Many countries still have a high rate of involuntary part-time work compared with the pre-crisis decade, implying that there is some scope to increase hours worked as demand strengthens.[14] In the OECD as a whole, the involuntary part-time rate in 2016 remained over 1 percentage point higher than in the pre-crisis decade, with a significantly larger gap in a number of European countries. There are also a comparatively high number of people only marginally attached to the labour market, but who might also return to the labour force if growth and job creation were to strengthen further.

Compositional effects from factors such as the increasing share of part-time jobs, rising female labour force participation and growing employment in low-wage service sectors may also have affected economy-wide wage growth in recent years (Broadbent, 2015; Daly and Hobijn, 2017). Across the OECD economies, the share of part-time employment in total employment rose by 2¾ percentage points over the period from 2000 to 2016.[15] In the same period, the share of women in total employment rose by

13. For the OECD economies overall, average annual real wage growth is just over 0.6% per annum in 2017-19 whether calculated on a producer wage basis (with nominal wages deflated by the GDP deflator) or a consumer wage basis (nominal wages deflated by the implicit household consumption deflator).
14. In contrast, economic part-time working has returned towards pre-crisis norms as the recovery has progressed.
15. Data on full-time and part-time employment based on a common definition of 30-usual weekly hours of work in the main job.

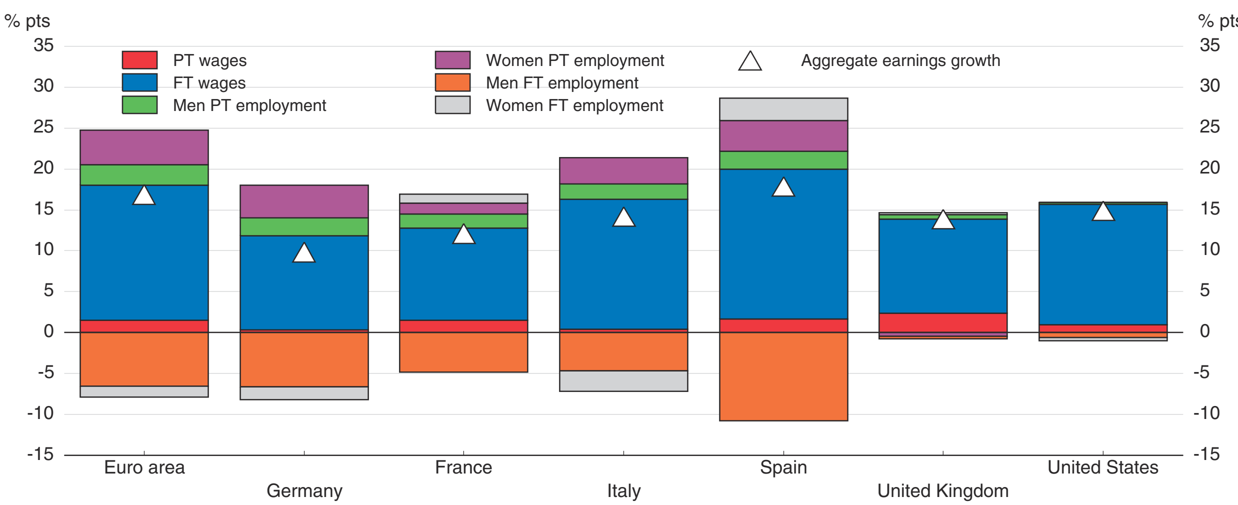
2 percentage points, with around two-thirds of the increase accounted for by female part-time employment.

An illustrative estimate of the impact of such compositional changes on economy-wide average pay growth over an extended period (averaging across all types of workers) can be obtained by breaking down changes in pay into the separate impacts from pay changes for each type of employment (full-time and part-time for men and women) and changes in the incidence of each type of employment at group-specific pay levels. The difference between the observed overall change in aggregate earnings and the sum of the pay changes for each category of employment provides an estimate of the net direct impact of compositional changes in employment (Figure 1.21).

- There are substantial absolute shifts in some European countries from compositional changes, especially from a lower incidence of full-time male employment.[16]
- However, the aggregate net direct impact of compositional changes on average pay of all workers over time appears to be relatively moderate, despite differences in the hourly pay rates of workers by gender and employment status.[17] The net estimates imply that compositional effects reduced the growth of average hourly (or weekly) pay in the aggregate euro area and the United States by around 0.1% per annum on average over the

Figure 1.21. **Compositional changes have had only modest net effects on the growth of average wages**

Contributions to the overall change in average wages in selected economies (2006-14 in all EU countries and 2008-16 in the United States)



Note: FT and PT refer to full-time and part-time respectively. The reference wage measure is average hourly pay in all EU economies and median weekly earnings in the United States. The EU data exclude public administration and enterprises with less than ten employees.
Source: Eurostat, Structure of Earnings Survey; Bureau of Labor Statistics, Current Population Survey; and OECD calculations.

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16. These compositional shifts may also help to account for the flattening of wage Phillips curves in recent years (OECD, 2016b).
17. Compositional effects could also affect the change in total earnings (earnings per hour multiplied by the number of hours worked) depending on changes in the annual hours (or weeks) worked by each category of employment. It may also be the case that the rising number of part-time and temporary workers has reduced the bargaining power of full-time workers, and hence wage growth, and that there are stronger effects in some sub-periods within the sample used.

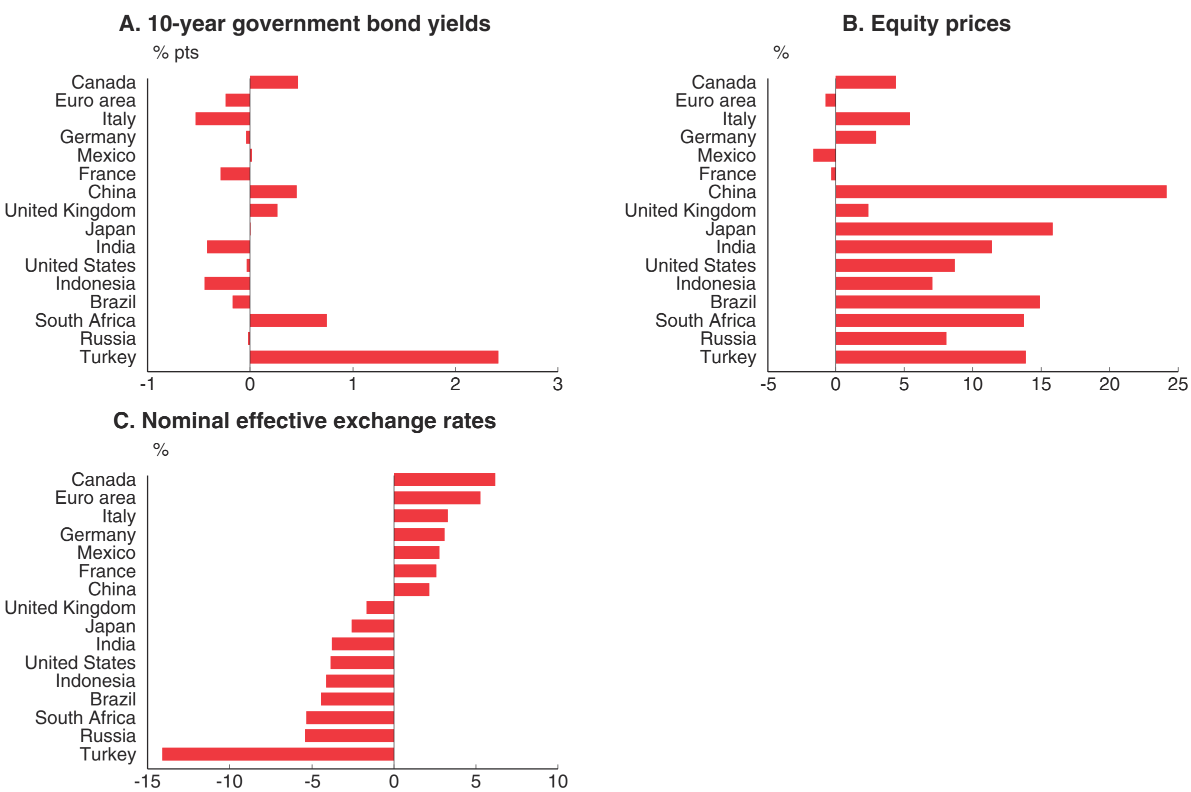
period shown.[18] The effects in a number of individual euro area countries were larger, at around 0.2% per annum on average, reflecting larger declines in the share of male workers in full-time employment.

- Related estimates for Japan, where compositional changes in the structure of employment have been relatively large and aggregate pay growth has been relatively weak, suggest that the rise in the number of part-time employees may have held down the growth of scheduled cash earnings by around ¼ percentage point per annum over 2015-16, and by between ½ and ¾ percentage point per annum over 2012-14 (Bank of Japan, 2017).

Financial conditions remain accommodative but risks of sudden tightening persist

In many advanced economies, long-term government bond yields have remained low since early May (when the assumptions for the last OECD *Economic Outlook* were set) (Figure 1.22). In several European economies and Japan, between half and three-quarters of government bonds still trade at negative yields. Continued low bond yields seem to reflect investors' expectations that policy interest rates will remain very low and that term premia

Figure 1.22. **Changes in bond yields, equity prices and exchange rates since early May**



Note: Changes between 4 May and 23 November 2017. An increase in the nominal effective exchange rate implies its appreciation.
Source: Thomson Reuters; OECD Exchange rate database; and OECD calculations.

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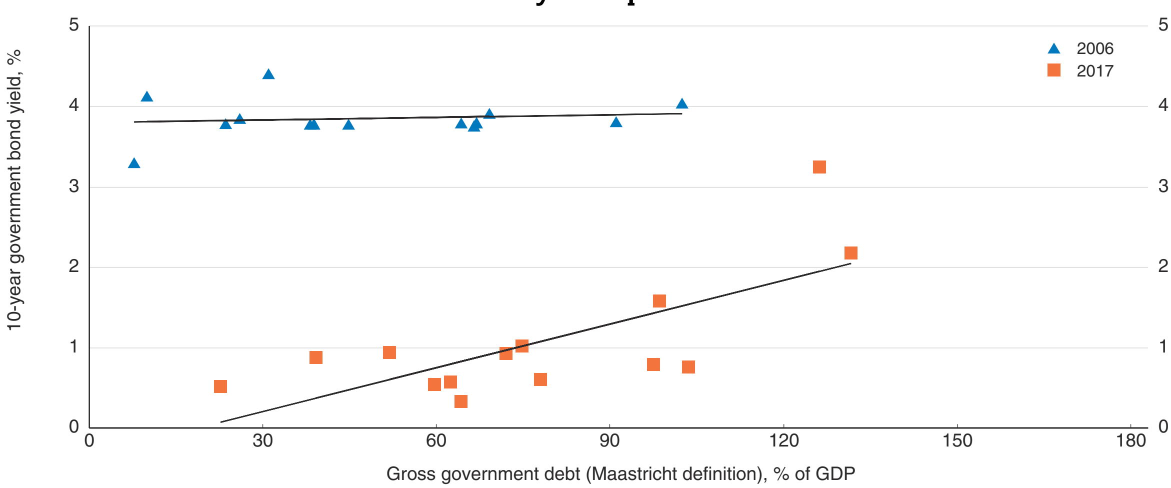
18. Average pay per hour in the euro area and median weekly earnings in the United States rose by 16.9% and 14.9% between 2006-14 and 2008-16 respectively, implying average annual growth of 2% and 1.75% respectively.

for government bonds will continue to be compressed in coming years. But this could change as the normalisation of monetary policy advances, prompting investors to adjust their expectations.[19] Moreover, as central banks become net sellers of government bonds, sovereign premia could also increase. In the euro area, long-term interest rates currently better reflect differences in government indebtedness than did spreads prior to the crisis, but sovereign premia could increase further in countries with high debt once the ECB stops government bond purchases (Figure 1.23).

Equity prices have risen in the main advanced economies, in several cases to post-crisis highs, helped by the broad-based upswing in global growth, higher corporate profits and, in some countries, weaker currencies against the background of still low interest rates and sustained risk-taking (Figures 1.22 and 1.24). However, the "improvement" may also reflect vulnerability. In the United States and the euro area, price-to-earnings ratios exceed historical averages, pointing to a potential overvaluation and risks of a future correction. Moreover, in the United States, perceived risks of a large decline in the S&P 500 index, as measured by the SKEW index, have risen.

Strong risk appetite is also evident in corporate bond markets in the euro area and the United States,[20] with spreads between high-yield corporate and government bond yields remaining at levels close to recent lows in 2014, despite their recent pick-up (Figure 1.25), and bond issuance remaining high (Figure 1.26). In the United States, non-financial corporations have issued more than USD 0.7 trillion of bonds so far this year, and 2017 is likely to be a third consecutive year of around USD 0.8 trillion (4.5% of GDP) issuance. Moreover, there has been a further decline in the quality of covenants that protect the

Figure 1.23. **Long-term bond yields in the euro area reflect differences in government debt more closely than prior to the crisis**



Note: Only OECD euro area member countries, excluding Greece. Government bond yields are annual averages. 2017 numbers refer to the OECD projections.
Source: OECD Economic Outlook 102 database.

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19. For instance, if term premia were to increase to their pre-crisis levels in the United States, bond yields would go up by nearly 90 basis points, which studies show could result from the normalisation of the Federal Reserve's balance sheet (Bonis et al., 2017a, b). In addition, if policy interest rates in the United States were to evolve in line with FOMC median expectations rather than those implied in financial market prices, the US 10-year yield would rise by around 60 basis points.
20. This is discussed further in Chapter 2.

Figure 1.24. **Equity market performance**

15-day moving average

1. Normalised values based on as long as possible historical averages expressed in standard deviations.
2. The Chicago Board Options Exchange (CBOE) SKEW is an option-based measure of the perceived risk of 30-day ahead large (two or more standard deviations) changes in returns of the S&P500. Numbers above 100 indicate a negative skew in the distribution (i.e. negative tail risk). Since the standard deviation varies over time, so does the size of expected equity price declines.

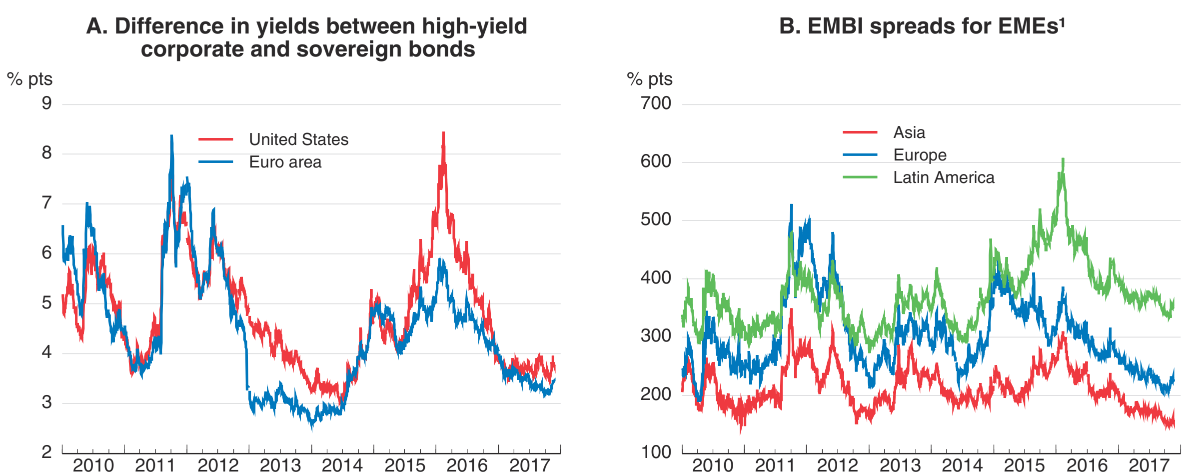
Source: Thomson Reuters; and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933630924

interests of holders of non-investment-graded bonds, including in the United States.[21] The share of non-investment-graded bonds in total corporate bond issuance has also been rising since the financial crisis (Chapter 2).

Measures of implied volatility have declined to very low levels and indicators of systemic stress remain subdued, but they may underestimate risks (Figure 1.27). Current low levels of volatility indices are broadly in line with the low perceived uncertainty of

Figure 1.25. **Risk-taking in bond markets persists**



1. EMBI stands for J.P. Morgan Emerging Market Bond Index.

Source: Thomson Reuters; and OECD calculations.

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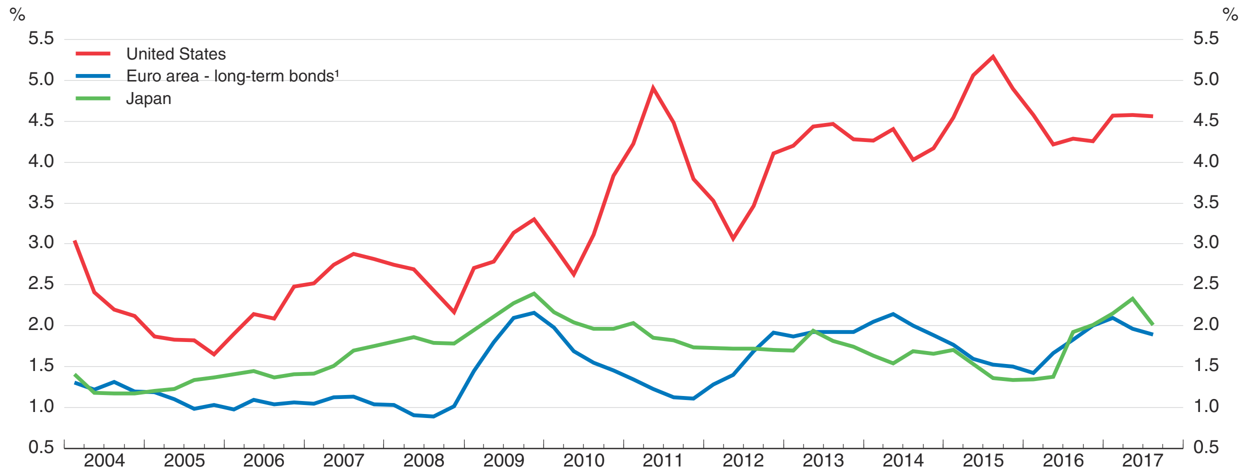
21. Moody's US high-yield bond covenant quality measure was close to a record low in October, see Moody's Investors Service, *Global Credit Research*, 14 November 2017.

Figure 1.26. **Gross issuance of bonds by non-financial corporations has been strong**

Annual moving sum in per cent of annual GDP



1. Long-term bonds refer to bonds maturing in more than one year.

Source: OECD Economic Outlook 102 database; US Federal Reserve; ECB; Japan Securities Dealers Association; and OECD calculations.

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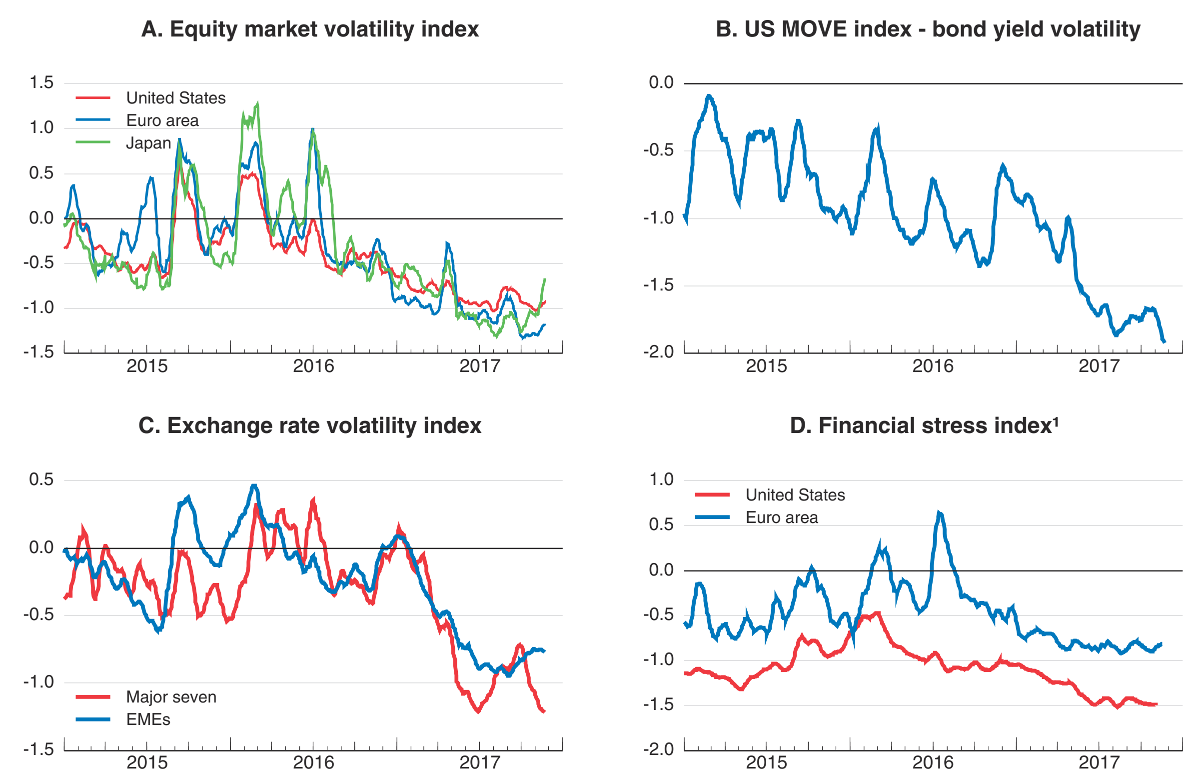
Figure 1.27. **Volatility in financial markets has remained subdued**

15-day moving average of normalised values, in standard deviations



Note: The equity market volatility indices measure an expected symmetric range of movements in the main equity indices over next 30 days. They are derived from options. The Merrill Lynch Option Volatility Estimate (MOVE) index and exchange rate volatility index are equivalents of the equity market volatility index for US Treasuries and exchange rates, respectively.

1. The financial stress index is the Composite Indicator of Systemic Stress for the euro area and the St. Louis Fed Financial Stress Index for the United States. Lower values of the indices imply less financial stress.

Source: Thomson Reuters; and OECD calculations.

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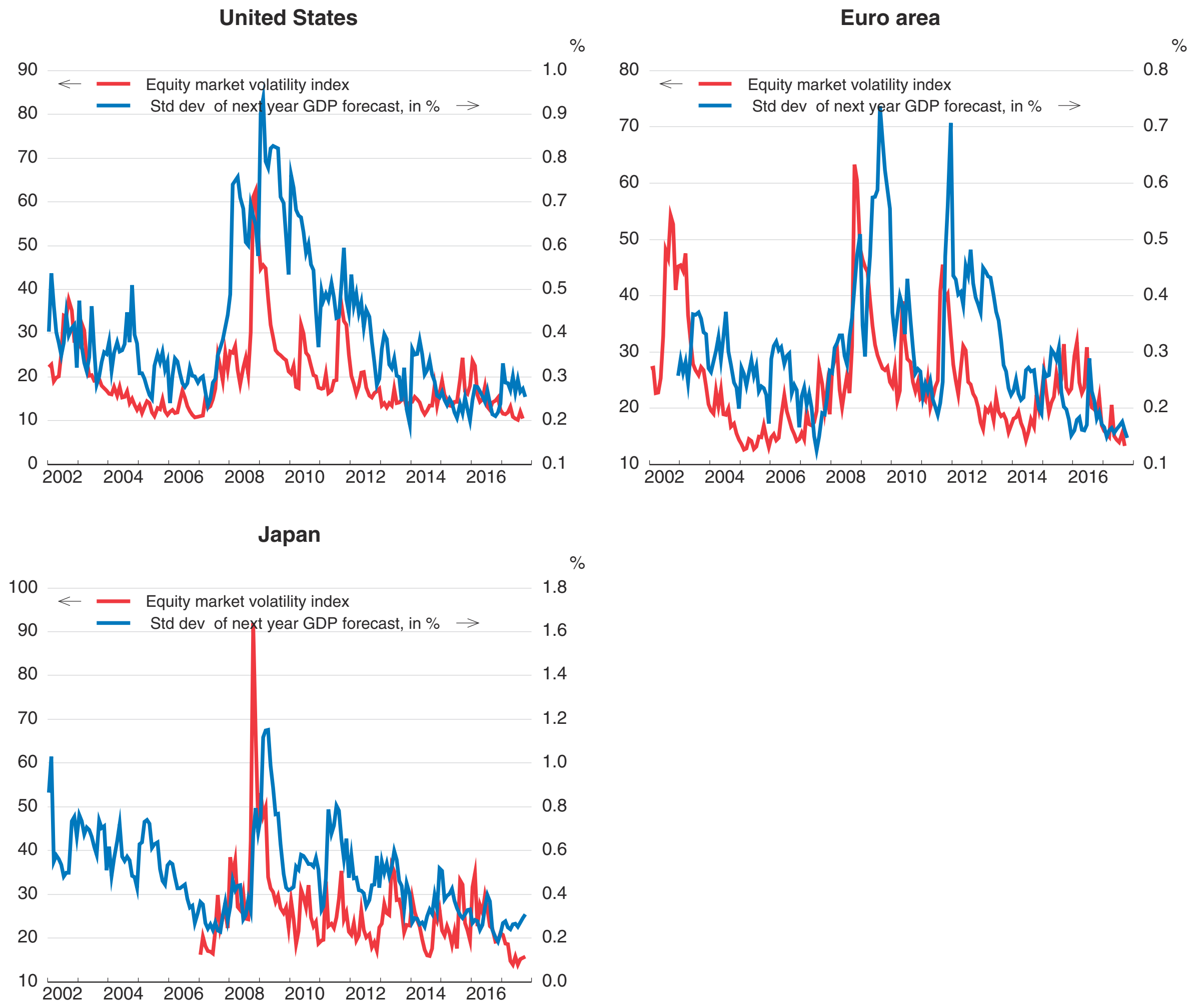
future economic growth, especially in the United States, suggesting perceptions of unusually low risks in financial markets and the real economy (Figure 1.28). Financial market volatility indices, however, tend to be strongly affected by actual volatility and are not necessarily good predictors of future volatility. Prolonged low volatility, together with a low and flat yield curve, tends to induce higher risk-taking and thus make the financial system more fragile (OFR, 2017). Riskier exposures could be encouraged through lowering asset-return correlations, enticing investors to diversify investments by buying riskier assets, and risk management practices based on Value-at-Risk or volatility control.[22] Such pro-cyclical strategies could amplify asset price corrections and volatility if market sentiment suddenly changes.

Figure 1.28. **Low volatility is broadly in line with the low perceived uncertainty of future economic growth**



Note: "Std dev" stands for standard deviation.
Source: CBOE; Consensus Economics; and OECD calculations.

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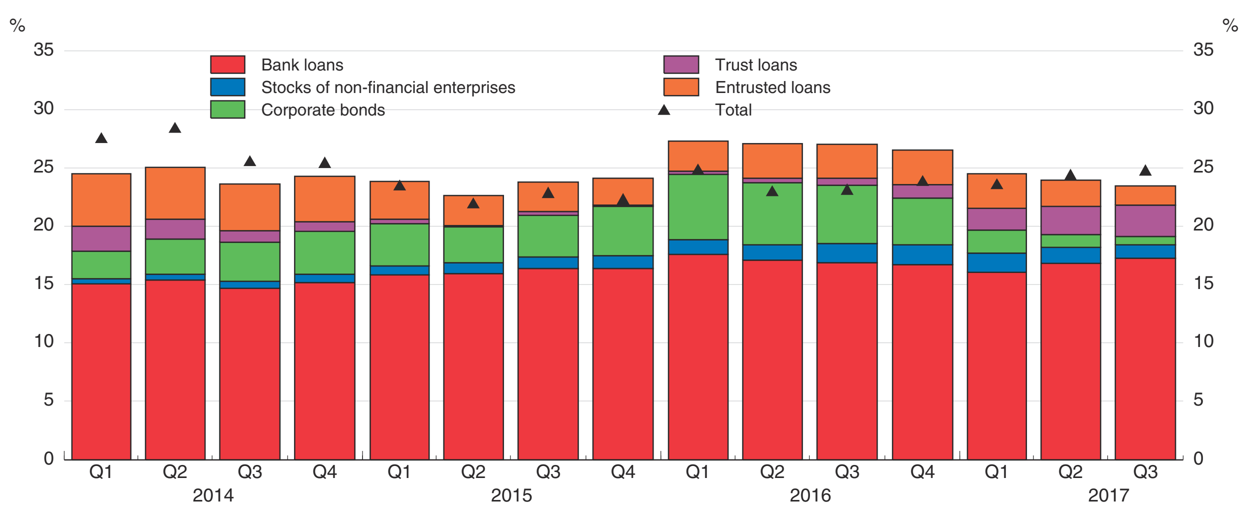
22. Value-at-Risk and volatility control are methods to manage investment risks based on the recent volatility of asset prices. With the Value-at-Risk method, investment positions are adjusted to limit the potential loss based on a probability of the maximum potential loss during a given period, which is positively related to the volatility. With volatility control, the allocation between risky and safe assets is dynamically adjusted so that the volatility of the total value of investment stays in line with a pre-determined benchmark.

Turbulence in equity markets may also be accentuated by increased index-linked trading, used in particular by exchange-traded funds (ETFs). The assets under management of ETFs have grown by 27% since the beginning of 2017 and have reached USD 4.3 trillion globally (ETFGI, 2017), representing more than 5% of global market capitalisation. The nature of ETFs, namely low transaction costs and high intraday liquidity, has attracted investors to invest in such funds instead of the underlying assets. However, when the underlying assets are less liquid than the ETFs, the funds can amplify market volatility. Similarly, volatility could be heightened by investors in ETFs that are driven by short-term returns. Demand from such investors usually evaporates during market turmoil (Cella et al., 2013) and equity prices of companies included in the same index tend to be strongly correlated during market turmoil (Da and Shive, 2014).

Financial conditions have tightened in China but eased in other large EMEs amid continued risk-taking. In China, this primarily resulted from macro-prudential and deleveraging measures, targeting in particular the shadow banking system. Nevertheless, total social financing flows in relation to GDP have remained robust (Figure 1.29). In many other EMEs, equity prices have increased and currencies have depreciated (Figure 1.22). Moreover, in some economies, the monetary policy stance has been eased and longer-term interest rates have declined, especially in India and Indonesia (Figure 1.22). Sovereign bond yield spreads vis-à-vis US Treasuries have declined to or below the levels last seen in 2014 in Asian and European EMEs (Figure 1.25). Capital is reported to have continued to flow into EMEs at a similar pace as in 2016, following short-lived capital outflows at the turn of the year. The increased risk tolerance of global investors has also allowed sub-prime sovereigns to issue debt at favourable rates. However, EMEs continue to be exposed to vulnerabilities, relating to recent rapid credit growth, especially in China, the exchange rate exposures of non-financial corporations and shifts in investors' sentiment (OECD, 2017c; Chapter 2).

Figure 1.29. **Total social financing flows in China remain robust despite the tightening of financial conditions**

4-quarter moving sum of flows over 4-quarter moving sum of GDP



Source: OECD Economic Outlook 102 database; Thomson Reuters; and OECD calculations.

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Policy measures need to catalyse a private sector response

In advanced economies, the firming and broadening recovery and financial stability risks call for a gradual normalisation of monetary policy, but to a varying degree across the main areas. This should be accompanied by further rebalancing of the policy mix towards fiscal policy changes and structural policy packages that strengthen potential output, building on the welcome initiatives taken in a number of countries in the past year. The monetary policy normalisation process will need to be calibrated against the financial market response, realised and expected inflation, and the need to support growth. Fiscal policy easing in 2018 should be implemented as planned, but with an increased focus on measures that enhance support for long-term supply potential and inclusive growth. A more active use of structural measures is necessary to create the environment in which business investment will strengthen to promote productivity growth, and thus the growth of real wages. Improved potential output is essential to underpin fiscal sustainability and living standards in the longer term. EMEs should adjust macroeconomic policies in line with macroeconomic developments, address vulnerabilities related to the build-up in private sector indebtedness in view of prospective tighter financial conditions in advanced economies (Chapter 2), and buttress the structural underpinnings of longer-term growth. In all countries, measures are required to ensure that the benefits of economic growth are more equally distributed within societies.

Monetary policy should be data driven, considering real, financial and price dynamics

Monetary authorities in the main advanced economies face the challenge of calibrating policy stances against a backdrop of stronger near-term growth momentum and narrowing economic slack, but not yet sufficiently strong inflationary pressures, insufficient improvement in supply-side potential, and still-high political and economic risks. Uncertainty about inflation dynamics and financial market developments calls for a multiple indicator, data-driven strategy for normalising monetary policy. Identifying and explaining the reasons for recently-subdued inflation rates will be key for central banks' decisions and communication. If inflation is currently held down by forces which are beyond the control of national central banks (like positive technological shocks, regulation or global forces), it would in principle justify a delayed and slower withdrawal of monetary policy stimulus than otherwise. However, given the already lengthy period of a very expansionary monetary policy stance, this could aggravate mispricing of asset prices and may not be warranted. In such a case, some undershooting of inflation targets may have to be tolerated but should be clearly communicated as being related to exceptional circumstances. By the same token, should inflation rise if non-linearities in the relationship between labour markets, prices and wages emerge, an over-shooting of the inflation objective should not engender a sharp response.

The large balance sheets of key central banks, following years of quantitative easing, raise questions about the sequencing of decisions regarding central bank assets and policy interest rates. The US Federal Reserve, after having stopped net asset purchases at end-2014, has raised the policy rate gradually by 100 basis points since December 2015 and initiated a plan to gradually scale back reinvestments of maturing securities in a predictable way.[23] This

23. As of October 2017, principal payments from maturing securities are planned to be reinvested only if they exceed gradually rising caps (from USD 6 billion per month to USD 30 billion for Treasuries and from USD 4 billion per month to USD 20 billion for agency debt and mortgage-backed securities (MBS); caps for agency debt and MBS may stop being binding before reaching the maximum cap (Federal Reserve Board, 2017; Federal Reserve Bank of New York, 2017).

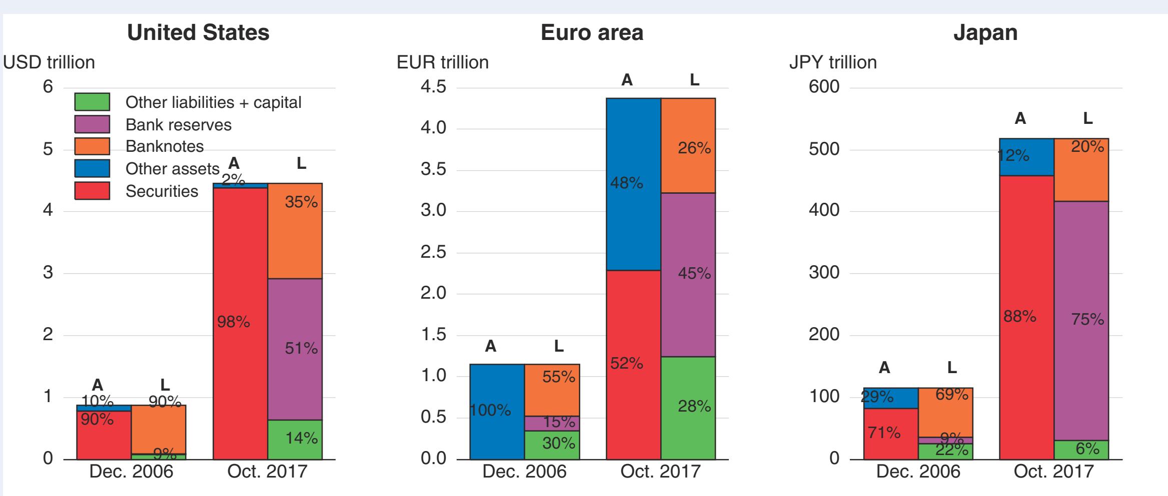
strategy has advantages and so far has not led to market disruptions. Effects of asset reductions on financial conditions are likely to be more uncertain than those of policy rate changes, if for no other reason that central banks have greater experience with using policy rates (Bernanke, 2017). It would also be easier to reverse any rise in policy rates, compared with an asset reduction, if growth were to moderate too quickly. The US normalisation strategy may serve as a blueprint for the ECB and the Bank of Japan,[24] which are still increasing assets held, though they may decide on different modalities to reflect area-specific circumstances.

The normalisation of monetary policy raises questions also about the ultimate size of balance sheets and instrument use in the future (Inaba et al., 2015; Box 1.2). The authorities can opt either for returning to the pre-crisis practice of controlling overnight interest rates with small balance sheets or for using the interest rate on banks' reserves at the central bank as a floor for market rates with large balance sheets, as in recent years. The floor

Box 1.2. **Future monetary policy frameworks and the size of central banks' balance sheets**

Given extraordinary monetary policy stimulus in the aftermath of the 2008 financial crisis, the size of major central banks' balance sheets and their composition have changed significantly (figure below). In the process of policy normalisation, the balance sheets are likely to be reduced but their ultimate size will depend primarily on the type of the future operational framework. The size of balance sheets will also be affected by the demand for banknotes. This box discusses different operational frameworks and the possible evolution of public demand for banknotes.

The size and composition of central banks' balance sheets have changed massively over the past decade



Note: "A" stands for assets, "L" stands for liabilities.
Source: Federal Reserve; European Central Bank; and Bank of Japan.

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24. The ECB has already announced elements of a similar strategy, involving a reduction of asset purchases and a commitment to keep interest rates low well past the end of asset purchases.

Box 1.2. **Future monetary policy frameworks and the size of central banks' balance sheets** *(cont.)*

Overview of operational frameworks of monetary policy

The corridor system has become a dominant operational monetary policy framework since the Bank of Canada first adopted it in 1994. The name derives from its feature of formulating a corridor of interest rates by putting a ceiling and a floor on short-term interest rates with standing lending and deposit facilities, respectively.[1] In the corridor system, central banks provide short-term liquidity (reserve balances) to neutralise aggregated liquidity imbalances of financial institutions, with liquidity distributed through the banking system via money markets. When liquidity provision is insufficient, short-term interest rates may go up to the ceiling, and vice versa. The corridor systems have been often combined with reserve requirements, helping stabilise day-to-day fluctuations in market demand for reserve balances and making it easier for central banks to predict demand.

A possible variant to the corridor system with still small reserve balances, not currently adopted by any major central bank, is the zero-corridor system where financial institutions are always allowed to obtain enough liquidity and to deposit all the excess liquidity at central banks' target rates without penalty. Therefore, financial institutions do not have any incentive to maintain precautionary reserve balances and central banks do not need to provide liquidity through market operations.

Another variant to the corridor system is the floor system. Under the floor system, central banks maintain short-term interest rates at the floor rate by deliberately supplying ample reserves in excess of market demand. Central banks that have expanded their balance sheets in recent years have been effectively operating the floor system.

In terms of the size and fluctuations of reserves, balances are the largest under the floor system, with little day-to-day fluctuations. In this framework, central banks can change the size of reserve balances without affecting short-term interest rates. In contrast, balances are significantly smaller under the corridor and zero-corridor systems and fluctuations are usually bigger. Reserve balances are likely to be slightly larger under the corridor system accompanied with reserve requirement arrangements than in the zero-corridor system. With the zero-corridor system, the size of reserve balances fluctuates with changes in demand from financial institutions.

Short-term market interest rates are best controlled in the zero-corridor and the floor systems. They may fluctuate considerably in the corridor system unless central banks intervene in money markets intensively. As a consequence, money market activity would be very limited under the floor system, in contrast to the corridor system. Well-functioning money markets are valuable for signalling liquidity and credit conditions. Under the zero-corridor system, allowing easy access to central banks' standing facilities is likely to reduce the stigma of using central banks' lending facilities. This is beneficial in case of market disruption, but may cause moral hazard in normal times.

Larger reserve balances under the floor system can contribute to financial stability. Ample reserves can work as a buffer in event of market liquidity shocks and could weaken, or crowd out, excessive short-term financing among private sector participants by satisfying the demand for safe short-term assets (Greenwood et al., 2016). On the other hand, larger reserve balances, probably with a high amount of government debt holdings, may induce higher political pressure on central banks. This could be motivated, among other things, by large fluctuations in net interest income and possible financial losses, since changes in policy interest rates pass through faster to the remuneration of reserve balances than to revenues from assets. These potential losses could be minimised by keeping the maturity of central banks' government bond holdings short.

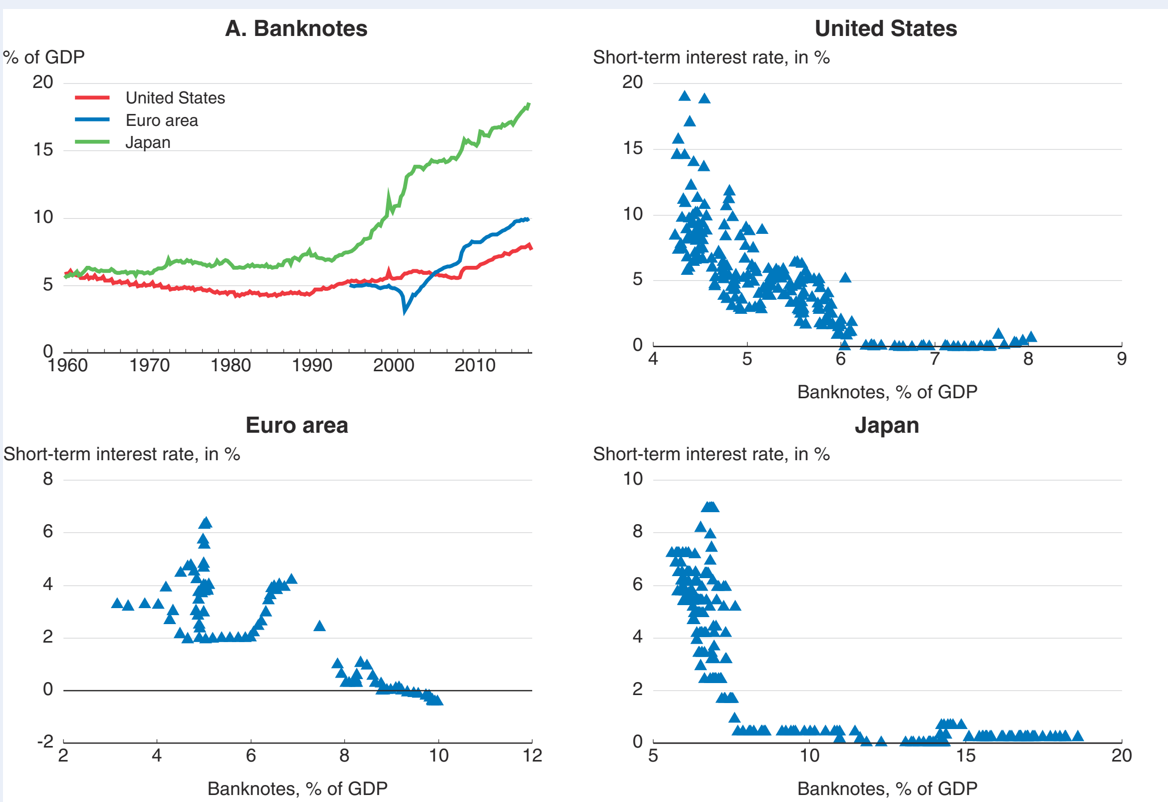
Each framework has advantages and disadvantages and each could serve in the future as the main operating framework. The increasing focus on financial stability issues and currently-large balance sheets tend to favour the floor system. Maintaining the floor system and the associated large holdings of government bonds by central banks would also avoid the potential instability in financial markets that might occur if central banks were to reduce their balance sheets.

Box 1.2. **Future monetary policy frameworks and the size of central banks' balance sheets** *(cont.)*

The effect of interest rates on the amount of banknotes

The amount of banknotes outstanding has increased significantly over the past decade (figure below). This change has been driven by public demand and has not been directly affected by quantitative easing policies. However, monetary policy has likely affected the demand for banknotes through interest rates, as these determine the opportunity cost of holding cash.[2] The amount of banknotes was negatively related to interest rates before rates reached the zero lower bound in the main OECD areas (figure below). Since then, the prolonged period of very low interest rates might have undermined incentives to place deposits with banks and thus contributed to the growth in banknotes. Once the normalisation of interest rates is well underway, this could possibly imply that the amount of banknotes outstanding as a percentage of nominal GDP will decline to the level prevailing when interest rates were well above zero. Even in such a case, however, the nominal amount of banknotes outstanding is likely to remain at recent levels in the United States, as long as the economy grows steadily. Consequently, this would impose a minimal level of central bank assets.

Changes in the amount outstanding of banknotes



Note: For the United States and the euro area, amount outstanding of banknotes are approximated by currency in circulation.
Source: Federal Reserve; European Central Bank; Bank of Japan; and OECD calculations.

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1. Although any framework with those facilities can be classified as the corridor system, hereafter the term refers to a system under which a central bank sets its policy interest rate somewhere between the ceiling and floor, in order to distinguish it from variants such as the floor system or the zero-corridor system.
2. The amount of US banknotes is also affected by changes in foreign demand, especially from EMEs. Foreign demand has increased since the financial crisis due to higher uncertainty about the global economy (Banegas et al., 2015).

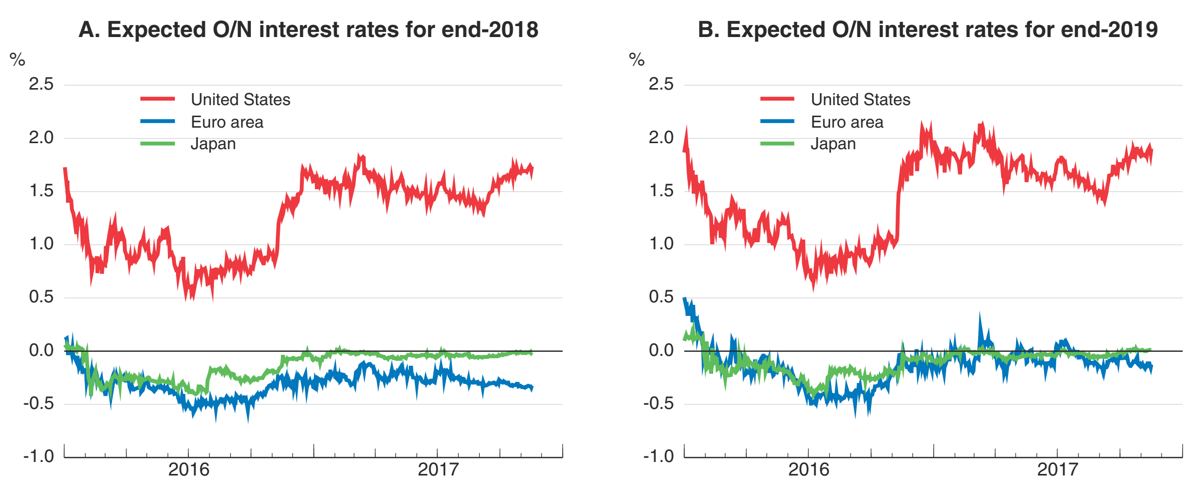
framework would require a calibration of the optimal size of balance sheets, which is challenging given the lack of clear criteria.

The need for a gradual removal of monetary stimulus differs among the main advanced economies, and this is reflected in expectations of interest rates in financial markets (Figure 1.30).

- In the United States, the Federal Reserve should, as planned, continue with a gradual increase in policy rates and a gradual reduction of its balance sheet. Even with the announced pace at which the proceeds of maturing securities cease to be reinvested, the decline in Federal Reserve's balance sheet in nominal terms might be relatively short-lived and not very large (Figure 1.31). This reflects a likely higher level of banknotes and reserve balances needed to satisfy demand for short-term safe assets and transactions.
- In the euro area, if realised and expected inflation strengthens with improving labour markets, the ECB should gradually taper asset purchases in 2018 in order to ultimately stop increasing the balance sheet. Decisions to increase policy rates should be deferred until 2020.
- The Bank of Japan should continue its current stimulus in order to achieve the inflation target. Maintaining asset purchases lowers the servicing costs of Japan's elevated and rising government debt and thus prevents the tightening of financial conditions that could otherwise occur with rising fiscal risks. A rethinking of the monetary policy strategy would, however, be needed if the inflation target is not met for a prolonged time, the Bank of Japan becomes an even more predominant holder and buyer of government bonds and financial intermediation and stability become compromised.[25]

Short-term monetary policy requirements differ also among the largest EMEs. A continuation of monetary policy easing is warranted in Brazil and Russia, given declining inflation and the moderate recovery, and also in India, provided that inflation remains low. In China, monetary policy should aim to reduce the heavy reliance of economic growth on

Figure 1.30. **Markets expect policy interest rates to differ among the main economic areas**



Source: Bloomberg; and OECD calculations.

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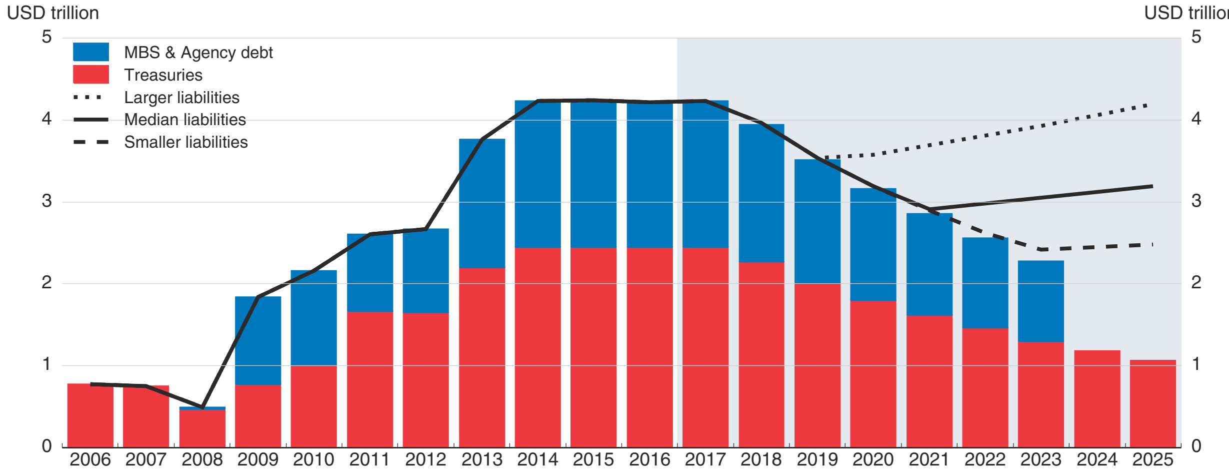
25. The Bank of Japan is likely to own more than half of Japanese government bonds in the market by the end of 2019, even at the reduced pace of purchases after the introduction of yield curve control in September 2016.

Figure 1.31. **Projections of the US Federal Reserve balance sheet**



Notes: Figures for 2006-2016 are historical settled holdings. Smaller and larger liabilities projections are based, respectively, on the 25th percentile and 75th percentile responses to a question about the size and composition of the Federal Reserve's long-run balance sheet in the New York Fed's June 2017 Survey of Primary Dealers and Market Participants.
Source: Federal Reserve Bank of New York; and OECD calculations.

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credit, thus targeting actions toward reducing the risks stemming from the significant accumulation of corporate and local government debt. The challenge for the Chinese authorities is to strike a balance between supporting demand and containing high risks to financial stability.

Structural and fiscal initiatives are still needed to boost potential growth

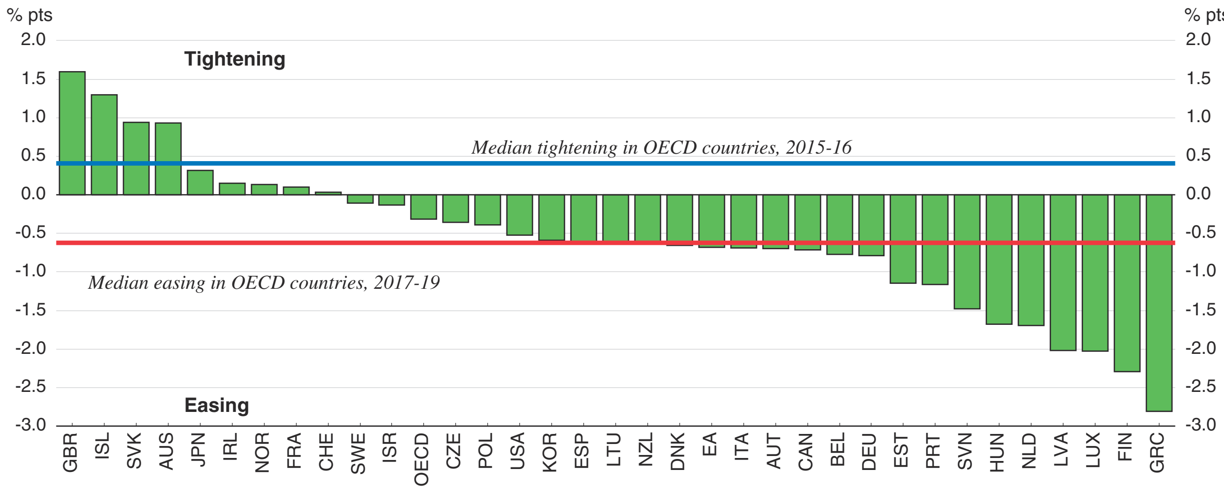
The fiscal policy stance is being eased in the majority of advanced economies as governments take advantage of the increase in the fiscal space offered by low borrowing costs. In the median OECD economy, a fiscal easing of just over ½ per cent of GDP is projected to occur over 2017-19, with the main boost in 2017 and 2018, after consolidation of around ½ per cent of GDP over 2015-16 (Figure 1.32). Despite the expected easing in many OECD countries, overall budget balances are projected to improve between 2017 and 2019, reflecting lower net interest payments and stronger cyclical momentum (Figure 1.33). Government gross interest payments have already declined between 2011 and 2017, even in many OECD countries with rising debt and even on a net basis, i.e. accounting for interest earnings on government financial assets (Figure 1.34).

How vulnerable are fiscal conditions to a rise in interest rates? Stylised simulations for the largest advanced economies (excluding Japan) suggest that even a lasting increase in 10-year government bond yields of 1 percentage point compared with the current *Economic Outlook* projections might worsen budget balances on average by only between 0.1% and 0.3% of GDP annually in the following three years.[26] Moreover, these estimates do not take

26. The budget impact is calculated as the increase in interest payments that would occur cumulatively in the following three years if the long-end of the yield curve increases permanently by 1 percentage point, while the short-end remains unchanged compared with the baseline and the yields in between adjust linearly. The increase in 10-year yields could be prompted by market participants expecting higher policy interest rates, normalisation of term premia or higher fiscal risk premia. These stylised calculations assume that higher interest rates have no effect on nominal growth and the primary balance and that the maturity structure of new debt issues is the same as the remaining maturity of government debt as of October 2017. Higher interest rates are assumed not to be passed through to returns on government financial assets.

Figure 1.32. **The fiscal stance is expected to ease in many OECD countries**

Change between 2016 and 2019 in the underlying primary balance, as a percentage of potential GDP



Source: OECD Economic Outlook 102 database; and OECD calculations.

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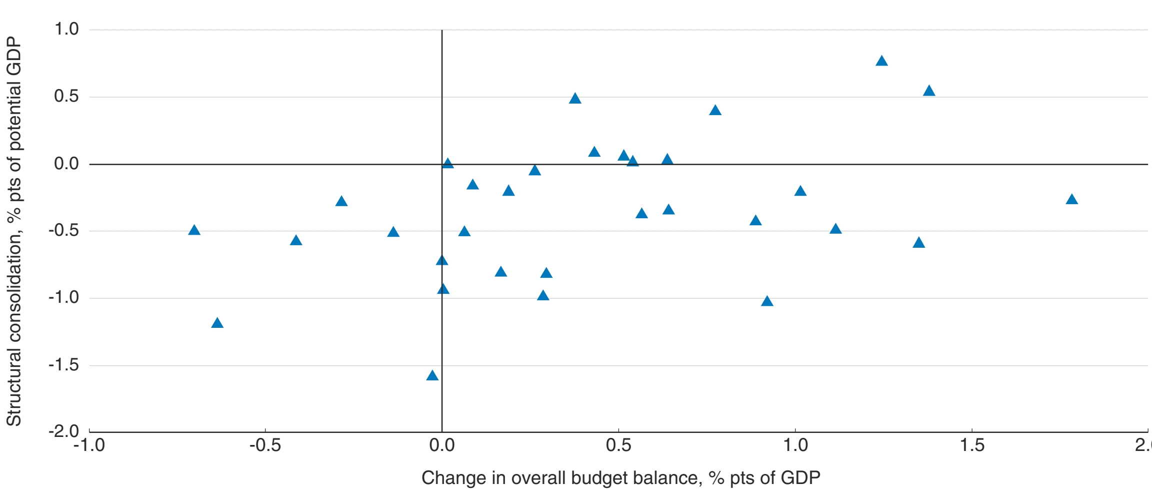
into account two factors that might reduce the budget impact. First, in countries where central banks hold a significant share of government debt, debt servicing costs are effectively reduced as central banks' profits are ultimately transferred to governments. Second, higher nominal growth would likely reduce the fiscal burden of higher interest rates thanks to an improved primary balance and denominator effects.

Against the background of mildly expansionary fiscal policies, there is a need to implement supply-side-enhancing measures to ensure that growth strengthens in a

Figure 1.33. **Overall government budget balances are projected to improve in most OECD countries**

Change between 2017 and 2019



Note: Excluding Greece and countries for which data are not available.

Source: OECD Economic Outlook 102 database; and OECD calculations.

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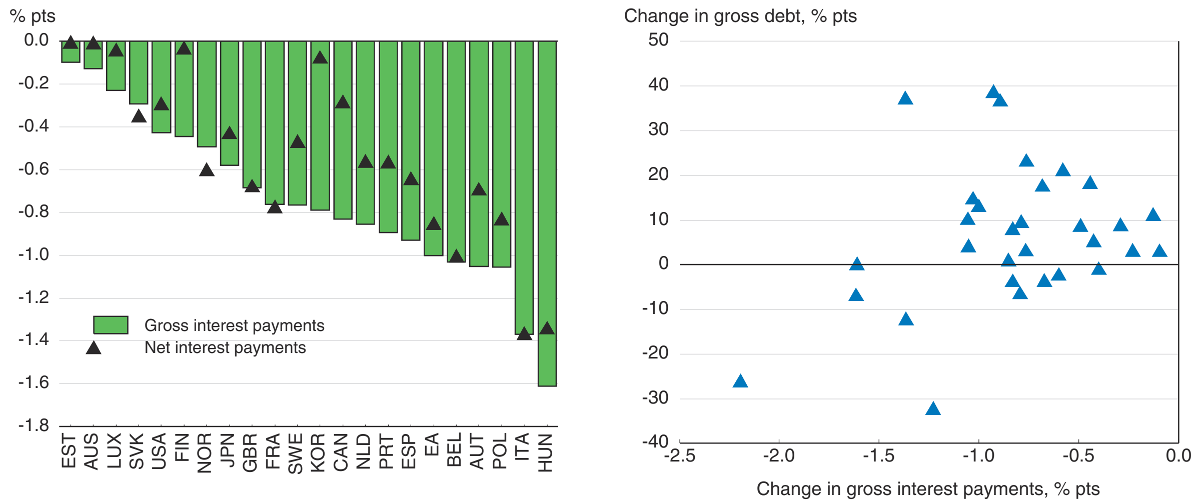
Figure 1.34. **Government interest payments have declined despite rising debt in many OECD countries**

Change from 2011 to 2017 as a per cent of GDP



Note: Excluding Greece and countries for which data are not available. The left hand side panel shows only countries with rising debt between 2011 and 2017.

Source: OECD Economic Outlook 102 database; and OECD calculations.

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sustainable way, increases in incomes and living standards are shared broadly and public finances are sustainable.

- These measures should involve hard, soft and remedial infrastructure investment, with the mix differing across countries according to need, as such spending enhances longer-term supply and adds to aggregate demand.[27]
- Countries should also aim to restructure their spending and tax policies towards a more growth-friendly and inclusive mix, including through the tax and transfer system (Cournède et al., 2013; Fournier and Johansson, 2016).
- Moreover, coherent packages of structural reforms are needed. These can enhance the overall effectiveness of policies by raising their combined economic impact and helping to ensure that their benefits are widely shared (OECD, 2017c). In particular, reforms to reduce barriers to product market competition, either at home or from abroad, should be accompanied by labour market measures. The latter can help vulnerable workers transition to new jobs, as product market reforms may be associated with more frequent transitions out of employment for less qualified and low-income workers (Cournède et al., 2016) and may result in job losses concentrated in specific industries or geographical locations (OECD, 2017c). Yet in recent years there has only been a limited packaging of reforms. Policy efforts have been concentrated either in the labour market or product markets, but very rarely in both areas (OECD, 2017b), despite the opportunities that exist to combine measures to boost competition, either in domestic product markets or through lower barriers to international trade and investment, with specific labour reforms.

27. Stylised simulations show that several OECD countries could debt finance spending of this type, amounting to 0.5% of GDP, for 3-4 years on average and boost output without a deterioration in debt-to-GDP ratios in the long term (Mourougane et al., 2016).

- Services sector reforms that tackle regulatory barriers, such as licenses and a lack of recognition of qualifications, could help small and medium-sized enterprises scale up at an earlier stage by entering international markets through digital platforms and networks (OECD, 2017g). Simultaneous labour market reforms that soften the regulatory burden of scaling up could help such companies achieve the full benefits of more open and competitive services markets.

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ANNEX A1

Policy and other assumptions underlying the projections

Fiscal policy settings for 2018 and 2019 are based as closely as possible on legislated tax and spending provisions and are consistent with growth, inflation and wage projections. Where government plans have been announced but not legislated, they are incorporated if it is deemed clear that they will be implemented in a shape close to that announced. For the United States, with the fiscal programme yet to be finalised, the projections assume an increase in the underlying primary deficit of around ½ per cent of GDP in 2018, primarily due to reduced taxes. Elsewhere, where there is insufficient information to determine budget outcomes, underlying primary balances are kept unchanged, implying no discretionary change in the fiscal stance; in euro area countries, the stated targets in Stability Programmes are also used. In Japan, it is assumed that a consumption tax rise is implemented in the fourth quarter of 2019.

Regarding ***monetary policy***, the assumed path of policy interest rates represents the most likely outcome, conditional upon the OECD projections of activity and inflation, which may differ from the stated path of the monetary authorities.

- In the United States, the upper bound of the target federal funds rate is assumed to be raised gradually to reach 2.75% in December 2019, up from the current level of 1.25%.
- In Japan, the overnight interest rate is assumed to be kept at -0.1% for the entire projection period.
- In the euro area, the main refinancing rate is assumed to be kept at 0% and the deposit interest rate at -0.4% until the end of 2019.
- In China, monetary policy is assumed to be neutral, with a tightening bias to address financial stability risks and targeted easing to ease access to credit by small and agriculture businesses.
- In India, the repo rate is assumed to be cut from the current level of 6% to 5.75% in mid-2018 and then remain constant.
- In Brazil, the policy rate is assumed to be cut gradually from the current level of 7.5% to 7% by the end of 2019.

Although their impact is difficult to assess, the following quantitative easing measures are assumed to be taken over the projection period, implicitly affecting long-term interest rates. In the United States, it is assumed that the Federal Reserve reduces, as announced, the stock of asset holdings as October 2017. In Japan, the Bank of Japan's asset purchases and yield curve control are assumed to last until the end of 2019, maintaining the 10-year government bond yield at 0%. In the euro area, it is assumed that the ECB will gradually taper asset purchases in 2018, keeping long-term interest rates fairly constant until mid-2018.

Structural reforms that have been implemented or announced for the projection period are taken into account, but no further reforms are assumed to take place.

The projections assume unchanged ***exchange rates*** from those prevailing on 8 November 2017: one US dollar equals JPY 113.82, EUR 0.86 (or equivalently one euro equals USD 1.16) and 6.63 renminbi.

The ***price of a barrel of Brent crude oil*** is assumed to remain constant at $60 throughout the projection period. Non-oil commodity prices are assumed to be constant over the projection period at their average levels from October 2017.

A technical assumption is made that the United Kingdom has a transition arrangement with the European Union after formal exit in 2019, resulting in little disruption to trade that year.

The cut-off date for information used in the projections is 23 November 2017.

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Chapter 2

RESILIENCE IN A TIME OF HIGH DEBT

Indebtedness of households and non-financial corporations in many advanced and emerging market economies is high. In many countries, it is continuing to rise. Highly indebted countries may be vulnerable to financial and real shocks, and such indebtedness may undermine the sustainability of growth in the medium term. Finance supports economic activity and innovation, but it can also increase risks, lower growth, and raise inequality. Whilst indebtedness does not necessarily imply financial distress, it is prudent to scrutinise high indebtedness and changes in the composition of financial portfolios, particularly at a time of exceptionally low, but likely rising, interest rates.

Household and non-financial corporation debt ratios have trended up in many countries from the late 1990s, mostly peaking around 2007/08 and remaining high thereafter with increasing cross-country variation:

- Corporate debt-to-GDP ratios are high in advanced economies relative to historical levels, although they vary considerably across countries. Indebtedness of non-financial firms is particularly high in China, while in other emerging market economies (EMEs), corporate debt-to-GDP ratios are lower than in advanced economies, but catching up. External financing since the financial crisis has seen a switch from bank to bond finance and declining credit quality for new bond issuance. International bond markets have expanded and the share of foreign currency in total bond issuance has increased.
- In advanced economies, household debt remains high relative to income, although a deleveraging has taken place in some countries since the financial crisis. Debt dynamics have increasingly diverged in recent years. In countries with rising household indebtedness, house prices have also increased at a faster pace than incomes and rents, raising sustainability concerns. While household borrowing is generally more modest in EMEs, it has reached a share of GDP comparable to that of advanced economies in a number of East Asian economies.

High indebtedness and the ongoing changes in corporate financing structures may not necessarily lead to financial instability, but they can create vulnerabilities to domestic and external shocks and erode medium-term growth:

- Higher debt ratios increase the sensitivity of balance sheets to increases in interest rates. As central banks in major advanced economies curtail their asset purchase programmes, corporates' increasing reliance on debt securities entails rollover and liquidity risks. Higher cross-border borrowing exacerbates potential international spillovers.
- The deepening of bond markets can be beneficial for firms – increasing funding diversification and lengthening debt maturity – but the post-crisis surge in bond finance has been accompanied by a decrease in credit quality. This makes debt markets more fragile and exposes bond holders to significant risks.

- Risks have migrated from the banking system to other financial institutions and credit intermediaries. This development warrants vigilance, as risks stemming from non-bank financial intermediaries are subject to ongoing debate.
- The efficiency of capital allocation is critical to ensure that corporate debt is sustainable and does not weigh on medium-term growth. However, weak investment since the crisis raises concerns that debt is not being used to enhance long-term productive capacity.
- A number of countries have experienced strong and continuing increases in house prices with a concomitant rise in household debt. High household debt, alongside slow growth of real disposable incomes, raises concerns about the impact of debt service costs on medium-term consumption growth, particularly for lower-income households.

These vulnerabilities require an integrated response to enhance the resilience of economies in the advent of adverse shocks and minimise the risk of sub-par growth in the medium run:

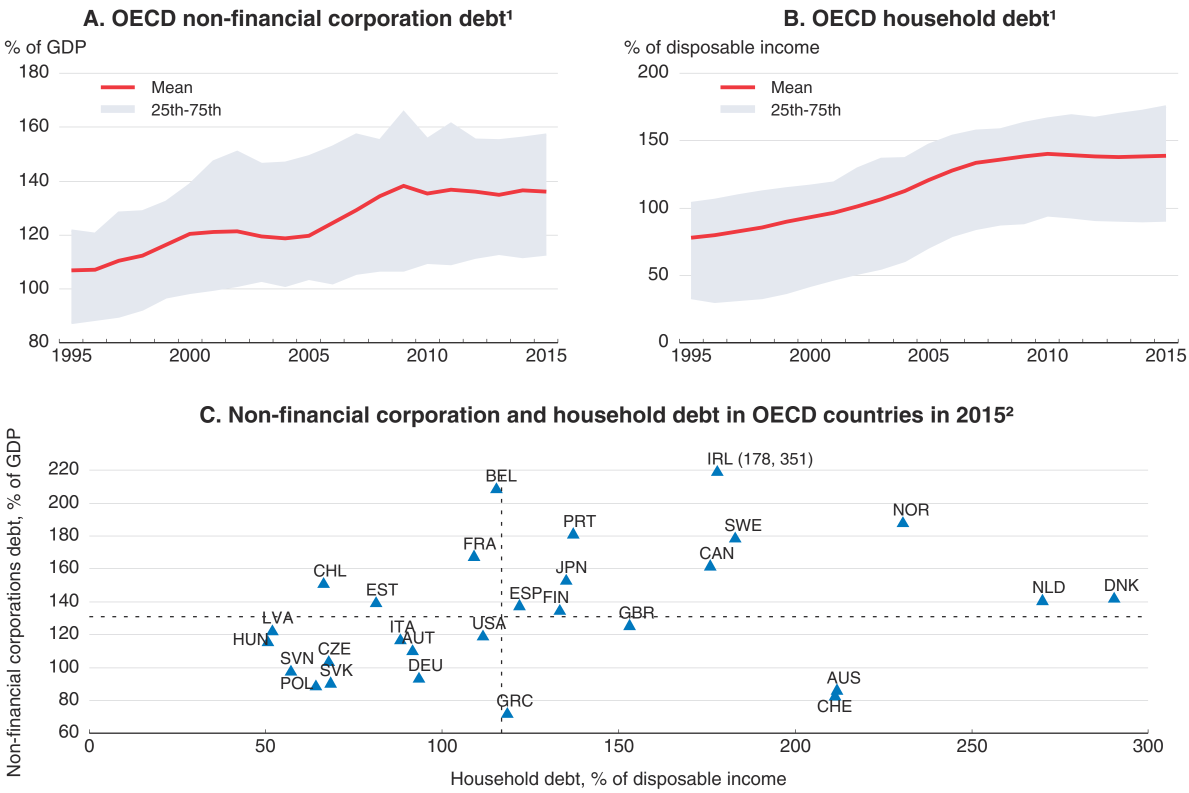
- Enhance use and co-ordination of prudential policies to prevent unsustainable credit dynamics, without penalising growth.
- Step up coordinated monitoring and supervision of non-bank activities, including capital structures of shadow banks and the use of off-balance sheet instruments.
- Reduce implicit home ownership subsidies and mortgage interest deductibility. Evaluate whether expanding housing supply would attenuate pressures on house prices.
- Strengthen the incentives to develop equity finance by reducing the debt bias in corporate taxation and fostering competition in equity markets (venture capital, IPO).
- Enhance the efficiency of capital re-allocation by improving insolvency regimes and ensuring that state-owned enterprises do not benefit from undue competitive advantages.
- Improve the quality of institutions to enhance growth and resilience. Foster financial literacy to allow more households to assess the costs and benefits of financial exposure.

This chapter focusses on the household and non-financial corporate sectors, leaving aside the rise of the government debt-to-GDP ratio in most advanced economies. While all sectors are interdependent and high public debt can be an important source of vulnerability, the non-financial private sector most closely corresponds to economic productive activity, and households are the ultimate recipients of income streams and the main drivers of consumption in the economy.

Debt ratios in the household and non-financial corporation sectors rose in the late 1990s, stabilising at historically high levels at the onset of the crisis

Household and non-financial corporation (NFC) debt ratios in the OECD economies have risen since the late 1990s, although with considerable differences across countries. Despite some deleveraging in recent years, the indebtedness of households and non-financial businesses remains at historically high levels in many countries, and continues to increase in some. Aggregate figures mask significant differences in cross-country trajectories (Figure 2.1, Panels A and B). Corporate and household debt ratios are positively correlated, suggesting that, in some economies, such as Canada and the Scandinavian countries, risks from high borrowing span both sectors (Figure 2.1, Panel C).

Figure 2.1. **Private non-financial sector debt has increased**



1. Simple average of OECD members for which data are available through the entire time sample: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Israel, Italy, Japan, Latvia, Netherlands, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, United Kingdom and United States. Shades show country distribution between the 25th and 75th percentiles.
2. Dotted lines are for medians.

Source: OECD calculations.

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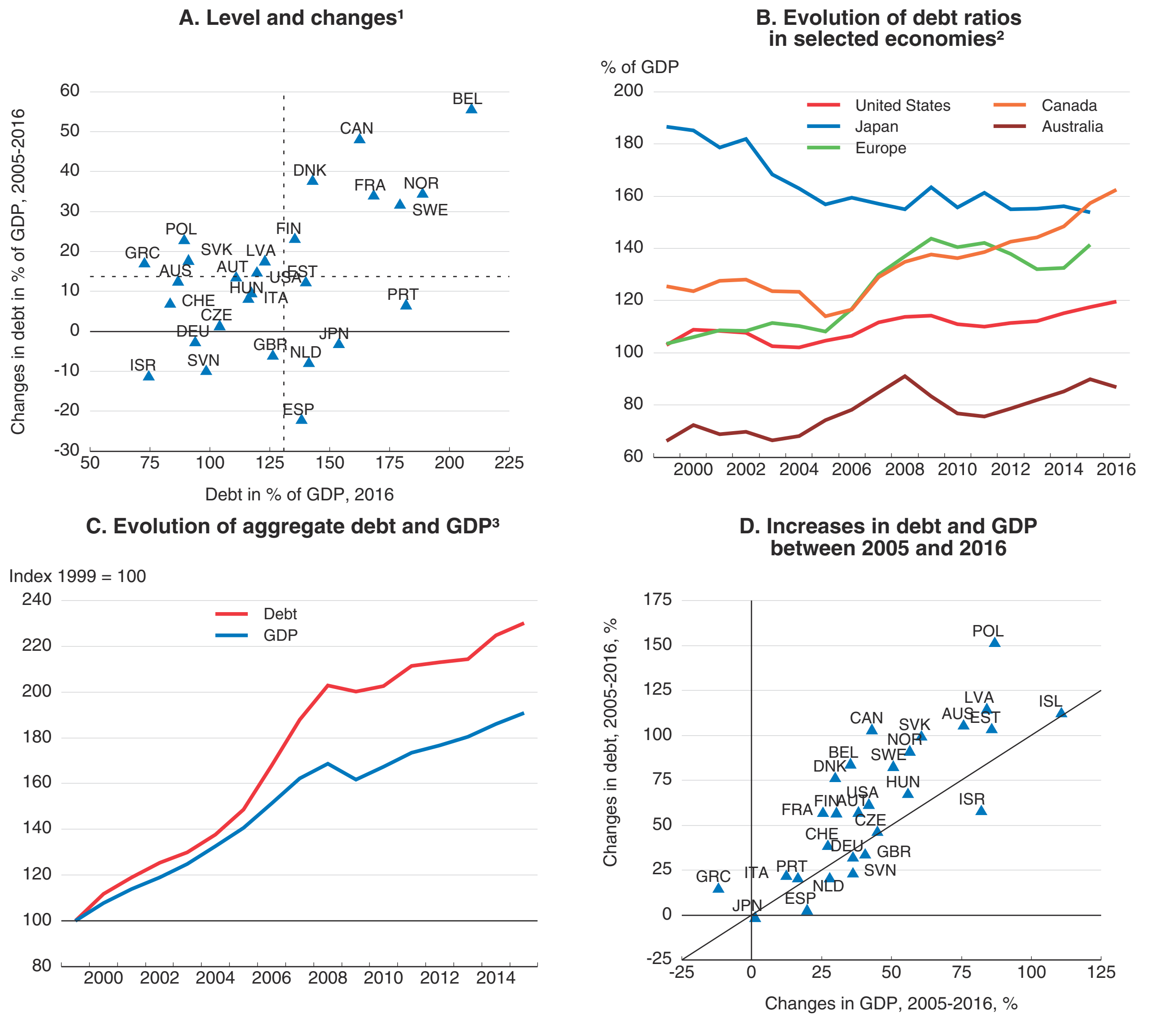
NFC indebtedness is high, although dynamics and debt ratios vary significantly across countries

The debt of non-financial firms rose relative to GDP in the majority of OECD countries during the mid-2000s, generally peaking at the onset of the global financial crisis and remaining stable thereafter. After a limited downward adjustment during the post-crisis period, NFC debt-to-GDP ratios have increased again in more recent years in many advanced economies (Figure 2.2, Panels A and B). In almost all OECD countries, corporate debt-to-GDP dynamics are dominated by a significant increase in the level of debt in the run-up to the financial crisis (Figure 2.2, Panels C and D).

Debt-to-GDP ratios of NFCs in EMEs have increased strongly since the crisis, albeit mostly from low levels compared to advanced economies (Figure 2.3). The aggregate debt accumulation in EMEs was primarily driven by China, where debt rose from less than 100% of GDP at the end of 2008 to 170% by early 2016, partly due to state-owned enterprises (OECD, 2017d). The rise of EME corporate debt has occurred amid a significant monetary expansion in advanced economies, a deepening of international debt markets and higher appetite for risk reflected in lower risk spreads.

Figure 2.2. **Non-financial corporation debt in advanced countries**



Note: Luxembourg (410; 217), Ireland (351; 203) and Iceland (257; 3) are not displayed in Panel A. Chile (142; 216), Ireland (56, 271), Luxembourg (80; 284) and Mexico (93; 214) are not displayed in Panel D.

1. Dotted lines are for medians.
2. The countries included for Europe are: Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Luxembourg, Netherlands, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden and Switzerland.
3. Simple average of Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Italy, Japan, Netherlands, Norway, Portugal, Slovak Republic, Spain, Sweden, Switzerland, United Kingdom and the United States.

Source: OECD calculations.

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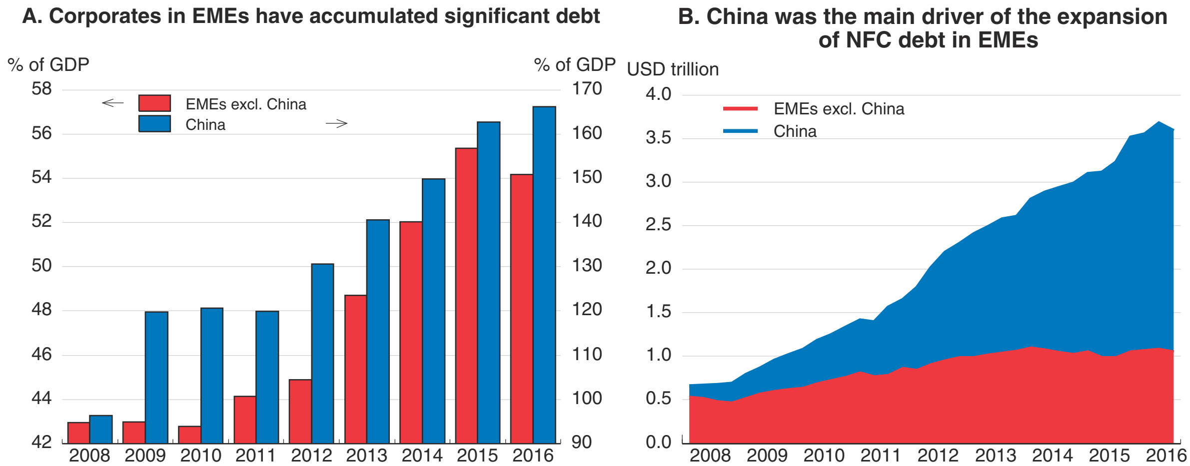
Accommodative monetary policy in the major advanced economies has lowered interest rates, providing firms in both advanced and emerging market economies with greater incentives and opportunities to increase leverage. To different extents, corporations in EMEs also benefitted from loose financial conditions in advanced economies via international investors' portfolio rebalancing decisions, leading to strong capital inflows. The post-crisis expansion of corporate debt has been characterised by three distinctive features: a surge in bond finance, an increase in international bond

Figure 2.3. **Credit and bond issuance in EMEs**



Note: Corporate debt for major EMEs. Countries included are Brazil, Chile, China, Colombia, Hong-Kong - China, Hungary, Indonesia, India, Mexico, Malaysia, Poland, Russia, Singapore, South Africa, Thailand and Turkey. Debt includes total credit to non-financial corporations issued by all sectors and outstanding debt securities.
Source: Bank for International Settlements.

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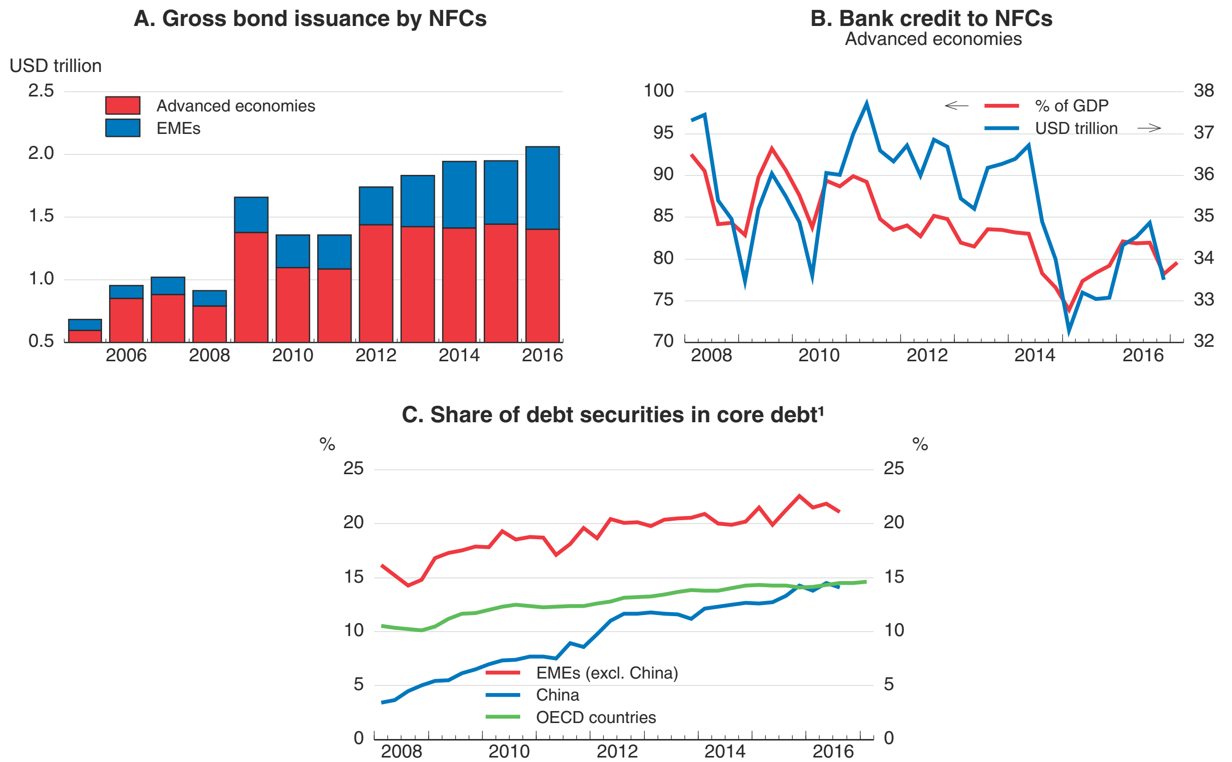
issuance – in large part denominated in foreign currency – and a deterioration of credit quality:

- ***A surge in bond issuance led to a reduction in the share of bank finance***: A steady upsurge in net bond issuance is observable in all advanced economies, including countries like Italy where external finance has historically been based largely on bank credit. In the United States, new bond issuance by non-financial firms accelerated following the crisis: the amount of outstanding debt securities doubled between 2008 and 2016. The rise in NFC bond issuance in EMEs over the same period was even more dramatic, increasing from 120 to 650 USD billion in nominal terms. EMEs net issuance was primarily driven by the Chinese corporate sector. While bank financing still remains the dominant source of external funding for firms in both advanced and emerging market economies, the surge in bond finance has led to a fall in the share of bank lending in total external financing by around 5 percentage points in advanced countries since 2008. The shift to bond finance has been substantial in China, but more modest in other EMEs, where bank lending still accounts for about 80% of core debt and bond finance is only accessible by a limited number of large firms (Figure 2.4).
- ***An increase in international issuance and a rise in foreign currency denominated bonds:*** After the global financial crisis, bond issuance in foreign markets has become more common practice, even for corporates in advanced economies (Figure 2.5). The recent rise in international issuance by firms located in countries with relatively stable exchange rates suggests that their primary motivation is to lower funding costs. For example, the increase in euro-denominated foreign currency issuance by US corporates has enabled these companies to take advantage of the relatively low financing cost in European debt markets. International bond issuance also remains relatively common for large EME firms due to the limited development of domestic financial markets. The development and internationalisation of bond markets differs amongst EMEs. The amount of foreign currency denominated bonds outstanding rose significantly in recent

Figure 2.4. **The role of bond financing has increased**



Note: Advanced economies comprise Australia, Canada, Czech Republic, Denmark, euro area, Japan, Korea, New Zealand, Norway, Sweden, Switzerland, United Kingdom and United States. EMEs comprise Argentina, Brazil, Chile, China, Colombia, Hong Kong - China, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey.
1. Core debt comprises loans, debt securities, and currency and deposits.
Source: OECD Business and Finance Scoreboard; Bank for International Settlements; and OECD calculations.

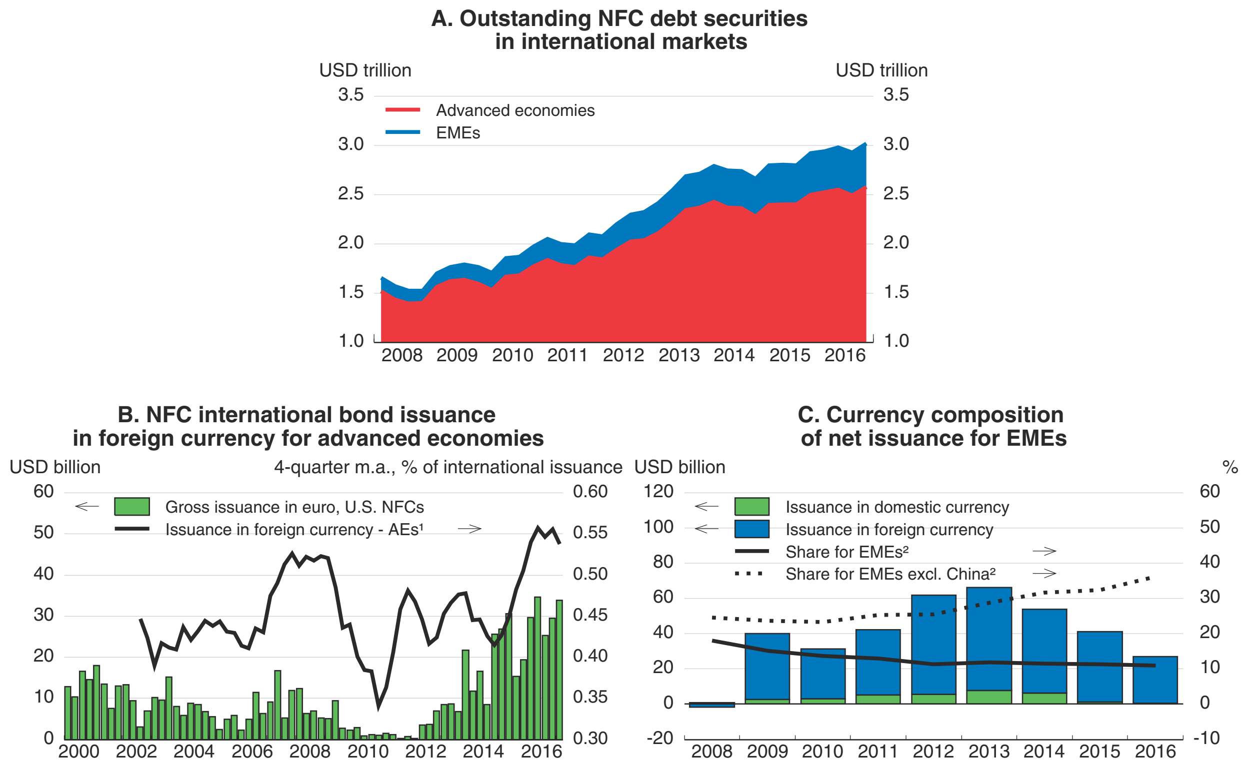
StatLink http://dx.doi.org/10.1787/888933626972

years in all EMEs except for China, where corporate bond issues are still primarily in yuan. China's bond issuance has grown exponentially since the financial crisis, but, until recently, has targeted primarily domestic investors.

- ***A substantial deterioration in credit quality:*** In the context of the protracted period of low interest rates, the post-crisis surge in corporate bond issuance has been accompanied by a substantial increase in risk-taking by bond investors. A strong appetite for risk has encouraged the proliferation of high-risk debt security issuance, such as non-investment grade bonds, and a weakening of covenants (Figure 2.6; BIS, 2017). This deterioration of credit quality has been combined with more favourable conditions for issuers, as shown by the increase in the share of fixed interest rate and callable bonds (Çelik et al., 2015). Stronger investor risk appetite is also reflected in the steady rise in duration risk for traded securities, as newly issued bonds have longer maturities and lower coupon rates, implying a shift forward of the cash flow.[1]

1. Duration is a measure of the sensitivity of the price of a fixed-income asset to a change in interest rates. Measured in years, the duration corresponds to the average time it takes to receive all the cash flow of the asset. It is therefore affected by the time to maturity and the coupon rate.

Figure 2.5. **International and foreign currency issuance has increased**



Note: Euro includes sum of ECU and legacy currencies now included in the euro for issuances preceding the introduction of the euro. International debt securities are on nationality basis. Advanced economies comprise Australia, Canada, Czech Republic, Denmark, euro area, Japan, Korea, New Zealand, Norway, Sweden, Switzerland, United Kingdom and United States. EMEs comprise Argentina, Brazil, Chile, China, Colombia, Hong Kong - China, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey.

1. Share of international issuance in foreign currency.
2. Share of international debt outstanding in foreign currency.

Source: Bank for International Settlements; and OECD calculations.

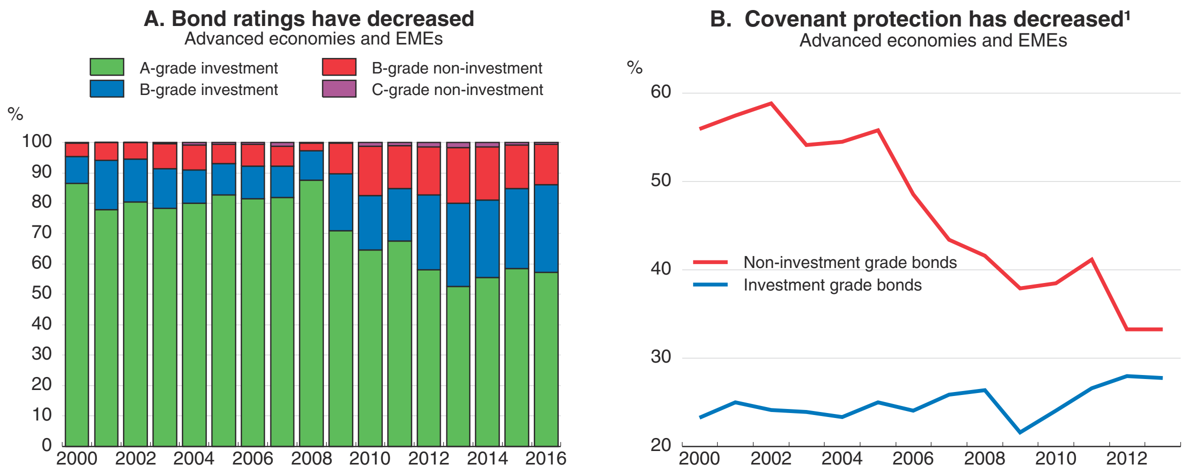
StatLink http://dx.doi.org/10.1787/888933626991

The broad expansion in debt security markets after the global financial crisis reflects the combination of two factors: a steady retrenchment in bank lending and historically low interest rates. Banks weakened by trading losses and credit provisions during the crisis, as well as affected by stricter prudential regulation and higher capital requirements in its aftermath, trimmed their lending, especially to risky borrowers. In contrast, demand for corporate debt securities expanded considerably in a low interest rate environment, offering NFCs ample alternative financing opportunities.

Household debt ratios are high in many advanced economies and have soared in some EMEs

Household debt-to-income ratios rose significantly until 2007 and stabilised thereafter at historically high levels in most advanced economies (Figure 2.7). The rise in the debt-to-income ratio was driven by the acceleration in debt accumulation prior to the crisis, with subdued household income growth impeding deleveraging thereafter. Household debt

Figure 2.6. **Credit quality has deteriorated in advanced economies and EMEs, risks for bond investors have increased**



1. The covenant index is constructed considering a list of 15 covenants which are coded in a binary variable reporting 1 if the covenant type is available in the bond indenture. The sum of the binary variables, divided by 15 and multiplied by 100 generates an index that ranges from 0 to 100, with 100 denoting the highest possible protection for bondholders. It should be noted that this index provides only a rough measure of covenant quality, since the measure changes based only on the existence or non-existence of a given covenant.

Source: OECD Business and Finance Scoreboard, Çelik et al., 2015.

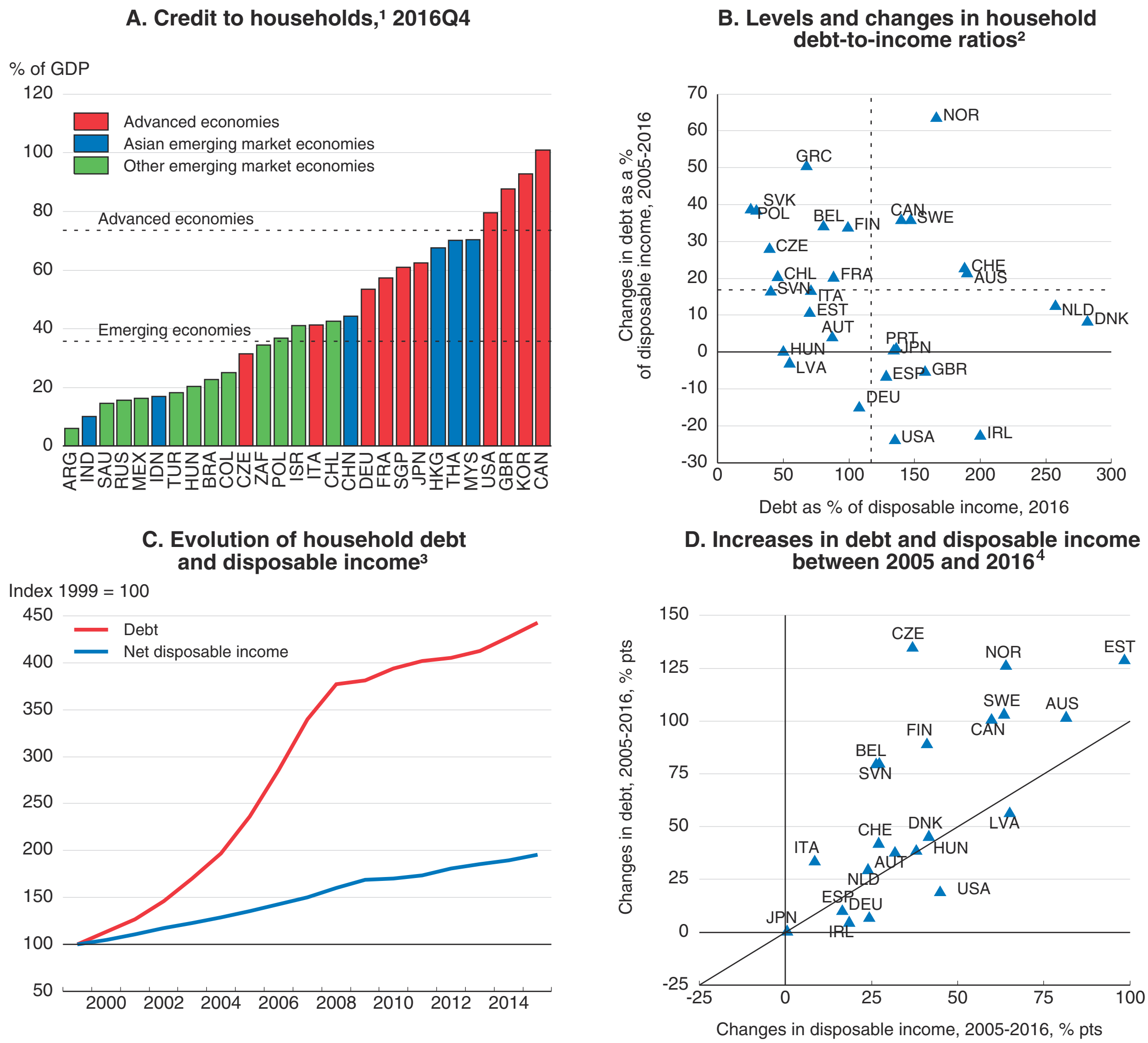
StatLink http://dx.doi.org/10.1787/888933627010

dynamics over the past decade nevertheless exhibit significant cross-country variation. Indebtedness has continued to rise from high levels in the Scandinavian countries, Australia and Canada, whereas some deleveraging has occurred in a few countries. In EMEs, household credit to GDP remains below advanced economy standards, but it has been buoyant over the last years, particularly in some Asian economies.

In both advanced economies and EMEs, household debt surged in an environment of loose financial conditions and low interest rates. This added to a longer-term trend towards higher household indebtedness due to the development of financial systems and demographic shifts that raise the demand for housing. In EMEs, lower interest rates compared to pre-crisis standards have contributed to the build-up in household debt. The substantial liberalisation and deepening of financial markets since the 1990s, including the increased presence of retail lending-oriented foreign banks, has also facilitated household borrowing.

While mortgages account for the largest share of household debt, consumer loans have expanded rapidly in Korea, the United Kingdom and the United States, creating pockets of risk that warrant vigilance (Figure 2.8). As consumer credit typically consists of unsecured products, lenders are directly exposed to non-repayment risk; as a result, borrowers are charged higher interest rates. Furthermore, the short maturity of consumer credit means that the credit quality of outstanding loans can deteriorate quickly (Bank of England, 2017).

Figure 2.7. **Household debt is high in many advanced economies**



1. Selected G-20 countries and selected middle-income countries.
2. Dotted lines are for medians.
3. Simple average of Australia, Austria, Belgium, Canada, Czech Republic, Germany, Denmark, Estonia, Finland, Hungary, Italy, Japan, Netherlands, Norway, Slovak Republic, Spain, Sweden, Switzerland and United States.
4. Chile (97; 186), Poland (67; 327) and Slovak Republic (55; 257) are not displayed in the chart.

Source: Bank of International Settlements; and OECD calculations.

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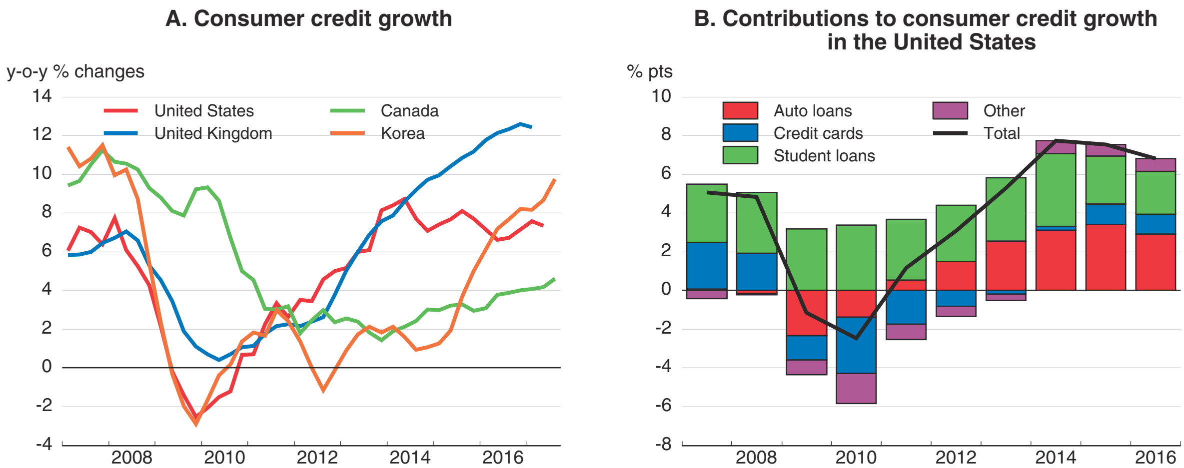
Household indebtedness is uneven across the income distribution. Many highly indebted households tend to have relatively high incomes and wealth. However, low-income indebted households tend to be more leveraged, have a higher debt service cost relative to income and have lower liquidity buffers than more affluent ones (André, 2016). At the same time, lower-income households also tend to have a higher propensity to consume, rendering private consumption expenditure particularly vulnerable to income and wealth shocks (O'Farrell et al., 2016).

Figure 2.8. **Consumer credit is rising in some countries**



Source: Thomson Reuters; Bloomberg; and Federal Reserve.

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High and rising debt creates vulnerabilities

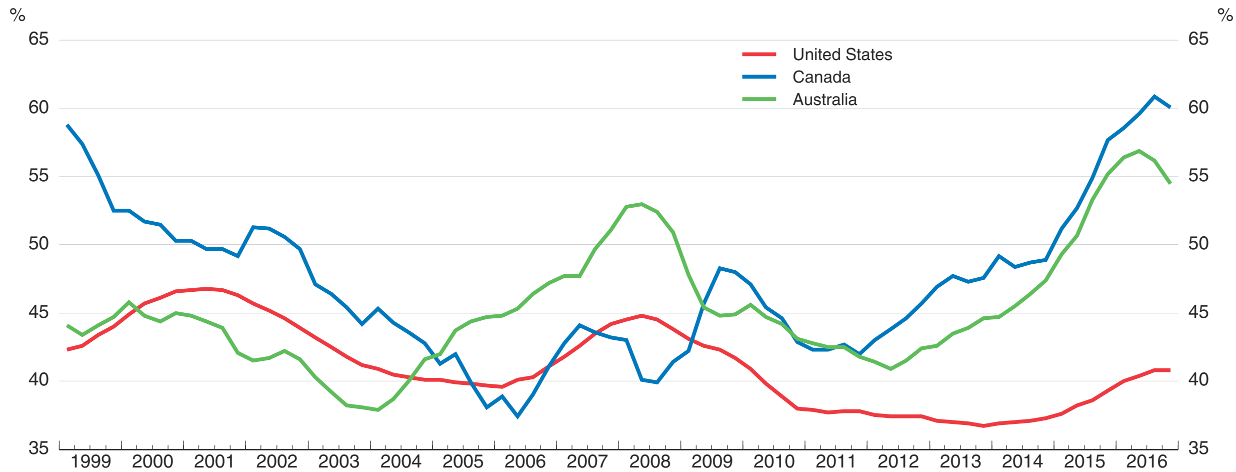
High debt increases corporate sector vulnerability to financial tightening

The current high levels of debt may not represent an imminent threat to corporates' solvency, but it weakens their ability to withstand demand fluctuations and increases their vulnerability to funding shocks. Further financial tightening could compromise the ability of firms to service debt, if it is not accompanied by a corresponding increase in earnings. Abrupt changes in market risk appetite and liquidity shocks also hamper the safe management of the debt stock. Highly indebted corporates are exposed via a number of channels:

- ***Higher sensitivity to monetary policy tightening***: for a given maturity structure, higher debt increases the sensitivity of debt servicing costs to any interest rate rises. After having increased in the post-crisis period, the average maturity of corporate debt is likely to decrease in the near term, as the gradual phasing out of central banks' asset purchase programmes is expected to result in a reversal of corporate term premia due to portfolio rebalancing effects (Greenwood et al. 2010; Gagnon et al., 2011; Joyce et at., 2012).[2] In some countries, like Australia, Canada and the United States, debt servicing ratios have started to rise, possibly reflecting expectations of future financial tightening (Figure 2.9).

2. Even if most central banks have asset purchase programmes primarily focused on the acquisition of sovereign bonds, this also impacts corporate term premia via portfolio rebalancing effects. From a theoretical stand point, central bank purchases of long-maturity assets, like medium-to-long-term government bonds, reduce the average maturity of the stock of bonds held by the private sector causing a fall in the premium required to hold maturity risk (Gagnon et al., 2011). A pre-condition of this formulation is some level of segmentation in bond markets, where investors have a preference for a particular segment of the yield curve (Modigliani and Sutch, 1996). For example, a pension fund or an insurance company that has a preference for long-term assets will buy other assets with a similar maturity, such as corporate bonds, if the relative availability of long-term sovereign bonds is reduced by central bank asset purchase programmes (Joyce et al., 2012).

Figure 2.9. **NFC debt servicing costs are rising in some countries**



Note: The debt service ratio is defined as the ratio of interest payments plus amortisations to income.
Source: Bank for International Settlements.

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- ***Rollover risks***: with the phasing out of central bank asset purchase programmes, the demand for corporate debt securities in primary markets is expected to decrease, as a consequence of the reversal of the crowding-out effects from market segments where central banks intervened (Duca et. al., 2016). Similar effects may occur in EMEs, via the rebalancing of investors' portfolios towards advanced economies and expected rises in risk premia (Neely, 2010; McCauley et al., 2015). For non-bank corporates in EMEs, the rollover risk associated with a decrease in gross issuance can be high; redemptions amounted to about half of the gross issuance of international debt securities in 2016.[3] Should rollover risk materialise, the ability of NFCs to refinance large proportions of outstanding debt in both advanced and emerging market economies may rely on their ability to switch back to bank credit. Rollover risk is particularly significant for outstanding non-investment grade securities, as demand for this type of asset is more sensitive to a reversal in investor risk appetite. In addition to liquidity risk, corporates willing to roll over existing debt securities in international markets may face exchange rate risk as their currency hedging of principal redemptions may be incomplete (Gruić et al., 2014).

Rising international bond issuance heightens concerns about spillovers and currency mismatch

The expansion of international bond markets may improve access to finance in countries with shallow domestic financial markets, but it can also increase the cross-border transmission of financial conditions and credit risk. For instance, credit risks from highly leveraged Chinese corporates can increasingly spill over to foreign investors following the recent opening up of China's debt market.[4] International debt markets can help corporate financing costs converge across countries, but they also limit the ability of

3. Bank for International Settlements debt securities statistics.
4. Following the establishment of the so-called bond connect on July 2017, international investors are allowed to trade in Chinese fixed-income securities via Hong Kong.

national authorities to control domestic financial conditions. These effects are likely to have uneven impacts across corporations, as only larger firms typically have access to international financial markets.

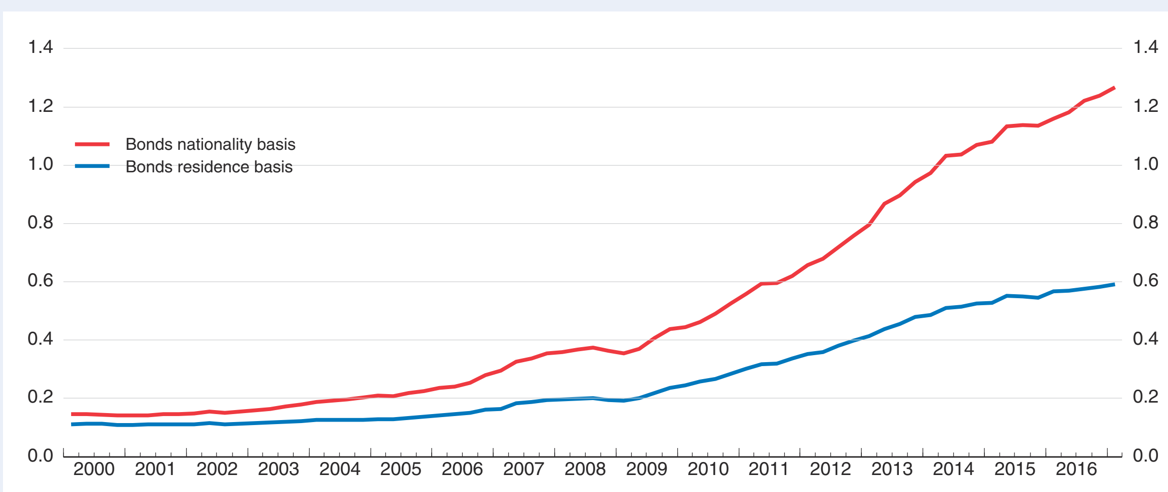
The rise in foreign-currency denominated bond issuance – much of which occurs via foreign subsidiaries[5] (Box 2.1) – can expose borrowers to currency fluctuations, as a depreciation of the local currency raises borrowing costs relative to domestic revenues. The exchange rate exposure depends on the extent to which financial costs in foreign currency

Box 2.1. **The rise of intermediation activities by non-financial firms**

NFCs are increasingly issuing debt overseas through foreign affiliates. It is estimated that almost half of international debt securities issuance by non-financial firms of EMEs between 2009 and 2013 was done through foreign affiliates, and since 2013 this type of financing has dominated. The increasing role of foreign affiliates in international bond issuance can be observed in the growing gap between the outstanding bonds of NFCs on a nationality and residence basis. A growing literature has pointed to strong links between NFC issuance via foreign affiliates and carry trades (Bruno and Shin, 2017; Caballero et al., 2016). These activities closely resemble those of banks and may reflect the increased regulation of domestic banks since the global financial crisis. Restrictions on the cross-border activities of banks and other financial transactions create an incentive for regulatory arbitrage. Cross-country studies at both the country and firm-level have found evidence that this type of activity is more prevalent in countries where capital controls are in place (Caballero et al., 2016). This suggests that capital controls should be discussed within the context of a multilateral platform, such as the OECD Codes of Liberalisation.

Difference in non-financial corporations' issuance on a nationality and residence basis, EMEs

Outstanding bonds



Note: EMEs comprise Argentina, Brazil, Chile, China, Colombia, Hong-Kong – China, Hungary, India, Indonesia, Israel, Malaysia, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa, Thailand and Turkey.
Source: Bank for International Settlements.

StatLink http://dx.doi.org/10.1787/888933626858

5. Between 2009 and 2013, almost half of the international debt securities issued by emerging market non-bank private corporations were issued through foreign affiliates (Chui et al., 2014).

Box 2.1. **The rise of intermediation activities by non-financial firms** *(cont.)*

Carry trade-like operations can occur when foreign affiliates issue bonds in a host country and then use the proceeds to "lend" back to the parent. The parent can use the proceeds to purchase domestic bonds yielding a higher interest rate than the one paid on its international bonds. Overseas funding by NFCs often re-enters the domestic economy as foreign direct investment (FDI), being classified as loans from subsidiaries to their parent. The Banco Central de Brazil estimates that these transactions account for almost 20% of total FDI inflows to Brazil. The possibility of capturing proceeds from international bond issuance by foreign affiliates as FDI (debt) represents a statistical distortion that makes it more difficult to assess the related risks to financial stability. These flows may in fact conceal significant vulnerabilities for NFCs in the form of high rollover and foreign currency risk.

For NFCs engaging in carry trade operations, unhedged exposures in foreign currency are a primary concern. Carry trades associated with credit extensions to non-related companies – if proceeds are held as a financial claim on an unrelated home resident – also involves counterparty risk. From the perspective of bond investors, NFCs carry trades conceal the international dimension of the investment and the additional risks that this entails. Such risk may not be appropriately reflected in bond yields and covenants. From a macroeconomic standpoint, intra-NFC financial intermediation via foreign subsidiaries can be destabilising by allowing the circumvention of capital-flow management measures. From a fiscal standpoint, it can be damaging as it leaves ample room for tax arbitrage, allowing transfer pricing and intentional profit relocation.

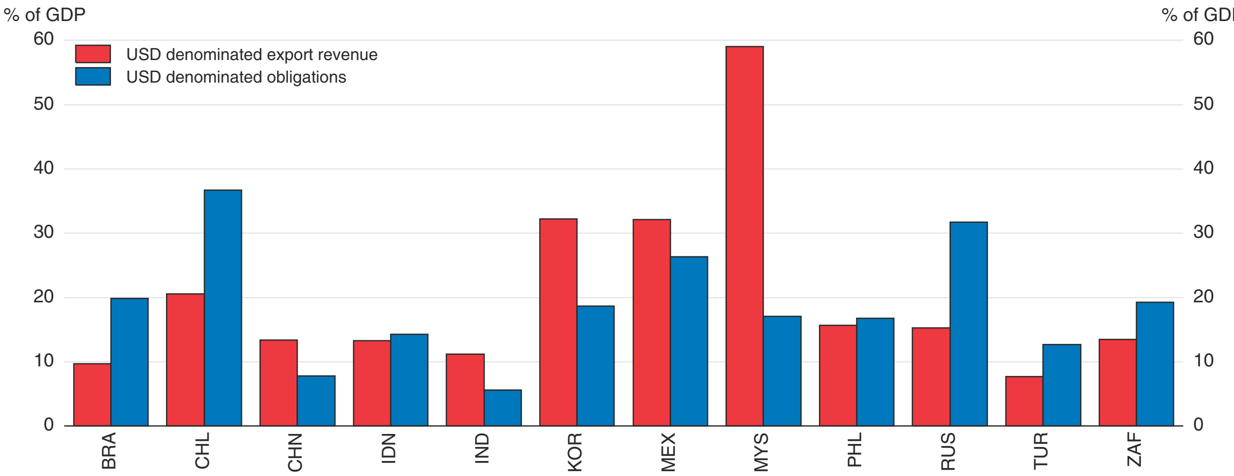
are matched with foreign currency revenues or hedged via financial instruments. Evidence on currency mismatches between NFC revenues and financial costs is scarce, requiring detailed information on the invoicing currency of individual transactions (BIS, 2014). At the country level, there is a gap between dollar-denominated obligations and estimated export revenues in Brazil, Chile, Russia and Turkey (Figure 2.10). Moreover, the use of financial hedging typically rises with the depth of the relevant hedging market, suggesting a more widespread use in advanced economies and in a few EMEs, such as Brazil or Mexico. The rising cost of cross-currency swaps, and thus hedging against the US dollar, might have further pushed corporates into unhedged trades. Finally, even (imperfectly) hedged positions may be exposed to basis risk due to wedges between the underlying positions – for example as a consequence of the standardised maturity of ordinary hedging tools – and to liquidity risk due to mismatches between the hedging costs and revenues received.[6]

Risks have shifted from banks to non-bank financial intermediaries

The development of debt markets improves firms' access to finance via a diversification of funding sources. This is particularly valuable when bank intermediation weakens, as happened at the onset of the financial crisis.[7] It also contributes to the deepening of asset markets, resulting in higher diversification possibilities for investors. However, the rising role of market debt finance in corporate funding implies that the risks have increasingly shifted from banking intermediaries to non-bank financial corporates.

6. The 'basis' is the difference between the spot price of the underlying asset and the price of a contract (i.e. a future) used for hedging. In foreign currency hedging with standardised instruments (like futures) the difference between the future and spot price can be substantial. Liquidity risks can arise because the two offsetting payments from the underlying asset and the hedge can be staggered.
7. In the context of SME financing, see for example Nassr and Wehinger (2015).

Figure 2.10. **International debt and currency mismatches**



Note: 2016Q4 estimate of the US dollar (USD) denominated debt of non-bank borrowers. This includes international bonds issued by non-banks (by nationality i.e. including bonds issued by offshore affiliates of domestic non-banks); foreign bank cross-border USD claims (loans and debt securities) on domestic non-banks; local USD claims of domestic banks on domestic non-banks; and cross-border USD claims of domestic banks on foreign non-banks. The latter is a proxy for USD loans to non-bank offshore affiliates, and may thus overstate the ultimate USD debt of domestic non-banks. The value of local and cross-border non-bank USD debt is approximated using bank claims on non-banks as a share of total bank claims and total bank USD claims on banks and non-banks. In China, the USD component of local bank cross-border claims on non-banks is assumed to be 50% of the total cross-border USD claims of local banks. Estimates for Indonesia, India, and Turkey do not include domestic bank USD claims on local and cross-border non-banks. US-dollar denominated export revenue is given by merchandise exports invoiced in USD in 2016. Estimates of the USD share of exports are based on Gopinath (2016) for all countries, except Chile (based on Cravino, 2014) and China and Russia (national sources).
Source: OECD (2017b), *OECD Economic Outlook*, Volume 2017 Issue 1, OECD Publishing Paris.

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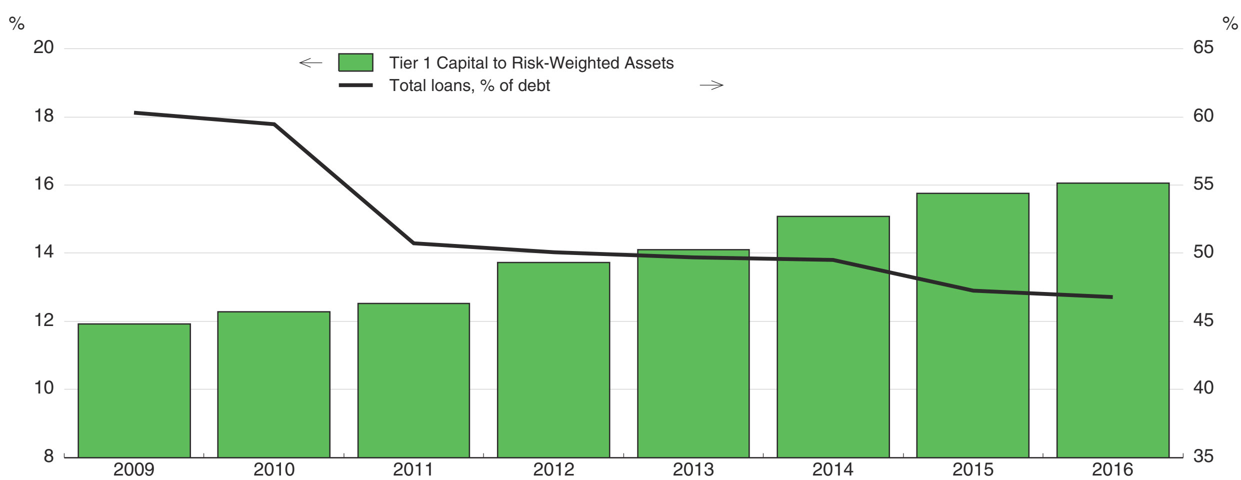
This shift may mitigate the efforts made since the global financial crisis to make the financial system more resilient by strengthening bank intermediaries – for example by raising bank capital requirements (Figure 2.11). Evidence from the major advanced economies suggests that non-bank financial intermediaries (including pension funds,

Figure 2.11. **Bank capital and the shift to debt securities**

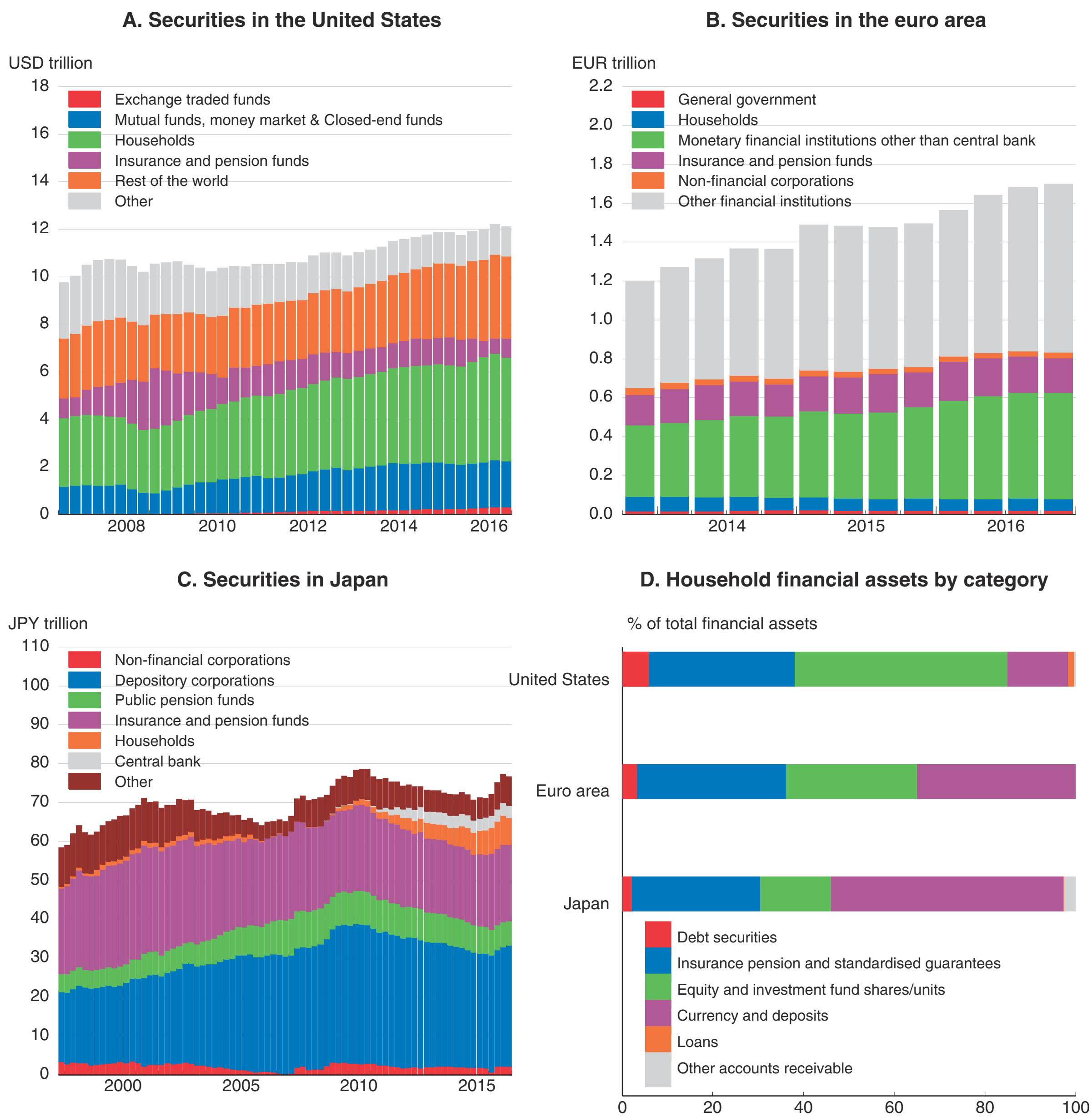


Note: Figures refer to simple averages among OECD countries for which the series are available.
Source: IMF Financial Soundness indicators; and OECD financial accounts.

StatLink *http://dx.doi.org/10.1787/888933627105* mutual funds and insurance companies) bear the largest exposure to corporate bond markets, although households are ultimately exposed through these intermediaries (Figure 2.12).

The extent to which this shift creates vulnerabilities for financial stability and macro-prudential risks is subject to ongoing research and debate. On the one hand, non-bank intermediaries, such as investment funds, can be less exposed to liquidity risks as they are less reliant on short-term liabilities than banks, and their failure is less likely to

Figure 2.12. **Households and non-bank financial intermediaries are exposed to NFC debt**



Note: Panels A, B and C depict the holders of corporate bonds. In the first panel the data refer to bonds issued by domestic corporations and foreign bonds held by US residents. Financial accounts of the United States, table L.213.

Source: Federal Reserve Board; European Central Bank; Bank of Japan; and OECD Financial Accounts.

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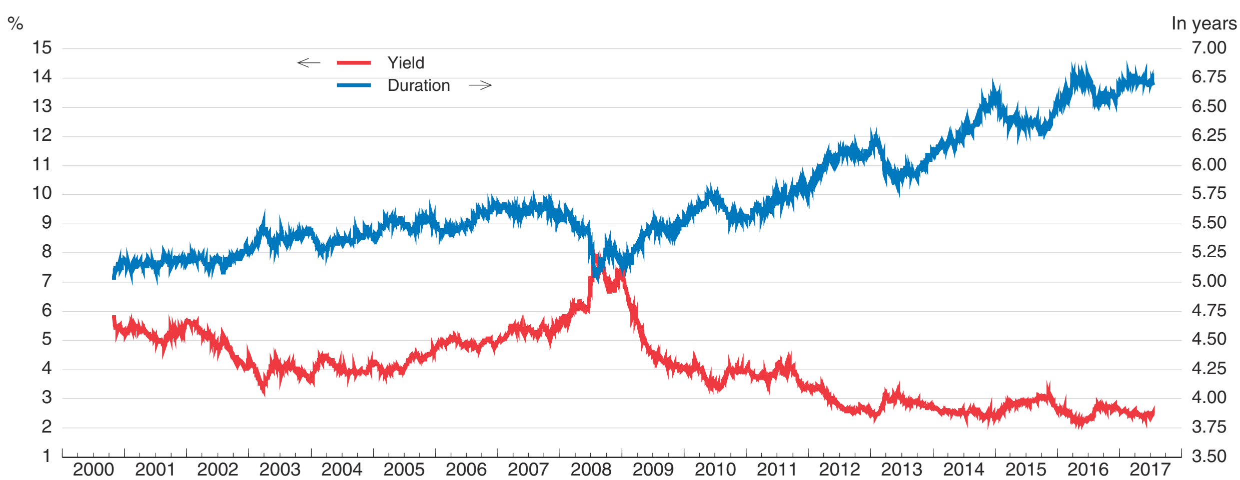
have systemic consequences than in the case of bank intermediaries (IMF, 2015). On the other hand, some bond investment vehicles (such as mutual funds or ETFs) engage in liquidity transformation, by offering liquid claims on illiquid underlying assets. In heavy outflow scenarios – triggered, for instance, by interest rate hikes (Banegas et al., 2016) – the illiquid nature of the underlying claims may expose these financial intermediaries to risks comparable to bank runs (Chen, 2010; IMF, 2015).

In addition to solvency risk and unlike banks extending loans, bond investors also bear price risks. In the current context of likely rising interest rates, these could be substantial as duration has now reached historically high levels and the prices of higher duration assets are more sensitive to interest rate fluctuations (Figure 2.13). The risks of negative price externalities stemming from the asset management industry could be systemic and are therefore a source of concern for macro-financial stability (IMF, 2015). Indeed, price movements in financial markets can trigger fire sales of assets held by other players in the financial sector or used as collateral, with potentially significant consequences for the stability of the financial sector as a whole. These movements are exacerbated by trading practices and first-mover advantage effects in fund management (OECD, 2015c). Systemic credit risk and abrupt downward corrections in collateral valuations, as the ones generated by fire sales, can also affect the stability of Central Counterparties (CCPs) and, through them, spread shocks across investors and asset classes (BIS, 2012).[8] Concentration in the

Figure 2.13. **Duration risk has never been higher**



Note: Duration and average yield refer to the Bloomberg Barclays Global Aggregate Corporate Index. This is a flagship measure of global investment grade, fixed-rate corporate debt. This multi-currency benchmark includes bonds from developed and emerging markets issuers within the industrial, utility and financial sectors.
Source: Bloomberg; and Barclays.

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8. Central counterparties (CCPs) are a fundamental component of the infrastructure of modern financial markets. In normal times, CCPs eliminate counterparty risk by inserting themselves between the buyer and the seller of an agreed-upon trade and potentially reduce the overall exposure in the market (multilateral netting). However while they are able to mutualise idiosyncratic counterparty risk in normal times, they remain vulnerable to systemic shocks (Boissel et al., 2016).

asset management industry can be another source of systemic risk. Depending on its size, complexity, and the interconnectedness among its various investment management strategies and activities, distress at a large asset manager could amplify or transmit risks to other parts of the financial system (Office of Financial Research, 2013).

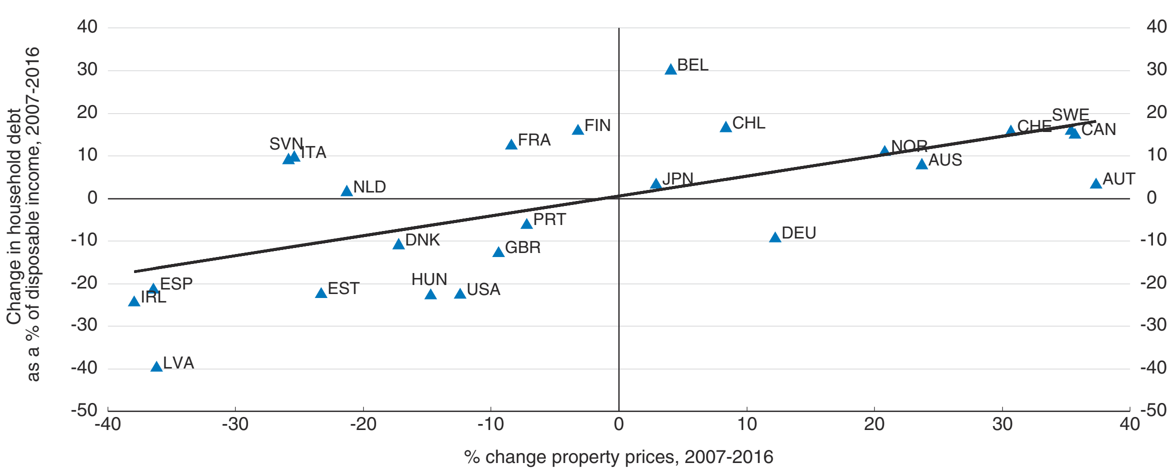
Elevated house prices increase risks related to household debt

Household debt ratios are closely linked to house prices and the credit cycle in mortgages can have strong effects on the price of dwellings. Among OECD countries, those that experienced the strongest increase in household debt since the crisis have also seen the steepest rise in house prices (Figure 2.14). During booms, the relationship between household credit and real estate valuations is typically strong because the supply of housing in local markets is inelastic in the short run. Second-round effects also play a role: a rise in house prices increases collateral valuations, augmenting household borrowing capacity. The herding behaviour of buy-to-let investors, often financed through credit, can further intensify these movements (André, 2016).

The close relationship between the evolution of real estate markets and household debt suggests that measures of leverage based on debt-to-asset ratios can remain broadly stable even during phases of sharp debt accumulation. However, these indicators mask households' growing exposure to a sharp fall in real estate prices. Housing booms often lead to busts which cause severe economic downturns and banking difficulties, as during the recent global financial crisis. Significant downward house price corrections negatively affect economic activity through self-reinforcing contractionary spirals, fuelled by adverse wealth effects, a reduction in collateral value, a negative impact on bank balance sheets, and a credit crunch. Empirical evidence suggests that rapid growth in household debt is typically associated with negative economic outcomes such as severe recessions (Sutherland and Hoeller, 2012; Hermansen and Röhn, 2017).

House prices have increased in many advanced economies since the global financial crisis. The rise in price-to-rent ratios has been particularly steep in the Scandinavian

Figure 2.14. **Changes in house prices and household debt are positively correlated**



Source: OECD Analytical House Price database; and OECD calculations.

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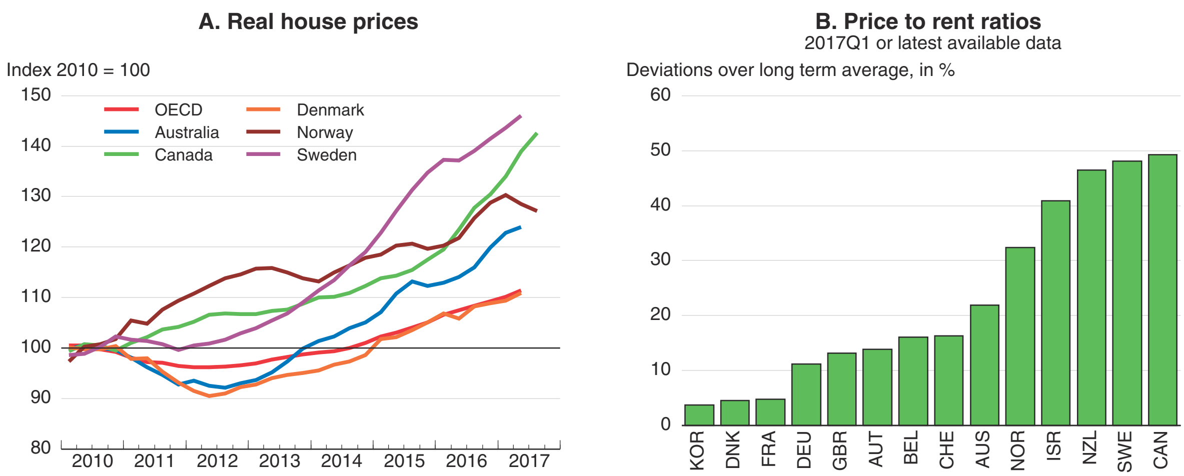
Figure 2.15. **House prices in OECD countries**



Note: Long-term average calculated over the period 2000-2016 or last available date.
Source: OECD Analytical House Price database.

StatLink http://dx.doi.org/10.1787/888933627181

countries, Australia and Canada (Figure 2.15). Although in part this reflects strong population growth, these developments may entail significant risk to financial stability, given the direct exposure of the financial system to the housing market, mortgages being one of the largest asset classes on bank balance sheets.

High household debt-to-income ratios can be detrimental for the economy, even if they do not lead to a crisis. For instance, high indebtedness can impede consumption smoothing during downturns, or amplify the negative effects on aggregate demand of economic shocks, even if they are small. Also, for given levels of borrowing costs, higher debt can reduce household disposable income and consumption. Some evidence also suggests that large run-ups in household debt, as occurred prior to the global financial crisis, appear to be followed by deleveraging phases characterised by prolonged contractions in economic activity (Mian et al, 2013).

High debt has longer term implications for growth

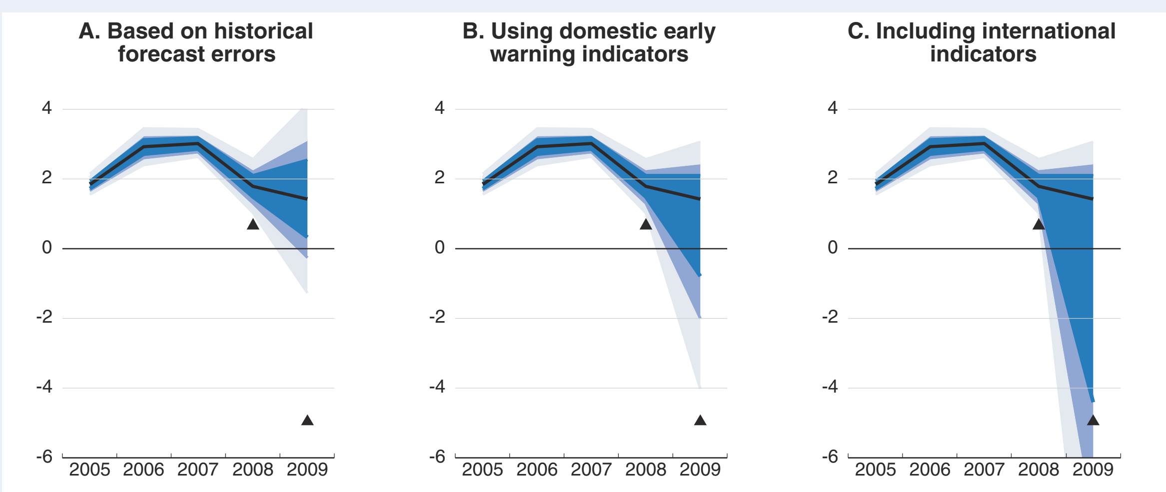
High indebtedness may create near-term vulnerabilities to financial and real shocks, but may also undermine growth and inclusiveness in the longer term. While finance and debt can support activity and innovation, there are potential trade-offs between growth and financial stability. Recent OECD research points to a number of links between high indebtedness and the risks of severe recessions. Among a set of more than 70 indicators, the variables measuring excessive developments in credit are the most useful for providing an early warning of severe recessions in OECD countries (Hermansen and Röhn, 2017). Indications of asset market misalignments, including those related to house prices, are also useful in signalling upcoming banking crises (Caldera Sánchez, et al., 2017). Taken together, these results indicate that among factors creating an environment prone to severe recessions and financial crises, excess leverage requires particular vigilance, in particular if it comes from rapid growth of private credit. Excessive credit dynamics can also be used as means of incorporating negative tail risk in economic projections (Box 2.2). Finally, global risk indicators such as the global credit-to-GDP ratio or global house prices are

Box 2.2. **Using early warning indicators to parameterise GDP growth forecast fan charts**

Macroeconomic forecasters have a poor track record of predicting future downturns as documented in numerous studies of many forecasters for different countries over various time periods (see for example: Fildes and Steckler, 2002; Loungani, 2001; Abreu, 2011; Pain et al., 2014). However, recent OECD research has found that housing-market and credit-related variables can be useful as early warning indicators to predict severe downturns in OECD economies (Hermansen and Röhn, 2017). Moreover, subsequent analysis finds that for G7 countries these early warning indicators are also strongly correlated with large forecast errors of GDP growth related to (a failure to predict) downturns and so can be used to calibrate the distribution of uncertainty surrounding a central forecast (Turner, 2017). In particular, such indicators can be used to distinguish a "safe" regime and a "downturn-risk" regime, with each regime having its own risk distribution and associated fan chart. The risk distribution associated with the downturn-risk regime is skewed to the downside and is assumed to be characterised by a two-piece normal distribution, which is a form commonly used by some central banks to convey uncertainties around inflation forecasts. In addition to domestic early warning indicators, a sum of similar indicators in other countries can be used to assess the risk of international contagion risks from other countries, and can substantially increase the negative skew in the fan chart.

Currently none of the early warning indicators used to calibrate the fan charts are 'flashing' for the G7 economies, which is because such indicators mostly relate to rapid growth in credit or house prices rather than a high level of such variables. Instead, the fan charts are illustrated here for an *Economic Outlook* projection published in May 2008, just prior to the global financial crisis, for the United Kingdom, one of the G7 economies most severely impacted by the crisis. A first fan chart is constructed as a 'straw man', being based on historical forecast errors assuming symmetry and ignoring the early warning indicators. On this basis the outturn for 2009 GDP growth at almost -5% is well outside even a 90% prediction interval on the fan chart (see panel A of the figure below), even though this interval for growth between -1% and 4%,

Alternative fan charts for the May 2008 *Economic Outlook* growth forecast for the United Kingdom



Note: Shaded blue areas show successively the 50%, 70% and 90% prediction intervals. The solid black line is the outturn up to 2007 and the projection for 2008 and 2009, as reported in the May 2008 Economic Outlook. The black triangles show the outturn according to the Economic Outlook published in the year following the first outturn data. The prediction intervals around the historical growth path reflect the extent to which historical estimates of GDP growth are subsequently revised.
Source: Turner (2017).

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Box 2.2. **Using early warning indicators to parameterise GDP growth forecast fan charts** *(cont.)*

around the central forecast of 1.4%, might seem quite wide. An alternative asymmetric fan chart (panel B), whereby the skew is calculated on the basis of a domestic early warning alarm for previous rapid growth in private credit, implies the outturn is closer to, but still outside, the lower 90% prediction limit of -4%. Thus, perhaps unsurprisingly, to encompass the extreme negative outturn, it is essential to take account of the international dimension of the crisis. Indeed, in the first half of 2008 early warning alarms were flashing for all G7 countries except Japan and Germany. A third fan chart, whereby the skew is calculated on the basis of both the domestic and international early warning alarms, encapsulates the outturn, which falls within the 50-70% prediction interval (panel C).

A similar set of fan charts can be computed for the forecasts of GDP growth for other G7 countries published in May 2008, with the position of the outturn for GDP growth in 2009 in each fan chart summarised in the table below:

- Calibrating the fan chart on the basis of historical errors, assuming symmetry (the 'straw man'), implies the outturn for 2009 is below, and usually far below, the 90% prediction interval for all G7 countries (as represented by the "S" in the table).
- Taking into account warnings from domestic early warning indicators brings the outturn for 2009 (the "W" in the table): within the 50-70% prediction interval for the United States; within the 70-90% interval for Canada and Italy; and for France and the United Kingdom is closer to, the 2009 outturn but still below, the lower limit of the 90% prediction interval. However, the position of the outturn for Japan and Germany remains unchanged and well outside the lower limits of the fan chart, simply because domestic early warning indicators were not flashing in these countries just prior to the crisis.
- Finally, allowing for the international dimension of the crisis, by taking into account the early warning indicators flashing in other G7 countries as well domestic indicators (the "G" in the table), brings the outturn for 2009 within the 50% prediction interval for the United States, Japan and Canada, and within the 50-70% prediction interval for all other G7 countries.

Position of the 2009 GDP growth outturn under alternative fan charts

Fan chart interval	United States	Japan	Germany	France	United Kingdom	Italy	Canada
0-50%	G	G					G
50-70%	W		G	G	G	G	
70-90%						W	W
90-99%	S			W	W		S
99%+		SW	SW	S	S	S	

Note: The table shows the prediction interval in which the outturn for GDP growth in 2009 is located in alternative fan charts constructed around the forecast made in the May 2008 Economic Outlook. The parameterisation of each fan chart is in some way grounded on the track record of historical forecast errors: "S" denotes the position of the outturn in a fan chart parameterised from all historical errors, assuming that underlying distribution is symmetrical (as per panel A in the chart for the United Kingdom above); "W" denotes the position in a fan chart parameterised using forecast errors during "downturn-risk" periods when domestic early warning indicators are flashing, recognising errors are not only larger but skewed to the downside (as per the chart in panel B above); and "G" denotes the position in a fan chart constructed when the global dimension of the crisis is taken into account by parameterising the fan chart from forecast errors when both domestic and international early warning indicators are flashing (as per panel C above).
Source: Turner (2017).

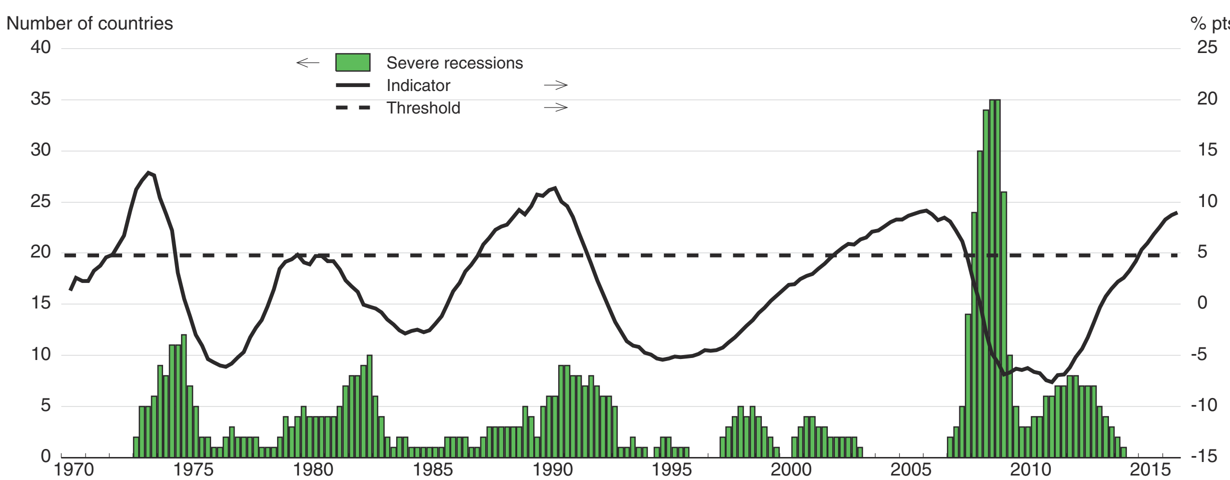
Box 2.2. **Using early warning indicators to parameterise GDP growth forecast fan charts** *(cont.)*

While these examples illustrate the potential usefulness of using the early warning indicators to calculate fan charts which correctly identify future downturn risks, there will also inevitably be false alarms when an early warning indicator flashes but a downturn does not occur within the immediate forecast horizon. The historical pattern suggests that on many of these occasions there will be a series of further alarms from the indicators as tensions in the housing market or credit growth continue to build until the bubble bursts and there is an eventual downturn in a manner consistent with Dornbusch's observation that "The crisis takes a much longer time coming than you think, and then it happens much faster than you would have thought". Indeed, this pattern and the difficulty of precisely predicting the timing of any downturn suggest that the early warning indicators are better employed in designing fan charts that identify potential risks rather than in adjusting the baseline forecast.

predictive signals of future recessions (Figure 2.16).[9] This highlights the importance of the global environment as a source of vulnerabilities for individual countries.

In the medium term, research shows that a marginal expansion in private credit is associated with lower long-term growth and rising inequality in advanced economies where credit provision is already high (Arcand et al., 2015; Cournède and Denk, 2015). Among the different sources of debt financing, bank lending, particularly mortgage lending to households, is negatively associated with economic performance. An overextension of housing finance not only potentially fuels house price bubbles, but may also misallocate capital that would otherwise be channelled towards corporate investment, thereby slowing GDP growth (Figure 2.17). Conversely, the development of stock markets has a positive effect on growth, but is associated with higher inequality.

Figure 2.16. **Real estate dynamics and severe recessions**



Note: Green areas represent the number of countries identified as being in a severe recession. The global real house price index is constructed as a GDP-weighted average across OECD countries and is measured as deviation from trend.
Source: Hermansen and Röhn (2017).

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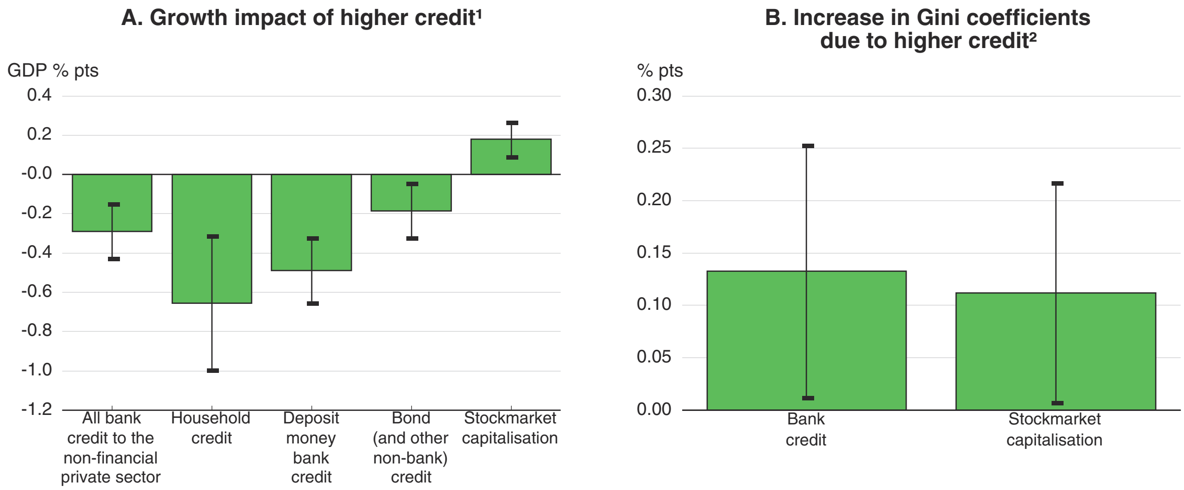
9. Global indicators are defined by Hermansen and Röhn (2017) as GDP weighted aggregates of individual country indicators used in the sample.

Figure 2.17. **Too much, or the wrong kind, of finance is negatively associated with growth and equality**



Note: The error bars show 90% confidence intervals.
1. For an increase in credit or stock market capitalisation equivalent to 10% of GDP.
2. Impact on the Gini coefficient, for an increase equivalent to 10% of GDP.
Source: Cournède and Denk (2015).

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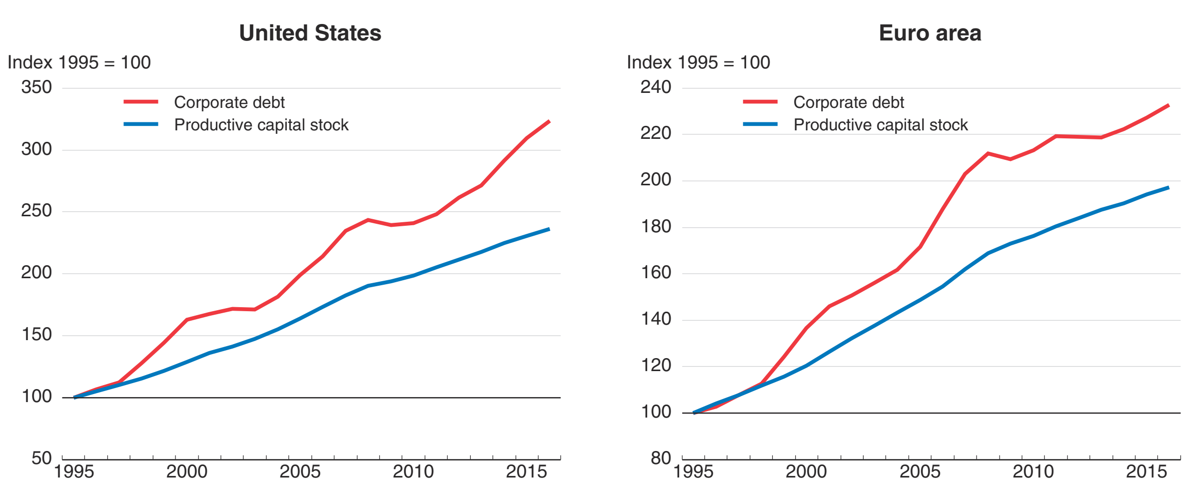
The disconnect between corporate debt and investment raises concerns about the allocation of capital

Rapid growth of corporate debt raises questions about what the funds are used for. If borrowing is well used, higher indebtedness contributes to economic growth by raising productive capacity or augmenting productivity. However, in many advanced economies, the post-crisis build-up of corporate debt has not translated into a rise in corporate capital expenditure (Figure 2.18). The divergence between corporate debt and investment is evident both in the euro area and the United States.

Figure 2.18. **The disconnect between debt and investment**



Note: Non-financial corporate debt and productive capital stocks are nominal series.
Source: OECD calculations.

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The post-crisis combination of rising corporate debt and historically high share buybacks may suggest that, rather than financing investment, firms took on debt to return funds to shareholders. A number of studies even suggest that corporations actively reduced investment in order to finance share repurchases and dividend payments (Gutierrez and Philippon, 2016; Almeida et al., 2016; Lee et al., 2016). However, the coincident rise in share buybacks and corporate debt could also reflect pessimism about future demand and economic growth, leading corporations to defer capital spending (OECD, 2015) and return cash to their shareholders for want of attractive investment opportunities (Brav et al., 2005). Alternatively, firms' decisions to buy back shares can be driven by a change in their financing structure, with a move from equity to debt financing motivated by the gap between the cost of equity and debt (Blundell-Wignall and Roulet, 2015).

High levels of debt may hamper the efficient allocation of capital

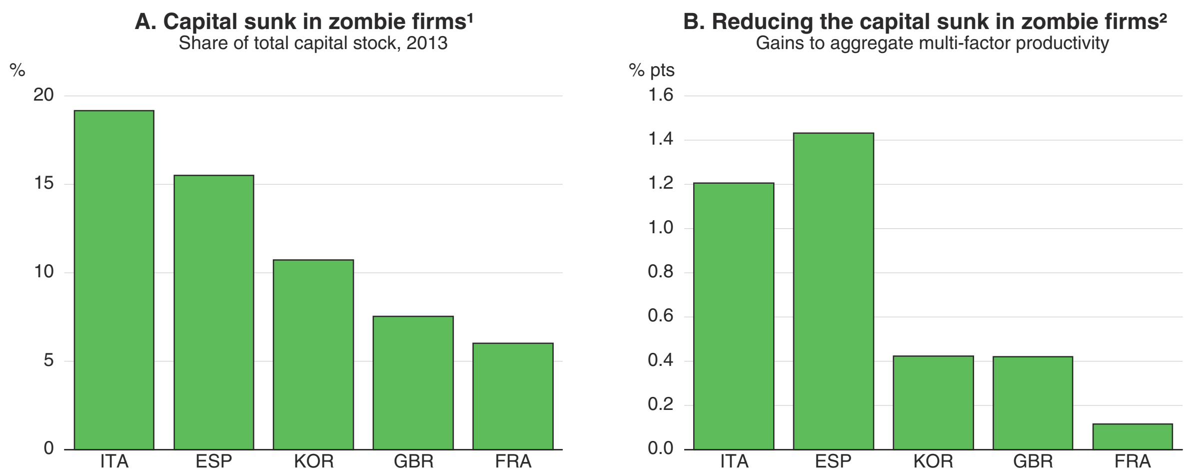
While finance is necessary to sustain corporate investment and productivity, too much debt relative to investment can also undermine the allocative efficiency of productive capital. High levels of debt, even when not resulting in default, can hamper the ability of corporates to undertake new borrowing to finance productive investments. Over-indebted firms tend to lose competitiveness, failing to keep up with the required investment to remain competitive. As a result, firms with persistently high level of indebtedness and low profits can become chronically unable to grow and become "zombie" firms.[10]

Zombie firms not only affect investment directly, but can also crowd out investment by non-zombie firms, hindering the efficient allocation of resources and slowing multi-factor productivity (MFP) growth by preventing more productive firms from gaining market share. Zombie "congestion" may thus reduce potential output growth by hampering the productivity-enhancing reallocation of resources towards more dynamic higher productivity firms (Figure 2.19).[11] Estimates of zombie congestion effects in OECD countries suggest that the prevalence of persistently weak firms that do not exit the market could be one factor behind the post-crisis weakness in business investment (Adalet McGowan et al., 2017a). The speed and efficiency of capital and labour reallocation is particularly important during economic expansions, to the extent that production factors tend to be scarcer.

High leverage and a bias toward debt financing, even in healthy firms, favours safer investment projects with a high component of tangible assets and a stable and predictable payout schedule. As such, debt financing may be less suited for investment in knowledge-based capital (KBC), which potentially help to explain currently low levels of productivity growth. KBC investments and business dynamism are instead favoured by seed capital and, more generally, by equity financing, raising concerns about the receding number of initial public offerings in all major OECD countries (Figure 2.20).

10. Adalet McGowan et al. (2017) define zombie firms as firms older than ten years and with an interest coverage ratio below 1 over three consecutive years.
11. Intuitively, zombie congestion can adversely affect the growth opportunities of healthier firms via two possible channels. First, zombie congestion could reduce the return on potential investment projects and thus make expansion less attractive for healthy firms by inflating wages relative to productivity, depressing market prices and undermining profitability. Second, the economic consequences of zombie congestion could also materialise due to the crowding out of credit, whereby banks direct less credit to healthy firms than otherwise to the extent that their balance sheets are weakened due to zombie exposure (Adalet McGowan et al., 2017a, b).

Figure 2.19. **Zombie firms capture capital and reduce dynamism**



1. Firms aged 10 years or more and with profits not covering interest payments over three consecutive years. The sample excludes firms that are larger than 100 times the 99th percentile of the size distribution in terms of capital stock or number of employees.
2. Counterfactual gains to aggregate MFP from reducing zombie capital shares to industry best practice level.

Source: Adalet McGowan, Andrews and Millot (2017a, b); and OECD calculations.

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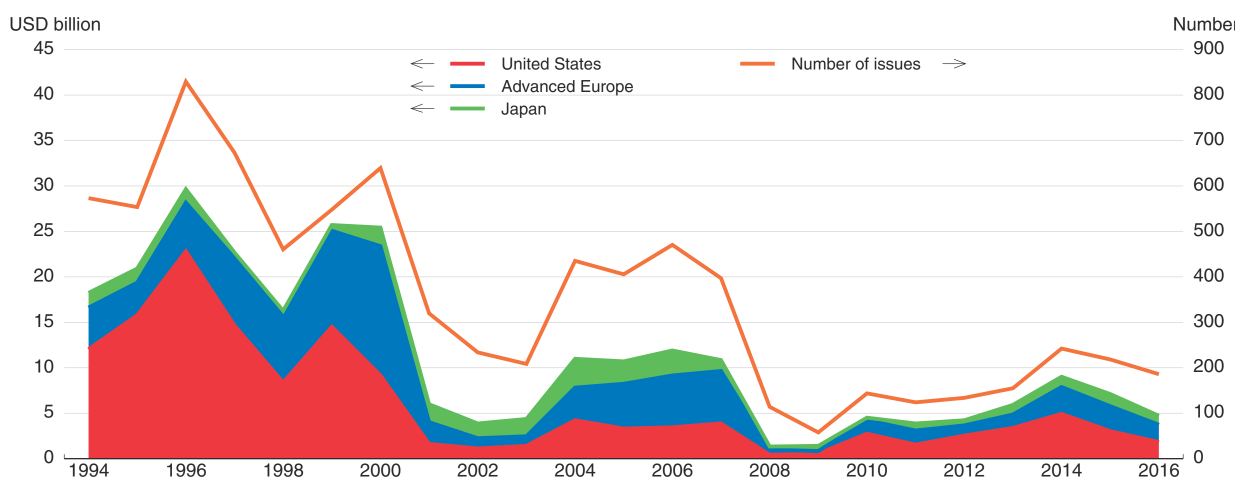
Figure 2.20. **Declining initial public offerings of smaller growth company listings in advanced economies**



Source: OECD Business and Finance Scoreboard 2017.

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Integrated policies to reduce financial vulnerabilities and enhance economic resilience

Reducing financial vulnerabilities and enhancing economic resilience in times of high private debt requires an integrated policy approach. The recent accommodative monetary policies in advanced economies have created very favourable conditions for borrowers and incited investors to take more risk. Against this backdrop, prudential policies can help to keep secure the sustainability of borrowing, alleviate the risk of currency and maturity mismatches, and curtail credit risk. Housing policies can attenuate pressures on house prices by fostering supply and residential mobility. Finally, financial regulation needs to find a balance between addressing risk concerns, ensuring that finance flows to the most productive uses and, at the same time, avoiding distorted incentives to move undue risks from banks to non-banks. OECD Economic Country surveys consistently recommend policies in this direction (see Annex A2.1 for an overview of recent policy recommendations).

Using and coordinating prudential policies to prevent unsustainable credit dynamics

Bank regulation has strengthened since the global financial crisis, including a growing use of macro-prudential policies, but risk has moved to other intermediaries and instruments. Basel III has set standards for countercyclical capital buffers (CCB) that are being phased in across Basel committee countries and Norway between 2016 and 2018, with the aim of reducing fluctuations in credit-to-GDP ratios. In addition, systemic risk buffers (SRB) have been imposed to limit leverage for a subset of other banks, to address systemic risks of a long-term, non-cyclical nature (Austria, Czech Republic and the Slovak Republic). Even with sufficient capital buffers, an apparently solvent institution could encounter difficulties due to risks arising from liquidity mismatches between assets and liabilities. To attenuate liquidity risks arising from excessive short-term debt, following the example of Sweden, the option of imposing liquidity coverage ratio caps should be considered.

Macro-prudential measures targeting individual borrowers include loan-to-value (LTV) and debt-to-income (DTI) caps. LTVs have been recently introduced or tightened in a number of countries (see Annex A2.2 for recently introduced measures). Fewer countries have opted for DTIs, while OECD research suggests that DTIs may be more efficient than LTVs in reducing the risk of negative GDP tail events (Caldera Sánchez and Röhn, 2016). Further instruments include loan amortisation requirements, increased risk weights for mortgage and consumer loans or mandatory interest rate stress tests. In the aftermath of the financial crisis, many Central and Eastern European countries experienced substantial depreciations of their currencies resulting in adverse balance sheet effects. In response, many of these countries implemented several measures to curb the share of loans denominated in foreign currency (Box 2.3).

Box 2.3. **Risks from leveraging in foreign currency loans – policy experiences from Central and Eastern Europe**

From the mid-2000s, households in Central and Eastern European countries (CEECs) borrowed extensively in foreign currencies, primarily euro and the Swiss Franc (CHF), from both foreign and domestic intermediaries. This was driven by substantial interest rate differentials. As a result, the share of foreign currency loans to the non-financial private sector reached high levels in some CEECs.

While this expansion of "cheap" lending had positive effects on growth (Rancière et al., 2010), foreign-currency denominated loans involved significant exchange rate risk. Households typically lack assets or income in foreign currencies that would serve as a natural hedge. Moreover, they do not have access to financial hedging instruments and lack sufficient understanding of exchange rate risks. At the onset of the global financial crisis in 2008, many CEEC currencies suffered sharp depreciations, leading to considerable increases in households' monthly re-payments. The inability of many households to cope with higher debt servicing costs affected consumption and spilled over to the financial sector through a sizeable rise in credit provisioning and non-performing loans.

Box 2.3. **Risks from leveraging in foreign currency loans – policy experiences from Central and Eastern Europe** *(cont.)*

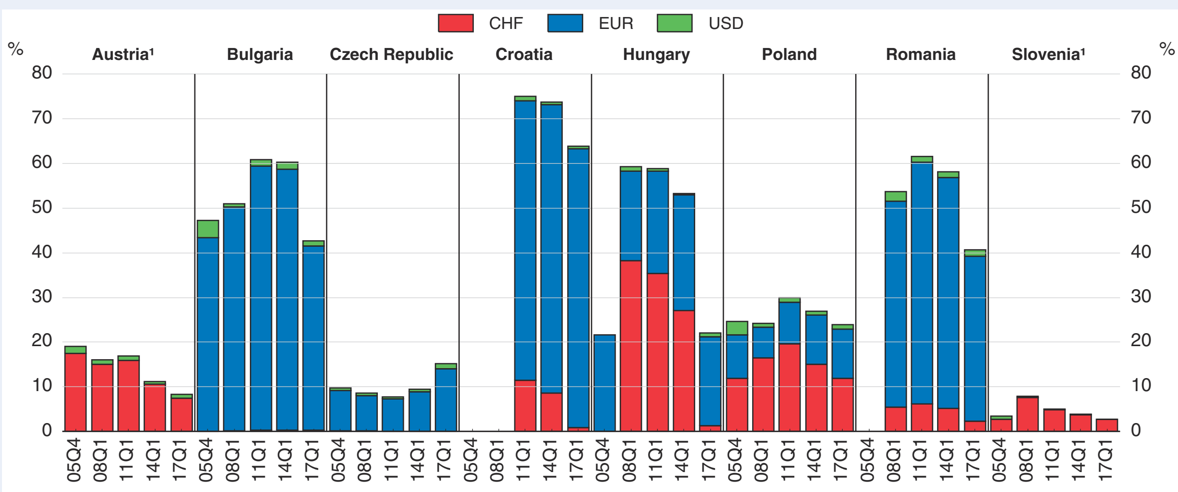
CEECs have subsequently implemented a wide range of policies to progressively curb the use of loans denominated in foreign currencies and to mitigate the associated risks (see Annex A2.2). Many of these policies lie in the macro-prudential domain[1] and are targeted at bank and household foreign exchange exposures. These new types of measures, so-called "currency-based measures", have recently proliferated globally (De Crescenzio et al., 2015, 2017; OECD, 2017) and are being analysed within the Advisory Task Force on the OECD Codes of Liberalisation.

Measures taken in CEECs range from soft recommendations to legal obligations and target different sectors (i.e. borrower based or supply side; covering non-bank financial sector or bank intermediaries). More direct legislative actions have also been taken or attempted. Foreign currency lending was temporarily prohibited in Hungary in 2010 and in Poland in 2013. Laws forcing all banks to convert CHF loans into domestic currency or euro were adopted in Hungary (conversion into forint at current market rates in 2014), in Croatia (into euro at historical rates in 2015), and in Romania (into leu at historical rates in 2016).

The implementation of currency-based measures in CEECs has been effective. The share of foreign currency loans, especially to households, has constantly decreased since 2011.

Foreign currency lending to the non-financial private sector

Per cent of total loans



Note: Lending in selected foreign currencies by resident financial institutions to the non-financial private sector as percentage of total loans to the sector. Data unavailable for Croatia in 2005Q4/2008Q1 and Romania in 2005Q4.

1. Countries part of the euro area.

Source: ECB Balance Sheet Items.

StatLink http://dx.doi.org/10.1787/888933626896

1. The use of such measures as macro-prudential tools has been most clearly spelled out in the ESRB Recommendation on Foreign Currency lending (ESRB 2011).

The effective implementation of prudential policy depends on the availability and timeliness of data to accurately observe financial conditions. The degree of responsiveness of macro-prudential tools will depend on the quality and lag of incoming data. Rubio and Unsal (2017) find that optimal macro-prudential policy should be less aggressive, in other words less reactive, in countries with poorer data. Experience with macro-prudential policies in the financial system as it now stands remains limited and this conditions their use.

Most macro-prudential measures are implemented in a country-specific manner, which creates possibilities of cross-border leakages and regulatory arbitrage across jurisdictions. It is therefore important to reinforce coordination between countries and reach reciprocity agreements if necessary. The *OECD Codes of Liberalisation of Capital Movements* provides an established and tested process of transparent international dialogue and co-operation (OECD, 2017e), but typically-used macroprudential rules fall outside the scope of its mandate. The Review of the Codes and their opening to adherence by non-members further raises opportunities for greater international co-operation including reciprocity agreements regarding macroprudential rules.

In addition, more specific regulation can help to reduce the risk of cross-border spillovers. For instance, Austria has implemented loan-to-local-stable-funding-ratios (LLSFR) to strengthen the resilience of subsidiaries of Austrian banks operating abroad, notably in Eastern and South-Eastern European countries. While this measure reduces vulnerabilities, it may also impede the efficiency of international debt markets and create geographic fragmentation (FSB, 2017a).

Monitoring and supervising non-bank credit intermediaries

The shift from bank loans to debt securities, combined with the increasing prevalence of non-bank credit intermediaries, calls for better coordinated monitoring and, as appropriate, more supervision of non-bank intermediaries. Avoiding regulatory arbitrage between bank and non-bank intermediaries, while recognising important differences in their activities, may be necessary to prevent unwarranted and difficult to observe shifts of risks to the shadow banking system.

Interconnectedness between banks and other financial intermediaries (OFIs) can exacerbate contagion in the financial system, in particular in EMEs (FSB, 2017b). In Brazil, Chile and South Africa, OFI funding as a share of bank assets exceeded 10% at the end of 2015, implying rollover-funding risks for banks. Also, banks claims on OFIs exceeded 10% of bank assets in Ireland, the United Kingdom and Belgium, exposing banks to credit risk spillovers from OFIs.[12] Insurance companies and pension funds are also heavily exposed to OFIs (FSB, 2017b). For instance, as of end-2015, close to 50% of Dutch pension funds' assets were claims on OFIs. Similarly, Australian insurance corporations' claims on OFIs exceed 50% of total assets. These investments are motivated, among other factors, by regulatory requirements restricting or penalising other types of investment.

The interconnectedness between banks and non-banks raises concerns over the potential adverse effects of sudden redemptions. Some measures have been proposed to mitigate liquidity risks for OFIs, several of which focus on the ease with which investments can be withdrawn (e.g. exit fees, redemption gates, side-pockets). Others focus on improving market functioning, including by making the underlying risks more transparent or by conducting stress tests. Some of these measures, in particular those penalising withdrawals, might create new distortions. Hence, their overall effect on market

12. While the record and measurement (according to the 2008 SNA) of OFIs and shadow banking financial activities presents significant challenges, recently efforts have been made to increase the availability of international comparable data, including through the OECD Working Party on Financial Statistics.

functioning and financial stability partly depends on their design and implementation, and should be assessed thoroughly. Further concerns arise from potential credit risk mispricing of OFIs, due to bundling and implicit or explicit enhancements and guarantees, offered partly by involved banks. The lack of granular and harmonised data often impedes the identification of specific risk and vulnerabilities. The rising importance of OFI activities in emerging market economies heralds strong international cooperation in the monitoring and supervision of non-bank credit intermediation activities.

Expanding housing supply

The growing importance of real estate as a source of wealth in most advanced economies raises the potential sensitivity of aggregate consumption and investment to changes in house prices. Low interest rates have stimulated the demand for mortgages, and restrictive regulations have often constrained housing supply. Macro-prudential measures that target the demand side of the housing market should be complemented by measures that address distortions on the supply side. Easing relatively strict rent controls and tenant-landlord regulations that are found in some countries (for example Denmark, Sweden and the Netherlands) could increase the supply of rental housing (OECD, 2011). The Netherlands has recently taken steps in this direction (OECD, 2016d). In some continental European countries, reducing the high costs involved with buying a residence could also enhance residential mobility. This would include tax restructuring and removing or curbing regulations that limit competition among intermediaries involved in housing transactions (e.g. notaries and real estate agencies).

Housing supply is also heavily affected by land-use regulations and, in most OECD countries land use regulations provide binding restrictions to housing supply, predominantly in large cities.[13] Recent OECD Economic Surveys have recommended a thorough review of regulations in several countries (Australia, Canada, Chile, Luxembourg and United Kingdom), while recognising that some planning constraints are necessary for environmental and social reasons. Rigid planning systems, such as in the United Kingdom or Canada, restrict the supply of available and affordable housing, whereas more flexible systems such as in Switzerland seem to be associated with more elastic housing supply and smaller demand-supply imbalances (Blöchliger et al., 2017). Finally, since land-use planning in virtually all OECD countries is the purview of local governments (OECD, 2017h), it is important for national governments to provide incentives to local governments to promote greater housing supply. This could be done through fiscal systems that generate greater tax revenues for local governments that increase housing supply or through transfer payments to local governments that are linked to housing supply (OECD, 2017g).

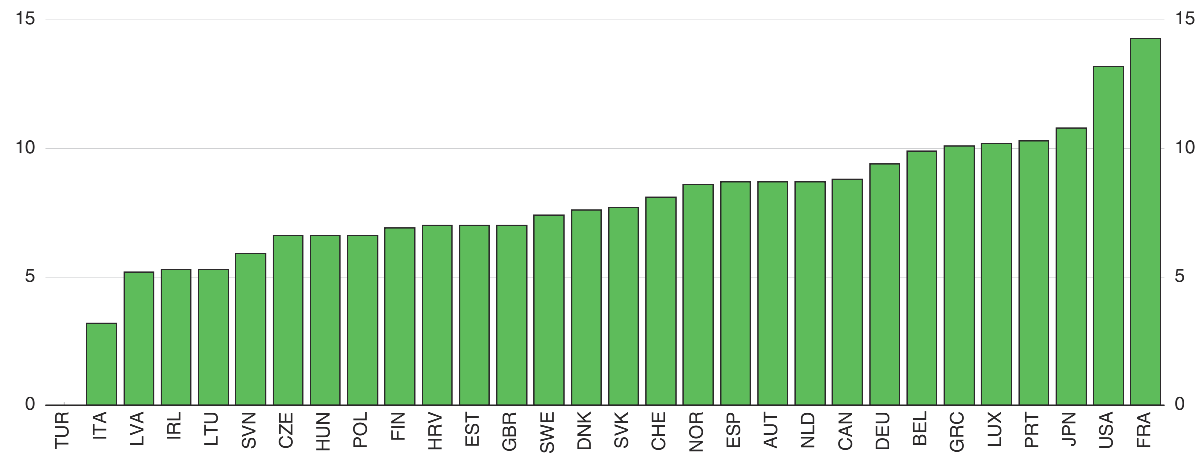
Strengthening equity finance and improving capital allocation

Strengthening equity funding would help reduce corporate leverage, curb insolvency risks and increase resilience. Agency costs and asymmetric information give firms a preference for debt (Myers and Majluf, 1984), and most corporate tax systems exacerbate this by favouring debt over equity, primarily through the deductibility of interest payments (Figure 2.21). Debt shifting, as part of the profit shifting strategies of multinational groups,

13. To the extent large parts of urban land is built-up at low densities, reforms of land-use regulations should encourage densification. In particular, maximum density restrictions and single-use requirements in land-regulations should be gradually relaxed (OECD, 2017g).

Figure 2.21. **Debt bias in corporate tax systems**

Differences in effective average tax rates (new equity minus debt), 2016



Source: ZEW (2016).

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can compound the debt-equity bias (Sorbe et al., 2017). Eliminating the tax bias would rebalance financing incentives and reduce the benefits of share buybacks.

A number of tax systems also contain biases towards mortgage debt and owner-occupied housing. Examples include: property taxes that do not appropriately reflect house price valuations (e.g. Denmark and Sweden); mortgage interest payment deductibility (e.g. Denmark, Luxembourg, Norway, Sweden and the United States); and tax credits for administrative costs of buying property for personal use (Luxembourg). Some countries have recently reduced mortgage interest rate deductibility (Finland and the Netherlands). Others have introduced incentives to reduce the preference for debt investment through allowances for corporate equity (Belgium, Italy and Turkey).

Removing barriers to the availability of equity financing would offer stronger potential for diversifying funding sources. This is particularly important for young and innovative firms with restricted access to bank financing or bond markets. The continuing decline in initial public offerings (IPOs) since the global financial crisis is reflected in a reduced depth of equity markets in many countries. Subdued competition amid the rising importance of bank consortiums controlling the IPO market seems to have triggered cost increases for IPOs, especially for small- and medium-sized businesses (OECD, 2017c). Strengthening competitive conditions by countering bank restrictive practices could help reinvigorate the IPO market.

Private equity markets remain relatively underdeveloped in many countries. In the vast majority of countries, venture capital represents less than 0.05% of GDP.[14] Exceptions are the United States (0.2%) and Israel (0.5%). Recent OECD research suggests that firms benefiting from venture capital financing, particularly in the early stages of development, exhibit higher productivity growth (Heil, 2017). Other alternative financing measures, such as peer-to-peer lending or crowdfunding, should also be developed further, subject to appropriate regulation, to foster business dynamism and innovation. Most OECD and EMEs have recently enacted legal frameworks for equity crowdfunding platforms, with quite

14. OECD Entrepreneurship Financing Database.

differentiated success, suggesting potentially important benefits from exchanging and learning from best practices.

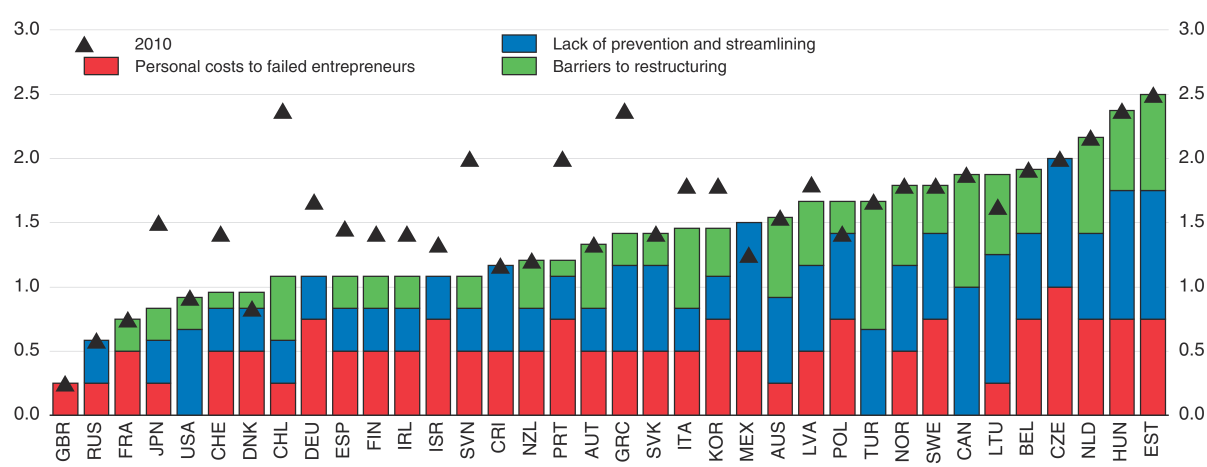
The relative importance of state-owned enterprises (SOE) in EMEs has also contributed to the increase in corporate debt, in particular in China. SOEs often benefit from preferential access to financial markets, including implicit government guarantees, and exhibit higher debt and higher leverage than other non-state owned companies (OECD, 2017c). The *OECD Guidelines on Corporate Governance of State-Owned Enterprises* provide concrete guidance on how to ensure that SOEs are appropriately governed and do not benefit from undue competitive advantages when they operate in markets, and establish good practices for financial and non-financial disclosures (OECD, 2015b).

Implicit guarantees have also distorted the allocation of capital in most advanced countries. German and Austrian banks, for instance, benefitted from *Länder* guarantees that were assumed to be backed by the central government in event of insolvency or liquidity crises. The resulting cheap money, coupled with the externalisation of bankruptcy risks, led to excessive risk taking by banks. As the risks materialised, many major banks collapsed and needed to be bailed out by the central government. Efficient bank resolution mechanisms, notably including burden-sharing by senior and sub-ordinated creditors, are key to reduce implicit guarantees and the associated market frictions (Denk et al., 2015).

Analysis suggests that the efficient allocation of capital depends on the efficiency of insolvency regimes in terms of i) low personal costs for failed entrepreneurs, ii) prevention and streamlining tools, and iii) tools for facilitating corporate restructuring. Results of a dedicated questionnaire addressed to OECD member countries reveal considerable differences across countries in the design of insolvency regimes. This suggests that there is substantial potential to benchmark and improve insolvency procedures, thereby making the restructuring and rehabilitation of distressed assets more efficient (Figure 2.22). Facilitating the liquidation or restructuring of firms would reduce the share of capital sunk in zombie firms, revitalise non-productive companies and facilitate technological diffusion

Figure 2.22. **The design of insolvency regimes across countries**

Indicator increasing in the extent to which the insolvency regime delays the initiation and resolution of proceedings



Note: The stacked bars correspond to three subcomponents of the insolvency indicator in 2016. The triangle corresponds to the value of the aggregate insolvency indicator based on these three subcomponents in 2010. Only countries for which data are available for the three sub-components in 2016 are included.

Source: Adalet McGowan et al. (2017b).

StatLink http://dx.doi.org/10.1787/888933627314

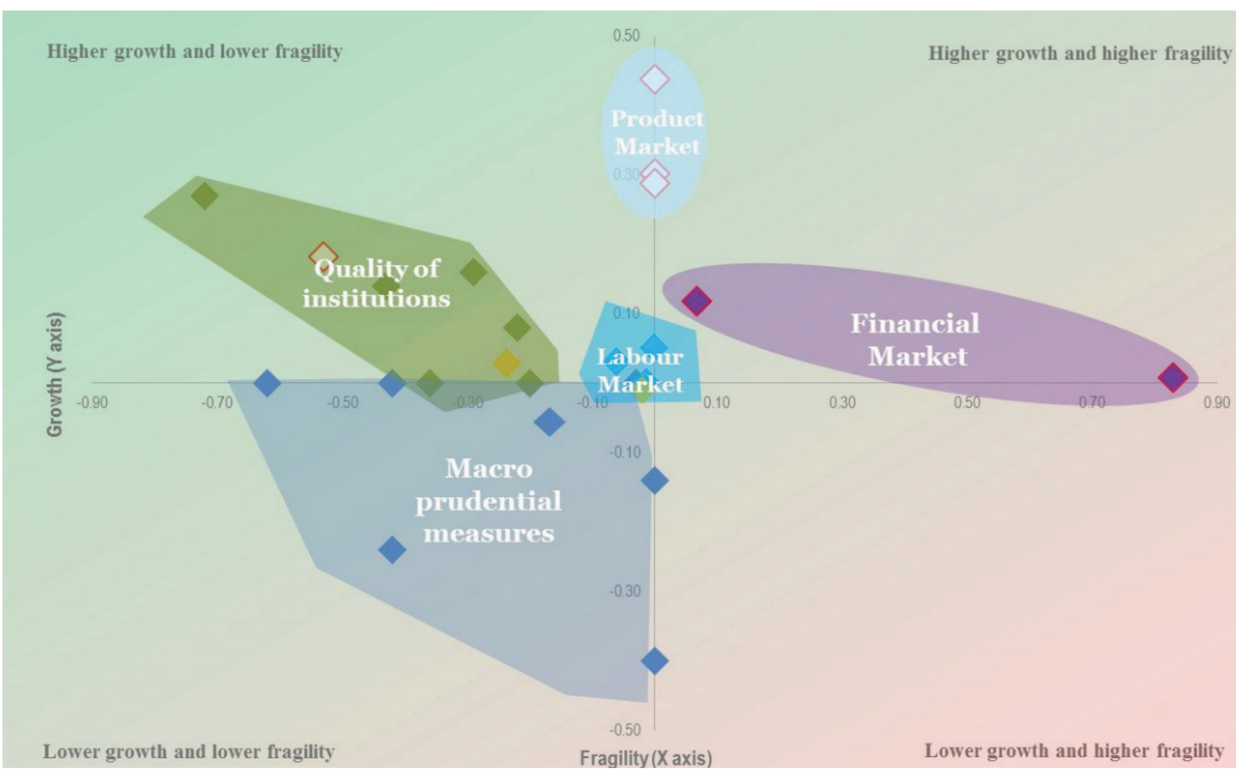
(Adalet McGowan et al., 2017b). The prevalence of zombie firms is negatively correlated with the health of banks, as measured by a composite index of banks' balance sheet indicators (Andrews and Petroulakis, 2017).

Addressing potential trade-offs between risk mitigation and growth-enhancing objectives

Fostering financial stability is only one objective of policy makers and may conflict with other goals. Recent research has shed light on potential trade-offs between the objectives of risk mitigation and growth maximisation (Figure 2.23). Financial market liberalisation, for instance, boosts growth but also leads to more frequent and deeper recessions, notably through its effect on credit dynamics. Similar effects are observed for capital account openness, in particular for EMEs operating under flexible exchange rate regimes, as they are exposed to volatile capital flows. There is broad consensus that foreign direct investment (FDI) produces fewer vulnerabilities than portfolio flows, as the latter are more volatile and typically of shorter maturity (e.g. Guichard, 2017).

A key driver of FDI is the quality of institutions, which is particularly relevant for EMEs (Economou et al., 2017). Reducing informality and strengthening the rule of law could help

Figure 2.23. **Growth-fragility trade-offs**



Note: The X axis plots the effect of policies on fragility; fragility is defined as higher likelihood of a financial crisis (policies with red outline) or a higher GDP (negative) tail risk. Three types of financial crises are considered: currency, banking and twin crises. Tail risk is defined as the effect of a policy variable on the bottom 10% of the distribution for quarterly GDP growth. The chart reports coefficients corresponding either to elasticities or marginal effects, depending on the policy considered. Institutional quality indicators are associated with both growth and lower fragility; labour and product market policies generally affect growth, with little or no impact economic risk. Growth fragility trade-offs exist when considering macro prudential and financial markets policies. The yellow dot under the green area (Quality of institutions) represents the effect on growth and fragility of a free-floating exchange rate, while the one under the light blue area (Labour market) represents automatic stabilisers.
Source: Caldera Sánchez et al. (2017).

rebalance international capital flows towards inward FDI, thereby reducing vulnerabilities, enhancing resilience and fostering technology transfers, investments and potential growth. Indeed, countries with higher-quality institutions are found to experience both higher growth and a lower risk of severe recessions (Caldera Sánchez et al., 2017).

Macro-prudential policies reduce vulnerabilities by curtailing systemic threats to financial stability arising, for example, from excessive credit, leverage and asset price growth. Limits on debt-to-income and loan-to-value ratios and limits on credit growth and foreign currency lending can be effective in reducing leverage during boom times. Some macro-prudential policies also increase the shock absorption capacity of the financial sector. For instance, capital and liquidity buffers increase the distance to default in the case of an adverse shock. However, prudential measures can also be associated with lower growth, by distorting incentives or reducing the efficiency of financial markets (Caldera Sánchez et al., 2017). The adoption of prudential measures should therefore be mindful of potential costs in terms of lower growth, and aim at striking the right balance between reducing fragilities and insuring strong economic performance.

Structural reforms of product and labour markets can help offset the growth-curbing effect of prudential policies insofar as they lead to higher growth without increasing the frequency of severe recessions. Some structural reforms such as active labour market programmes or reducing barriers to trade actually come with the double dividend of higher growth and lower risk of recession (Caldera Sánchez and Gori, 2016). Against this background, and given the fact the responsiveness rate of OECD Going for Growth recommendations has lately declined to pre-crisis level (OECD, 2017a), policymakers should step up efforts to unlock skills, boost business dynamism and allow workers and institutions to adapt to rapidly changing labour markets (Chapter 1).

Strengthening financial literacy stands out as a cross-cutting policy objective amid increasing digital transformation of societies, labour and financial markets. Improving households' understanding of financial concepts not only serves inclusiveness by broadening access to economic opportunities; it also helps mitigate risks, for instance by allowing households to better understand the long-term impacts of consumer loans. Recent evidence suggests that more than half of the adult population in G20 countries lacks the basic financial knowledge to make informed financial decisions (OECD, 2017f). Ongoing efforts to design and improve national strategies to overcome gaps in financial education should be pursued.

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ANNEX A2.1

Recent OECD Economic Survey recommendations to address vulnerabilities arising from private debt

Table A2.1.1. **Household debt**

Key recommendation	Survey
Macro- and micro-prudential measures	
Maintain tight macro-prudential measures.	Australia, March 2017
Continue to tighten macro-prudential measures and target them regionally, including through increasing capital requirements in regions with high house price-to-income ratios, as planned.	Canada, June 2016
Encourage mortgage institutions to strengthen the use of debt-service-to-income ratios.	Denmark, May 2016
Give consideration to extending some of the locally targeted "Best practices" introduced by the regulator for granting a mortgage in hotspot areas to the whole country.	Denmark, May 2016
Introduce additional macro-prudential measures, such as limits to loan-to-value or loan-to-income ratios.	Luxembourg, June 2017
Add a debt-to-income limit to the Reserve Bank's macro-prudential instruments to increase the resilience of bank balance sheets, with attention to benefits exceeding costs.	New Zealand, June 2017
Should house-price growth remain uncomfortably high, consider tightening macro-prudential measures while closely monitoring and reviewing their effectiveness.	Norway, January 2016
Stand ready to further tighten macro-prudential policy settings if financial sector risks do not diminish.	Slovak Republic, June 2017
Introduce a cap on household debt-to-income ratios.	Sweden, February 2017
Establish a framework for explicitly addressing affordability risk, to be used if needed to contain financial stability risks related to imbalances in the housing and mortgage markets.	Switzerland, December 2015
Monitor closely mortgage lending to firms or households for rental properties, which may not be as responsive as the owner-occupied segment to recent regulatory measures.	Switzerland, December 2015
Continue to uphold underwriting standards in mortgage lending.	United Kingdom, February 2015
Enhance prudential regulation by requiring lenders to take into account borrowers' repayment ability when extending loans.	China, March 2017
Implement further macro-prudential measures if risks to the financial system (from housing prices) rise.	Israel, January 2016
Develop macro-prudential instruments to rein in excessive growth of consumer loans as part of regulatory and supervisory reforms. Improve monitoring and processing of non-performing loans. Resolve the potential conflict of interest at the central bank, which is the majority owner and supervisor of the largest Russian commercial banks.	Russia, January 2014
Housing Policies	
Facilitate housing supply increases through improved planning regulations.	Austria, March 2017
Support a bigger private rental housing market by easing rent regulation while striking a balance between landlord and tenant protection.	Denmark, May 2016
Continue to improve the responsiveness of housing supply including in the rental market and avoid home buyer subsidies.	Ireland, September 2015
Reform land planning and introduce time-limited building permits.	Luxembourg, June 2017
Support the supply of rental housing by further limiting strict rent regulation in the private market.	Netherlands, March 2016
Enhance co-operation between central and local government in land-use planning and increase incentives for municipalities to facilitate the timely release of development land. Simplify land-use planning procedures, balancing economic, environmental and social considerations.	Sweden, February 2017
Ease rental regulations to incentivise rental housing supply, mobility and better utilisation of the housing stock, while maintaining tenant protection against abuse.	Sweden, February 2017

Table A2.1.1. **Household debt** *(cont.)*

Key recommendation	Survey
Review spatial planning regulations to make it easier to build denser housing.	Switzerland, December 2015
Further relax regulatory constraints to boost housing supply, in particular by thoroughly reviewing the boundaries of protected areas of the Green Belt.	United Kingdom, February 2015
Tax Policies	
Reform property taxation, including by decreasing mortgage interest rate deductibility and regularly updating valuations in order to establish neutrality across different asset classes.	Denmark, May 2016
Increase taxation of non-used constructible land.	Luxembourg, June 2017
Limit further mortgage interest deductibility to reduce housing demand.	Luxembourg, June 2017
Reform the recurrent property tax to better align tax charges with property values. Phase out the deductibility of mortgage interest rate payments.	Sweden, February 2017
Limit the tax deductibility of mortgage interest so that, combined with maintenance outlays, it does not exceed the amount of declared imputed rent. Update the imputed rent calculations more frequently to better reflect market values.	Switzerland, December 2015

Note: The table includes key recommendations only. Surveys may contain other recommendations. The sample includes 48 Economic Surveys in total, for each country the most recent Survey is considered.

Table A2.1.2. **Corporate debt**

Key recommendation	Survey
Insolvency/Restructuring	
Use debt-equity swaps more frequently by forcing creditors to share the burden of firm restructuring.	Italy, February 2017
Improve the workings of insolvency rules by: • Reconsidering the privileged treatment of public creditors. • Enlarging the scope for simple-majority decisions among creditors. • Shortening out-of-court settlement procedures.	Portugal, February 2017
• Enhance the leading role of the Bank Asset Management Company to ensure swift restructuring of companies and effective liquidation of assets. • For the most important firms to be restructured, ensure that all assets in a company group are transferred to the Bank Asset Management Company. • The Bank Asset Management Company should maintain its independence and ability to attract highly professional staff, while adhering to the highest standards of corporate governance and transparency. • Monitor the implementation of the new insolvency regulation and improve institutional capacity by training judges and insolvency administrators. Make out-of-court restructuring faster and more attractive.	Slovenia, May 2015
Tax policies	
Broaden the tax base by reforming exemptions that facilitate tax avoidance such as the notional interest rate deduction.	Belgium, June 2017
Other	
Gradually remove implicit guarantees to SOEs and other public entities to reduce contingent liabilities.	China, March 2017
Reduce state ownership in commercially oriented, non-strategic sectors. Let unviable SOEs go bankrupt, notably in sectors suffering from over-capacity.	China, March 2017
Resolution of non-performing loans	
• When NPLs create a serious economic risk, speed up and facilitate the resolution of NPLs by not triggering bail-in procedures within the existing rules. • Consider establishing asset management companies where needed, and possibly at the European level. • Take supervisory measures to encourage banks to resolve NPLs, which might include raising capital surcharges for long-standing NPLs.	Euro area, June 2016
Continue improving the bankruptcy framework to speed up resolution of non-performing loans. Introduce effective incentives and performance targets for banks to monitor their progress in reducing non-performing loans.	Greece, March 2016
• Implement a strategy for the asset management company to step-up offloading of non-performing assets. • Expand capital surcharges on nonperforming loans detained by banks beyond a certain period. • (Bolster competition in the banking sector by selling stakes in state-owned banks.)	Hungary, May 2016
Accelerate through the court system the resolution of non-performing loans that require repossessions.	Ireland, September 2015

Table A2.1.2. **Corporate debt** *(cont.)*

Key recommendation	Survey
• Continue to develop the secondary market for NPLs. • As envisaged by the European Supervisory Mechanism, set gradual and bank-specific targets to reduce non-performing loans, backed up by sanctions such as additional provisions, asset sales, suspension of dividend payments and restructuring banks operations. • (If public funds are needed to recapitalise distressed banks, take full advantage of EU regulations, imposing losses on equity and bondholders, and restructuring banks' operations. Compensate retail bondholders for the losses they will incur).	Italy, February 2017
• Strengthen current regulatory incentives for reducing NPLs, including through write-offs and sales. • Support the development of a market for distressed debt, notably through the creation of asset management companies.	Portugal, February 2017

Note: The table includes key recommendations only. Surveys may contain other recommendations. The sample includes 48 Economic Surveys in total, for each country the most recent Survey is considered.

ANNEX A2.2

Recently introduced prudential measures

	Creditworthiness: borrower-based measures	Resilience of financial sector: capital-based measures (% of risk-weighted assets)	Maturity and currency mismatches and liquidity risk
Austria	• Sector-specific LTVs (e.g. 80% for building societies).	• Systemic risk buffer of up to 2%for 12 banks (from 2016, fully phased in in 2018). • O-SII buffer, 1-2% (phased in 2016-2018). • The capital conservation buffer being gradually introduced between 2016 and 2019; when fully phased in it is at 2.5%.	
Belgium		• 5 percentage point risk weight add-on for internal rating-based banks' residential real estate exposures since 2014. • O-SII buffer of 0.75-1.5% phased in from 2016. • CCyB at 0 % from January 2016.	
Denmark	• LTV limit of 95% (2015). • Cap on LTI ratio (Effective as of Jan 1, 2018). • Cap on LTI ratio: additional restrictions on mortgage products available to homeowners with a (total) DTI ratio above 400 per cent (before tax) (Effective as of Jan 1, 2018). • Minimum 5% down-payment when purchasing a home from November 1, 2015.	• Systemic risk buffer at 1-3% by 2019 (0.4-1.2% in 2016). • CCyB at 0% from January 2016. • Capital conservation buffer being phased in between 2016 and 2019 (0.625% in 2016 and 2.5% in 2019). • LCR of a least 100 % for all institutions by 1 January 2018.	• Core funding ratios (the lending divided by the sum of deposits, issuances with more than 12 months to duration, subordinated debt and equity should be less than 1).
Estonia	• Requirements for new housing loans (as of 1 March 2015): at least 85% of new housing loans issued. • LTV limit of 85% (90% if guaranteed by KredEx), DSTI limit of 50% and a maturity limit of 30 years.	• Systemic risk buffer requirement of 1% from 1 August 2016. • O-SII buffer of 2% from 1 August 2016 for the two largest banks; CCyB requirement to be maintained at 0%.	
Finland	• LTV limit of 90% (95% for first-time buyers) in effect since July 2016.	• Capital conservation buffer 2.5% since January 2015. • O-SII buffers of 0.5-2.0% since January 2016. • Initiated process to introduce an average risk weight floor of 10% for internal rating-based banks' mortgage exposures.	
Hungary	• Specific LTV cap for foreign currency loans (2010,2015). • Specific DTI and DSTI caps for foreign currency loans (2010, 2015).		• Foreign Exchange Funding Adequacy Ratio (FFAR) (2012). • Foreign Exchange Coverage Ratio (FECR)[1] (2015).
Japan	• DSTI decreased to 30% from 40% in "overheated speculation areas". • DSTI's will be mandatory for all banks from the second half of 2018 onwards.		

	Creditworthiness: borrower-based measures	Resilience of financial sector: capital-based measures (% of risk-weighted assets)	Maturity and currency mismatches and liquidity risk
Netherlands	• LTV limit for new mortgages lowered from 106% in 2012 to 100% in 2018 (currently 102%). • Recommendation of Financial Stability Committee to continue the gradual reduction of LTVs beyond 2018 to a 90% limit. • DSTI and LTI limits in place since 2012, being gradually tightened (limits depend on income and interest rates). • New mortgages must be fully amortising in order for the interest payments to be tax-deductible (from 2013)	• 3% systemic risk buffer and O-SII buffer between 1-2% being phased in 2016-2019; the higher of two applies to each bank. • The CCyB has been 0% since 2016. • Macro-prudential tools for loans (LTV limits, etc.) apply to banks and non-banks.	
Norway	• DTI limit of 5 times gross income. • LTV limit of 85%. • Principal repayment requirements of 2.5% annually with LTV above 60%.	• CCyB at 1.5% from January 2015. • Capital conservation buffer 2.5% since January 2013. • 3% systemic risk buffer. • Sectoral capital requirement (risk weight on residential mortgages). • Leverage ratio requirement.	• Liquidity coverage ratio (LCR) requirements: 100% for systemically important banks, 80% for others (100% from 31 December 2017); LCR requirements in individual currencies.
Poland	•Specific LTV and DSTI caps for foreign currency loans (2010, 2011).	• Higher risk weights or capital requirements on foreign currency loans (2007, 2012).	
Slovak Republic	• Recommendations in October 2014: LTV ratio should not exceed 100%, with a given share of loans above 90%; DSTI limit at 100%; 30-year maturity restriction for mortgages.	• Capital conservation buffer set to 2.5% as of 1 October 2014. • Systemic risk buffer and O-SII buffer with a combined value of up to 3% from 1 January 2018 after a phase-in. • CCyB increased to 0.5% as of August 2017.	
Slovenia		• Higher risk weights or capital requirements on foreign currency loans (2007).	
Sweden	• LTV cap at 85% since 2010. • Amortisation requirement for all new mortgages, depending on the LTV (June 2016).	• 25% risk weight floor on mortgages since 2013/2014. • 5 percentage point additional capital requirement for systemic banks. • Liquidity coverage ratio of 100% in aggregate and separately in USD and EUR (since 2013). • CCyB at 2% (effective March 2017).	
United Kingdom	• LTI limit at 4.5 for 85% of new owner-occupied mortgages (June 2014). • Financial Policy Committee recommendation on interest rate stress tests for assessing mortgage affordability (June 2014).	• Financial Policy Committee's Stress Testing Framework (incl. annual housing market downturn scenario). • Leverage ratio requirement for major UK banks and building societies.	

Note: CCyB = countercyclical capital buffer; O-SII = other systemically important institutions, LTI = loan to Income, LTV = Loan-To-Value, DTI = Debt-To-Income, DSTI = Debt-Service-To-Income.

1. Designed to limit the overreliance on off-balance sheet FX swaps which were used to meet financing needs for lending long term in FX.

Source: ESRB (2017), Advisory Task Force on the OECD Codes, De Crescenzio et al (2015).

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Chapter 3

DEVELOPMENTS IN INDIVIDUAL OECD AND SELECTED NON-MEMBER ECONOMIES

ARGENTINA

Economic growth is projected to strengthen and become more broad-based. Inflation is falling, as monetary policy remains restrictive, raising households' purchasing power and lifting consumer spending. Infrastructure outlays, improvements in the business environment and rising capital flows will boost investment. Exports will benefit from the recovery in Brazil. The labour market will improve gradually as the recovery picks up.

Fiscal policy will be moderately contractionary to reduce the deficit while safeguarding the recovery. Monetary policy will remain appropriately restrictive to bring down double-digit inflation. Growth and jobs would be boosted by wide-ranging structural reforms, including a comprehensive tax reform to simplify the system and improve fairness. Efforts to reduce inequalities in access to quality education would make growth more inclusive.

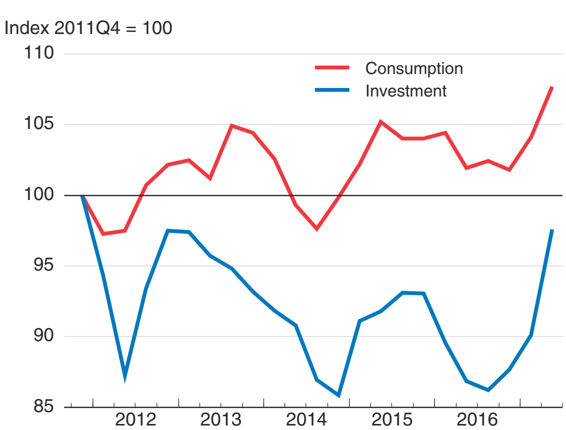
The financial system remains small. Bank credit to the private sector and stock market capitalisation are well below the levels of OECD countries. Long-term finance is almost non-existent, constraining investment and growth. Household and corporate sector debt are low. The main challenge for financial stability will be to monitor and avoid vulnerabilities as the financial sector expands.

Growth is firming

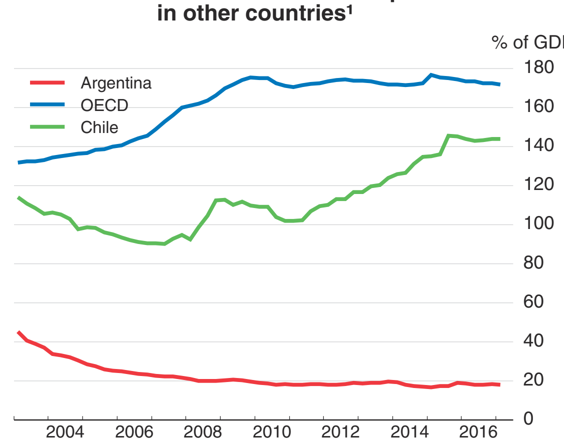
The recovery is gathering pace and becoming more broad-based, with agriculture, construction, manufacturing and retail all picking up. The labour market is also improving, with employment gains recorded across most sectors, most notably in construction. Consumer and business confidence are on the rise. Exports were strong at the start of the year, after which they fell due to weather conditions and a fall in soy prices, but are expected to recover. Import demand has started to outpace exports and the current account is expected to remain in deficit. From a rate of more than 40% in 2016, inflation has

Argentina

Consumption and investment are picking up



The financial sector is less developed than in other countries[1]



1. Loans to private non-financial sector.

Source: BIS, CEIC.

StatLink http://dx.doi.org/10.1787/888933631171

Argentina: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices ARS billion	Percentage changes, volume (2004 prices)				
GDP at market prices	4 579.1	2.6	-2.2	2.9	3.2	3.2
Private consumption	2 993.8	3.5	-1.4	4.8	3.3	2.9
Government consumption	776.1	6.8	0.3	3.0	1.7	0.8
Gross fixed capital formation	731.7	3.8	-5.1	11.3	10.8	9.1
Final domestic demand	4 501.6	4.2	-1.7	5.4	4.1	3.4
Stockbuilding[1]	58.7	0.0	0.4	-0.2	0.0	-0.1
Total domestic demand	4 560.4	4.0	-1.4	5.2	4.2	3.6
Exports of goods and services	659.8	-0.6	3.7	-0.3	4.5	5.4
Imports of goods and services	641.1	5.7	5.7	9.9	7.6	6.2
Net exports[1]	18.7	-0.9	-0.3	-1.4	-0.5	-0.2
Memorandum items						
GDP deflator	_	24.5	40.6	22.2	14.3	8.0
Current account balance (% of GDP)	_	-2.7	-2.7	-3.6	-3.5	-3.3

1. Contributions to changes in real GDP, actual amount in the first column.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632292

fallen substantially and markets expect a continuation of this decline to a level slightly above 17%, the upper bound of the central bank's inflation target for the end of 2017. The unemployment rate has started to fall, but remains close to 9%.

Wide-ranging structural reforms would boost inclusive growth

Macroeconomic policies need to continue reducing large past imbalances. Monetary policy should remain restrictive to bring down inflation in a sustained way. Fiscal policy will be moderately contractionary to reduce the large deficit, which was 5.8% of GDP at end-2016. The current plans strike an appropriate balance, given social needs, the incipient recovery and the need to ensure debt sustainability. Low public debt levels allow smoothing of the needed fiscal adjustment over the next few years.

Stronger and inclusive growth requires boosting productivity and investment through wide-ranging structural reforms. Lowering barriers to entrepreneurship, improving regulations in product and labour markets and strengthening competition would stimulate investment and facilitate both job and firm creation. A comprehensive tax reform to broaden the tax base, reducing barriers to trade and improving infrastructure would enhance the competitiveness of firms and create better paying jobs. Increasing financial development would also help to finance more investment.

Stronger efforts to expand access to quality education and reduce labour market informality, such as lowering social security contributions for low-paid workers who join the formal labour market, would boost inclusive growth. Improving active labour market policies and training would support workers in acquiring new skills and in getting ready for new jobs. Expanding early childhood education would improve school outcomes, allow more women to take up paid work and reduce inequalities.

Growth is set to rise

Growth is projected to strengthen, supported by rising domestic demand. Investment will be a key driver of growth in 2018 and 2019, aided by stronger infrastructure investment. An improving business climate and rising inflows of foreign investment will provide additional impetus. Declining inflation will push real incomes up and support consumption, in conjunction with stronger job creation. The improving outlook in key trading partners, including Brazil, will provide support to exports.

Upside risks include a larger impact from reforms already undertaken, which could unleash stronger growth in investment and productivity than projected. In particular, the construction sector holds potential for upside surprises. Downside risks include a delayed recovery in Brazil, which would affect export demand. Tighter external financing conditions would imply higher financing costs and less favourable debt dynamics, which may require a more frontloaded fiscal adjustment.

AUSTRALIA

The economy will continue growing at a robust pace. Business investment outside the housing and mining sectors will pick up, with exports boosted as new resource-sector capacity comes on stream. The strengthening labour market and household incomes will sustain private consumption, and inflation and wages will pick up gradually.

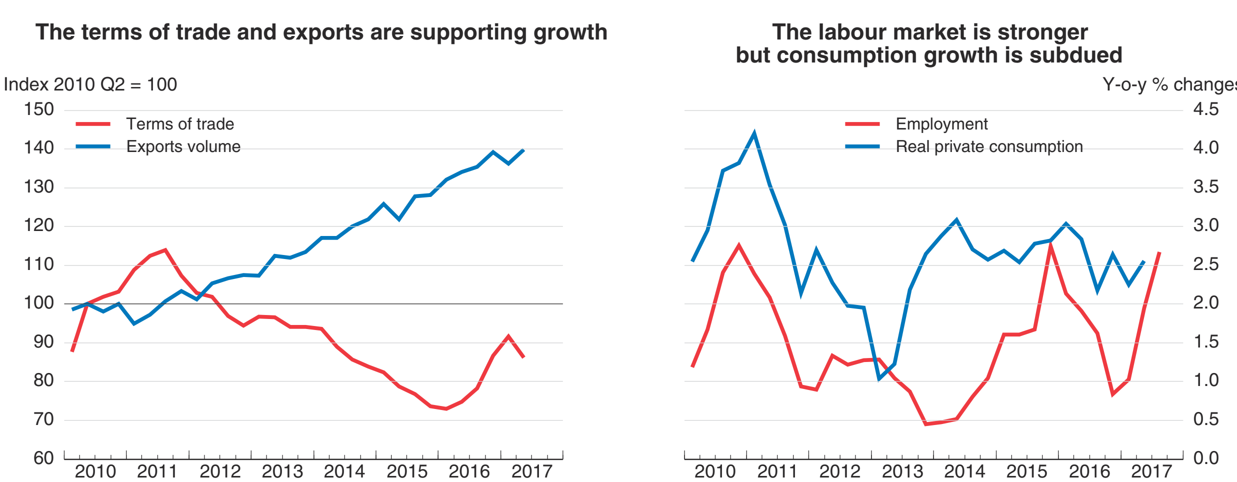
The central bank is projected to start raising the policy rate in the second half of 2018 and expectations of this move, together with macro-prudential measures, are helping cool the housing market. The fiscal position is sound and the government is committed to gradually close the budget deficit. In the event of an unexpected downturn, fiscal policy should be used to support activity and protect the incomes of the most vulnerable.

The prolonged period of low interest rates has fuelled high house prices in large metropolitan areas. Substantial mortgage borrowing has resulted in households being highly indebted. To contain risks associated with potential large house-price corrections and financial stress, macro-prudential measures should be maintained. Australia is also vulnerable to "too big to fail" risks, due to its highly concentrated banking sector.

Strong commodity prices and exports underpin growth

Stronger terms of trade and continued growth in resource exports have boosted incomes and tax revenues. Mining investment looks to have bottomed out, while rising capacity utilisation and high business confidence point to a renewed cycle in business investment outside the resource sector. The recovery in employment growth and a rising number of vacancies indicate a strengthening labour market. However, underemployment has edged higher and wage growth and inflation remain steady. These factors, plus rising household indebtedness and signs of a cooling housing market, are keeping consumer sentiment relatively soft. Household consumption growth remains subdued.

Australia



Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933631190

Australia: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices AUD billion	Percentage changes, volume (2014/2015 prices)				
GDP at market prices	1 605.5	2.4	2.5	2.5	2.8	2.7
Private consumption	897.3	2.7	2.7	2.5	2.4	2.4
Government consumption	285.5	3.5	4.3	2.2	1.4	2.0
Gross fixed capital formation	431.6	-2.9	-2.7	0.3	1.6	3.4
Final domestic demand	1 614.4	1.3	1.6	1.9	2.0	2.6
Stockbuilding[1]	0.0	0.0	0.1	0.2	-0.1	0.0
Total domestic demand	1 614.4	1.3	1.6	2.1	2.0	2.6
Exports of goods and services	326.7	5.8	7.4	4.8	6.3	3.7
Imports of goods and services	335.6	1.8	0.2	4.2	3.0	4.3
Net exports[1]	- 8.9	0.8	1.4	0.1	0.8	0.0
Memorandum items						
GDP deflator	_	-0.6	1.3	3.9	1.3	1.9
Consumer price index	_	1.5	1.3	1.9	2.0	2.2
Core inflation index[2]	_	2.1	1.5	1.7	2.1	2.2
Unemployment rate (% of labour force)	_	6.1	5.7	5.6	5.4	5.3
Household saving ratio, net (% of disposable income)	_	7.2	6.6	5.6	5.4	5.4
General government financial balance (% of GDP)	_	-1.5	-2.1	-1.7	-1.3	-0.9
General government gross debt (% of GDP)	_	44.3	46.4	45.2	44.7	43.7
Current account balance (% of GDP)	_	-4.8	-2.6	-1.1	-0.6	-0.6

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.

Source: OECD Economic Outlook 102 database.

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Monetary and fiscal support can be gradually withdrawn

Monetary policy remains supportive; the policy rate has been kept at 1.5% since August 2016. Policy tightening is projected to begin in the second half of 2018 when the pick-up in wages and prices becomes more entrenched. A tighter policy stance will ease pressures on house prices and will reduce the threat of the build-up of other financial distortions. Indeed, housing markets in certain areas already show signs of easing. In recent years, regulators have taken steps to limit the growth of investor lending and have discouraged loans with high loan-to-valuation ratios, to improve the resilience of borrowers and lenders.

Public debt in relation to GDP has risen somewhat in recent years, but remains low and is projected to start falling given the government's proposed budgetary aims of annual deficit reduction of around ½ percentage point of GDP per year. The pace of consolidation is appropriate given projected growth. Still, the strong fiscal position provides room for a more gradual fiscal consolidation, or even an expansion, should economic activity weaken unexpectedly.

Improvements to the business environment and measures to combat social exclusion can facilitate continued broad benefits from growth and trade. There is scope for further tax reforms that make greater use of efficient tax bases, such as the Goods and Services

Tax and land tax, in lieu of corporate tax and inefficient taxes. Improved competition policy would boost productivity and encourage market entry by innovative businesses.

Robust growth will continue

Economic growth is projected to continue at a robust pace. New liquefied natural gas production will add to export growth, while rebalancing towards non-mining sectors, including through investment, will drive overall activity. Amid gradual policy tightening, and a slow pick-up in wages and prices, consumption growth will remain subdued. Due to a mild slowdown in global growth over the projection period, particularly in China, growth in activity will edge slightly lower in 2019.

Developments in commodity markets, particularly those linked to China, remain a source of uncertainty and risk. High house prices and rising household debt, amid subdued income growth, pose macroeconomic and financial risks, calling for continued use of macro-prudential tools. Large corrections in house prices could reduce household wealth and consumption, and damage the construction sector, leading to job losses. In addition, some highly indebted households could face financial stress when interest rates rise. On the other hand, a stronger pick-up in wages and incomes could result in higher consumption and growth.

AUSTRIA

Following strong rebounds in investment and exports, economic activity is set to remain buoyant through 2018 and, to a lesser extent, 2019. Unemployment will continue to decline and labour market participation will rise further, in particular for women and older workers. Inflation remains higher than in other euro area countries, mainly driven by prices in sectors that are little exposed to international trade.

Job creation could be further enhanced by facilitating job-matching. Residential mobility is low, held back by non-portable social housing entitlements and residence-dependant access to social services. Labour participation of parents is impaired by a lack of full-day schooling and childcare in rural areas. Dedicated life-long learning solutions and greater supply of apprenticeship positions in rapidly digitalising professions would help the transition to the digital economy.

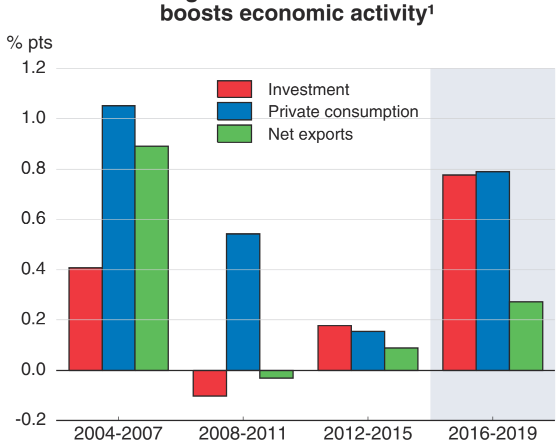
The indebtedness of the non-financial private sector remains moderate compared with other advanced countries. Business investment is mainly financed by internal sources reducing vulnerabilities but also holding back innovation. Bank lending dominates external financing, suggesting room for deeper private capital markets to diversify funding. House price dynamics have raised some concerns in recent years, but pressures have eased somewhat in 2017 as residential construction has picked up.

Strong demand, both domestic and foreign, underpins growth

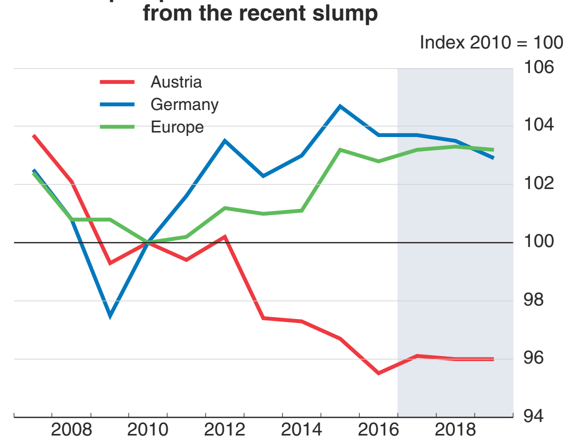
A virtuous combination of domestic and international drivers has pushed Austria's growth momentum to heights not seen since the vigorous recovery from the global financial crisis. Investment has recovered strongly after several years of sluggishness. Labour market participation continues to increase, in particular for women and older workers. Employment outpaces the labour force, pushing down the unemployment rate following five years of steady increases. Inflation remains higher than in other euro area

Austria

Strong and broad-based demand boosts economic activity[1]



Export performance[2] will recover from the recent slump



1. Average contributions to annual GDP growth.
2. Export performance is defined as the ratio of Austria's export volumes to weighted import volumes in its export markets.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933631209

Austria: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices*	333.3	1.1	1.4	3.0	2.5	1.8
Private consumption	177.9	0.4	1.6	1.5	1.7	1.2
Government consumption	66.0	1.4	2.1	1.3	1.8	1.6
Gross fixed capital formation	75.5	1.2	3.6	4.9	2.9	2.0
Final domestic demand	319.3	0.8	2.2	2.3	2.0	1.5
Stockbuilding[1]	2.7	0.4	-0.1	0.0	0.0	0.0
Total domestic demand	322.0	1.2	2.0	2.2	2.0	1.5
Exports of goods and services	178.2	2.9	2.2	5.7	4.7	4.4
Imports of goods and services	167.0	3.2	3.2	4.9	4.0	4.1
Net exports[1]	11.3	-0.1	-0.4	0.6	0.5	0.4
Memorandum items						
GDP deflator	_	2.3	1.1	1.6	2.1	2.2
Harmonised index of consumer prices	_	0.8	1.0	2.2	2.3	2.3
Harmonised index of core inflation[2]	_	1.7	1.6	2.1	2.3	2.3
Unemployment rate (% of labour force)	_	5.8	6.1	5.4	5.0	4.8
Household saving ratio, net (% of disposable income)	_	6.9	7.9	7.5	6.9	6.6
General government financial balance (% of GDP)	_	-1.0	-1.6	-0.8	-0.4	0.1
General government gross debt (% of GDP)	_	105.3	106.7	101.1	98.1	96.1
General government debt, Maastricht definition (% of GDP)	_	84.3	83.5	78.0	75.0	73.0
Current account balance (% of GDP)	_	1.9	2.1	2.0	2.6	2.7

* Based on seasonal and working-day adjusted quarterly data; may differ from official non-working-day adjusted annual data.
1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632330

countries. Private consumption continues to support growth, buoyed by job creation and improving confidence.

Embracing digitalisation and mobility would boost labour market performance

Record high numbers of vacancies indicate that more jobs could be added if labour supply better matched demand. A growing share of women and older workers are joining the labour market, increasing inclusiveness, but their digital skills are relatively weak. A wide-ranging education reform launched in 2017 addresses the digital challenge for young cohorts and ought to be implemented swiftly, while life-long learning solutions need to be developed further to upgrade skills of middle-aged and older workers. Women's labour force participation is still hindered by insufficient full-day schools and childcare facilities, in particular in rural areas.

The business sector is adapting to the global digital revolution, albeit at a slower pace, especially among smaller firms, than in the most advanced countries. The ability of firm owners to fully embrace digitalisation and renew their business models should be enhanced through awareness-raising and by further improving the depth of private capital markets to foster innovation. Against the backdrop of digitalisation, labour market performance would benefit from stronger incentives for businesses to offer apprenticeship positions in rapidly digitalising professions. Finally, job-matching would benefit from increased worker mobility which could justify a revisiting of public policies favouring stable living conditions over regional mobility, including housing policies, commuting subsidies and eligibility criteria for social transfers.

Economic activity, though decelerating, remains buoyant

Economic growth reached 3% in 2017. Momentum is projected to remain strong into 2018 before slowing somewhat as the investment cycle matures and the labour market tightens. Household incomes will benefit from robust employment and positive real wage growth and private consumption will be further buttressed by declining saving rates as confidence improves. Against the backdrop of buoyant activity and increasing wages, inflation is projected to remain above 2% throughout the projection horizon. Driven by strong growth, declining government interest payments and the winding-down of bad bank liabilities, the public debt ratio is set to decrease sharply.

Performance may surprise on the upside if international trade were to pick up more than projected or if export market shares recover further, leading to more buoyant exports, investment and growth. Conversely, export performance could continue to deteriorate if recent market share losses in global value chains proved to be structural rather than cyclical, or in the event of unforeseen protectionist measures. Finally, if progress with reforms were to stall in the aftermath of the 2017 general election, consumer and business confidence and domestic demand could weaken.

BELGIUM

Economic growth increased in 2017 and is projected to stabilise at 1.7% in 2018 and 2019. Private consumption will be an important driver of growth. Government investment will be strong in 2018 and private investment will support growth. Inflation will increase due to tightening labour markets and higher wages.

The fiscal stance will provide modest support for growth in 2018 and 2019, due to planned reductions in labour taxation. Raising skills and work opportunities for disadvantaged groups would make growth more inclusive. Re-orientating public spending towards education and physical infrastructure investment would enhance productivity growth and inclusiveness.

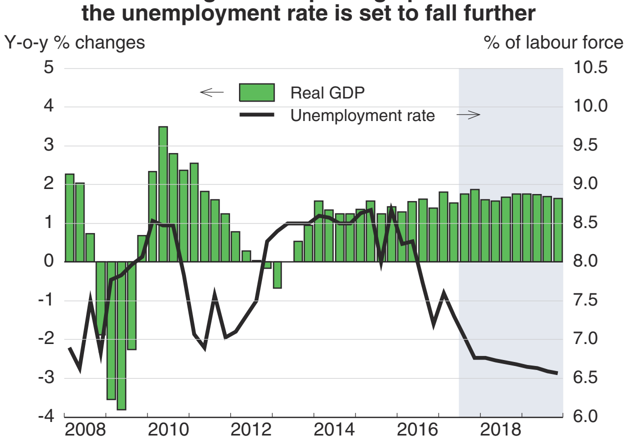
Public debt, at 105.7% of GDP in 2016, remains high. To ensure sustainability, it is important that the government sticks to its medium-term consolidation path. Financial sector vulnerabilities are limited, with stress tests indicating resilience in the banking sector. However, prolonged low interest rates could create risks. House prices and mortgage lending have already increased considerably. Further improving macro-prudential measures to mitigate risks related to the housing market would be welcome.

Growth has strengthened

Economic growth strengthened in 2017, supported by domestic demand. Business confidence has risen and business investment shows signs of strengthening. Consumer confidence has improved and household consumption has increased, with continued employment growth, supported by expanding output, labour tax cuts and past wage moderation measures. With wage moderation measures now unwound, wage growth has increased, notwithstanding the recent reform of the wage-setting system. Inflation has been higher than in neighbouring countries due, in part, to recent increases in indirect taxes.

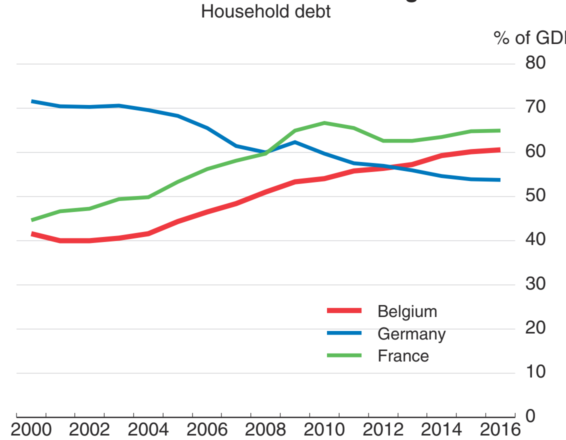
Belgium

GDP growth is picking up and the unemployment rate is set to fall further



Household debt is increasing

Household debt



Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933631228

Belgium: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2015 prices)				
GDP at market prices	400.3	1.4	1.5	1.7	1.7	1.7
Private consumption	206.9	0.9	1.7	1.3	1.8	1.9
Government consumption	97.4	0.5	0.5	0.7	0.7	0.8
Gross fixed capital formation	92.3	2.7	3.6	1.0	2.9	2.4
Final domestic demand	396.6	1.2	1.8	1.1	1.8	1.8
Stockbuilding[1]	1.1	0.2	0.3	0.4	0.0	0.0
Total domestic demand	397.8	1.4	2.1	1.5	1.8	1.8
Exports of goods and services	330.7	3.3	7.5	5.3	4.4	4.3
Imports of goods and services	328.2	3.3	8.4	5.2	4.6	4.4
Net exports[1]	2.5	0.0	-0.6	0.2	-0.1	0.0
Memorandum items						
GDP deflator	_	1.1	1.6	2.4	1.8	1.8
Harmonised index of consumer prices	_	0.6	1.8	2.2	1.6	1.8
Harmonised index of core inflation[2]	_	1.6	1.8	1.6	1.7	1.8
Unemployment rate (% of labour force)	_	8.5	7.9	7.2	6.7	6.6
Household saving ratio, net (% of disposable income)	_	3.9	3.7	4.1	3.9	3.5
General government financial balance (% of GDP)	_	-2.5	-2.5	-1.7	-1.6	-1.6
General government gross debt (% of GDP)	_	126.9	127.5	125.4	123.9	122.3
General government debt, Maastricht definition (% of GDP)	_	106.0	105.7	103.6	102.0	100.4
Current account balance (% of GDP)	_	-0.1	0.1	-0.4	-0.1	-0.1

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632349

Productivity and inclusiveness could be enhanced

The budget deficit was 2.5% of GDP in 2016 and is projected to decline to around 1.6% of GDP by 2019, with the fiscal stance providing modest support to growth in 2018 and 2019. With public debt at 105.7% of GDP in 2016, it is important that the government adheres to its medium-term fiscal targets to permit a steady reduction of the debt ratio. The authorities should increase public investment, which has been low for several decades, while at the same time reduce inefficient government spending in order to boost productivity growth and ensure fiscal sustainability.

Growth could be made more inclusive by further enhancing the labour market performance of immigrant, low-skilled and older workers. Improving the capacity of the education system to provide disadvantaged students with necessary skills, on-the-job training and increased use of flexitime is particularly important. Recent pension and wage indexation reforms are also likely to have improved labour market outcomes, but should be monitored. While the shift from labour taxes to excise duties and environmental taxes will also likely improve the employment of low-skilled workers and enhance green-growth, Belgium will continue to have rates of labour taxation amongst the highest in the OECD, suggesting further reform is warranted. Recently announced reforms to the corporate tax regime, which has a relatively high statutory rate and numerous exemptions, are welcome.

Further measures to broaden the capital income tax base as part of a broader reform of household savings taxation should also be considered.

Growth will remain stable

GDP growth is estimated to have risen to 1.7% in 2017 and is projected to remain at this level in 2018 and 2019. Private consumption will continue to be an important driver of growth, supported by employment growth and cuts in labour taxation in 2018 and 2019. Private investment will support growth in 2018 and 2019, thanks to favourable financial conditions. Government investment will contribute to economic activity in 2018. Export growth is projected to slow as competitiveness gains from past wage moderation measures subside. Employment growth is projected to remain solid and lead to further declines in the unemployment rate, to 6.6% in 2019. Inflation will peak at 2.2% in 2017, due to the effects of past energy prices and other measures, ease in 2018 as these factors subside, before rising again in 2019, as economic slack is eliminated.

Economic growth could be stronger if tax reductions enhance private consumption more than expected. A weaker-than-expected international environment could reduce economic growth somewhat. A fall in house prices, which have risen steadily along with household debt since 2000, would pose a moderate risk to household consumption.

BRAZIL

After falling for eight consecutive quarters, growth has finally resumed. Initially driven by agriculture, the recovery now appears increasingly broad-based. Growth is expected to strengthen further, although confidence will remain sensitive to political developments. Inflation has fallen to below the central bank's target, raising real incomes and allowing lower interest rates, which will support a recovery of investment. Credit to the corporate sector is still falling, but unemployment has already started to decline.

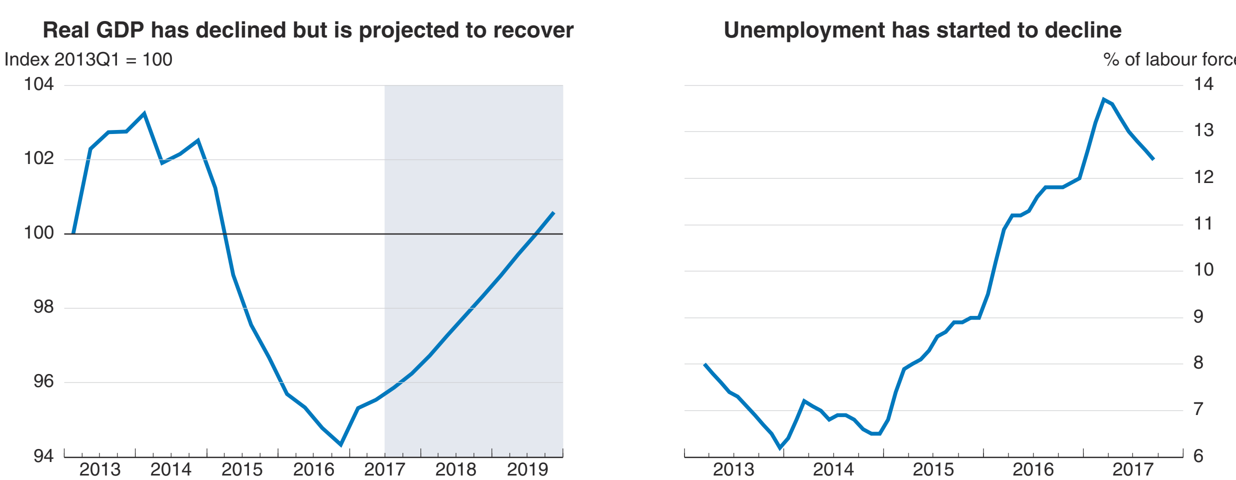
Low inflation justifies an easy monetary policy stance over the projection period, with real interest rates at a long-time low, which will support investment. The current neutral fiscal policy stance will have to become even more prudent in 2019 to ensure medium-term fiscal sustainability, given high and rising public debt. The planned pension reform is crucial to ensure compliance with the expenditure rule and promote fiscal sustainability. Re-orienting social spending towards conditional cash transfers while reducing ineffective industrial subsidies will make growth more inclusive and reduce high inequality. Phasing out loan subsidies from public banks will improve the allocation of capital and raise productivity. Reducing high trade barriers would strengthen competition and innovation, and lower the cost of intermediate inputs.

While corporate sector liabilities relative to GDP have risen towards the average of emerging market economies, banks are well capitalised and expected to withstand possible stress resulting from risks related to corporate debt, especially as activity is picking up. The deep and prolonged recession has been a significant real-world stress test for banks, and has not exposed weaknesses in financial institutions.

The economy is emerging from a severe and protracted recession

The economy is exiting a severe recession that wiped out almost 7 years of income growth. After an initial boost from the agricultural sector, the recovery is now becoming

Brazil



Source: IBGE; and OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933631247

Brazil: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices BRL billion	Percentage changes, volume (2000 prices)				
GDP at market prices	5 779.0	-3.8	-3.6	0.7	1.9	2.3
Private consumption	3 638.4	-3.9	-4.3	0.5	2.1	2.3
Government consumption	1 106.9	-1.1	-0.6	-1.6	0.8	1.3
Gross fixed capital formation	1 148.5	-13.9	-10.3	-3.6	1.5	2.5
Final domestic demand	5 893.7	-5.3	-4.6	-0.6	1.7	2.1
Stockbuilding[1]	39.0	-1.0	-0.5	0.9	-0.2	0.0
Total domestic demand	5 932.8	-6.3	-5.2	0.4	1.6	2.1
Exports of goods and services	636.4	6.2	1.7	4.3	4.2	4.2
Imports of goods and services	790.2	-13.9	-10.3	0.9	1.8	3.4
Net exports[1]	- 153.8	2.6	1.7	0.4	0.3	0.2
Memorandum items						
GDP deflator	_	7.9	8.3	5.0	4.6	4.9
Consumer price index	_	9.0	8.7	3.6	3.9	4.2
Private consumption deflator	_	9.6	9.4	3.5	4.7	5.2
General government financial balance (% of GDP)	_	-10.2	-9.0	-8.2	-8.0	-7.3
Current account balance (% of GDP)	_	-3.2	-1.3	-0.4	-1.0	-1.0

1. Contributions to changes in real GDP, actual amount in the first column.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632368

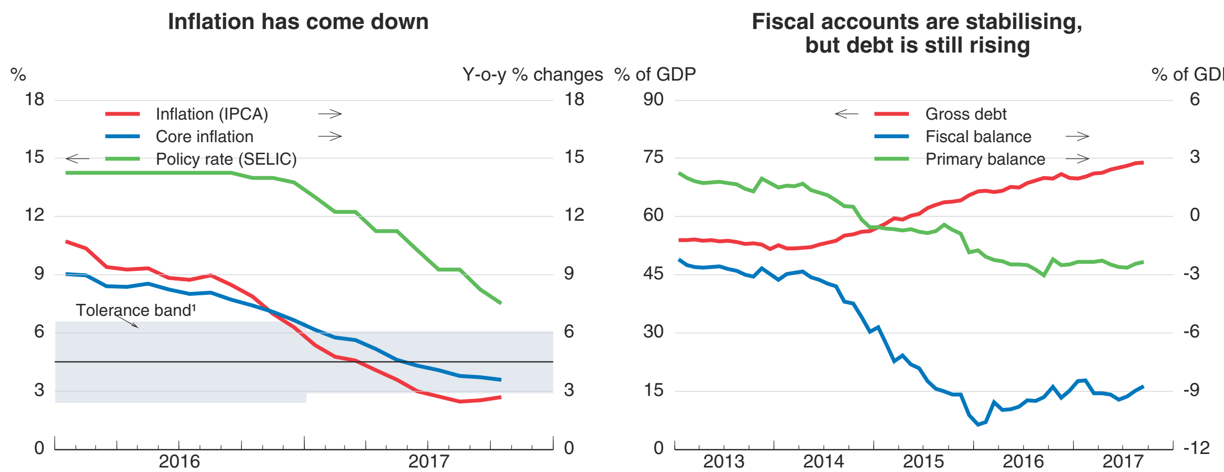
firmer and more broadly based. Confidence, especially among businesses, is improving. Retail sales are rising, including for durable goods, automobiles and construction material, but investment is still declining. Falling inflation, partly reflecting falling food prices and lower demand, has buoyed consumer purchasing power. This is further supported by expanding household credit, although corporate credit continues to contract. Unemployment has turned around and fallen by over a percentage point from its 14% peak earlier this year.

Policies are supporting the recovery

The fall in inflation from almost 11% year-on-year to below 3% provides room for further interest rate cuts and will bring financing costs to record-low levels, supporting a recovery of investment. The phase-out of subsidies embedded in directed lending operations will gradually align directed lending rates with market rates. This will make the credit channel of monetary policy more effective while at the same time paving the way for the development of private credit markets with longer maturities by levelling the playing field between public and private lenders. The current low-interest rate environment will support this as investors will seek investment opportunities with higher returns, including by extending maturities.

Fiscal policy has to ensure a medium-term adjustment without derailing the incipient recovery, given the rise in public debt to 74% of GDP and the headline deficit of 9% of GDP. The current primary deficit of 2.7% of GDP is significantly below the estimated 2% primary surplus required to stabilise public debt in the medium term. Nevertheless, fiscal targets have recently been relaxed slightly and now aim at a gradual improvement of the primary

Brazil



1. The inflation target is met whenever the accumulated inflation during the period January-December of each year falls within the tolerance band.

Source: Central Bank of Brazil; and IBGE.

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balance to -0.6% of GDP by 2020. The fiscal stance will be broadly neutral in 2017 and 2018, but will tighten in 2019. This should stabilise public debt by 2024 at around 91% of GDP. Some relief will come from lower interest expenditures, down from 8.4% of GDP in 2015 to 6.4% in September 2017 (accumulated over 12 months), with further declines coming up as maturing debt is rolled over at lower interest rates.

Significant reductions in permanent expenditures are a prerequisite to comply with fiscal targets and the new expenditure rule that will be binding as of 2020. Expenditures can be lowered without detriment to inclusive growth objectives. The planned pension reform is one crucial element of this, but further adjustments will be required. Better targeting of social benefits towards poor and vulnerable households would lower expenditures while accelerating social progress towards lower inequality and poverty. Cuts to subsidies and tax expenditures benefitting the corporate sector can lessen distortions, reduce rents and limit the scope for corruption.

Additional structural reforms have significant potential to boost growth. Reducing the compliance costs and distortions imposed by the fragmented system of indirect taxes would provide an almost immediate cost reduction for firms. The recently passed labour reform will increase flexibility for both employers and employees and reduce the judicial uncertainty around labour disputes. Reducing comparatively high barriers to international trade would cut the costs of imported inputs, increase competition and enhance productivity. This would open up new job opportunities with higher wages, while lowering prices. Accompanying policies, such as training or job search assistance, could ease the temporary burden on those affected by job movements across sectors. Improvements in infrastructure could also reduce transport costs, particularly for exporters. Further advances in education and skills would not only raise productivity, but allow more low-income households to join Brazil's growing middle class.

Growth is projected to strengthen gradually

Growth is projected to rise gradually throughout 2018 and 2019. Private consumption will improve on the back of rising real incomes due to lower inflation. Improvements in confidence and the easy monetary stance will support a recovery of investment. Risks to these projections include political uncertainty in the run-up to the 2018 presidential election and a failure to implement planned reforms. Particularly, the much-needed fiscal adjustment will be successful only if the pension reform is implemented. Financial sector risks seem limited at present as banks are well capitalised, including substantial provisions for possible deteriorations in loan quality. Corporate debt of 43% of GDP is in the middle range of emerging market economies. Of this debt, around 9 percentage points is unhedged foreign-currency liabilities of non-exporting firms. By contrast, external debt is not a vulnerability for the public sector as 96% of public debt is denominated in domestic currency and 86% is held by domestic residents.

CANADA

Strong economic growth in the first half of 2017 is set to ease in coming quarters. Growth has been led by household consumption, which should slow as rapid job growth and wealth effects from house price appreciation abate. Earlier robust export increases have weakened substantially, in part because of the stronger Canadian dollar. Consumer price inflation is expected to reach 2% in 2019, as remaining spare capacity is exhausted and exchange rate effects dissipate.

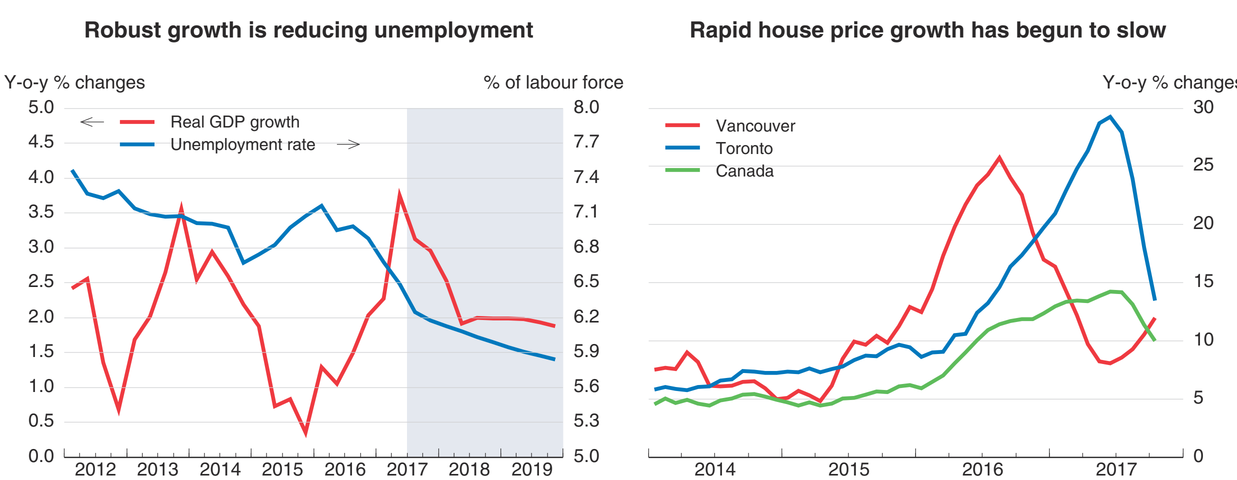
Interest rate rises this year have reduced monetary stimulus. Additional increases are projected in order to stabilise inflation around the midpoint of the 1-3% official target range. Mildly expansionary fiscal policy has supported growth in 2016 and 2017, hastening the economy's return to full employment. However, delays have limited the benefits from planned increases in infrastructure spending. Modest fiscal tightening is projected in 2019, consistent with an absence of spare capacity at that stage of the cycle.

High house prices and associated debt levels remain a substantial financial vulnerability. A disorderly correction would adversely impact growth and could threaten financial stability. The federal government has responded with a number of macro-prudential measures. Provincial government measures have also temporarily slowed house price growth, but some – notably Ontario's expanded rent controls – risk discouraging the supply of new housing. Macro-prudential policies will need to be tightened further if rapid increases in house prices and debt resume.

Robust economic growth has strengthened the labour market

The economy has grown strongly in recent quarters. Adjustment to the fall in commodity prices that commenced in mid-2014 is now complete, with the energy sector rebound boosting growth. Private consumption is expanding solidly, supported by wealth gains from house price appreciation, rapid job growth and accommodative monetary policy. Robust growth in merchandise export volumes reversed course with three

Canada



Source: OECD Economic Outlook 102 database; Teranet and National Bank of Canada, House Price Index.

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Canada: **Demand and output**

	2014	2015	2016	2017	2018	2019
	Current prices CAD billion	Percentage changes, volume (2007 prices)				
GDP at market prices	1 983.1	0.9	1.5	3.0	2.1	1.9
Private consumption	1 110.3	1.9	2.3	3.8	2.8	1.9
Government consumption	405.4	1.5	2.0	1.5	1.2	0.5
Gross fixed capital formation	479.4	-4.6	-3.1	2.3	3.8	2.5
Final domestic demand	1 995.1	0.3	1.0	3.0	2.7	1.7
Stockbuilding[1]	8.3	-0.3	-0.2	0.7	-0.1	0.0
Total domestic demand	2 003.4	0.0	0.8	3.6	2.6	1.7
Exports of goods and services	626.3	3.4	1.0	1.7	1.9	4.1
Imports of goods and services	646.6	0.3	-0.9	3.7	3.6	3.2
Net exports[1]	- 20.3	1.0	0.6	-0.7	-0.6	0.2
Memorandum items						
GDP deflator	_	-0.8	0.6	2.4	2.3	2.0
Consumer price index	_	1.1	1.4	1.5	1.9	2.0
Core consumer price index[2]	_	2.2	1.9	1.1	1.4	2.0
Unemployment rate (% of labour force)	_	6.9	7.0	6.4	6.1	5.9
Household saving ratio, net (% of disposable income)	_	4.8	4.9	3.9	3.1	3.5
General government financial balance (% of GDP)	_	-1.1	-1.9	-1.6	-1.4	-1.1
General government gross debt (% of GDP)	_	98.4	99.1	97.4	97.6	97.6
Current account balance (% of GDP)	_	-3.4	-3.3	-3.1	-3.3	-3.1

1. Contributions to changes in real GDP, actual amount in the first column.
2. Bank of Canada definition: consumer price index excluding eight of the most volatile components and the effects of changes in indirect taxes on the remaining components.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632387

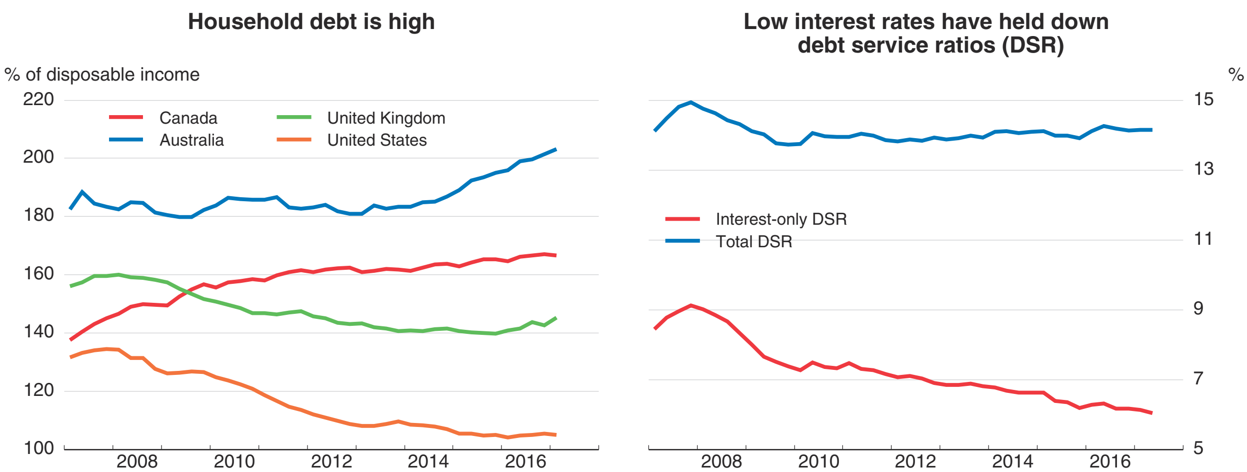
successive monthly declines between June and August, contributing to an expectation of more moderate GDP growth in the third quarter. Forward-looking indicators suggest that investment activity will remain firm but grow more gradually than in the first half of 2017. Machinery and equipment investment expectations reached their highest level since 2010 during the first quarter, but have since returned closer to the historical average. The number of housing starts has plateaued, consistent with housing investment remaining elevated as a share of GDP but growing more slowly than in recent years.

The unemployment rate is down by three-quarters of a percentage point from a year earlier, and more people are coming into the labour force. Wage increases are still weak but are beginning to pick up, reaching around 2% over the past 12 months. Consumer price inflation remains below the mid-point of the Bank of Canada's 1-3% target range, with the Bank's preferred measures of core inflation between 1.5% and 1.8%. Consumer price inflation excluding volatile items is below 1%, driven lower by the effect of recent exchange rate appreciation on import prices.

Macroeconomic policy tightening is appropriate

Some monetary stimulus has been withdrawn through interest rate increases in July and September 2017, and the effective exchange rate appreciated 8.5% between May and September. More rate rises are likely to be necessary with excess capacity projected to be

Canada



Source: OECD, National Accounts - Household Dashboard database; Statistics Canada, Selected Indicators - Household, Table 380-0073.

StatLink http://dx.doi.org/10.1787/888933631304

used up by mid-2018. Rising mortgage rates and cooling in the Toronto market following the introduction in April of Ontario's Fair Housing Plan, which included a foreign buyers' transaction tax, contributed to an easing in national price pressures. However, the recent resumption of price escalation in Vancouver, despite the introduction of a similar tax in August 2016, raises the possibility that the cooling in Toronto might be temporary. Ontario's Plan also expanded rent controls, which risk exacerbating medium-term housing market pressures by discouraging the supply of new rental housing. The most recent round of macro-prudential tightening (which comes into effect from January 2018) focuses on uninsured loans, which now constitute almost half of outstanding loans. While all uninsured loans require a minimum 20% deposit, their riskiness has increased as measured by the share of borrowers with high debt-to-income ratios.

The federal government's fiscal stance is mildly expansionary, with the general government deficit expanding on a cyclically adjusted basis in 2016 and 2017. However, the Parliamentary Budget Officer has estimated that only about half of the overall budgeted federal infrastructure stimulus was actually spent in the 2016-17 fiscal year. These delays are assumed to be recovered by the end of 2019. Some fiscal consolidation is projected for 2019 based on forward estimates in federal and provincial budgets, which will be appropriate if solid growth continues. Policy action is needed to address affordability and quality issues in childcare, which contribute to a large (29%) gender earnings gap for women aged 25 to 44 with children. Increased spending announced in the 2017 federal budget is a good first step in this regard.

Growth is projected to ease

Economic growth is projected to ease as private consumption and government spending slows. Recent strong private consumption gains have not been supported by commensurate increases in wages and thus are set to ease with further interest rate rises, slowing job growth, the absence of further substantial increases in government transfers and house price appreciation that is assumed to return to a more historical average annual rate of around 3% in real terms. Investment will be supported by capacity constraints, recent oil price increases, high profitability and low, but increasing, financing costs. Export growth will, however, be constrained over the next few quarters by exchange rate appreciation but should subsequently be driven higher by strengthening global demand, including a pick-up in US investment. Declines in unemployment are likely to moderate along with growth.

A disorderly housing market correction would push growth sharply lower through weaker residential investment, household wealth and private consumption. A sufficiently large shock could even threaten financial stability. Conversely, a resumption of rapid house price growth would boost growth, at least in the short-term. There are risks to trade from the ongoing renegotiation of the North American Free Trade Agreement and also from increases in specific barriers, such as countervailing duties imposed by the United States on certain Canadian products. Faster growth is possible if private consumption gains do not slow to the extent anticipated or if business investment and export growth remain high as part of a stronger synchronised global upturn.

CHILE

GDP growth is projected to strengthen to around 3% in 2018-19, supported by improving external demand, a more accommodative monetary policy and mining investment. As exports and investment pick up, the labour market will strengthen, reducing income disparities and stimulating private consumption. Increasing aggregate demand and a stabilising exchange rate will bring back inflation towards target.

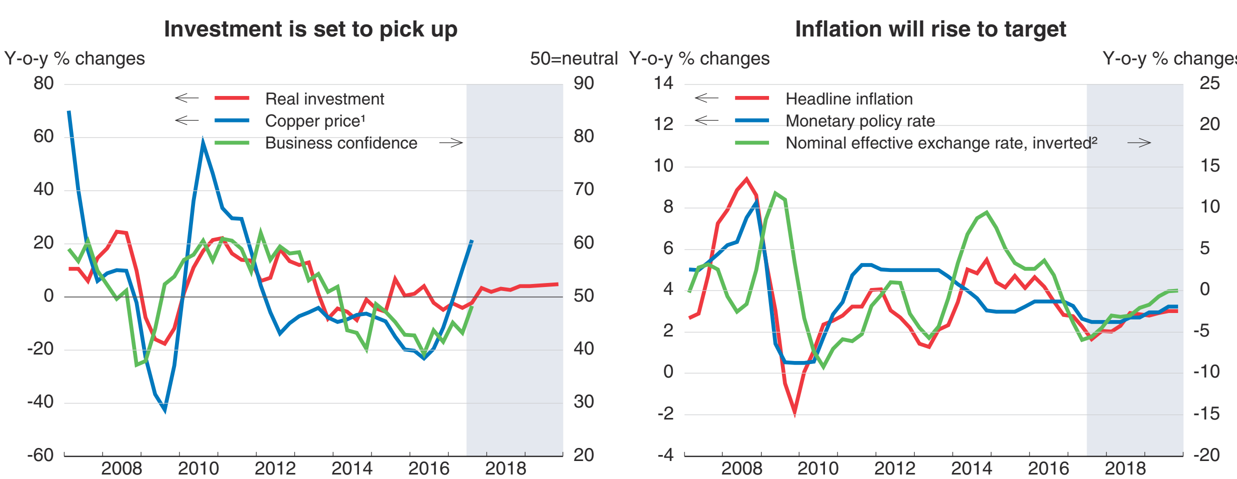
Monetary policy has eased since the end of 2016, supporting growth and inflation. Fiscal consolidation is set to be appropriately gradual in 2018 and 2019 and should remain progressive to raise room for investments in health, education and infrastructure over the medium term. Tackling labour market disparities, and streamlining licencing procedures and regulations, would boost productivity, while reducing inequalities.

The financial system has been resilient to a sharp depreciation and a prolonged growth slowdown. However, continued monitoring of increasing household and corporate vulnerabilities is needed as financing costs could increase. The adoption of draft laws implementing Basel III requirements, strengthening the oversight of financial conglomerates and creating a centralised register for bank and non-bank credit providers would all improve financial supervision.

GDP growth has bottomed out

Economic growth is recovering. Business confidence and exports are slowly improving, helped by historically low interest rates, higher external demand and firmer copper prices. Employment and wage gains are accelerating, supporting real disposable income and private consumption. However, the slow adjustment of the mining sector to the end of the commodity boom and low corporate profit margins have held back investment.

Chile



1. Four-quarter moving average.
2. Four-quarter moving average of the inverted nominal effective exchange rate, an increase means a relative depreciation.

Source: OECD Economic Outlook 102 database; and Central Bank of Chile.

StatLink http://dx.doi.org/10.1787/888933631323

Chile: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices CLP billion	Percentage changes, volume (2013 prices)				
GDP at market prices	148 855.3	2.2	1.5	1.5	2.9	2.9
Private consumption	93 735.5	2.0	2.4	2.5	2.8	2.9
Government consumption	19 080.0	4.5	5.1	3.7	2.8	2.5
Gross fixed capital formation	35 444.7	-0.9	-0.6	-1.4	2.9	4.3
Final domestic demand	148 260.2	1.6	2.0	1.8	2.8	3.1
Stockbuilding[1]	- 862.3	0.3	-0.9	1.3	0.0	0.0
Total domestic demand	147 397.8	2.0	1.2	3.1	2.8	3.1
Exports of goods and services	49 212.9	-1.9	0.0	-2.7	3.1	3.5
Imports of goods and services	47 755.3	-2.8	-1.6	5.5	3.4	4.5
Net exports[1]	1 457.5	0.3	0.5	-2.3	-0.1	-0.2
Memorandum items						
GDP deflator	_	4.3	3.8	4.5	3.3	2.7
Consumer price index	_	4.3	3.8	2.2	2.5	3.0
Private consumption deflator	_	5.5	3.7	2.1	2.5	3.0
Unemployment rate (% of labour force)	_	6.2	6.5	6.6	6.5	6.3
Central government financial balance (% of GDP)	_	-2.1	-2.7	-2.7	-1.9	-1.7
Current account balance (% of GDP)	_	-2.0	-1.4	-1.8	-1.2	-1.4

1. Contributions to changes in real GDP, actual amount in the first column.
Source: OECD Economic Outlook 102 database.

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Structural reforms would support productivity and more inclusive growth

Monetary policy remains appropriately supportive. The central bank reacted to the growth and inflation slowdown by cutting the policy rate from 3.5% in December 2016 to 2.5% in May 2017, well below historical norms. Inflation expectations remain well anchored, and prudential measures have moderated household lending growth, thereby containing vulnerabilities. As the economy strengthens and the effects of the recent currency appreciation and good harvest for fruits and vegetables dissipate, the central bank is projected to slowly raise its policy rate from the middle of 2018.

The authorities plan to lower the central government deficit from 2.7% of GDP in 2017 to 1.9% in 2018. Increasing tax revenues from higher copper prices and the full implementation of the 2014 tax reform would compensate a rise in public spending. Consolidation is set to continue in 2019 in line with the fiscal rule. The fiscal stance is broadly appropriate, with a welcome sustained expansion of health-care and education spending. However, the decline in infrastructure investment could weigh on long-term growth, if the planned increase in public-private partnership projects fails to materialise. Broadening public revenues, notably by increasing recurrent housing and green taxes and reviewing the taxation of natural resources, would ensure more sustainable funding for social spending and infrastructure.

The ongoing educational reform, the simplification of export and entrepreneurship regulation, new support programmes for firms and an improved competition framework will raise investment and equity. However, simplified regulations and licensing procedures, more public-private research collaboration, better transport and logistic infrastructure and direct support for R&D are needed to strengthen entrepreneurship and innovation. Further expansion of childcare facilities would boost still low female employment in paid jobs and the adoption of a draft pension reform could improve work incentives for women and equity of the private pension system. Easing labour market regulations on open-ended contracts and extending unemployment insurance would reduce labour market inequalities and skill mismatches.

Growth will pick up

Growth is estimated to have bottomed out in 2017 and is projected to strengthen to 2.9% in 2018 and 2019. Exports will rebound, underpinned by improving export markets and base effects from the end of a prolonged strike in the largest copper mine. Strengthening demand, good financing conditions and recent policy measures to support productivity and exports will boost business investment. Private consumption will accelerate with increasing real disposable incomes. As growth picks up, the unemployment rate will edge down.

The main risks to growth relate to the performance of Chile's principal trading partners and the evolution of commodity prices. Lower or higher growth in China, the United States and Latin American neighbours could reduce or boost external demand. In particular, further recovery of copper prices would raise confidence and investment, and increase government revenues. Alternatively, lower export prospects would weigh on growth. Growth could also be weakened if business sector confidence does not recover further.

CHINA

Growth has strengthened somewhat in 2017, driven by services and some strategic industries, but is projected to soften in 2018-19, as exports decelerate. Industrial production growth has been picking up and profits have improved on the back of higher producer prices. The share of processing trade is declining but demand for services, in particular on account of tourism and foreign intellectual property, will remain high. Exports will slow somewhat but remain robust, making for a stable current account surplus. Infrastructure investment will also remain strong, notably to meet the targets of regional development initiatives. Housing investment will slow somewhat following a series of measures to restrict demand.

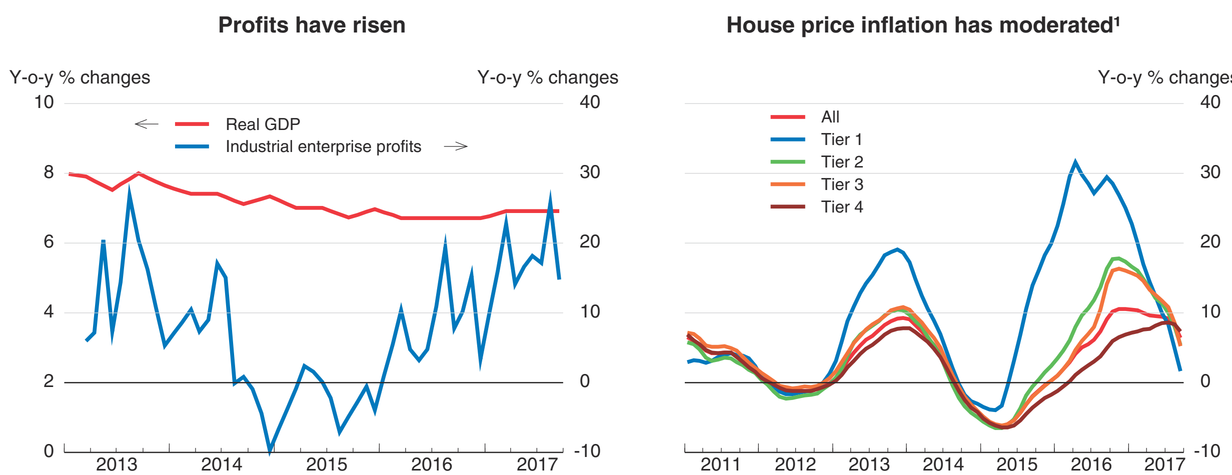
The monetary policy stance will continue to be neutral with a tightening bias even though selective easing will be implemented to improve access by small businesses and agriculture to credit. Attention is increasingly shifting towards enhancing financial stability as capital outflows moderate and the exchange rate is stabilised. Fiscal policy will remain supportive with the launch of multiple large-scale infrastructure projects, but public spending on education, health and social policies deserves greater emphasis.

Shadow banking is being reined in, but bank lending continues to grow unabated, increasing the probability of future bad loans. Corporate debt has stabilised relative to GDP at a high level but household debt is rising, though from a very low base. House price increases have moderated, but prices remain high in several large cities. Banking sector stability is being strengthened by new prudential measures discouraging interbank lending. The cut in compulsory reserve ratios for banks that lend for inclusive purposes, such as agriculture and small businesses, is expected to boost those banks' profits.

Growth has strengthened

Growth has picked up, notwithstanding the impact of environmental protection inspections on activity in heavy manufacturing and construction in the second half of the

China



1. Calculated from China's 70 cities residential property price index.
Source: CEIC; and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933631342

China: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices CNY trillion	Percentage changes, volume (2010 prices)				
GDP at market prices	64.4	6.9	6.7	6.8	6.6	6.4
Total domestic demand	63.0	8.3	7.8	6.4	6.2	6.4
Exports of goods and services	15.2	-2.3	1.9	8.0	5.4	4.0
Imports of goods and services	13.8	2.6	6.6	6.4	3.8	4.0
Net exports[1]	1.4	-1.3	-1.1	0.4	0.4	0.0
Memorandum items						
GDP deflator	_	0.1	1.2	4.1	4.0	4.0
Consumer price index	_	1.5	2.1	1.5	1.8	2.0
General government financial balance[2] (% of GDP)	_	-1.3	-3.1	-4.0	-4.3	-4.4
Headline government financial balance[3] (% of GDP)	_	-2.4	-3.0	-3.0	-3.0	-3.2
Current account balance (% of GDP)	_	2.8	1.7	1.1	0.9	0.9

1. Contributions to changes in real GDP, actual amount in the first column.
2. Encompasses the balances of all four budget accounts (general account, government managed funds, social security funds and the state-owned capital management account).
3. The headline fiscal balance is the official balance defined as the difference between revenues and outlays. Revenues include: general budget revenue, revenue from the central stabilisation fund and sub-national budget adjustment. Outlays include: general budget spending, replenishment of the central stabilisation fund and repayment of principal on sub-national debt.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632425

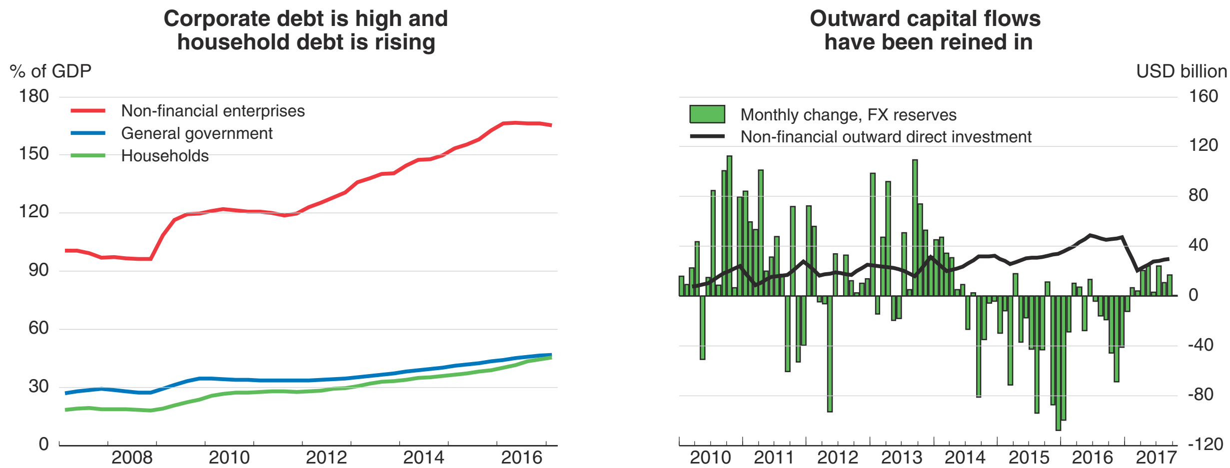
year. Industrial profits are recovering on the back of higher producer prices and surging demand for construction machinery as large infrastructure projects move ahead. Strong infrastructure investment has more than made up for capacity reductions in coal, steel, aluminium and other industries suffering from excess capacity. Slowing investment amid stable consumption dragged down domestic demand, but the surge in exports more than offset it. The recovery of private investment in early 2017 proved temporary, and it is unlikely to accelerate as long as excess capacity needs to be worked off in manufacturing and many services industries remain off limit for private investors. Housing investment growth has moderated somewhat as house price inflation receded to a more normal pace in the largest cities.

Supported by rising real incomes and a low unemployment rate, consumption has remained robust. E-commerce sales are buoyant. Firming foreign demand has boosted exports. Efforts to move the production of parts and components onshore are holding back imports but surging services imports – especially in tourism - are keeping overall imports stable. Producer price inflation has moderated somewhat and consumer price inflation remains subdued.

Tightening monetary and expansionary fiscal policies aim at stabilising growth while addressing risks

Monetary policy retains a tightening bias and financial stability has become a major objective for the coming years. Shadow banking is being reined in and more stringent regulations are to be applied to interbank certificates of deposit, adversely affecting medium-size banks that heavily rely on this source of funding. The reduction of interbank

China



Source: Bank of International Settlements; and CEIC.

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assets, though they carry a lower risk weight, will strengthen banks' capital ratios and enhance banking sector stability. Tighter regulation of asset management by banks and non-banks is also expected to help contain systemic risks. The move to cut the required reserve ratio conditional on lending for inclusive purposes is expected to boost banking sector profitability. Deleveraging in the corporate sector, in contrast, has been limited, even though some sectors, like real estate and local government investment vehicles, have experienced a tightening of funding conditions. Moreover, the household sector is leveraging up, with credit card and other consumer loans soaring. Monetary tightening alone is unlikely to restore financial stability. Implicit guarantees to state-owned enterprises and public entities need to be removed to create a level playing field, instil greater market discipline and achieve better credit risk pricing.

A series of capital control measures and the introduction of a new exchange rate fixing formula have reversed the trend of renminbi depreciation. Curbing of "irrational" investments has moderated outflows through the capital account and expectations of a stronger currency have reduced incentives to get funds out of the country by other innovative means. As a result, foreign exchange reserves have been rising anew for some time.

Fiscal policy remains expansionary, though less so than earlier in the year, following renewed efforts to tackle illegal local government debt. Misuse of public-private partnerships, government foundations and borrowing disguised as government service procurement at the sub-national level prompted the central government to curb such practices. Any such regulations, however, are unlikely to be effective in the longer term as long as implicit guarantees to public entities prevail and sub-national governments, in particular at the lowest levels, are burdened by unfunded spending mandates. The rapid expansion of public investment may lead to further misallocation of capital. Entry barriers to private capital need to be further removed, especially in services.

Growth is set to remain strong but risks continue to build up

GDP growth is projected to edge down over the next two years as exports and investment moderate, but will remain strong. The Belt and Road Initiative will continue to boost trade and investment ties with participating countries. Restrictions on house purchases and sales as well as on mortgage lending have started to impact the housing market, but prices will remain elevated as long as supply is constrained. This is reflected in the steady rise of land area auctioned notwithstanding moderating house prices and sales. Still robust housing price increases will keep residential investment relatively strong, absent alternative investment opportunities with comparable returns. Employment creation, aided by exemptions from user charges and taxes as well as by subsidised loans for entrepreneurs, will support consumption growth. However, without structural reforms to reduce precautionary saving, such as the provision of a better social safety net and higher-quality public services, rebalancing will advance only slowly.

Lower interbank activity as a result of more stringent prudential rules may cause liquidity problems in smaller banks that tend to rely more on interbank funding, but tighter regulation is necessary to safeguard financial stability. Corporate deleveraging is necessary to restore balance sheets amid rising debt service costs. Slower deleveraging would result in stronger growth in the short term but larger imbalances later. Moderating house price inflation may slow housing investment somewhat, but is necessary to reduce imbalances. Weaker fiscal stimulus may adversely affect growth, but would reduce the risk of a further build-up of implicit government liabilities. Infrastructure investment is mainly financed by public funds, but only partly from the budget, thereby reducing transparency. A stronger-than-foreseen global rebound would boost Chinese exports of goods and services and GDP growth.

COLOMBIA

Economic growth is projected to rise to around 3% in 2018 and 2019. Reduced corporate taxation, the historic peace agreement, better financing conditions and new infrastructure projects will boost investment. Private consumption will gain momentum as the labour market strengthens. Increasing activity and a stable exchange rate will put an end to the inflation slowdown. Inequalities and informality will remain key social challenges.

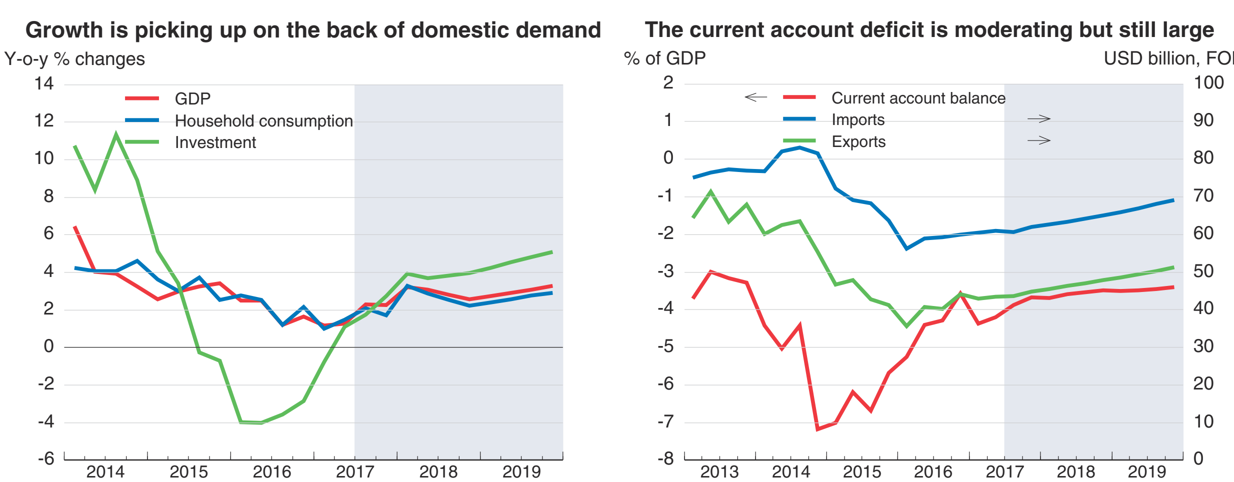
As inflation stabilises within the target range of 2-4%, monetary policy is projected to remain broadly neutral. The progressive fiscal consolidation path in line with the fiscal rule is broadly appropriate. Policies to make growth more inclusive, via better education and public infrastructure, and informality reduction with lower non-wage labour taxes, will be partly financed by the 2016 tax reform, but more revenues will be needed over the medium term.

Sizeable, but moderating, external financing needs expose Colombia to global financial volatility. Household and non-financial corporate debts are historically high. However, the financial system has been broadly resilient to the past growth slowdown. The ongoing adoption of Basel III capital standards and the strengthening of the regulation and supervision of financial conglomerates will help manage risks.

Growth has bottomed out

Economic growth started to improve at a gradual pace during 2017. The 2016 tax reform, low consumer confidence and the still high unemployment rate weighed on household consumption. Exports disappointed, with a continued decline in oil exports. The trade deficit has narrowed significantly as imports have contracted markedly since 2015. However, employment has recently increased and consumer confidence is improving. Investment started growing in the second quarter of 2017, and exports and imports are slowly recovering.

Colombia



Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933631380

Colombia: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices COP trillion	Percentage changes, volume (2005 prices)				
GDP at market prices	757.1	3.1	2.0	1.7	2.9	3.0
Private consumption	465.6	3.2	2.2	1.6	2.7	2.7
Government consumption	133.8	4.9	1.8	4.4	1.7	1.5
Gross fixed capital formation	195.4	1.8	-3.6	1.2	3.8	4.7
Final domestic demand	794.7	3.2	0.7	2.0	2.8	2.9
Stockbuilding[1]	3.6	-0.2	-0.3	0.1	0.0	0.0
Total domestic demand	798.3	2.9	0.3	2.2	2.7	3.0
Exports of goods and services	120.7	1.2	-0.9	-0.7	3.7	4.5
Imports of goods and services	161.9	1.4	-6.2	2.4	2.5	3.6
Net exports[1]	- 41.2	-0.1	1.3	-0.6	0.0	-0.1
Memorandum items						
GDP deflator	_	2.5	5.9	4.7	3.0	2.7
Consumer price index	_	5.0	7.5	4.3	3.3	3.0
Core inflation index[2]	_	4.7	6.5	5.0	3.3	3.0
Unemployment rate (% of labour force)	_	8.9	9.2	9.3	9.2	9.0
Current account balance (% of GDP)	_	-6.4	-4.4	-4.0	-3.6	-3.5

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding primary food, utilities and fuels.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632444

Macroeconomic policies are broadly appropriate

With inflation decelerating sharply over 2017, the central bank has gradually eased its policy rate since December 2016. Inflation is projected to stabilise within the central bank's target band in 2018-19 as temporary factors, such as the large devaluation and the indirect tax rate increase, fade and the economy strengthens. Therefore, the projected broadly neutral monetary policy stance in 2018-19 is appropriate.

The fiscal stance is also broadly appropriate, with the central government deficit set to narrow slightly in 2017. The medium-term goal is to reduce the deficit to 1% of GDP by 2022 in line with the fiscal rule. This will need further measures to raise revenues, notably as social spending is boosted in the coming years.

Structural reforms focused on inclusion could further support the peace transition and boost potential growth. To foster regional development and social inclusion, the peace agreement will need to be accompanied by policies that reduce inequalities and informality, such as further reduction in the tax burden on wages and simplifying the complex procedures for the registration of companies and the affiliation of workers to social security. Productivity would also be boosted by policies to enhance investment in innovation, improving the quality of infrastructure and education, increasing competition, closing gender gaps in labour force participation, and enhancing deeper integration with countries in the region.

GDP growth is projected to rebound but significant uncertainties remain

Growth is projected to strengthen to 3% in 2018-19, supported by lower interest rates, investment in infrastructure, higher oil prices and significantly stronger exports. Peace-related reforms will spur investment, particularly in rural areas. Improvements in the business climate will encourage public-private infrastructure investment. The past depreciation of the peso and better regional prospects will support exports, particularly of manufactured goods, but the limited production base will sustain import demand. The current account deficit will continue to moderate as exports gain momentum.

The main risks include trade prospects and commodity prices. On the downside, a faster-than-expected normalisation of US monetary policy and reduced corporate tax rates in the United States could affect exports and capital flows. In turn, recessions in some key trading partners, particularly Venezuela, would lower exports. Delays in public-private investment projects could also temporarily lower investment. On the upside, a stronger-than-expected recovery in business and consumer confidence given the peace deal would boost investment and consumption. Also, a stronger recovery of oil or coal prices would increase investment and government revenues.

COSTA RICA

Robust growth is projected to continue as export performance remains strong and investment is supported by FDI inflows and public infrastructure projects. However, domestic demand will be held back by the inflationary impact of the recent currency depreciation, increasing interest rates and fiscal consolidation. Past commodity price increases and the narrowing output gap have helped inflation increase to within the target range.

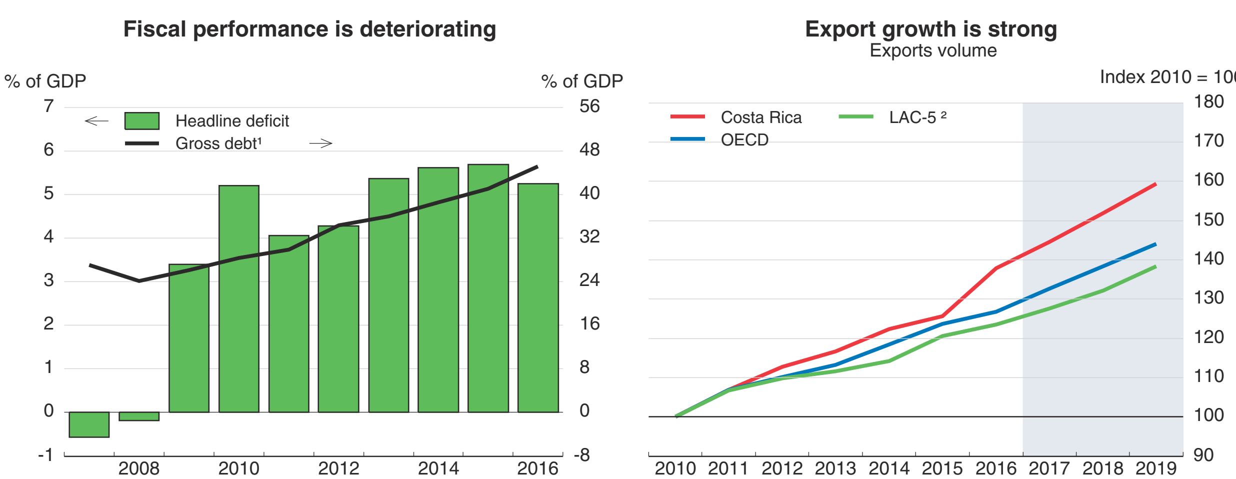
Restoring sustainable public finances has become more urgent as the deteriorating debt trajectory could threaten macroeconomic stability and growth prospects. A comprehensive reform package is needed to curb public spending, raise tax revenues and strengthen the fiscal framework. Structural policy reforms to improve education, reduce informality, facilitate women's labour force participation, address infrastructure gaps and strengthen competition would make growth more inclusive.

Sovereign debt has been below investment grade for over a year, with a significant share held by fully government-guaranteed state-owned financial institutions, creating the risk of a negative feedback loop. The cessation of commercial activities at one public bank and investigations into the business practices of another highlight weaknesses in banking regulations and the corporate governance of public banks. Policy efforts to reduce the high level of dollarisation in the banking sector should continue as it poses a threat to financial stability, particularly as global monetary conditions tighten.

Broad-based growth continues

Growth remains robust, supported by strong exports and inflows of foreign direct investment. Despite this, private consumption growth is slowing and household credit has decelerated. Investment growth has also weakened recently, but is projected to recover, supported by public infrastructure programmes, such as ongoing work on the Moín

Costa Rica



1. Gross debt refers to central government debt.
2. LAC-5 is the weighted average of five main countries of Latin America: Argentina, Brazil, Chile, Colombia and Mexico.

Source: Ministry of Finance; and OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933631399

Costa Rica: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices CRC trillion	Percentage changes, volume (2012 prices)				
GDP at market prices	27.2	3.6	4.5	3.9	3.9	3.8
Private consumption	18.0	4.6	4.5	3.8	3.7	3.7
Government consumption	4.8	2.4	3.0	3.0	3.0	2.5
Gross fixed capital formation	5.3	3.2	0.1	2.7	4.7	4.1
Final domestic demand	28.1	4.0	3.4	3.5	3.7	3.6
Stockbuilding[1]	- 0.2	0.2	0.8	-0.1	0.3	0.0
Total domestic demand	27.9	4.2	4.3	3.5	4.2	3.5
Exports of goods and services	8.8	2.6	9.8	4.8	5.1	5.0
Imports of goods and services	9.5	4.5	8.5	3.6	5.6	4.0
Net exports[1]	- 0.7	-0.8	0.1	0.3	-0.4	0.2
Memorandum items						
GDP deflator	_	3.8	1.9	2.2	3.7	3.1
Consumer price index	_	0.8	0.0	1.4	2.6	3.1
Core inflation index[2]	_	1.8	0.1	1.2	2.8	3.1
Unemployment rate (% of labour force)	_	9.6	9.5	9.1	9.4	9.3
Current account balance (% of GDP)	_	-3.5	-3.0	-3.8	-4.0	-4.0

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632463

Container Terminal and reconstruction related to the recent hurricane and tropical storm. However, not all workers have benefited from this strong growth. Labour force participation has declined and the share of workers holding informal jobs has increased to 43%. The unemployment rate remains high at 9.4%, reflecting structural factors as economic activity has shifted towards more technology- and knowledge-intensive sectors.

After a period of deceleration, inflation has increased to within the 2-4% target range. While inflation expectations are well anchored, a sharp depreciation of the colón led to concerns that they might be driven up, prompting the central bank to remove its accommodative stance and increase the policy rate from 1.75% in April 2017 to 4.5% in June 2017.

The deteriorating fiscal situation requires urgent action

Fiscal performance has deteriorated as improvements in 2016 were offset by recent constitutional court rulings mandating stricter enforcement of earmarked spending. The authorities estimate that the deficit will be 6.1% of GDP in 2017 and 7% in 2018, and that central government debt will reach 53.1% of GDP in 2018. Interest rates on public debt are rising, heightening concerns about the debt trajectory, with debt servicing accounting for almost a third of spending in next year's draft national budget. Political gridlock is preventing the enactment of legislation to contain the deficit and the adoption of structural reforms to boost inclusive growth. Draft bills to broaden and increase VAT, introduce two new top personal income tax brackets, and reform public sector employment have failed to progress. With parliamentary and presidential elections in early 2018 and a new administration taking office in May, there is significant uncertainty about how the situation will evolve. However, the projections assume that gradual fiscal consolidation will begin by 2019.

In October 2017, Tropical Storm Nate caused widespread damage in Costa Rica and is projected to dent short-term production, particularly in the agriculture and construction sectors. The cost of the storm is estimated at USD 385 million (0.7% of GDP), with damage to road infrastructure accounting for 45% of the total. However, the fiscal impact is unclear since it is not yet known how much will be spent on reconstruction nor what sources of funding will be drawn on.

There are significant downside risks to the outlook

The absence of reforms to restore fiscal sustainability will generate successive deficits and fast-rising public debt. There will be little space to deal with large negative macroeconomic shocks or natural disasters. Growth prospects will be damaged as business investment is crowded out and debt servicing costs divert resources from education, health, infrastructure and social assistance, which will also worsen the already-high levels of inequality. The size and associated costs of the necessary adjustment will grow the longer reforms are delayed.

A larger-than-expected rise in US interest rates could lead to exchange rate depreciation and trigger monetary policy tightening, further hampering domestic consumption. A weakened currency could also increase non-performing loans due to the heavily dollarised banking sector, and, in particular, the high share of foreign currency credit to unhedged borrowers.

CZECH REPUBLIC

Strong growth will continue in 2018 and 2019, driven by robust private demand and a dynamic external sector. Increasing wages will support household consumption and low interest rates will boost capital investment. Labour shortages will weigh on growth. Historically low unemployment will push inflation above the central bank's 2% target.

Following the removal of the exchange rate floor in April 2017, the value of the koruna has appreciated slightly. Monetary policy should continue to tighten gradually to counter inflation pressures. Given current and expected primary surpluses, the government could boost infrastructure investment and leverage EU funds. Structural policies to reduce labour shortages and raise labour productivity – such as reducing skills mismatches – would facilitate faster growth and sustain higher wage levels.

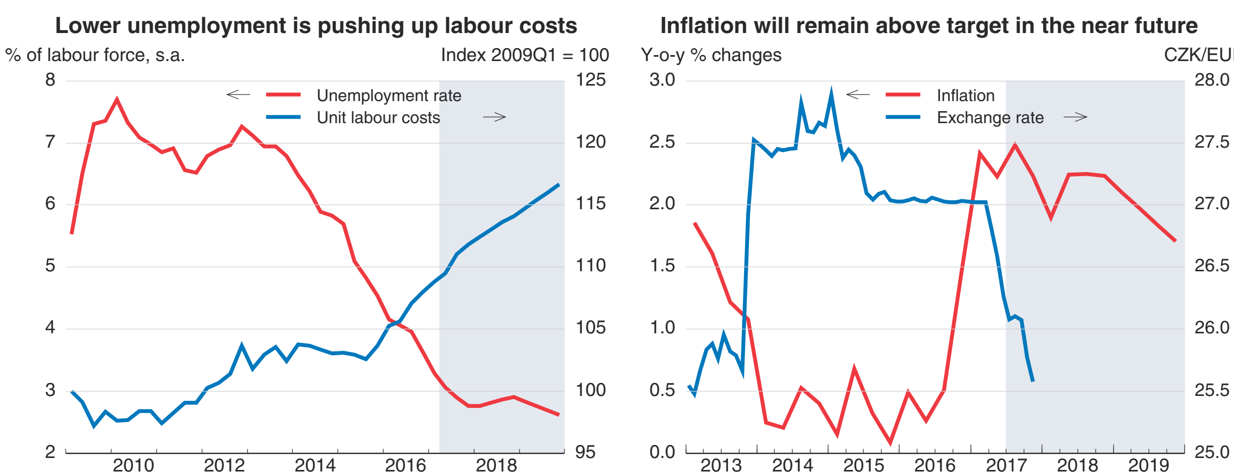
The financial sector is appropriately capitalised, liquid and profitable. However, the low levels of interest rates and strong economic activity have boosted mortgage credit demand and pushed up house prices. Decreased risk weights assigned to mortgage loans in many banks may amplify risks posed by the housing market and associated loans. A change in prudential rules may be needed as a result.

The economic boom is driven by both domestic and foreign demand

Economic activity continued to grow robustly in 2017 on the back of a broad-based expansion. Foreign demand contributed strongly to growth, which is above potential. Strengthening of growth in Europe contributed to drive exports and industrial production. Household consumption also supported growth thanks to low unemployment and high wage increases.

A tight labour market is becoming the binding constraint on growth. The unemployment rate has fallen to a historic low, creating labour shortages in some industries and pushing up labour costs. Moreover, the number of vacancies is high and the

Czech Republic



Source: OECD Economic Outlook 102 database; and Czech National Bank.

StatLink http://dx.doi.org/10.1787/888933631418

Czech Republic: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices CZK billion	Percentage changes, volume (2010 prices)				
GDP at market prices	4 312.5	5.4	2.5	4.3	3.5	3.2
Private consumption	2 073.4	3.7	3.5	4.0	3.8	3.0
Government consumption	849.2	1.9	2.0	1.6	1.8	1.6
Gross fixed capital formation	1 083.4	10.4	-2.5	6.6	4.3	3.1
Final domestic demand	4 006.0	5.1	1.5	4.2	3.6	2.8
Stockbuilding[1]	32.3	0.8	0.0	-0.7	0.0	0.0
Total domestic demand	4 038.3	5.9	1.4	3.4	3.5	2.7
Exports of goods and services	3 558.6	6.2	4.3	7.4	5.8	5.4
Imports of goods and services	3 284.3	7.0	3.1	6.6	6.1	5.0
Net exports[1]	274.3	-0.2	1.1	1.2	0.2	0.6
Memorandum items						
GDP deflator	_	1.2	1.2	1.0	1.7	1.7
Consumer price index	_	0.3	0.7	2.3	2.2	1.9
Core inflation index[2]	_	1.3	1.6	2.0	1.9	1.7
Unemployment rate (% of labour force)	_	5.0	3.9	3.0	2.8	2.7
Household saving ratio, net (% of disposable income)	_	6.6	6.9	6.7	6.5	6.6
General government financial balance (% of GDP)	_	-0.6	0.7	1.3	1.3	1.5
General government gross debt (% of GDP)	_	53.5	49.1	46.8	44.8	42.6
General government debt, Maastricht definition (% of GDP)	_	39.9	36.8	34.5	32.5	30.3
Current account balance (% of GDP)	_	0.2	1.1	0.7	0.8	1.0

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632482

ratio of unemployed persons per vacancy decreased to 1.3. The decline in unemployment will exert further pressures on wages and inflation.

It is time to boost investment in infrastructure and increase the inclusiveness of growth

Inflation is accelerating and will stay above the central bank's 2% target in 2018. Apart from wage pressures, food prices and industrial producer prices will keep driving up inflation. The Czech national bank is likely to increase interest rates by the end of 2017 and further tightening of monetary policy in 2018 will be necessary to keep inflation expectations anchored. Parallel tightening of monetary policy in the euro area would help limit the appreciation of the koruna. Moreover, the expected rising of credit costs should help limit the increase in house prices and mortgage loans. Monitoring of house prices developments and related bank loans is recommended, in particular in the face of tightening monetary policy.

The fiscal surplus will continue in 2018 and the public debt-to-GDP ratio will fall further. Pressures to increase civil servants' wages will continue. The strong fiscal position provides room to invest in the well-being of disadvantaged people, including old-aged individuals, to increase their inclusion in the labour market and society. Housing programmes and targeted education policies to better integrate Roma are affordable. Also, developing childcare facilities and reforming family policies would bring more women into the labour market and facilitate work-life balance.

The fiscal room could also be mobilised to improve the use of EU funds. The implementation of identified infrastructure projects, such as highways, railways and the development of the Prague metropolitan area, should be accelerated, as this would increase long-run potential growth. Streamlining procedures for granting building permits and further reducing the administrative burden on businesses by rolling out key e-government services could accelerate infrastructure investments.

Strong growth will continue

Growth is projected to remain above 3% throughout the projection period. Strengthening of growth in Europe and wage gains will drive demand and growth. Progress in the use of EU funds should also boost investment.

Risks to the projections include developments in the labour market and inflation dynamics. In particular, persistent labour shortages could create a wage-price inflation loop that could derail growth. As wage gains accelerate, firms' prices will have to increase, raising inflation and diminishing the price competitiveness of Czech firms. Also, a greater differential between euro area and Czech interest rates would lead to an appreciation of the koruna that could affect exports and limit growth.

DENMARK

After reaching 2.2% in 2017, GDP growth is projected to return to a pace of 2% in 2018 and 2019, supported by robust domestic demand. Wages and inflation are expected to rise as labour resources become increasingly scarce.

Monetary policy conditions will continue to support demand, especially private investment. A neutral fiscal stance over the projection period is appropriate, given intensifying capacity constraints. Tensions in the labour market should be eased by addressing barriers to employment for immigrants, older workers and those with reduced work capacity.

Financial vulnerabilities stem from very high gross household debt and continued house price increases. House price developments pose risks to future domestic demand, since sustained very low interest rates can fuel a housing bubble in the Copenhagen area. The recent strengthening of macro-prudential policies and reform of property valuation and taxation are welcome. However, the debt-bias in the tax system in favour of housing and credit needs to be lowered.

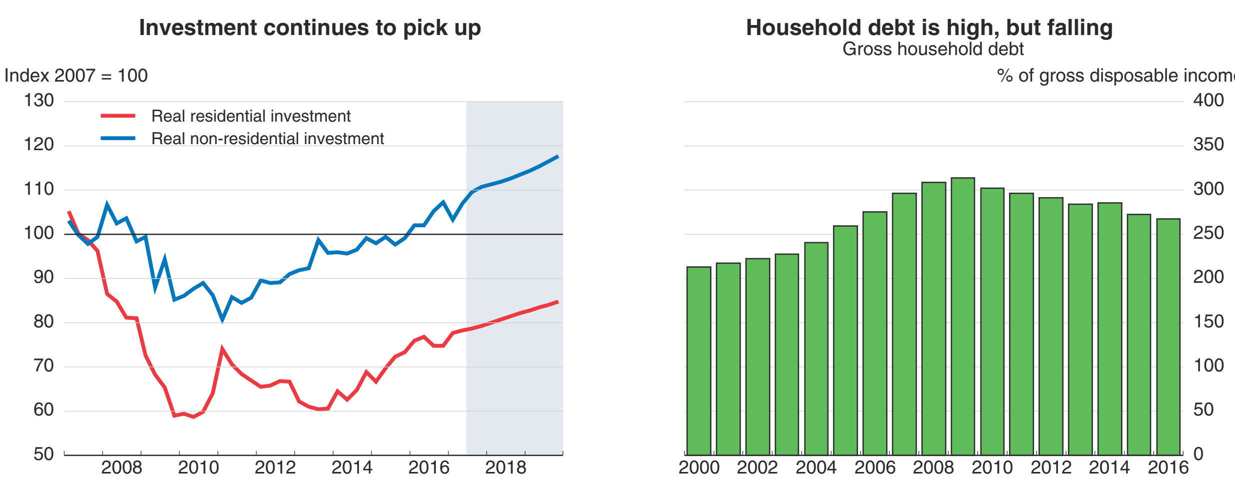
Domestic demand is broad-based and solid

With solid growth over the past two years, the economy is reaching its full potential, sustained by strong household spending and public investment. The unemployment rate has fallen to its estimated structural level and labour shortages are spreading. Inflation has picked up, even though it remains close to that of the euro area. Both consumer and business confidence are relatively upbeat. In line with strengthening external demand, export performance has also improved, notably in services.

Policy needs to limit the risks of over-heating

While the fiscal stance is projected to be broadly neutral in both 2018 and 2019, economic growth will be supported by continued expansionary monetary policy

Denmark



Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933631437

Denmark: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices DKK billion	Percentage changes, volume (2010 prices)				
GDP at market prices	1 981.2	1.6	2.0	2.2	2.0	2.0
Private consumption	934.3	1.6	2.1	2.3	2.4	2.7
Government consumption	510.9	1.1	0.3	0.5	0.8	0.7
Gross fixed capital formation	379.7	3.1	6.0	3.5	4.1	3.3
Final domestic demand	1 824.9	1.7	2.4	2.1	2.3	2.3
Stockbuilding[1]	18.3	-0.4	0.0	0.1	0.0	0.0
Total domestic demand	1 843.2	1.3	2.4	2.2	2.3	2.3
Exports of goods and services	1 082.0	2.3	2.8	4.5	3.5	3.7
Imports of goods and services	944.0	1.9	3.8	4.7	4.3	4.5
Net exports[1]	138.0	0.4	-0.3	0.1	-0.2	-0.1
Memorandum items						
GDP deflator	_	0.7	0.0	1.8	1.8	2.2
Consumer price index	_	0.5	0.2	1.2	1.6	1.8
Core inflation index[2]	_	1.3	0.7	1.1	1.7	1.8
Unemployment rate (% of labour force)	_	6.2	6.2	5.8	5.7	5.6
Household saving ratio, net (% of disposable income)	_	4.2	4.3	4.9	4.8	4.7
General government financial balance (% of GDP)	_	-1.5	-0.4	-1.3	-1.1	-0.8
General government gross debt (% of GDP)	_	54.2	52.8	53.9	54.8	55.3
General government debt, Maastricht definition (% of GDP)	_	39.5	37.7	38.8	39.7	40.2
Current account balance (% of GDP)	_	8.8	7.3	8.5	8.5	8.6

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632501

conditions. Easy financial conditions could translate into excessive price increases of owner-occupied flats in Copenhagen. Following a recommendation by the Systemic Risk Council, credit conditions have been tightened for borrowers with liabilities above four times their annual income, which will help to stabilise the housing market.

A long-awaited reform of property taxation was approved earlier this year. It should help to stabilise property prices, especially when it becomes fully effective in 2021. The possibility of reducing property taxation again in event of a sustained rise in the property tax revenue as a share of GDP should be abandoned, in order to allow the taxes to damp the housing cycle. Moreover, interest rate deductibility in the tax system could be reduced further.

Sustained employment growth has been helped by recent reforms improving work incentives. To ease tensions in the labour market, addressing barriers to low-wage jobs and disincentives to longer working hours are priorities. Policy action is needed to expand the employment potential of marginalised groups, such as migrants with low language skills or those with reduced work capacity. Enhancing their employability would also improve their inclusion and the distribution of the growth dividend.

Economic expansion will continue at a sustained pace

The economy is projected to maintain GDP growth of around 2% in both 2018 and 2019. Inflation will strengthen to 1.8% in 2019 and increased labour market tightness will translate into faster wage growth. Real disposable income growth will remain robust, sustaining household spending. Business investment is expected to pick up as economic slack disappears. While interest rates will start to rise over the projection period, monetary conditions will remain accommodative.

A tighter-than-projected labour market could stoke wage pressures that would increase household incomes but undermine the competitiveness of Danish exports. Frontloading of residential construction could happen before the recently approved property tax reform takes effect and that could result in temporarily higher economic activity, adding further to the labour shortages in the construction sector. Downside risks are related mainly to unfavourable developments in the main trading partners in Europe.

ESTONIA

After exceeding 4% in 2017, economic growth is projected to decline to 3% by 2019. Public and private investment should recover from past low levels, notably supported by resumed disbursement of EU funds. High wage growth, due to the tightening labour market, will sustain private consumption. While this poses a risk to competitiveness, export growth will remain strong.

Fiscal room is available for measures to increase the productive capacity of the economy and to foster inclusive growth. Public spending should be used to tackle important societal issues, including high inequality in wealth and health status and significant gender gaps. The planned accommodative fiscal stance is appropriate, but fiscal initiatives should rely on ex-ante evaluation to guarantee high economic and social returns.

Financial vulnerabilities have receded since the global financial crisis. The banking sector, concentrated and mostly foreign-owned, is highly profitable and enjoys low non-performing loans. Capital outflows from Nordic parent banks are nevertheless a tail risk that could undermine the recovery of investment.

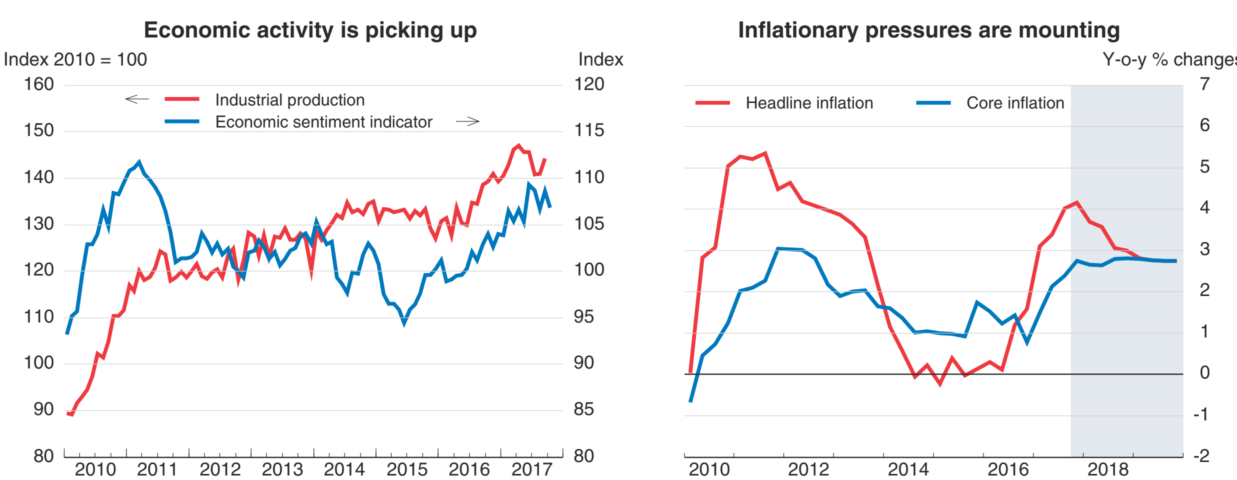
The economy has gained strong momentum

Economic growth has strengthened, reflecting a sharp pick-up in private and public investment. Disbursements of EU funds have accelerated and strengthening demand from neighbouring countries combined with favourable financing conditions have supported capital spending in the private sector. Oil shale and energy sectors have benefitted from higher global oil prices. Consumer confidence has improved, auguring for robust household spending.

Public spending should focus on expanding supply

Fiscal policy will be accommodative but remain prudent, as fiscal deficits are expected to remain below 1% of GDP. As the economy is reaching full capacity, public spending needs

Estonia



Source: OECD Economic Outlook 102 database; European Commission, Business and Consumer Surveys; and Statistics Estonia.

StatLink http://dx.doi.org/10.1787/888933631456

Estonia: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	19.8	1.8	2.2	4.4	3.3	3.0
Private consumption	10.1	4.6	4.2	2.3	4.0	3.5
Government consumption	3.8	3.3	2.0	0.8	1.2	1.6
Gross fixed capital formation	4.9	-3.1	-0.9	18.3	3.9	4.6
Final domestic demand	18.8	2.4	2.5	5.8	3.4	3.4
Stockbuilding[1]	0.4	-1.3	0.7	-2.0	-0.1	0.0
Total domestic demand	19.2	1.1	3.4	3.9	3.3	3.3
Exports of goods and services	16.3	-0.6	4.1	3.4	4.0	4.3
Imports of goods and services	15.8	-1.8	5.2	4.5	4.7	4.8
Net exports[1]	0.6	0.9	-0.7	-0.7	-0.3	-0.2
Memorandum items						
GDP deflator	_	1.2	1.5	4.4	3.6	3.1
Harmonised index of consumer prices	_	0.1	0.8	3.7	3.3	2.8
Harmonised index of core inflation[2]	_	1.2	1.2	2.2	2.7	2.8
Unemployment rate (% of labour force)	_	6.2	6.8	6.9	7.6	7.7
Household saving ratio, net (% of disposable income)	_	7.4	7.3	7.4	7.0	6.9
General government financial balance (% of GDP)	_	0.1	-0.3	-0.1	-0.3	-0.5
General government gross debt (% of GDP)	_	13.0	13.1	12.8	12.6	12.8
General government debt, Maastricht definition (% of GDP)	_	10.0	9.4	9.1	8.9	9.1
Current account balance (% of GDP)	_	2.0	1.9	2.3	2.0	1.8

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632520

to prioritise measures to boost potential growth and mitigate the risk of overheating. Given the relatively high level of inequality in terms of income and health status, policy action should also focus on improving the redistributive impact of taxes and transfers and strengthening social protection.

In 2018, the reform of the personal income tax will boost household purchasing power. It should support labour market participation by reducing the tax wedge on low incomes and increasing progressivity of the tax system. The rising legal retirement age and ongoing implementation of the Work Ability reform will also boost labour supply. All people with reduced work capacity will have to progressively register as unemployed and participate in activation programmes. This measure should improve the employability of disabled people but also increase the number of unemployed, as not all will be able to find a job.

Skills shortages have emerged in some sectors and, despite increasing labour market participation, buoyant economic activity will induce further tensions on the labour market. Wages will continue to grow at a high pace, weighing on exporters' price competitiveness and impeding gains in export market shares. Supporting employment of women with children, improving the relevance and the quality of adult education, and facilitating skilled migration could ease labour market bottlenecks.

Tensions on the labour market pose risks to future growth

GDP growth will slow to 3% by 2019. Investment will continue to recover after four years of decline as capacity utilisation tightens. Private consumption is also projected to strengthen in 2018 sustained by fiscal policy, still low interest rates and a recovery in real wages. Strong domestic demand will lift imports and net exports will exert a small drag on GDP growth. Employment growth is projected to decline, due to capacity constraints and rising labour costs. Headline inflation will however ease gradually from 3.7% in 2017 to 2.8% in 2019, as the impact of higher excise duties fades away.

If labour shortages and wage inflation were to be higher than projected, exporters could lose competitiveness and market shares. The financial sector poses only limited risks. The banking sector, mostly foreign-owned, is well capitalised with effective home-host cooperation. Nevertheless, financial turbulence in Nordic parent banks and subsequent capital outflows could affect credit supply. Positive risks relate to the improved global outlook and a stronger recovery in the European Union which would support exports and deeper integration into global value chains.

EURO AREA

GDP growth is projected to remain strong, but ease to 1.9% in 2019, supported by the ongoing recovery of global output and trade, accommodative monetary policy and diminished political uncertainty. Growth is broad-based, driven by domestic and external demand. Wage growth is set to remain moderate, and inflation is projected to rise closer to, but still below, 2% by end-2019.

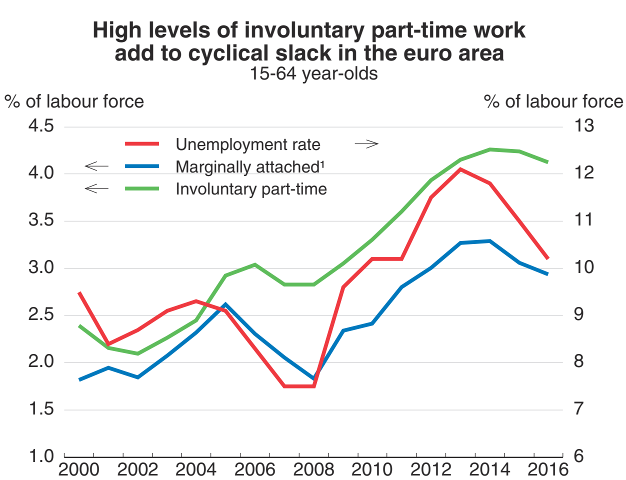
The ECB announced in October a gradual reduction of asset purchases, which is justified by an improving economic outlook and by the need to reduce the risk of financial imbalances. Policy rates should remain on hold well past the end of asset purchases and until inflation is clearly and persistently rising to the target, as emphasised by ECB guidance. The euro area fiscal stance is expected to be slightly expansionary. Countries with fiscal space should give priority to initiatives that yield the highest benefits for medium-term growth and inclusiveness. Removing unnecessary barriers to competition, easing entry barriers to professional services and investing in infrastructure for new technologies would boost much needed productivity growth.

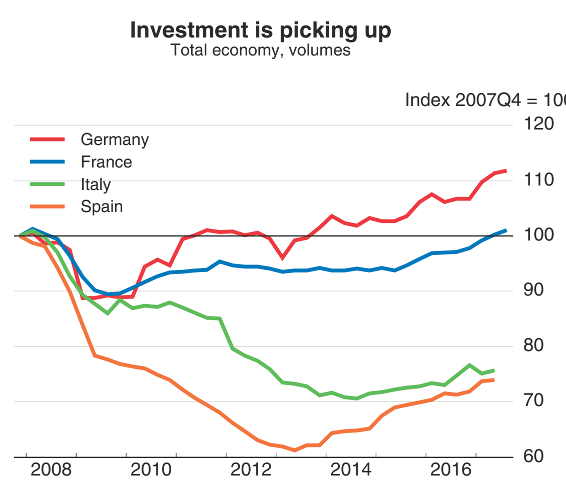
Private debt remains high by historical and international standards and policy measures, such as improving insolvency frameworks, should support a faster reduction. High private indebtedness has led to a large stock of non-performing loans in some countries, which is hurting bank profitability and restraining new lending. To bolster resilience, the authorities need to further reduce links between sovereigns and banks and introduce more risk-sharing at the European level.

The recovery continues at a dynamic pace

Growth has continued steadily, broadening across sectors and countries, supported mostly by domestic demand. Improving labour markets and very favourable financing conditions continue to boost incomes and promote private consumption, despite lacklustre wage growth. Investment is becoming more supportive of the recovery and has

Euro area





1. Excluding Slovenia, for which data are not available.
Source: OECD Employment database; and OECD Economic Outlook 102 database.

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Euro Area: **Demand and output**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2014 prices)				
GDP at market prices	10 101.8	2.0	1.8	2.4	2.2	1.9
Private consumption	5 597.4	1.8	1.9	1.8	1.5	1.4
Government consumption	2 118.8	1.3	1.8	1.1	1.3	1.4
Gross fixed capital formation	1 989.2	2.9	4.5	3.6	3.7	3.5
Final domestic demand	9 705.3	1.9	2.4	2.1	2.0	1.9
Stockbuilding[1]	26.2	0.0	-0.1	0.1	0.1	0.0
Total domestic demand	9 731.6	1.9	2.3	2.2	2.1	1.9
Net exports[1]	370.3	0.1	-0.4	0.3	0.1	0.0
Memorandum items						
GDP deflator	_	1.4	0.8	1.1	1.5	1.7
Harmonised index of consumer prices	_	0.0	0.2	1.5	1.5	1.7
Harmonised index of core inflation[2]	_	0.8	0.8	1.1	1.4	1.7
Unemployment rate (% of labour force)	_	10.9	10.0	9.1	8.5	8.0
Household saving ratio, net (% of disposable income)	_	5.9	5.8	5.8	5.7	5.6
General government financial balance (% of GDP)	_	-2.1	-1.6	-1.1	-0.7	-0.4
General government gross debt (% of GDP)	_	109.5	108.9	107.1	105.1	103.2
General government debt, Maastricht definition (% of GDP)	_	92.3	91.3	89.4	87.5	85.6
Current account balance (% of GDP)	_	3.7	3.6	3.4	3.4	3.4

Note: Covers the euro area countries that are members of the OECD.

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632539

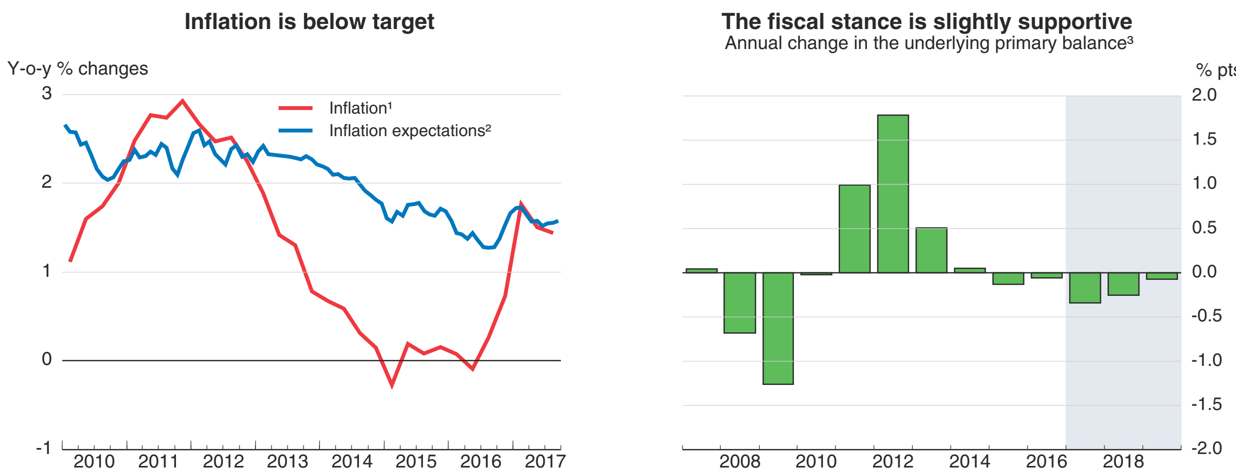
expanded at a dynamic pace in the first half of the year in most countries, sustained by buoyant business sentiment, the need to upgrade the capital stock, rising profits and easy financial conditions. Exports have continued to strengthen on the back of the rebound in world trade. Business and consumer confidence indicators remain very high.

Labour market conditions continue to improve. Employment continues to grow strongly and is already above its pre-crisis level. The unemployment rate keeps declining although large differences in unemployment rates remain across countries. Improving labour market conditions have not translated into wage pressures: wage growth in the euro area has been picking up only slightly. Factors weighing on wage growth include still significant labour market slack, weak productivity growth and expectations of continued low inflation. Labour market slack is probably bigger than the unemployment rate suggests, as the shares of involuntary part-time work and marginally attached workers in the labour force are still elevated and only declining slowly.

Structural reforms are needed to increase medium-term growth

The ECB has extended its asset purchases until September 2018, at a lower monthly rate of 30 billion euros, or beyond if necessary. The announced gradual reduction of asset purchases by the ECB is welcome to avoid disruptions in financial markets and anchor interest rates at a low level. On the basis of this projection, policy rates are expected to begin to rise in 2020, but longer-term market interest rates will start rising earlier, as

Euro area



1. Harmonised consumer price index.
2. Expected average inflation rate, based on the difference between 5- and 10-year inflation swaps.
3. Measured in per cent of potential GDP.

Source: OECD Economic Outlook 102 database; OECD calculations based on Thomson Reuters data.

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financial markets start pricing in a policy rate rise. This is appropriate in an environment of below target inflation, continuing labour market slack, and anchored inflation expectations.

In the euro area as a whole, the fiscal stance is expected to remain slightly expansionary. Countries with room to provide additional fiscal support should use it to support public initiatives that yield the highest benefits for inclusiveness and long-run supply, including investment, education and childcare. Potential growth has fallen substantially since the global financial crisis, as a result of weak productivity and investment. There is ample scope for product market reforms to boost competition, encourage innovation and business dynamism and enhance diffusion of new technologies in many countries. Faster implementation of Europe's digital single market and the swift completion of the single market in network sectors and services would foster investment and productivity growth. Investment needs are important in trans-European transport and energy networks and the recently expanded Investment Plan for Europe should support these investments.

A number of private sector financial vulnerabilities still pose challenges in some euro area economies. Euro area banks have made progress in cleaning up their balance sheets, but non-performing loan ratios remained above 10% in six member countries in the first quarter of 2017. New initiatives at the European level to help develop a market for impaired assets, notably through the blue-print for national asset management companies, should be implemented swiftly. Private debt has declined, although at a slow pace and remains above 100% of GDP in many countries. Policies to improve insolvency frameworks, including more efficient judicial processes and out-of-court mechanisms, could help reduce debt and facilitate the efficient restructuring of viable companies and debt recovery for lenders.

Public debt-to-GDP ratios remain above historical averages in many countries. High debt can weaken fiscal sustainability, including by triggering shifts in market sentiment, making debt financing more difficult. Countries should implement employment-friendly fiscal reforms and shift the composition of spending towards items that spur potential growth. The credibility of the EU fiscal governance should also be strengthened with simplified fiscal rules. Continued progress to complete the banking union by creating a common fiscal backstop to the Single Resolution Fund, as well as an agreement on the European Deposit Insurance Scheme, remains essential to strengthen the financial stability of the euro area banking sector. A fully developed Capital Markets Union would enhance both the domestic and cross-border supply of capital, especially to small and medium-sized enperprises, and facilitate risk-sharing in the European Union.

Growth will ease to about 2% in 2019

Rising employment should boost incomes and support private consumption, despite moderate wage growth. Strong business confidence, increasing corporate profitability and dynamic global demand should keep supporting investment. Public investment growth is expected to become more supportive of growth in some countries, as projects from the new programming period of EU funding start. Despite tepid export growth, a large area-wide current account surplus will remain, with a projected continuation of large current account surpluses in Germany and the Netherlands. The projected decline in unemployment will still leave the unemployment rate above pre-crisis levels in many countries, and inflation, though gradually increasing, will remain below 2%.

Policy uncertainty remains high and could increase further. The outcome of the Brexit negotiations will be determinant for confidence and trade, and political events in other EU countries could undermine confidence in the economic and monetary union. A too rapid tightening of monetary policy could weigh on the recovery in countries with high unemployment and large output gaps. On the upside, the cyclical recovery in world trade and ongoing momentum in the global economy could lead to stronger-than-expected growth.

FINLAND

Boosted by exports, output growth is on course to exceed 3% in 2017. Growth will remain strong in 2018-19 but will slow somewhat, as private consumption softens due to the impacts of wage moderation and rising inflation on household real incomes. Investment in construction is also set to decelerate, but export demand and the implementation of some major industrial projects will support business investment.

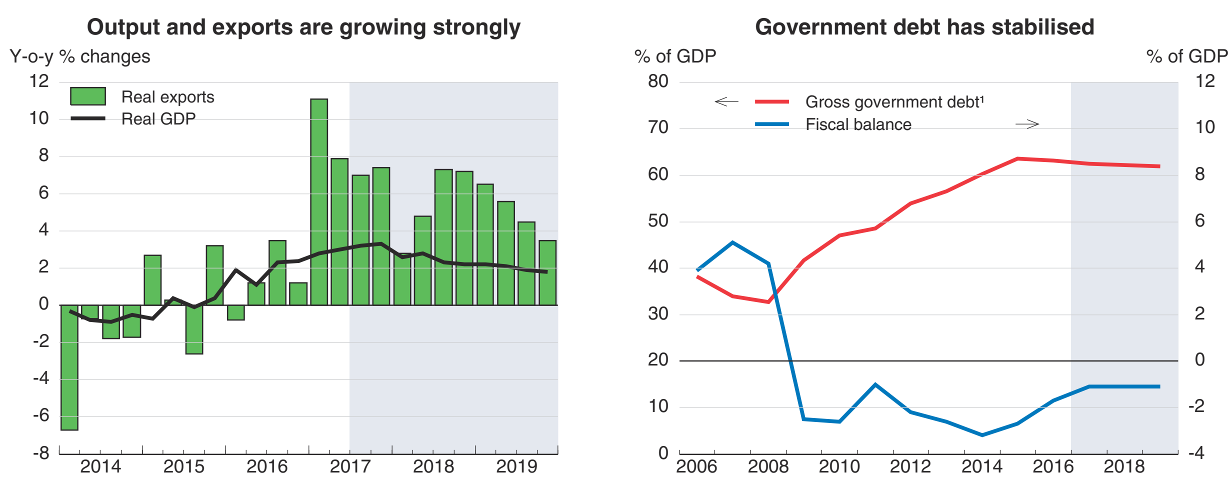
The economic recovery and measures to contain public spending are stabilising the government debt-to-GDP ratio. Nevertheless, a rapidly ageing population will continue to strain public finances and limit output growth, calling for efficiency gains in public services and for lifting the employment rate through improved competitiveness and enhanced work incentives.

Finland's high and increasing household indebtedness, largely in the form of mortgages, is a source of financial and macroeconomic vulnerability, although less so than in the other Nordic countries. House prices are stable, but may pick up as the economy gathers momentum. The set of macro-prudential tools is being expanded to help prevent any overheating of the housing market.

A strong revival in exports is underpinning growth

Supported by buoyant exports amid improving global demand and cost competitiveness, the economy is growing rapidly. Private consumption is healthy, thanks to job creation and low inflation. Business and consumer confidence have risen strongly in the past year, which along with low interest rates, has boosted both residential and business investment. While employment is expanding, the fall in unemployment has been held back by an increase in the labour force, as discouraged workers resume job search. Economic growth, together with cuts in government spending, has reduced the government deficit.

Finland



1. Maastricht definition.
Source: OECD Economic Outlook 102 database.

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Finland: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	205.5	0.0	1.9	3.1	2.5	2.0
Private consumption	113.6	1.7	1.8	2.6	2.3	1.3
Government consumption	50.7	0.0	1.2	0.0	-0.3	1.0
Gross fixed capital formation	42.2	0.7	7.2	7.8	3.5	3.5
Final domestic demand	206.6	1.0	2.8	3.1	2.0	1.7
Stockbuilding[1,2]	0.8	0.2	-0.2	-0.7	-0.1	0.0
Total domestic demand	207.4	1.2	2.6	2.4	1.9	1.7
Exports of goods and services	76.5	0.8	1.3	8.3	5.5	5.0
Imports of goods and services	78.4	3.2	4.4	2.5	4.4	4.3
Net exports[1]	- 1.9	-0.9	-1.2	2.0	0.4	0.3
Memorandum items						
GDP deflator	_	2.0	0.9	0.9	1.0	1.5
Harmonised index of consumer prices	_	-0.2	0.4	1.0	1.7	2.0
Harmonised index of core inflation[3]	_	0.8	1.1	0.7	1.4	2.0
Unemployment rate (% of labour force)	_	9.4	8.8	8.7	8.4	8.0
Household saving ratio, net (% of disposable income)	_	-1.0	-2.5	-2.8	-2.7	-2.8
General government financial balance (% of GDP)	_	-2.7	-1.7	-1.1	-1.1	-1.1
General government gross debt (% of GDP)	_	74.5	75.4	75.6	75.3	75.1
General government debt, Maastricht definition (% of GDP)	_	63.6	63.1	62.5	62.2	61.9
Current account balance (% of GDP)	_	-1.0	-1.4	-0.4	-0.6	-0.6

1. Contributions to changes in real GDP, actual amount in the first column.
2. Including statiscal discrepancy.
3. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632558

The public finances are improving

General government debt has stabilised at slightly over 60% of GDP. Nevertheless, as population ageing pushes up welfare costs, a fiscal sustainability gap remains. Closing this gap will require enhancing the efficiency of public services, as well as boosting employment to raise potential growth and generate more tax revenue. A pension reform entered into force in 2017, a health care and social services reform is under preparation, with implementation due in 2020, and savings and tax measures have been taken.

Raising the employment rate, which is lower than in all the other Nordic countries, is crucial to address the long-term fiscal challenges posed by ageing and foster inclusive growth. The Competitiveness Pact which entered into force this year is helping contain labour costs and strengthen demand for labour. Recent measures to enhance work incentives, notably the cut in the duration of unemployment benefits, will lift labour supply. However, further reforms to boost employment are needed, as high tax rates upon return to work and complex benefit rules still undermine work incentives.

Robust economic growth will continue

Economic growth is projected to remain robust in 2018 and 2019, albeit slower than in 2017. Private consumption growth is expected to weaken, due to moderate wage growth and the erosion of household purchasing power by higher inflation. Residential investment growth is set to come down from record highs. Business investment will strengthen as the launch of major industrial projects (in energy, forestry and metals) is scheduled for 2018 and growing world trade supports export-oriented business investment. Exports will remain robust as a result of strengthening foreign demand and improving competitiveness. Inflation is likely to pick up as spare capacity shrinks, but will be contained by wage moderation.

Finland's economic performance is very dependent on exports. Swings in foreign demand, particularly for the intermediate and investment goods in which the country specialises, imply both negative and positive risks. Increased protectionism and rising geopolitical tensions could reduce exports. Recent competitiveness gains could boost exports more than expected. High and increasing household indebtedness, largely in the form of mortgages, increases the vulnerability of households to a rise in interest rates or a fall in house prices. Risks are nevertheless limited, as house prices have been broadly stable over recent years. Furthermore, macro-prudential tools, such as a loan-to-value cap and minimum risk weights on mortgages, are being put in place to safeguard financial stability.

FRANCE

Economic growth will remain robust at an annual pace of around 1¾ per cent in 2018-19 thanks to stronger external demand, a rebound in tourism, robust business confidence and job creation. Cuts in business taxes and labour market reforms should further support investment and employment.

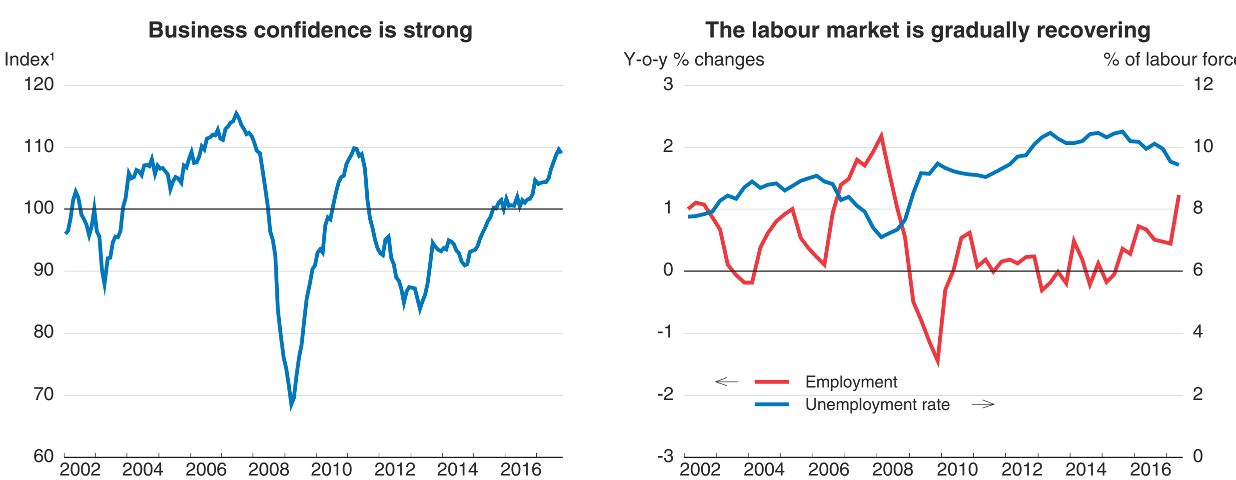
Despite reductions in business and capital income taxes, stronger economic growth and some spending restraint should help to bring the budget deficit below 3% of GDP. The fiscal stance is expected to be largely neutral, implying that further spending reductions will be needed to finance tax reductions in a sustainable way. To strengthen the economy's growth potential and social outcomes, this should be based on structural reforms that reduce inefficiencies and non-priority spending, while preserving expenditure on education, training and infrastructure, benefitting lower-income households in particular. Plans to increase spending on training and improve the system are welcome in that respect.

Financial-sector vulnerabilities are limited, and in spite of relatively high and still rising public debt stress tests indicate that the banking sector is resilient. Less than 4% of loans are non-performing, credit conditions are favourable, and lending is rising faster than in other big euro area economies. Both household and business-sector indebtedness are increasing; the latter exceeded 70% of GDP at end-2016 compared to a euro area average of 63.5%. If this trend continues, it could make enterprises vulnerable to faster-than-expected interest rate increases.

Stronger growth is taking hold

Economic growth has strengthened, benefitting from social security and business tax cuts. In fact, investment growth has slowed far less than expected following the end of the accelerated depreciation allowance in April 2017, underlining the underlying strength of the economy. The labour market is recovering, supporting consumption and household

France



1. Standardised synthetic indicator with mean 100 and standard deviation 10.
Source: INSEE; and OECD Economic Outlook 102 Database.

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France: **Demand and output**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	2 149.2	1.0	1.1	1.8	1.8	1.7
Private consumption	1 186.7	1.4	2.1	1.2	1.3	1.3
Government consumption	515.8	1.1	1.2	1.4	1.4	1.2
Gross fixed capital formation	469.7	0.9	2.7	3.5	3.6	3.9
Final domestic demand	2 172.2	1.2	2.0	1.7	1.8	1.9
Stockbuilding[1]	19.5	0.3	-0.1	0.6	0.1	0.0
Total domestic demand	2 191.8	1.5	1.9	2.3	1.9	1.8
Exports of goods and services	621.8	4.0	1.9	3.0	4.3	4.0
Imports of goods and services	664.4	5.5	4.2	4.5	4.5	4.3
Net exports[1]	- 42.6	-0.5	-0.8	-0.5	-0.2	-0.2
Memorandum items						
GDP deflator	_	1.1	0.4	0.8	1.2	1.4
Harmonised index of consumer prices	_	0.1	0.3	1.1	1.1	1.3
Harmonised index of core inflation[2]	_	0.6	0.6	0.6	1.0	1.3
Unemployment rate[3] (% of labour force)	_	10.4	10.1	9.4	9.2	8.8
Household saving ratio, gross (% of disposable income)	_	13.9	13.6	13.9	13.9	13.9
General government financial balance (% of GDP)	_	-3.6	-3.4	-2.9	-2.8	-2.9
General government gross debt (% of GDP)	_	120.4	123.3	124.2	124.6	125.0
General government debt, Maastricht definition (% of GDP)	_	95.8	96.6	97.5	97.8	98.3
Current account balance (% of GDP)	_	-0.4	-0.9	-1.5	-1.7	-1.9

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
3. National unemployment rate, includes overseas departments.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632577

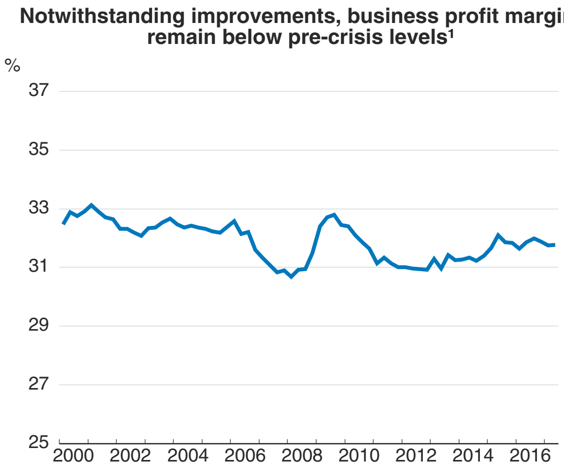
investment, which continues to grow at a vigorous pace owing to exceptionally low interest rates. Market-sector employment has increased vigorously in the first half of the year, and business surveys continue to indicate a favourable hiring outlook.

Exports have strengthened as the negative impact of a number of temporary factors, in 2016, such as supply disruptions in aeronautics and bad weather impacting agricultural exports, has waned. Yet, export growth remains volatile. Since 2012, it has been mainly driven by just a few sectors, notably the transportation industries. French firms have not yet fully benefitted from their trading partners' strengthening demand. Headline inflation has increased markedly as a result of higher energy prices, but so far core inflation has hardly moved.

Policies will support activity, investment and productivity

The government intends to reduce the share of government spending in GDP by 3 percentage points of GDP over five years to make room for tax cuts. These include a gradual reduction of the corporate income tax rate from 33% to 25%, and cuts in capital income, wealth and the residency taxes. On the other hand, energy and tobacco taxes are set to increase markedly, helping to make growth greener and strengthen prevention in health care. The government has taken some measures to reduce public spending in 2017-18,

France



1. Non-financial corporations, gross operating surplus as a percentage of gross value added.
Source: INSEE; and Eurostat, Comext database.

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including reductions in hiring and housing subsidies, and plans to lower real public spending growth to less than ½ per cent annually over 2018-22. Helped by stronger GDP growth, the fiscal deficit is expected to have fallen below 3% of GDP in 2017. The fiscal stance is projected to be largely neutral over the projection horizon.

Structural government reforms to target inefficient and non-priority spending for further cuts will be needed to finance the tax reductions in a sustainable and equitable way. It will be particularly important to reduce overlap in sub-central governments' responsibilities, accelerate the merger of small municipalities and identify other areas where there is room not to replace every retiring civil servant. Gradually increasing the retirement age, while improving access for senior workers to training and gradual retirement, would also help limit public spending growth, while increasing employment and output.

This year's labour market reform should facilitate firm-level negotiations, particularly in small enterprises. It requires branch-level agreements to differentiate by firm size to better take into account the situation of smaller firms. The complex governance of workers' representation will be simplified. The reform is expected to facilitate investment and growth, in particular of small and innovative firms. The government also plans a substantial investment in training, while simplifying the overly complex training system and strengthening apprenticeships. This could go a long way to improving labour market outcomes of less-skilled workers and inclusiveness. An upper limit on indemnities set by courts to compensate workers for unfair dismissals is expected to encourage hiring on open-ended contracts. Implementing the plan to increase social contributions for firms that rely excessively on short-term contracts would have the same effect. This could improve access to more stable jobs and training for many workers.

Growth is projected to continue

Despite the elimination of hiring subsidies for SMEs and a sizeable reduction of subsidised jobs in the non-market sector, employment growth should continue, supported by higher GDP growth, although at a slower pace. This should support private consumption growth and lead to a further gradual fall of the unemployment rate. Since December 2016 business confidence has continuously risen, reaching its highest level since 2011 in September 2017, supporting investment growth, as will planned business tax cuts. Exports should benefit from stronger demand from France's trading partners and a rebound in tourism after a number of terrorist attacks. Core inflation is expected to rise gradually as more and more enterprises start to signal capacity constraints.

The recovery in exports owes much to the aircraft sector and the strong rebound in demand from emerging market economies. Should this demand slow more than expected or the export recovery fail to become anchored in a larger number of sectors, exports could disappoint and GDP growth could be weaker than projected. A disorderly exit of the United Kingdom from the European Union and political events in other EU countries could undermine confidence in the economic and monetary union and activity and trade in member countries. On the other hand, tax reductions and the labour market reform could strengthen employment and business confidence more than expected, leading to stronger internal demand.

GERMANY

Growth is projected to ease somewhat but still remain solid and employment is set to expand further. Stronger activity in the euro area is boosting exports and business investment, but euro appreciation and higher wages may dent competitiveness. Low unemployment and wage gains underpin private consumption, but are also raising consumer price inflation. Low interest rates and strong housing demand, partly due to immigration, sustain residential investment. The current account surplus will fall somewhat, but will still remain high.

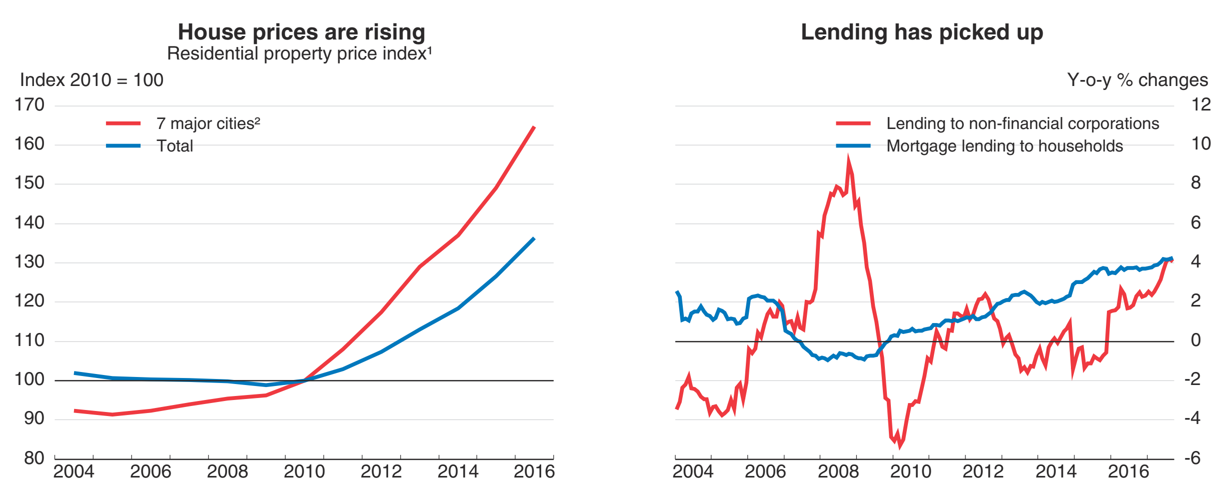
Fiscal policy is mildly supportive of growth, but the budget balance will remain in surplus. The supply of childcare and full-day primary schools needs to expand and infrastructure needs to be modernised. There is scope to shift the tax burden from wage income to environment and real estate taxes. Taxes on second earners should be lowered. These steps would strengthen inclusive, green growth.

Private and public indebtedness are modest. However, house prices have risen, especially in major cities. So far the rise is mostly in line with higher household incomes, lower interest rates and immigration. The authorities need to be ready to apply macro-prudential tools which would specifically address risks in case house prices and mortgage lending accelerate. More demanding leverage requirements on banks would reduce risks, improve the efficiency of lending and strengthen inclusiveness.

Economic growth is strong

Economic activity has expanded on a broad basis. The recovery in euro area trading partners has boosted exports and machinery and equipment investment. Construction has also been buoyant as the housing needs of immigrants, higher incomes and low interest rates have increased housing demand and the government has stepped up spending to improve maintenance of transport infrastructure and schools. House prices have risen,

Germany



1. Bundesbank calculations based on price data provided by Bulwiengesa AG.
2. Berlin, Düsseldorf, Frankfurt, Hamburg, Cologne, Munich and Stuttgart.

Source: Deutsche Bundesbank.

StatLink http://dx.doi.org/10.1787/888933631570

Germany: **Demand and output**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	2 937.0	1.5	1.9	2.5	2.3	1.9
Private consumption	1 595.5	1.6	1.9	2.3	1.3	1.4
Government consumption	563.9	2.9	3.7	1.2	1.7	1.9
Gross fixed capital formation	588.4	1.0	2.9	4.4	3.6	3.4
Final domestic demand	2 747.9	1.7	2.5	2.5	1.9	1.9
Stockbuilding[1]	- 15.3	-0.3	-0.1	0.0	0.3	0.0
Total domestic demand	2 732.6	1.5	2.4	2.5	2.2	2.0
Exports of goods and services	1 344.2	4.7	2.4	4.8	4.3	3.7
Imports of goods and services	1 139.9	5.2	3.8	5.2	4.4	4.1
Net exports[1]	204.4	0.1	-0.3	0.2	0.3	0.1
Memorandum items						
GDP without working day adjustments	2932.5	1.7	1.9	2.2	2.3	1.9
GDP deflator	_	2.0	1.3	1.5	1.6	1.8
Harmonised index of consumer prices	_	0.1	0.4	1.7	1.8	2.0
Harmonised index of core inflation[2]	_	1.1	1.1	1.4	1.8	2.0
Unemployment rate (% of labour force)	_	4.6	4.2	3.7	3.5	3.4
Household saving ratio, net (% of disposable income)	_	9.6	9.7	9.9	9.8	9.7
General government financial balance (% of GDP)	_	0.6	0.8	1.1	1.5	1.6
General government gross debt (% of GDP)	_	79.0	76.3	72.4	69.1	66.2
General government debt, Maastricht definition (% of GDP)	_	70.9	68.2	64.3	60.9	58.0
Current account balance (% of GDP)	_	8.6	8.3	7.9	8.0	7.9

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632596

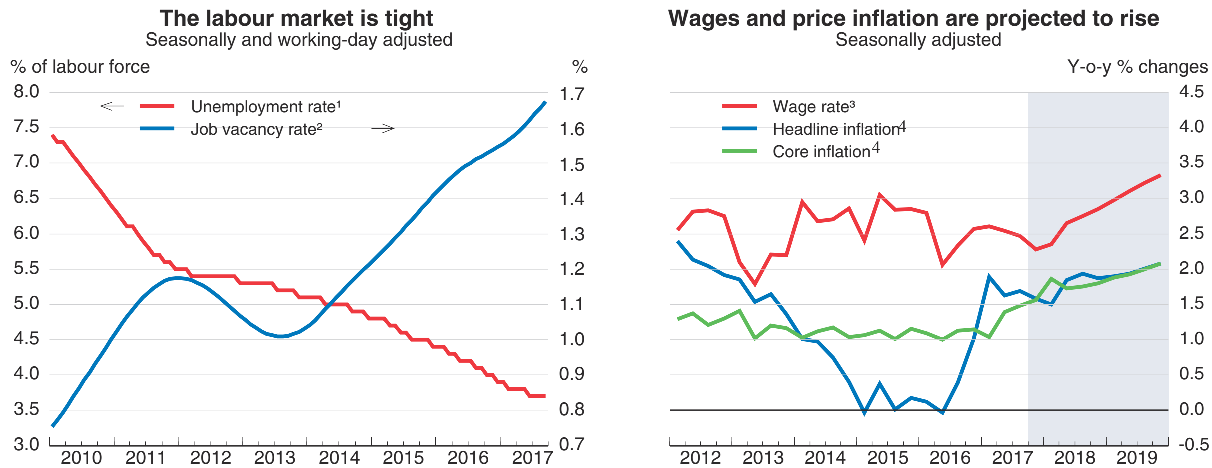
mostly in line with lower interest rates, higher rents and incomes. However, price increases have been particularly strong in major metropolitan areas. Mortgage lending has also been in line with income growth. On the back of stronger investment, business borrowing has picked up.

Strong labour market performance underpins the growth of household consumption. Vigorous employment growth has pushed the unemployment rate to record-low levels, while the number of vacant jobs is rising strongly. Female labour market participation is increasing and more women work longer hours, reflecting in part improved childcare provision. Still, most women work part-time, which limits their access to attractive careers. Skill shortages are increasing, yet women's skills are used less than men's, resulting in unexploited opportunities for productivity, income and well-being gains. Immigration, mostly from other EU countries, remains strong. The number of refugees entering the labour market after they have received initial training is increasing and many of them are unemployed.

Fiscal policy should support inclusive growth

The fiscal stance is projected to be mildly supportive in 2018 and 2019. Higher income tax allowances, child benefits and somewhat higher public spending to support municipal

Germany



1. Population aged 15-74 years. Based on the German labour force survey.
2. Percentage of unfilled job vacancies relative to total employment.
3. Average nominal wage per employee. Projection from 2017Q3.
4. Harmonised consumer price index (HICP). Core HICP excludes energy, food, alcohol and tobacco.

Source: OECD Economic Outlook 102 database; and Statistisches Bundesamt.

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investment and to improve childcare provision are mostly offset by revenue-raising measures. These include stricter rules in the taxation of households' capital income and the extension of road user charges to a wider range of roads and freight transport vehicles. On current policies, tax revenue growth is likely to increase the government surplus above 1% of GDP.

The strong fiscal position provides room to fund priority spending and tax reforms. Despite substantial improvements in recent years, the demand for full-day care for young children is not yet met and the quality of childcare is uneven. Most school children attend school only half-day. Enrolling more young children from disadvantaged socio-economic backgrounds in high-quality childcare and providing more full-day schooling would boost education outcomes and increase social mobility, which is low in Germany. These steps would also make it easier, especially for women, to reconcile family life and full-time employment. Rollout of high-speed fibre broadband infrastructure is low, especially in rural regions. Accelerating rollout could improve economic development of rural regions which have fallen behind.

The incidence of low-pay employment in Germany is widespread, but the tax burden on low labour incomes is high. Steps to lower social security contributions especially for low-paid workers would make the tax system more inclusive. Lower taxation of second earners would give women access to better professional carriers and reduce the large gender earnings gap. To make room for such tax reductions, tax expenditures for environmentally damaging activities could be phased out, energy tax rates could be aligned with carbon intensity and taxation of nitrogen oxide emissions could be introduced. Updating real estate tax valuations and extending the taxation of capital gains to residential real estate would be particularly timely in view of house price developments and would also benefit inclusiveness. Taxes on household capital income could be better aligned with taxation of other household income. Reduced VAT tax rates, for example on hotel services, should be raised to the standard rate.

Financial market conditions are supporting the economic expansion. Lower implicit government guarantees for banks and lower leverage have reduced risk. Nonetheless, leverage remains high among large banks, which continues to exacerbate risks, harm efficiency and increase inequality. The small cooperative and public savings banks are less leveraged but their profits are under pressure on account of low interest rates. They are more exposed to losses should short-term interest rates rise.

Growth is projected to remain robust

Economic growth is projected to ease somewhat but still remain robust and broad-based. The recovery in the euro area sustains exports and business investment. Nevertheless, business investment is still subdued by historic standards. Housing investment will remain strong, driven by higher house prices, although unmet housing needs of refugees will diminish. The tight labour market will boost private consumption and is expected to result in some pick-up of wage and price inflation. The current account surplus will remain large.

There are downside risks related to the impact of the exit of the United Kingdom from the European Union, as it may disrupt the sourcing of inputs by key German industries, including automotive production and chemicals. On the other hand, some businesses have announced they will transfer activity to Germany. Geopolitical risks could reduce world trade and German exports. Steps to implement reforms to complete the Single Market in the European Union and establish a more comprehensive banking union in the euro area could strengthen confidence in the euro and boost the attractiveness of Germany as a location to invest.

GREECE

GDP growth is projected to rise to 2.3% in 2018, and then moderate to 2% in 2019. Private consumption and investment will lead the recovery, responding to reduced policy uncertainty and gradually improving financial conditions. Exports should continue to increase, supported by rising external demand. Accelerating imports will subtract from growth in 2019. Excess capacity is diminishing but remains exceptionally large, limiting price and wage pressures.

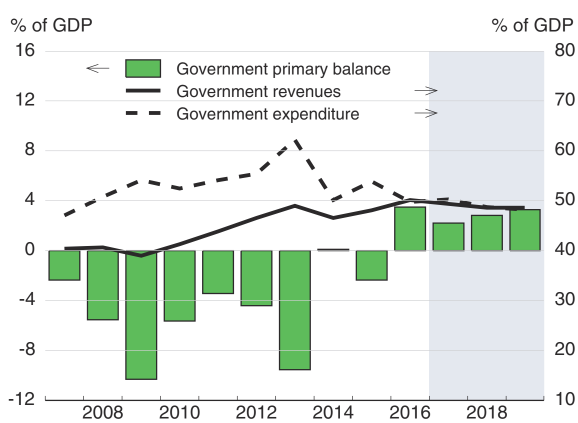
The budget surplus is on track to exceed the 2017 target, through improved tax compliance and restrained expenditure. Further progress is needed in addressing tax arrears. Reducing high levels of poverty, especially among young people, remains urgent. The guaranteed minimum income programme is a welcome first step but social protection overall needs to be refocused. The recent spending review has identified fiscal space for a moderate expansion of targeted social programmes. Continued product market reforms would further improve competitiveness.

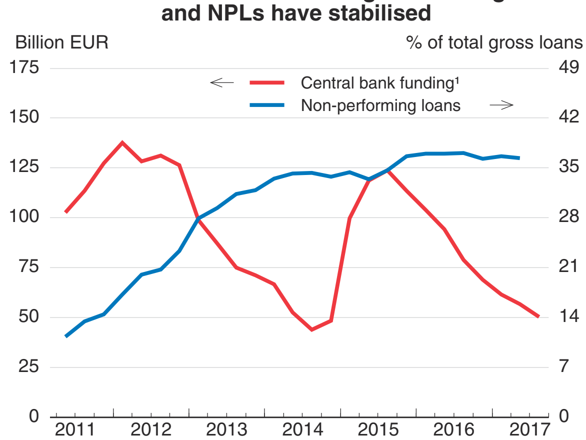
Greece's high public debt and banks' large stock of non-performing loans (NPLs) are sources of financial vulnerabilities. Putting public debt on a stable downward path will require sustained reforms to boost potential output and additional debt restructuring. Banks' large stock of NPLs adds to risks and limits banks' lending. Gradually curing and disposing of NPLs while ensuring banks retain sufficient capital buffers is a priority.

A gradual recovery is emerging

The completion of the second EU programme review in June 2017 buoyed confidence, supporting activity. Employment growth is buttressing incomes and private consumption, although many new positions are temporary or part-time and pay the minimum wage. Greece's improved competitiveness is boosting goods exports while the international recovery is supporting tourism revenue. Excess capacity remains significant and inflation and wage pressures weak.

Greece





1. Includes emergency liquidity assistance (ELA) provided by the Bank of Greece and financing provided by the European Central Bank.
Source: OECD Economic Outlook 102 database; Bank of Greece; and IMF.

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Greece: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	178.7	-0.3	-0.2	1.4	2.3	2.0
Private consumption	125.4	-0.5	0.0	0.9	1.3	1.4
Government consumption	36.2	1.2	-1.5	1.3	0.4	1.4
Gross fixed capital formation	20.6	-0.3	1.6	3.3	7.2	7.5
Final domestic demand	182.3	-0.1	0.1	1.2	1.9	2.3
Stockbuilding[1,2]	0.7	-1.0	0.5	0.0	0.0	0.0
Total domestic demand	183.0	-1.0	0.5	2.2	2.5	2.3
Exports of goods and services	57.8	3.1	-1.8	5.7	5.8	4.9
Imports of goods and services	62.1	0.4	0.3	5.0	4.3	5.8
Net exports[1]	- 4.3	0.9	-0.7	0.2	0.4	-0.3
Memorandum items						
GDP deflator	_	-1.0	-1.0	0.1	1.8	0.5
Harmonised index of consumer prices	_	-1.1	0.0	1.2	1.0	1.2
Harmonised index of core inflation[3]	_	-0.4	0.6	0.5	1.0	1.2
Unemployment rate (% of labour force)	_	24.9	23.5	21.7	20.5	19.5
Household saving ratio, net (% of disposable income)	_	-19.5	-22.1	-21.1	-20.8	-20.9
General government financial balance[4] (% of GDP)	_	-5.7	0.5	-0.9	-0.1	0.4
General government gross debt (% of GDP)	_	183.3	189.5	186.6	181.5	178.0
General government debt, Maastricht definition (% of GDP)	_	176.8	180.8	177.9	172.8	169.3
Current account balance[5] (% of GDP)	_	-0.2	-1.1	0.4	0.4	0.1

1. Contributions to changes in real GDP, actual amount in the first column.
2. Including statiscal discrepancy.
3. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
4. National Accounts basis. Data also include Eurosystem profits on Greek government bonds remitted back to Greece. For 2015-2019, data include the estimated government support to financial institutions and privatisation proceeds.
5. On settlement basis.

Source: OECD Economic Outlook 102 database.

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Banks' access to funding is improving. While deposits lost during the crisis are yet to return, banks' access to interbank funding is rising, while their use of emergency financing from the central bank is decreasing. However, banks continue to reduce lending. Non-performing loans (NPLs) rates remain high, at 36% of total loans in early 2017.

Rebuilding banking and fiscal resilience for an inclusive recovery

The government is on track to achieve a primary budget surplus of 2.2% of GDP in 2017, above its target. Ongoing improvements in revenue collection and the end of temporary spending programmes support the budget and offset cuts in personal income tax rates and increased government consumption. Reduced uncertainty over public finances led to an upgrade in the government's credit rating and to lower spreads on public debt, and allowed the government to issue its first bond in three years. Improved tax compliance and spending controls are expected to raise primary budget surpluses in 2018 and 2019.

Reforms are improving banks' governance and reducing costs. A new NPL resolution framework is in place, and banks have met initial targets. Banks are well capitalised, but the quality of the capital is uncertain, as much is in the form of deferred tax assets. Capital controls remain in place, while a roadmap outlines their future relaxation.

The initial economic recovery has yet to reduce poverty. Existing social protection programmes continue to be dominated by pension spending, providing little support to the young. The social protection system can be better focused on protecting families, especially those with children and parents without work, from a steep rise in poverty. The guaranteed minimum income, rolled out nationally in 2017, is a step towards building a more equitable system, which will require more targeted programmes, such as school meals, and family and housing benefits.

Improving investment will boost the recovery

GDP growth is projected to strengthen in 2018 and remain solid in 2019. Business and housing investment are projected to rebound, after 10 years of contraction, as financing conditions and confidence improve. The effect of recent product and labour market reforms will support competitiveness. Expanding employment and low inflation will buttress private consumption. The recovery in domestic spending will progressively accelerate imports relative to exports, with net exports contributing negatively to GDP growth in 2019.

High levels of public debt and NPLs make Greece's economic outlook highly sensitive to any slippage in policy. Slower progress in addressing NPLs would lower confidence and investment and activity. Higher public debt service costs, especially after the EU programme concludes in August 2018, could adversely affect public finances and broader confidence, dragging down growth. Additional public debt restructuring would accelerate gains in access to finance and in activity. Stronger progress on the reform programme would raise productivity, investment and by more than projected.

HUNGARY

The recent strong economic performance is projected to continue into 2018, before softening somewhat in 2019. Investment remains a main driver with the resumed disbursement of EU structural funds and domestic and foreign firms responding to capacity constraints. Solid private consumption growth will be underpinned by continued strong real wage and employment increases. However, rising inflation is expected to harm cost competitiveness and increasingly constrain exports.

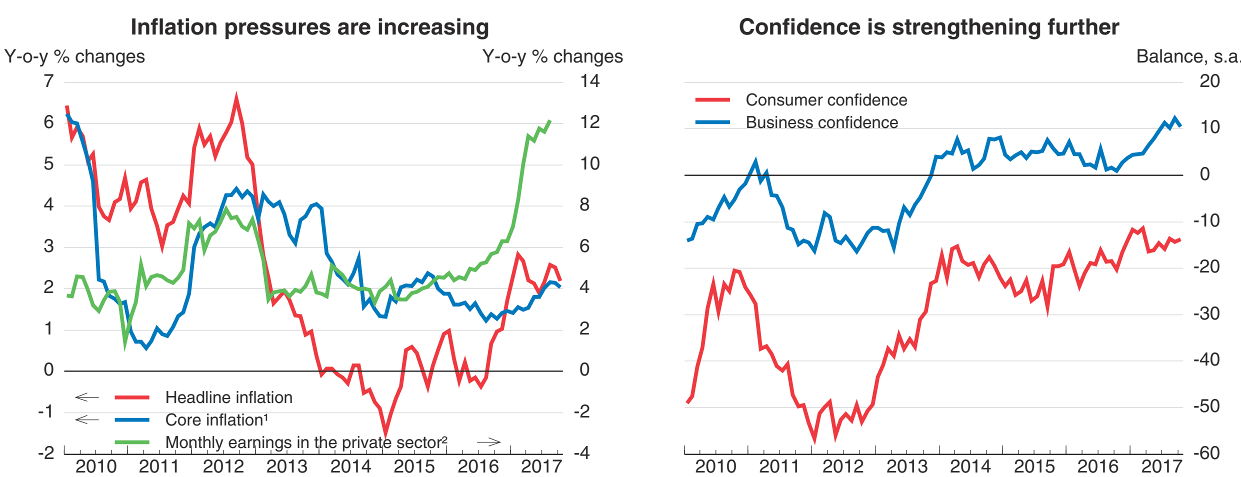
The fiscal stance is expansionary in 2017-18, due to reductions in employers' social security contributions and business taxes along with pro-cyclical spending increases, but is projected to be neutral in 2019. Tightening product markets, double-digit wage growth and the likelihood of inflation surpassing the official 3% inflation target in 2018, all point to the need for a prudent macroeconomic policy stance.

Banks have become more robust and profitable, although they still incur relatively high operating costs. Despite major improvements, the stock of non-performing loans needs to be further reduced. Having a more competitive and efficient banking sector would lower operating costs and facilitate conversion of non-performing loans through market-based burden sharing between debtors and creditors.

Domestic demand is driving growth

The robust expansion of private consumption continues due to strong gains in employment and real wages. Public investment has recovered with the faster disbursement of EU structural funds. Business investment has grown as firms have taken advantage of favourable credit conditions, and the further strengthening of business sentiment and export orders, to respond to rising capacity constraints. Housing investment has been boosted by new housing subsidies. Export growth lost momentum in 2016, before regaining strength on the back of strong FDI inflows that increased production capacity in the export sector.

Hungary



1. Core inflation excludes energy and food.
2. Three-month moving average.

Source: OECD Main Economic Indicators database; and Thomson Reuters.

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Hungary: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices HUF billion	Percentage changes, volume (2005 prices)				
GDP at market prices	32 591.7	3.4	2.2	3.9	3.6	2.8
Private consumption	16 406.2	3.6	4.3	4.4	5.1	4.8
Government consumption	6 504.5	1.1	0.8	-1.7	1.4	0.9
Gross fixed capital formation	7 223.4	1.9	-10.6	19.6	10.5	6.8
Final domestic demand	30 134.2	2.7	-0.1	6.3	5.6	4.5
Stockbuilding[1]	376.6	-1.3	1.5	-0.8	-0.6	0.0
Total domestic demand	30 510.8	1.3	1.6	5.4	4.9	4.4
Exports of goods and services	28 568.1	8.5	3.4	8.5	5.6	4.8
Imports of goods and services	26 487.1	6.4	2.9	10.8	7.1	6.6
Net exports[1]	2 081.0	2.2	0.7	-1.0	-0.9	-1.3
Memorandum items						
GDP deflator	_	1.9	1.0	3.6	3.4	3.8
Consumer price index	_	-0.1	0.4	2.3	2.7	3.4
Core inflation index[2]	_	2.0	1.5	1.9	2.9	3.4
Unemployment rate (% of labour force)	_	6.8	5.1	4.2	4.0	3.8
Household saving ratio, net (% of disposable income)	_	6.3	7.1	7.3	6.6	6.1
General government financial balance (% of GDP)	_	-2.0	-1.9	-2.4	-2.7	-2.4
General government gross debt (% of GDP)	_	97.5	97.4	95.1	93.5	92.0
General government debt, Maastricht definition (% of GDP)	_	74.7	73.9	71.5	70.0	68.4
Current account balance (% of GDP)	_	3.5	6.1	4.0	2.5	0.8

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

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Private-sector job creation has lost some momentum, which, together with a reduction in public work schemes, has moderated the decline in the already low unemployment rate. Private-sector wages had accelerated to around 12% by mid-2017, reflecting the impact of a six-year wage agreement that raises minimum wages by 15-24% in 2017 and by about half as much again in 2018. To preserve external competitiveness, the government reduced employers' social security contributions, with an associated fiscal cost of 1% of GDP. Consumer price inflation has fluctuated before moderating to 2.2% most recently, partly on the back of lower energy prices, while core inflation has stabilised at around 2%.

Macroeconomic policies should counter the risk of overheating

The fiscal policy stance will loosen further in 2018, with reductions in employers' social security contributions and increases in public spending and housing subsidies, which will lead to a widening of the structural deficit-to-GDP ratio. The easier fiscal stance is adding to labour market tensions and cost pressures. In September 2017, the central bank lowered the overnight deposit rate by 10 basis points but left other rates unchanged while communicating that maintaining the loose monetary stance is appropriate for its inflation target of 3%. However, wage hikes are eroding high levels of profits and external cost competitiveness.

Growth is projected to slow

Economic growth will continue to rely on domestic demand. Public infrastructure spending will still benefit from EU structural funds and business investment from easy credit conditions and the need to address capacity constraints. Construction activity will be further boosted by housing subsidies. Growth in private consumption should continue unabated, with strong gains in real wages and employment. New production capacity will support export growth, although this effect will be moderated by an erosion of external competitiveness, as cost increases continue to easily outstrip productivity gains. Demand will increasingly be satisfied through imports, narrowing the current account surplus significantly. The lack of underutilised resources could push inflation towards 4% – the upper band of the central bank's target range – by end-2019.

A faster scaling back of public works schemes could expand available labour resources, countering labour market tensions and inflation pressures. Similarly, higher-than-expected productivity increases from public infrastructure and business investments could preserve external competitiveness, supporting exports and inward FDI. On the other hand, a rise in geopolitical tensions would reduce European growth with a negative impact on Hungarian exports.

ICELAND

Growth will ease but remain robust; the economy is approaching capacity limits. Household consumption will increase on the back of continued labour immigration and rising wages in 2018 but slow down in 2019. Business investment will decline after completion of several large projects. Unemployment has reached its lowest level since the 2008-09 economic and financial crisis and will continue to fall slightly. After a strong 2017, revenues from exports and tourism will decline.

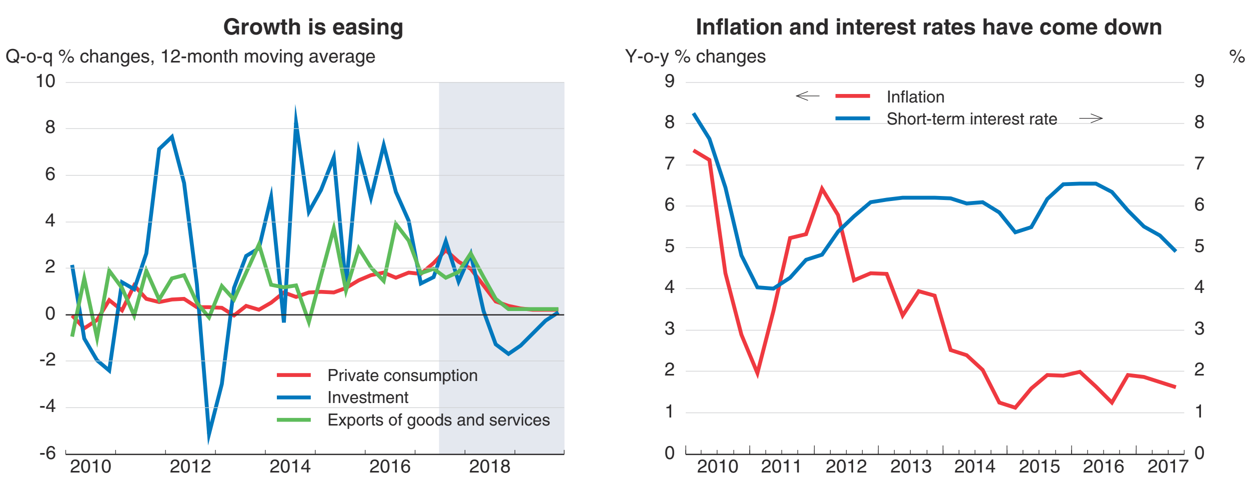
After appreciating for two years, the króna edged down in the second half of 2017 and became more volatile, possibly due to the removal of capital controls. The central bank should stand ready to tighten the monetary policy stance to address inflationary pressures from strong demand. Fiscal policy should not be expansionary since growth is well above trend and inflationary tensions are emerging. Reforming the wage-bargaining system could help reduce the pro-cyclical impact of wage negotiations.

As a small open economy, Iceland remains vulnerable to external shocks. The financial system is stable. Deleveraging has improved firms' balance sheets. Debt restructuring and write-offs have reduced household indebtedness, while increased savings and rising asset prices improved their asset position. Capital flows stabilised despite the lifting of capital controls. Yet continued use of macro-prudential tools is warranted.

Growth has slowed

GDP growth has begun to slow. Consumption has remained strong, but investment, exports and tourism have cooled off. Household income continues to benefit from considerable wage increases. The unemployment rate has fallen to below 3%. Investment has declined, as housing construction and tourism activity have reached a peak, while imports remain high, owing to strong consumption. The current account balance remains positive.

Iceland



Source: OECD Economic Outlook 102 database.

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Iceland: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices ISK billion	Percentage changes, volume (2005 prices)				
GDP at market prices	2 019.0	4.3	7.4	5.1	4.3	2.5
Private consumption	1 061.0	4.7	7.1	9.4	4.2	0.9
Government consumption	484.9	1.0	1.9	2.2	1.4	0.5
Gross fixed capital formation	345.7	18.5	22.8	7.1	-0.4	-2.3
Final domestic demand	1 891.6	6.3	8.9	7.0	2.5	0.1
Stockbuilding[1]	2.0	-1.0	-0.7	-0.7	-0.3	0.0
Total domestic demand	1 893.6	5.3	8.3	6.4	2.2	0.1
Exports of goods and services	1 068.3	9.2	10.9	7.2	5.2	1.0
Imports of goods and services	942.9	13.8	14.5	12.4	5.9	1.0
Net exports[1]	125.4	-1.6	-0.8	-1.7	-0.1	0.1
Memorandum items						
GDP deflator	_	6.0	2.1	-1.2	0.4	-1.0
Consumer price index	_	1.6	1.7	1.7	2.8	3.3
Core inflation index[2]	_	2.1	2.2	2.6	3.1	3.3
Unemployment rate (% of labour force)	_	4.0	3.0	2.8	2.5	2.4
General government financial balance (% of GDP)	_	-0.8	12.6	1.0	1.1	1.0
General government gross debt[3]	_	72.5	66.4	65.0	63.6	62.4
Current account balance (% of GDP)	_	5.2	7.8	4.9	4.2	3.7

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
3. Includes unfunded liabilities of government employee pension plans.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632653

Monetary and fiscal policy should be tighter to contain overheating

Inflation has remained below the central bank's target of 2.5% for the past three years. After appreciating throughout 2016, the króna began to weaken and fluctuate in 2017, and it could depreciate rapidly if export or tourism earnings continue to decline. Moreover, rising wages and asset prices continue to generate inflationary pressures. The central bank should be vigilant and defend its inflation target by raising rates. Capital flows remained steady after controls were fully lifted and capital mobility restored in spring 2017.

The fiscal position is favourable. Public debt is declining, and the budget balance remains positive. The "stability contribution", an arrangement with banks and investment funds before lifting capital controls, brought additional fiscal receipts worth around 15% of GDP. As the economy is running much above trend and tensions build up, fiscal policy is unduly expansionary. Public spending needs to be more firmly controlled to create fiscal space for harder times to come. Moreover, by increasing spending efficiency, the government could provide the same quality of public services at lower cost.

The tax system could be more growth-friendly and greener. Shifting the burden from personal income taxes towards consumption taxes could reduce disincentives to work and raise labour productivity. Broadening the consumption tax base could boost tax revenues and reduce their volatility. CO2-taxes, currently below the OECD average, could be increased. Efforts at improving the collective wage bargaining system, especially better linking wages to productivity growth, could help reduce pro-cyclical effects of wage negotiations.

Growth will slow but remain robust

Growth is projected to ease in 2018. Private consumption and residential investment will remain strong while business investment, exports and tourism services will slow as capacity constraints bite and cost competitiveness declines. Growth will fall closer to trend in 2019 as household consumption and export growth eases further, while business investment will recover slightly.

Volatility is the biggest risk to the outlook. Liberalisation of the capital account raises uncertainty about future financial flows. A weaker króna would raise growth by boosting exports and tourism, but also exacerbate inflationary pressures. Disruptive strikes could hurt growth and result in unsustainable wage gains. Slower growth in the global economy could have negative consequences for exports. However, geopolitical tensions could again boost tourism directed towards destinations such as Iceland.

INDIA

Economic growth is projected to strengthen to above 7%, gradually recovering from the transitory adverse impact of rolling out the Goods and Services Tax (GST) and measures to choke off the black economy, including demonetisation. In the longer run, the GST will boost corporate investment, productivity and growth by creating a single market and reducing the cost of capital equipment. Investment will be further supported by the plan to recapitalise public banks and by the new road plan.

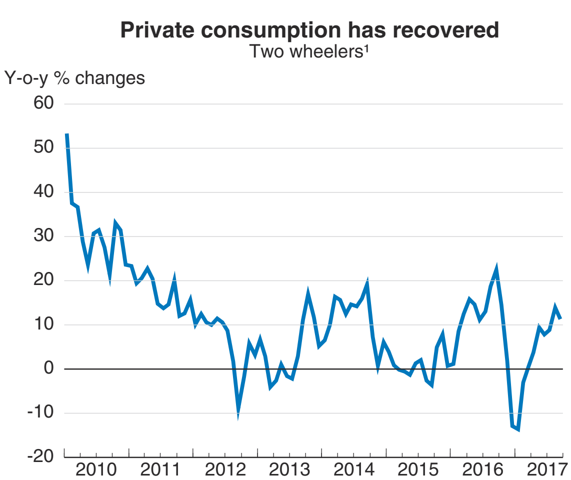
Recent measures to digitise the economy and improve tax compliance should boost tax revenue in the medium term. They are accompanied by an increase in public pensions and wages, as well as debt write-offs in some states, resulting in a broadly neutral fiscal stance over the projection period. Given the high public debt-to-GDP ratio, increasing social infrastructure, such as health and education, will require raising more property and income tax revenue. With inflation expectations adjusting down, there could be room for further cuts in interest rates if inflation durably remains below 4%.

Non-performing loans have increased, largely reflecting recognition efforts, and are particularly high in public banks. Steps have been taken to clean up banks' balance sheets, giving creditors more control over the stressed entities. A new bankruptcy law is also being implemented. The large recapitalisation plan for public banks should be accompanied by governance reform. External debt remains low and foreign exchange reserves have increased, reducing vulnerabilities.

Consumption is driving growth

After suffering from a temporary setback, the economy is bouncing back. Ahead of the implementation of the GST in July 2017, enterprises ran down their inventories, causing a fall in manufacturing activity. Since the new tax regime is in place, some businesses have struggled to adjust to the underlying information technology system. Small enterprises with limited cash flows and exporters have suffered from delays in getting refunds for

India



1. The data are seasonally adjusted and smoothed using a two-month moving average filter.

Source: Society of Indian Automobile Manufacturers; and Central Statistics Office.

StatLink http://dx.doi.org/10.1787/888933631665

India: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices INR trillion	Percentage changes, volume (2012/2013 prices)				
GDP at market prices	124.5	8.0	7.1	6.7	7.0	7.4
Private consumption	72.3	6.1	8.7	7.4	7.4	7.4
Government consumption	13.0	3.3	20.8	10.4	7.3	9.4
Gross fixed capital formation	37.8	6.5	2.4	2.8	4.6	6.8
Final domestic demand	123.2	5.9	8.1	6.5	6.6	7.5
Stockbuilding[1]	5.0	0.0	0.0	0.0	0.0	0.0
Total domestic demand	128.2	7.7	6.6	7.7	6.5	7.4
Exports of goods and services	28.6	-5.3	4.5	2.0	4.4	4.8
Imports of goods and services	32.4	-5.9	2.3	7.2	2.4	5.1
Net exports[1]	- 3.7	0.2	0.4	-1.1	0.4	-0.1
Memorandum items						
GDP deflator	_	1.8	3.6	4.0	4.2	4.0
Consumer price index	_	4.9	4.5	3.2	4.6	4.2
Wholesale price index[2]	_	-3.6	1.7	3.1	4.0	4.1
General government financial balance[3] (% of GDP)	_	-6.4	-6.4	-6.1	-5.9	-5.7
Current account balance (% of GDP)	_	-1.0	-0.8	-1.6	-1.7	-1.5

Note: Data refer to fiscal years starting in April.
1. Contributions to changes in real GDP, actual amount in the first column.
2. WPI, all commodities index.
3. Gross fiscal balance for central and state governments.
Source: OECD Economic Outlook 102 database.

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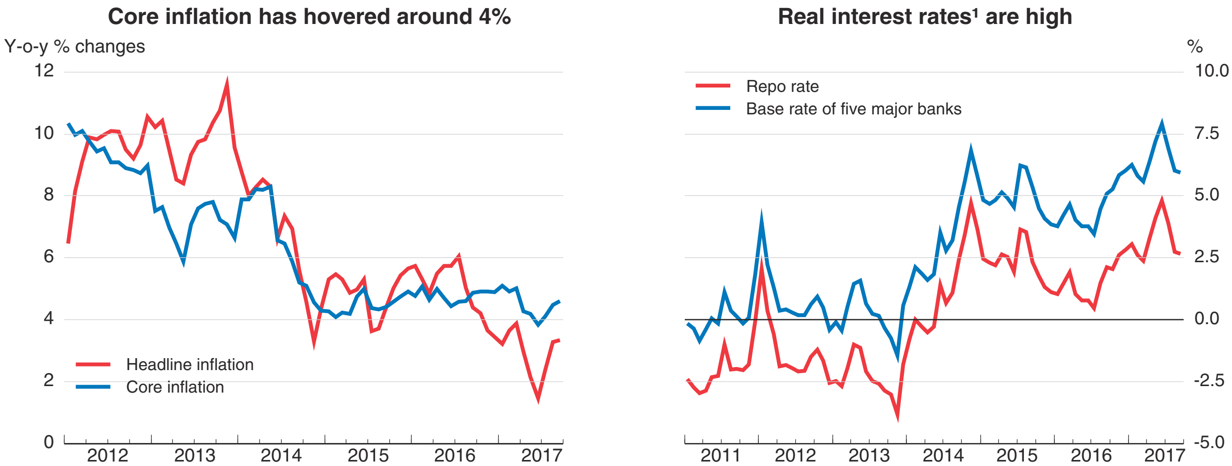
taxes paid on inputs. Industrial production and exports are, however, rebounding suggesting that disruptions from GST implementation are abating.

Consumption has recovered after the liquidity crunch associated with demonetisation. Indicators of rural consumption, such as two-wheelers sales, have rebounded, also supported by generous crops and higher rural wages. The large increases in wages, pensions and various allowances for public servants are also boosting private consumption, in particular in urban areas. Import growth has slowed, after the surge in gold and silver import ahead of tax changes. Investment has failed to rebound so far, affected by the weak financial position of most public banks and some corporations, combined with low capacity utilisation.

Structural reforms are needed to support inclusive growth, with marginal leeway for monetary policy

There is scope for improving the quality of public finances. Recent efforts to move away from the informal economy and to digitise transactions are boosting tax revenue. However, non-tax revenues, including dividends, privatisation and telecom receipts, are below budget targets. On the spending side, wages and various allowances for government employees are being adjusted up while several states have announced farm loan waivers. Given the already relatively high deficit and debt-to-GDP ratios, this leaves little scope for further stimulus in the short term. Still, in the medium term, the GST should spur tax

India



1. Real interest rates are calculated using the consumer price index.
Source: Central Statistics Office; and Reserve Bank of India.

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revenue. To support inclusive growth with better social and physical infrastructure, measures should be taken to raise more revenue from property and personal income taxes.

The existing slack in the economy and the benign inflation environment provide room for some monetary policy easing. Consumer price inflation has declined dramatically, supported by the move to inflation targeting and measures to reduce the fragmentation of agricultural markets. Transitory factors have helped, including demonetisation, which led to a sharp fall in the price of perishable goods, large discounts offered by retailers to run down inventories before the new GST, the rupee appreciation and subdued commodity prices. Overall, inflation has fluctuated well below the 4% target since October 2016 and inflation expectations are adjusting down. Some price spikes are likely in the coming months, as base effects vanish.

The resolution of non-performing loans is progressing slowly. Many of them originate from delays in infrastructure projects and are backed by “real” assets which could be expected to become profitable if projects are completed swiftly. They are also concentrated in a few companies, making the resolution process easier. If existing resolution mechanisms do not deliver rapidly, the creation of a bad bank could be considered. The comprehensive recapitalisation plan for public banks (about 1.3% of GDP), announced in October 2017, should enable them to extend new loans. To avoid a renewed accumulation of bad loans in the future, the plan should be accompanied by governance reform for public banks.

Creating more and better quality jobs, for both women and men, is necessary to promote inclusive growth. Some states have reformed labour regulations, encouraged by the central government benchmarking efforts. Central government proposals to modernise labour codes should be pursued. Improving the quality and timeliness of labour data is also key to assess outcomes and design better policies.

Growth is projected to strengthen as investment revives

Recent reform efforts will gradually pay off and economic growth will strengthen. Measures recently introduced to ease tax compliance requirements for small enterprises, refund taxes faster to exporters and streamline GST rates will ease the adjustment to the new tax regime. Private consumption will remain solid as public wages and rural incomes are growing steadily. Investment should recover gradually, as capacity utilisation increases. The GST, by lowering the price of capital goods and creating a single market, will spur investment demand. The recent increase in imports of capital goods is encouraging. Large infrastructure projects, such as the initiative to add 35 000 km of new highways over the next five years (at a cost equivalent to about 3.4% of GDP) and freight rail corridors, will also boost investment. The availability of credit will become a key factor.

The prospect for further structural reforms, in particular in the labour market, is a clear positive risk for growth. Too strong an increase in public wages and allowances, combined with new loan write-offs at the state level, may squeeze much needed investment in social and physical infrastructure and thus weigh on inclusive growth.

INDONESIA

GDP growth is projected to gradually pick up, underpinned by domestic demand. Rising household incomes will support private consumption. Public infrastructure investment is continuing to expand, and private investment will be boosted by easier monetary conditions and a more business-friendly regulatory environment. Exports will continue to benefit from the recent revival in regional trade. Inflation is projected to remain benign, partly reflecting low food price inflation.

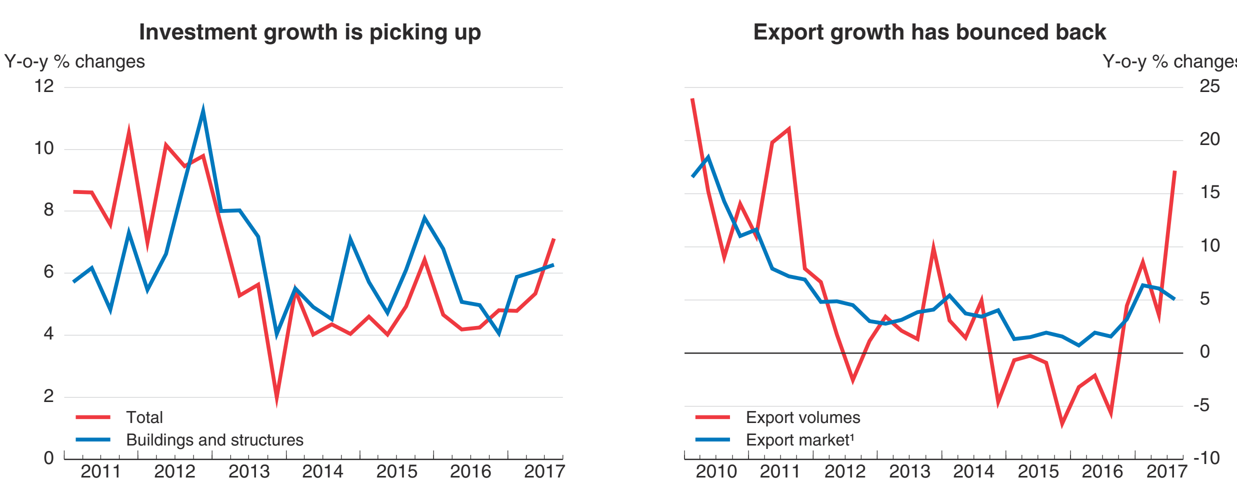
Lower inflation and greater currency stability allowed Bank Indonesia to reduce its policy rates twice in recent months. Monetary policy is now expected to remain on hold. Fiscal policy is supporting growth by enhancing the quality of government spending, including on much-needed infrastructure, education, health and social programmes. Further subsidy reductions would allow more effective and targeted social spending. Continued efforts to reform tax administration and strengthen enforcement will improve the system's equity and provide revenues for redistribution.

Bank asset quality has deteriorated somewhat in recent years as the economy slowed. Although non-performing loans have stabilised, quality concerns appear to be weighing on bank lending. Nonetheless, banks are well capitalised, and bank lending is low relative to GDP, limiting macroeconomic risks. A high share of corporate debt is denominated in foreign currency. However, the associated risks are reduced by regulations requiring partial hedging of foreign exposures. Further financial market deepening could increase financial resilience by developing instruments for managing risk.

Growth has remained solid thanks to support from external demand

GDP growth has remained around 5%, allowing per capita incomes to rise by around 3.8% a year. Consumption gains eased slightly despite a fall in the unemployment rate and

Indonesia



1. Export market is defined as weighted import volumes in partner countries.
Source: OECD Economic Outlook 102 database; and Thomson Reuters.

StatLink http://dx.doi.org/10.1787/888933631703

Indonesia: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices IDR trillion	Percentage changes, volume (2010 prices)				
GDP at market prices	10 569.7	4.9	5.0	5.0	5.2	5.4
Private consumption	6 039.4	4.8	5.0	5.0	5.1	5.4
Government consumption	996.2	5.3	-0.1	2.4	3.2	3.5
Gross fixed capital formation	3 436.9	5.0	4.5	5.7	5.9	6.0
Final domestic demand	10 472.6	4.9	4.3	5.0	5.2	5.4
Stockbuilding[1]	176.2	-0.9	0.6	-0.7	-0.2	0.0
Total domestic demand	10 648.8	3.9	5.0	4.2	5.0	5.5
Exports of goods and services	2 501.4	-2.1	-1.7	10.8	7.7	5.2
Imports of goods and services	2 580.5	-6.4	-2.3	7.2	7.3	5.7
Net exports[1]	- 79.1	1.0	0.1	0.9	0.2	0.0
Memorandum items						
GDP deflator	_	4.0	2.5	4.2	3.5	4.1
Consumer price index	_	6.4	3.5	3.9	3.8	3.8
Private consumption deflator	_	4.4	3.1	3.8	3.6	3.6
General government financial balance (% of GDP)	_	-2.8	-2.3	-2.8	-2.5	-2.4
Current account balance (% of GDP)	_	-2.0	-1.8	-1.5	-1.7	-1.7

1. Contributions to changes in real GDP, actual amount in the first column.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632691

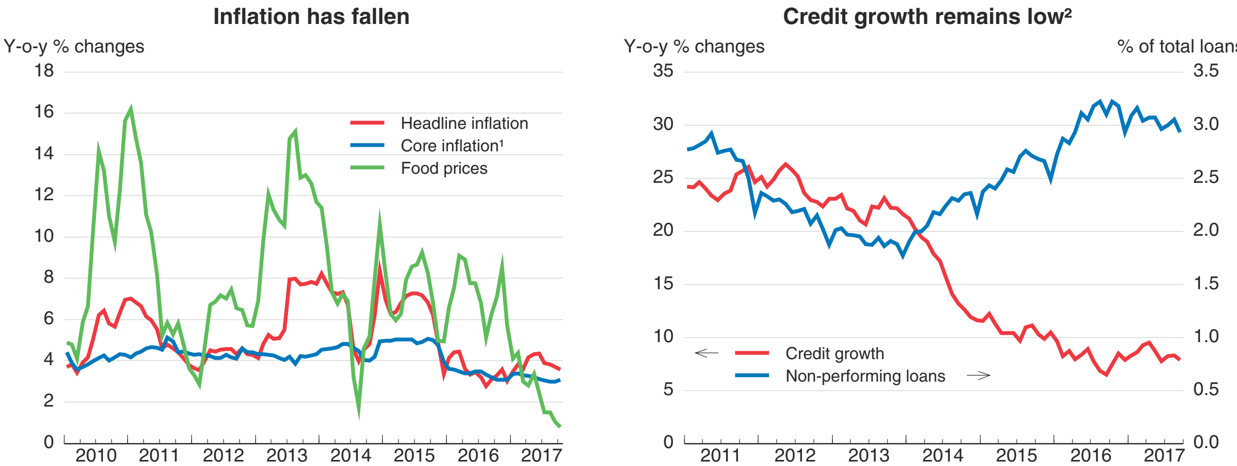
rising real household incomes. Investment growth has picked up, led by public investment in infrastructure, including energy and transport projects. Private investment appears to have picked up, reflecting improved business conditions, in line with the credit ratings upgrade earlier in the year, lower domestic interest rates and a more business-friendly regulatory environment. Exports are growing strongly. Supporting factors include higher commodity prices, progress in lifting previous export bans on unprocessed minerals and extending export licences, and stronger growth in regional trade. Nonetheless, the mining sector still faces headwinds from policy uncertainty.

Inflation has eased due to very low food price increases. This reflects a combination of factors that should continue in the near term, including the effects of favourable weather conditions and the authorities' efforts to identify and reduce supply-side bottlenecks at the local level. Administered price increases have been significant due to reforms to lower energy subsidies in favour of more targeted social support. However, the inflationary effects will fade because further adjustments to energy subsidies have been postponed. The recent depreciation of the rupiah follows a period of relative stability and should only have a mild effect on prices. Improvements in the balance of trade have reduced the current account surplus.

Supportive macroeconomic policies should be accompanied by further structural policy reforms

With inflation well within its target range of 4% +/- 1% for 2017 (3.5% +/-1% for 2018), Bank Indonesia lowered its policy rate twice by 25 basis points in recent months to stimulate growth. However, credit supply may be limited by credit quality concerns,

Indonesia



1. Core excludes administered prices and volatile food inflation.
2. Credit growth covers commercial and rural banks; non-performing loans are for commercial banks.

Source: OECD Main Economic Indicators database; and Thomson Reuters.

StatLink http://dx.doi.org/10.1787/888933631722

indicated by the increase in the share of non-performing loans in recent years. Monetary policy is expected to remain on hold. If growth fails to pick up and the rupiah does not depreciate further, there is some scope for Bank Indonesia to cut interest rates again to buttress activity.

The fiscal deficit is likely to have widened slightly in 2017, while remaining within the legal limit of 3% of GDP, and is expected to narrow in 2018. The shift of spending has been towards much-needed infrastructure investment, which should have a higher impact on growth, and social spending, which is crucial for improving well-being. It has been financed by a 2 percentage point reduction in state subsidies relative to expenditure since 2015; however, energy-related subsidies are budgeted to increase slightly in 2018. The low-inflation environment could be used to replace energy subsidies with targeted social assistance that would more efficiently reduce inequality. Low tax revenues remain a major challenge. Continuing to tighten enforcement will allow fiscal policy to better support growth, reduce inequality across the country and tackle poverty. Reforms that encourage formality would also broaden the tax base.

Given the macroeconomic framework, policies to encourage private-sector activity are crucial for raising growth and incomes. The government has launched two economic policy packages during 2017 that accelerate licence issuance and create a one-stop shop for permits. Further regulatory simplification and enhanced regulatory certainty would help capitalise on the upgrade of Indonesia's sovereign credit rating earlier in the year. It would also help the government to leverage private capital through public-private partnerships, for example, taking care to apportion the risks appropriately. The business sector is also exposed to exchange rate movements through its high share of foreign-currency-denominated debt. Part of this is hedged, in line with regulatory requirements that strengthen corporate risk management, thereby reducing vulnerabilities associated with currency movements. Further efforts to deepen Indonesia's financial markets and increase liquidity would assist borrowers in tapping into private capital and in managing the associated risks.

Growth is projected to gain more momentum

GDP growth is projected to edge up in the coming years, underpinned by domestic demand. Improved household confidence and rising incomes will feed into faster consumption growth. The combination of easier monetary policy and the government's regulatory reforms should boost private investment. Public investment is projected to remain strong, as the government continues to prioritise infrastructure. Slower rates of growth in key trading partners will weigh on exports, but reforms to facilitate exporting and further improve competitiveness should partly offset this. In this context, inflation is projected to remain within the central bank's target range.

A key downside risk is increased regional geopolitical tensions, which would hit confidence and regional trade. Although a large exchange rate depreciation could stimulate exports, it would increase inflation, which may require tighter monetary policy. On the upside, efforts to raise tax collections could quickly bear fruit, raising government revenues and allowing greater spending than projected. Further increases in commodity prices would support government revenues directly and boost confidence and activity.

IRELAND

The economy is projected to keep growing robustly, as domestic demand is set to remain solid. As the labour market tightens, wage pressures will continue to be strong and are projected to feed into higher inflation. Output is expected to expand at a slower pace than in past years due to already high labour costs and high external uncertainty, including about the final outcome of the Brexit negotiations.

The government should ensure that its medium-term goal of balancing the budget is met. It leaves room to use fiscal policy to support growth if needed, while avoiding over-heating pressures in the economy. Structural policy should prioritise getting more people back into work by enhancing government programmes that improve the skills of the long-term unemployed.

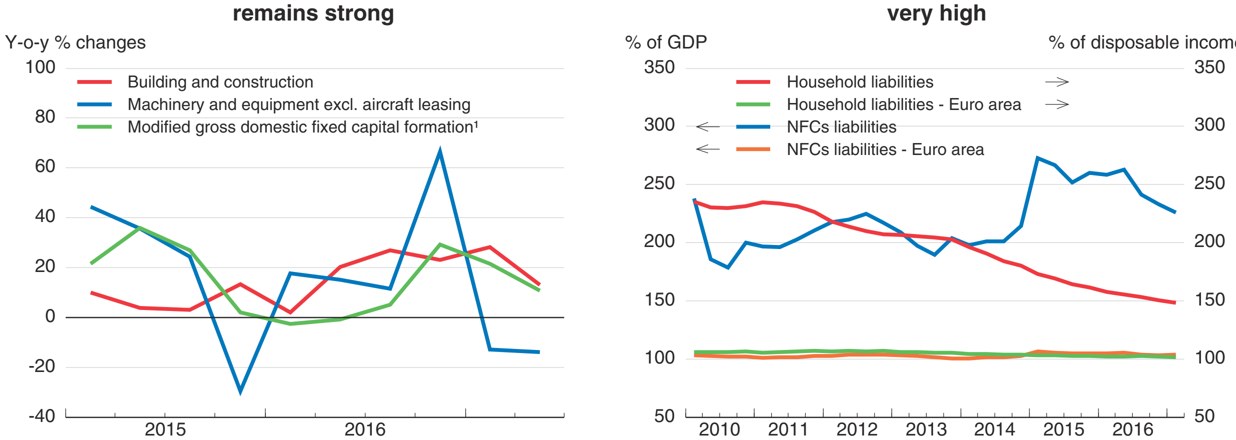
Private sector debt remains high, as some households and corporations are heavily indebted with poor prospects of debt repayment. As a consequence, the stock of non-performing loans (NPLs) remains stubbornly high, while banks often extend forbearance, which impairs the Irish banking system. The authorities should address high indebtedness by strengthening insolvency regimes and support a further resolution of NPLs by ensuring collateral enforcement and NPL write-offs.

The recovery is maturing

GDP continues to grow strongly. Abstracting from volatile activities of multinational enterprises (MNEs), domestic demand remains solid. The headline number for investment has been strongly affected by MNEs, but business investment by local Irish firms continues to recover strongly, particularly in the construction sector. The unemployment rate continues to decline rapidly. As the labour market is increasingly tight, wages are rising rapidly. Even so, inflation is subdued, notably because prices of goods imported from the

Ireland

Growth in investment of local firms remains strong | Private sector indebtedness remains very high



1. Modified Gross Fixed Capital Formation (GFCF*), as calculated by the Central Statistics Office (CSO) of Ireland, excludes R&D-related imported intellectual property assets and aircrafts related to leasing, both attributed essentially to multinational enterprises.

Source: Central Statistics Office, Ireland; and Eurostat.

StatLink http://dx.doi.org/10.1787/888933631741

Ireland: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2015 prices)				
GDP at market prices	194.2	25.5	5.1	3.6	2.7	2.2
Private consumption	83.4	4.2	3.0	2.5	2.7	2.3
Government consumption	31.4	2.1	5.1	2.0	2.0	2.0
Gross fixed capital formation	40.3	27.9	60.4	-7.4	5.7	3.3
Final domestic demand	155.1	10.0	21.2	-1.6	3.8	2.6
Stockbuilding[1]	4.9	-0.3	0.3	-1.0	0.0	0.0
Total domestic demand	160.0	9.1	20.3	-3.8	3.7	2.6
Exports of goods and services	219.4	38.5	4.7	3.4	3.7	3.6
Imports of goods and services	185.3	26.0	16.4	-1.6	5.9	5.6
Net exports[1]	34.2	18.6	-9.2	5.7	-1.1	-1.0
Memorandum items						
GVA[2], excluding sectors dominated by foreign-owned multinational enterprises	_	4.4	5.1	3.1	2.4	2.2
GDP deflator	_	7.3	0.0	1.1	1.3	1.8
Harmonised index of consumer prices	_	0.0	-0.2	0.3	1.5	2.1
Harmonised index of core inflation[3]	_	1.6	0.7	0.3	1.5	2.1
Unemployment rate (% of labour force)	_	9.4	7.9	6.4	5.8	5.6
Household saving ratio, net (% of disposable income)	_	2.2	2.0	2.0	1.9	1.8
General government financial balance[4] (% of GDP)	_	-1.9	-0.7	-0.4	-0.2	-0.2
General government gross debt (% of GDP)	_	90.5	88.3	87.4	85.5	83.6
General government debt, Maastricht definition (% of GDP)	_	77.0	72.9	72.0	70.1	68.2
Current account balance (% of GDP)	_	10.9	3.3	3.0	2.2	1.6

1. Contributions to changes in real GDP, actual amount in the first column.
2. Gross value added. Data for 2016-2019 are OECD 's estimates.
3. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
4. Includes the one-off impact of recapitalisations in the banking sector.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632710

United Kingdom have been declining due to the depreciation of sterling. With rising real wages, household consumption has grown steadily over the past years.

Property prices continue to rise rapidly due to a shortage of housing supply. Property-related loans are increasing fast, driving the recent recovery in new lending. Activity in the construction sector is gaining momentum, boosting job creation, but housing supply is expected to fall short of demand for some time. The authorities should encourage more construction by greater liberalisation of planning requirements. The sharp rise in prices and lending raises concerns that another property bubble may be forming, and the authorities should stand ready to tighten prudential regulations if needed.

Policies should lay the ground for sustainable growth

While private sector debt remains high, the banking system is still impaired due to a stubbornly high stock of NPLs. NPLs still account for around 13% of total outstanding loans, while banks have often extended forbearance and circumvented write-offs over the past years. Reflecting high default rates and difficulties in collateral enforcement, bank lending rates for SMEs remain very high, despite the accommodative euro area monetary policy.

The authorities should address high indebtedness by strengthening insolvency regimes and support a further resolution of NPLs by ensuring collateral enforcement and NPL write-offs, which would enable the banking sector to regain its normal functioning, and strengthen credit supply.

Due to past fiscal efforts, the budget deficit has diminished sharply and public debt, although high, is on a downward path. The fiscal stance is projected to be less contractionary in 2018 and 2019 than in past years. Public investment will reverse its past declines. The government should not spend more than planned currently to avoid overheating pressures. It should instead ensure that its medium-term goal of balancing the budget is met, while leaving as much room as possible for fiscal support in the event of future shocks from Brexit or other sources.

Growth will fall toward moderate rates

The economy is projected to expand robustly, but growth will fall toward more moderate rates, as productivity gains in the domestic sector remain limited and equipment investment will weaken, with the prospects of Brexit damping confidence even if an agreement on a transition period is concluded. Employment will also grow at a slower pace, but the labour market will increasingly tighten, feeding further wage pressures. Inflation will gain traction, gradually aligning to rising labour costs. Weaker real disposable income growth will result in some easing in household consumption growth. Construction investment will keep its momentum, contributing increasingly to overall growth.

Economic prospects are surrounded by more risk and uncertainty than usual, including notably the final outcome of the Brexit negotiations. The high level of private indebtedness leaves Ireland sensitive to a rise in interest rates, which would weigh on private spending and further raise NPLs. Property prices may increase more strongly than projected, which would support construction activity in the near term, though this would come at the cost of raising private indebtedness to even higher levels.

ISRAEL*

Economic growth is projected to strengthen to above 3¼ per cent in 2018 and 2019. Domestic demand will be supported by accommodative fiscal and monetary conditions, the development of new gas fields and higher wage increases due to the persistence of low unemployment. With the somewhat stronger external environment, exports are also picking up as the shekel has stabilised at least temporarily.

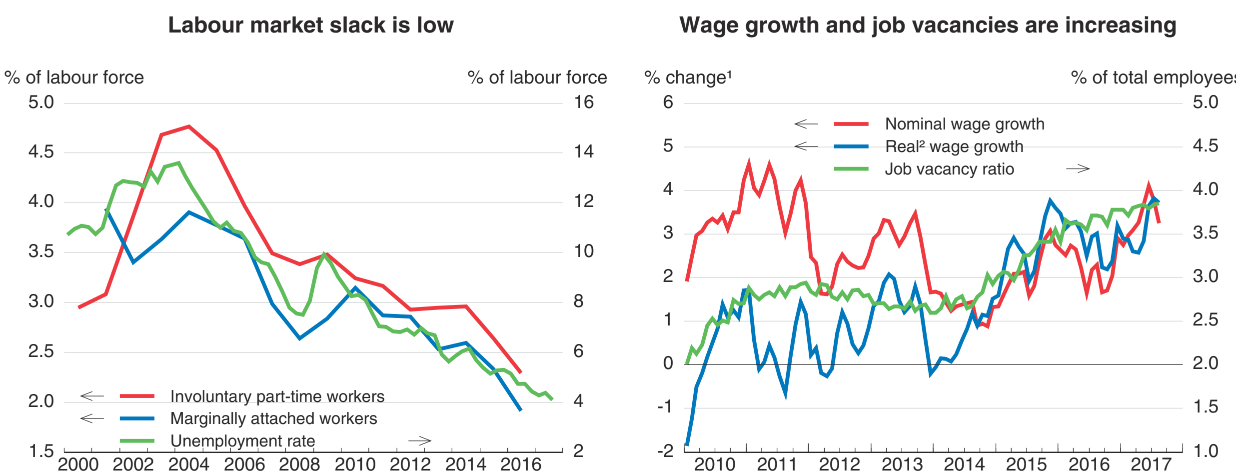
With rising wage pressures, the authorities should move ahead with a progressive withdrawal of monetary stimulus, once inflation becomes entrenched in its target range. A gradual tightening would also moderate housing market tensions. Budgetary expansion in 2017-18 could curb declining government debt, but higher spending on education and training, health and pensions will promote more inclusive growth.

As house prices continue to increase rapidly, the authorities should maintain prudent macro-prudential policies. The risks of unfavourable developments in the real estate market remain high, and the banks are heavily involved in this sector. Continued public debt control and wide budgetary margins are needed given Israel's particular geopolitical situation.

Activity accelerated in the course of 2017

Domestic demand remains the main driver of growth thanks to expansionary macroeconomic policies and a strong labour market. With the unemployment rate down to almost 4% and rising skill shortages, wages have picked up and contributed to private consumption gains during the year. Business investment has strengthened, and exports

Israel



1. Three-month moving average of the year-on-year percentage changes.
2. Deflated by the consumer price index.

Source: OECD, Labour Force Statistics database; Bank of Israel; and Central Bureau of Statistics.

StatLink http://dx.doi.org/10.1787/888933631760

* The statistical data for Israel are supplied by and under the responsibility of the relevant Israeli authorities. The use of such data by the OECD is without prejudice to the status of the Golan Heights, East Jerusalem and Israeli settlements in the West Bank under the terms of international law.

Israel: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices NIS billion	Percentage changes, volume (2015 prices)				
GDP at market prices	1 103.5	2.6	4.0	3.1	3.5	3.3
Private consumption	614.3	4.1	6.1	3.5	4.2	3.3
Government consumption	250.6	3.1	3.9	2.4	1.9	2.0
Gross fixed capital formation	219.3	-0.8	11.9	4.5	7.8	8.4
Final domestic demand	1 084.2	2.9	6.7	3.4	4.4	4.1
Stockbuilding[1]	3.7	0.6	-0.6	-0.6	-0.3	0.0
Total domestic demand	1 087.9	3.5	6.0	2.9	4.1	4.1
Exports of goods and services	355.5	-2.4	2.5	3.6	4.5	4.2
Imports of goods and services	339.9	0.0	9.4	3.2	7.2	6.9
Net exports[1]	15.6	-0.8	-1.9	0.2	-0.6	-0.7
Memorandum items						
GDP deflator	_	2.7	1.0	0.2	1.3	1.9
Consumer price index	_	-0.6	-0.5	0.2	0.9	1.6
Core inflation index[2]	_	0.4	0.0	-0.1	0.8	1.6
Unemployment rate (% of labour force)	_	5.3	4.8	4.2	4.1	4.2
Household saving ratio, gross (% of disposable income)	_	0.5	-0.1	1.5	2.5	3.4
General government financial balance[3] (% of GDP)	_	-2.1	-2.1	-1.8	-2.7	-2.5
General government gross debt (% of GDP)	_	64.1	62.3	62.2	62.2	61.7
Current account balance (% of GDP)	_	4.9	3.5	3.0	2.4	1.5

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
3. Excluding Bank of Israel profits and the implicit costs of CPI-indexed government bonds.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632729

have held up well despite the shekel's appreciation in the first half of the year. Inflation remains very low, at only 0.2% in October, due mostly to lower import prices and cuts in certain public tariffs, including water.

A policy more geared towards the longer-term objective of more inclusive growth is desirable

The Bank of Israel has maintained its policy rate at 0.1% since March 2015. The authorities' interventions on the foreign exchange market have moderated since the summer. After an appreciation in the first half of 2017, the shekel seems to have stabilised in nominal effective terms at around 5% above its previous-year level. House price growth has slowed but remains high at around 4% year-on-year, which continues to reflect tensions in the real estate market. A gradual withdrawal of monetary stimulus, as is assumed in the projections, would moderate these tensions.

The fiscal deficit is expected to decline in 2017 to about 1¾ per cent of GDP, before rising to about 2½-2¾ per cent of GDP in 2018 and 2019. The strong increases in budgeted public spending in 2017-2018 are expected to be offset by a one-off surge in tax revenues in 2017, due in particular to the ending of the temporary exceptionally low tax rate on dividends and to capital gains taxation related to a large single transaction. Budgetary efforts to strengthen social cohesion and growth must continue, while maintaining public debt control. Reforms are also needed to improve infrastructure, particularly in public transport, the functioning of product markets and the training and education of disadvantaged groups, especially in Israeli-Arab and Ultra-Orthodox communities.

Growth is projected to strengthen

GDP is expected to grow between 3¼ and 3½ per cent in 2018 and 2019. The ongoing support from macroeconomic policies will continue to stimulate demand. Demand will also be supported by increased infrastructure spending related to the start-up of the Leviathan offshore gas field planned for end-2019. The good labour market performance and low unemployment should continue to spur wages and private consumption. However, the increase in imports, coupled with the still moderate growth in exports, should slow growth. With stronger wage increases and higher import prices, inflation is expected to rise to around 1¾ per cent by the end of 2019.

These projections would be weakened if the exchange rate were to appreciate again or if the geopolitical situation or the external environment deteriorated. On the other hand, a stronger economy, due, for example, to a more buoyant global recovery, cannot be excluded, which could lead to overheating if the central bank were slow to withdraw stimulus or if the government follows through with further tax cuts.

ITALY

GDP growth is projected to edge down to 1.5% in 2018 and 1.3% in 2019. Private consumption will continue to be the main driver of the recovery, which will continue to broaden to investment and exports. Employment gains will buttress household disposable income. Tax incentives and rising external demand will support business investment and export growth. Excess capacity is narrowing but consumer price inflation and wage pressures will remain muted.

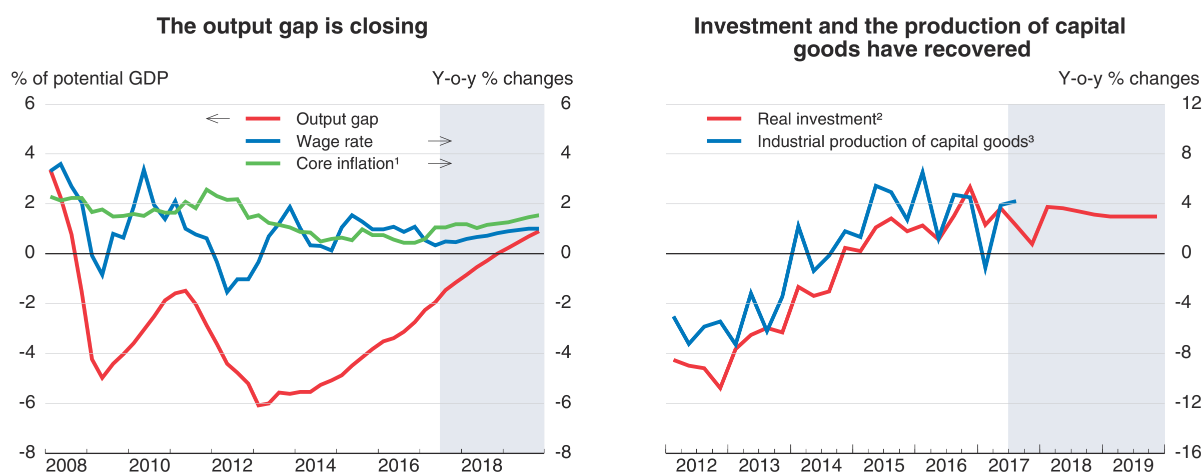
Fiscal policy will turn from a mildly expansionary to a broadly neutral stance in 2018. As the recovery firms, the implementation of structural reforms needs to be accompanied by a gradually rising primary budget surplus. This hinges on further progress on reducing tax evasion and on rationalising fiscal expenditures and current spending. To enhance social inclusion, resources need to be shifted towards anti-poverty programmes and employment incentives targeting the young.

The large stock of banks' non-performing loans (NPLs) and the high public debt pose financial vulnerabilities. NPLs weigh on banks' balance sheets, heightening risks for public finances in the event of a crisis. The high public debt constrains fiscal policy by making it overly sensitive to changes in interest rates. The government's strategy to deal with weak banks is bearing fruit and NPLs have started to decline.

The recovery is broadening

The growth of business investment, especially in machinery and equipment, has increased due to generous investment tax incentives and firms' need to renew their productive capacity. Rising external demand is sustaining export growth. Employment growth has been resilient despite the expiration of social-security contribution exemptions

Italy



1. Harmonised consumer price index (HICP). Core HICP excludes energy, food, alcohol and tobacco. Projection from 2017Q4.
2. Real gross fixed capital formation.
3. Based on monthly data.

Source: OECD Economic Outlook 102 database; and National Institute of Statistics (ISTAT).

StatLink http://dx.doi.org/10.1787/888933631779

Italy: **Demand and output**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	1 622.8	0.9	1.1	1.6	1.5	1.3
Private consumption	985.8	2.0	1.5	1.4	1.0	0.9
Government consumption	313.3	-0.6	0.5	1.0	0.4	0.4
Gross fixed capital formation	271.9	1.7	3.0	2.3	3.5	3.0
Final domestic demand	1 571.0	1.5	1.6	1.5	1.3	1.2
Stockbuilding[1]	5.3	0.0	-0.3	0.2	0.2	0.0
Total domestic demand	1 576.3	1.4	1.2	1.7	1.5	1.2
Exports of goods and services	475.3	4.2	2.6	4.7	3.4	3.9
Imports of goods and services	428.8	6.6	3.3	5.5	3.6	3.8
Net exports[1]	46.5	-0.5	-0.1	-0.1	0.0	0.1
Memorandum items						
GDP deflator	_	0.9	0.8	0.4	1.3	1.3
Harmonised index of consumer prices	_	0.1	-0.1	1.4	1.2	1.4
Harmonised index of core inflation[2]	_	0.7	0.5	1.0	1.1	1.4
Unemployment rate (% of labour force)	_	11.9	11.7	11.2	10.5	10.1
Household saving ratio, net (% of disposable income)	_	3.1	3.3	2.8	3.0	2.9
General government financial balance (% of GDP)	_	-2.6	-2.5	-2.1	-1.6	-1.1
General government gross debt (% of GDP)	_	158.9	157.3	157.0	155.2	153.1
General government debt, Maastricht definition (% of GDP)	_	131.6	131.9	131.6	129.8	127.7
Current account balance (% of GDP)	_	1.5	2.7	2.8	2.9	3.1

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632748

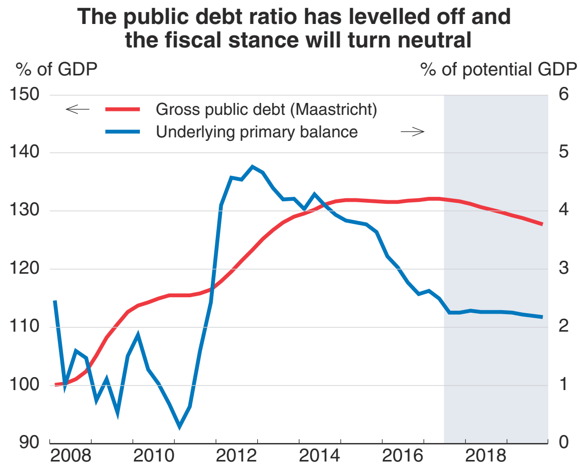
for permanent contracts. However, job creation relies increasingly on temporary contracts. Rising real disposable income and consumer lending has supported private consumption while allowing households to rebuild their saving rate. Lending to non-financial rate corporations, adjusted for securitisation and cancellation of NPLs, is recovering.

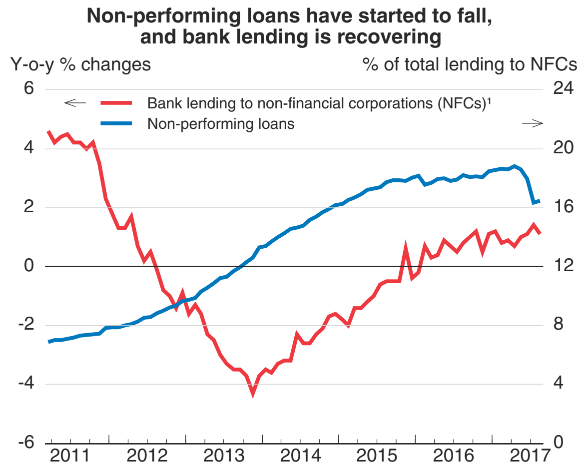
Leading indicators for manufacturing and services, and rising business and consumer confidence, point towards robust economic activity in the near term. The share of businesses planning to increase investment in the months ahead is rising. Excess capacity is narrowing but is not yet leading to higher price and wage pressures. Firms report little pressure to raise prices because of rising wage and intermediate costs. Businesses' inflation expectations have receded from their peak earlier in the year and are low. Labour market slack remains sizeable because of increasing labour force participation and under-employment, damping wage growth.

Policy measures will strengthen inclusive growth and lower debt

The fiscal stance is projected to turn neutral in 2018. The 2018 budget repeals the VAT increase planned for 2018 and appropriately extends the tax incentives for business investment and real estate improvements. It also introduces lower social security contributions for young people hired on a permanent basis, while allocating resources for raising civil servants' wages. The planned introduction of e-invoicing for

Italy





1. Adjusted for the effect of securitisation.
Source: OECD Economic Outlook 102 database; and Bank of Italy.

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business-to-business transactions is an important further step to reduce tax evasion. Lowering the cash payment threshold would complement these efforts. Tax expenditures without any social and economic rationale still need to be cut.

Structural reforms must continue if Italy is to enhance social cohesion and strengthen potential growth. The approval of the competition law and the progress through parliament of the enabling law reforming the insolvency system go in the right direction. The turnover due to retirement of a large share of civil servants in the near future is an opportunity to restructure the public administration.

Efforts must continue to open up local public services to competition. Fully implementing the new job search and training policies, as envisaged by the Jobs Act, and linking them to unemployment benefits will help the unemployed and discouraged job seekers. Though female labour market participation has risen, fewer than half of working-age women are in employment. Expanding childcare facilities will boost employment opportunities for women. Ensuring that the new Inclusive Income scheme is well funded will enable a reduction in poverty, especially among children. The link between the retirement age and life expectancy must be preserved to strengthen intergenerational equity and safeguard the long-term sustainability of the pension system.

Italy's main financial vulnerabilities are the high level of NPLs and public debt. NPLs sap confidence in the banking sector and are a risk for the public finances. The government has earmarked EUR 20 billion (1.2% of GDP) to deal with the banking sector, of which 50% has already been used. Its strategy has so far relied on a mix of recapitalisation and resolution. This has improved confidence and led to a large reduction in NPLs by mid-2017. The public debt ratio has stabilised but remains high. Fiscal policy is vulnerable to increases in interest rates. Continuing pro-growth reforms and gradually raising the primary surplus are key to reducing the public debt ratio.

Growth is set to decline slightly

GDP growth is projected to remain broadly stable in 2018 and edge down in 2019. Private consumption growth will ease following moderate wage increases and rising employment. Rising global and domestic demand and tax incentives will support export and investment growth. Increasing domestic demand will sustain import growth but the current account surplus will continue to increase.

A faster-than-expected, even if still gradual, decline in NPLs would foster confidence, further strengthening private investment. Stronger and more resilient consumer confidence might lead to lower saving and stronger private consumption. A faster global recovery would boost export growth. On the other hand, the rising share of temporary contracts could result in rising precautionary saving, reducing private consumption growth. Higher inflation in the euro area than projected could hasten the pace of monetary policy normalisation, requiring a higher primary fiscal surplus to reach the fiscal targets and reducing consumer credit, thus denting private consumption growth. Slowing down the pace of structural reforms and fiscal slippage after the planned elections in early 2018 would lower confidence and derail a durable recovery.

JAPAN

Growth is estimated to have picked up to 1.5% in 2017, aided by stronger international trade and fiscal stimulus. Although fiscal consolidation is set to resume in 2018, growth is projected to remain close to 1% in 2018 and 2019, as export growth remains robust. Employment is projected to peak in 2018 as the decline in the working-age population accelerates. Sustained above-potential growth will boost inflation to 1% in 2018 and around 1½ per cent in 2019 (excluding the impact of the increase in the consumption tax rate).

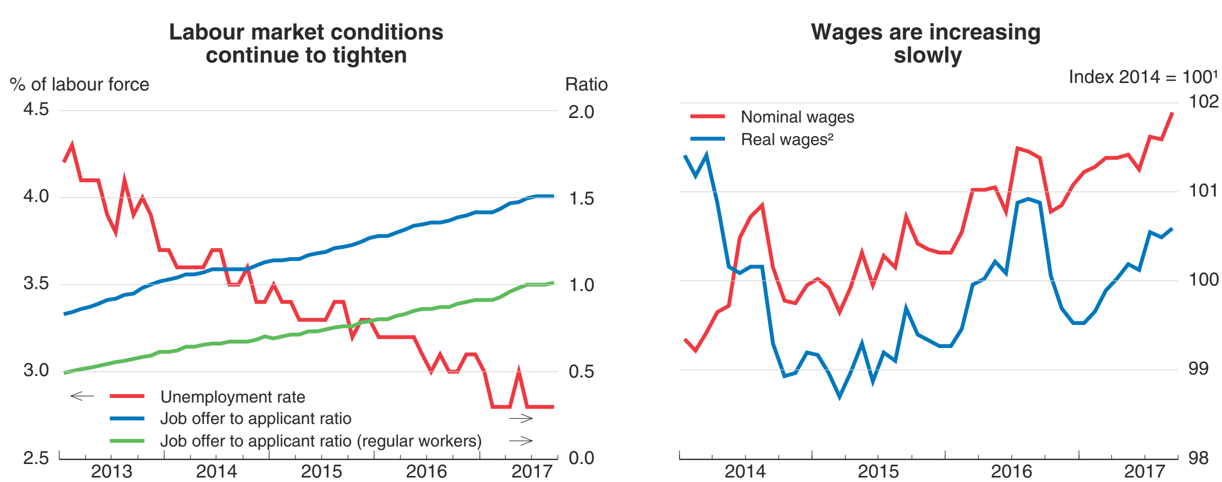
The Bank of Japan should maintain its expansionary monetary policy until the 2% inflation target is achieved. Structural reforms, including measures to improve corporate governance, facilitate the exit of non-viable firms and raise productivity in small firms, are key. Increasing female employment by expanding childcare and improving work-life balance is also essential to boost growth and help put the government debt ratio on a downward trend.

In contrast to household and corporate debt, government debt, which has surpassed 220% of GDP, the highest ever recorded in the OECD area, poses a serious risk. The debt burden is limited at present by negative interest rates on government bonds of less than ten years maturity, as a result of purchases by the Bank of Japan, which now owns 41% of the outstanding stock of government bonds. Achieving fiscal sustainability requires measures to durably strengthen economic growth and a more detailed consolidation path, including gradual hikes in the consumption tax rate and measures to control social spending in the face of rapid population ageing.

Robust export growth is boosting domestic demand

Japanese exports have risen with the rebound in international trade since mid-2016, contributing to a pick-up in business investment. Residential investment has also been

Japan



1. Seasonally-adjusted data (three-month moving average) based on establishments with 30 or more workers.
2. Deflated by the consumer price index, excluding rent.

Source: OECD Economic Outlook 102 database; OECD calculations; and Ministry of Health, Labour and Welfare.

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Japan: **Demand and output**

	2014	2015	2016	2017	2018	2019
	Current prices YEN trillion	Percentage changes, volume (2011 prices)				
GDP at market prices	513.7	1.1	1.0	1.5	1.2	1.0
Private consumption	300.1	-0.3	0.4	1.1	0.6	0.7
Government consumption	103.6	1.7	1.3	0.2	0.5	0.1
Gross fixed capital formation	122.9	0.1	0.9	2.5	0.8	0.3
Final domestic demand	526.6	0.1	0.7	1.2	0.6	0.5
Stockbuilding[1]	- 0.2	0.6	-0.3	-0.3	0.1	0.0
Total domestic demand	526.4	0.7	0.4	0.9	0.7	0.5
Exports of goods and services	90.1	2.9	1.2	6.0	4.0	4.0
Imports of goods and services	102.8	0.8	-2.3	2.5	1.2	1.5
Net exports[1]	- 12.7	0.4	0.6	0.6	0.5	0.5
Memorandum items						
GDP deflator	_	2.1	0.3	-0.3	0.2	1.0
Consumer price index[2]	_	0.8	-0.1	0.4	1.0	1.7
Core consumer price index[3]	_	1.0	0.4	-0.1	0.7	1.7
Unemployment rate (% of labour force)	_	3.4	3.1	2.8	2.8	2.8
Household saving ratio, net (% of disposable income)	_	0.7	2.5	3.1	3.1	2.7
General government financial balance (% of GDP)	_	-3.5	-4.6	-4.8	-4.1	-3.6
General government gross debt (% of GDP)	_	214.7	217.7	221.0	223.3	224.3
Current account balance (% of GDP)	_	3.1	3.7	3.9	3.9	4.1

1. Contributions to changes in real GDP, actual amount in the first column.
2. Calculated as the sum of the seasonally adjusted quarterly indices for each year.
3. Consumer price index excluding food and energy.

Source: OECD Economic Outlook 102 database.

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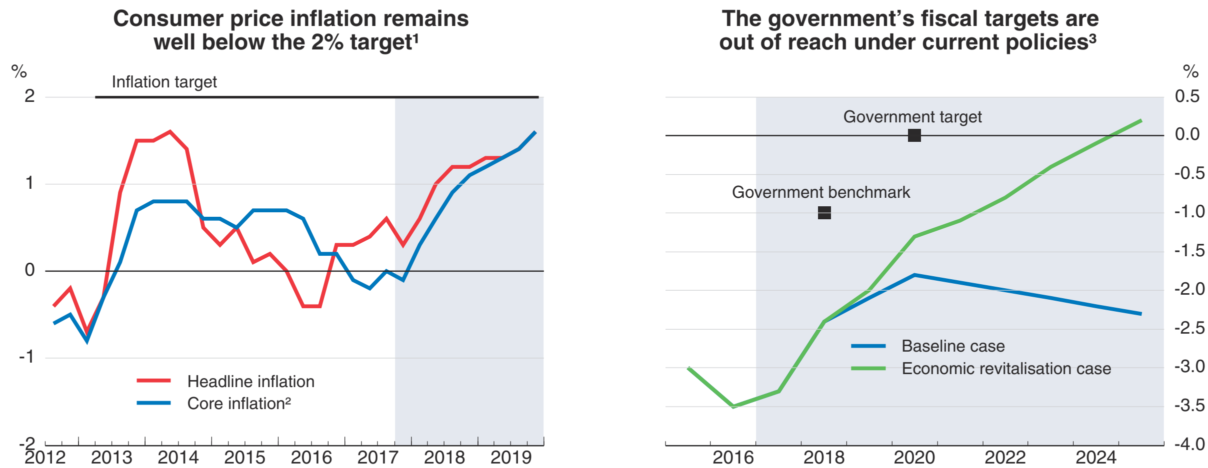
robust in the context of extremely low long-term interest rates. Employment gains helped lift private consumption growth to its highest level since the 2014 consumption tax hike. However, wage growth remains sluggish despite the decline in the unemployment rate to below 3% and the highest ratio of job openings to applicants since 1974. Purchasing power has been squeezed by a pick-up in inflation from negative rates in 2016, reflecting higher energy and food prices.

Employment, which has risen 3.6% since 2013 despite a declining working-age population, continues to support output growth. Despite growing labour shortages, sustaining employment gains will be difficult as the fall in the working-age population accelerates. Recent initiatives to further increase childcare capacity and reduce working time to improve work-life balance should help remove obstacles to female employment. Reducing the gender wage gap, which is the third highest in the OECD at 26%, is also a priority. Ending labour market dualism is part of the solution, and will involve a comprehensive approach that includes relaxing employment protection for regular workers and an expansion of social insurance coverage and training for non-regular workers. The government guidelines for “equal pay for equal work” could help narrow wage gaps and reduce non-regular employment, which is concentrated among women.

Japan



1. Year-on-year percentage change, excluding the effects of the April 2014 consumption tax hike, which added 2 percentage points to inflation in FY 2014 according to a government estimate. It also excludes the scheduled October 2019 consumption tax hike, which would add 1.1 percentage points to inflation in the fourth quarter of 2019, according to an OECD estimate.
2. OECD measure, which excludes food and energy.
3. Government projections of the primary balance (central and local governments), excluding recovery and reconstruction measures, as a percentage of GDP on a fiscal year basis. The annual growth rate is between 1.0% and 1.5% in the baseline case and more than 3.0% in the economic revitalisation case.

Source: OECD Economic Outlook 102 database; OECD calculations; Ministry of Internal Affairs and Communications; and Cabinet Office.

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Fiscal expansion is coming to a close while monetary policy remains expansionary

A series of supplementary budgets supported output growth in 2016-17, while boosting the overall primary deficit to around 4½ per cent of GDP in 2017. Fiscal consolidation is set to resume in 2018 as the impact of the supplementary budgets wanes. Nevertheless, the government projects a primary deficit (central and local governments) of 2.4% of GDP in FY 2018, well above its 1% benchmark, reflecting the postponement of the consumption tax hike from 8% to 10%. The consumption tax rate increase is assumed to be implemented in October 2019. Even so, the longstanding target of a primary surplus by FY 2020 appears out of reach, even with robust output growth.

With government debt rising further into uncharted territory, a comprehensive fiscal plan is needed, in addition to measures to strengthen long-term economic growth, to maintain confidence in Japan's fiscal sustainability and put the debt-to-GDP ratio on a sustained downward trend. Such a plan should include detailed and concrete measures to boost revenues by gradually increasing the consumption tax, broadening the personal and corporate income tax bases and raising environmental taxes. A fiscal plan should also include reforms to further limit the growth of social spending, given that the share of the elderly is projected to rise from 27% of the population to 38% by 2050. Such reforms should shorten hospital stays, accelerate the increase in the use of generic drugs, further reduce long-term care insurance coverage for those with less severe needs, fully apply macroeconomic indexation to pension benefits and raise the pension eligibility age. The wide variation between prefectures in per capita public spending also suggests scope for fiscal consolidation at the local government level.

The impact of high government debt has been mitigated thus far by low interest rates. The Bank of Japan's "yield curve control" framework has kept the yield on ten-year government bonds close to zero since September 2016, while allowing the central bank to reduce its purchases of government bonds, which had been set at 80 trillion yen (16% of GDP) per year. The Bank of Japan's "inflation-overshooting commitment" promises to continue expanding the monetary base until CPI inflation (excluding fresh food) exceeds the 2% target and stays above it in a stable manner. This very supportive monetary stance should continue until the inflation target has been sustainably achieved.

Growth is projected to slow to 1% by 2019

Growth is expected to slow as fiscal consolidation resumes in 2018. The primary deficit is projected to fall to around 3¼ per cent of GDP in 2019. Wages are projected to continue rising gradually in the face of further labour market tightening, thus sustaining private consumption, although its path in 2019 will be volatile due to the consumption tax hike. Strong demand from other Asian countries is expected to support export growth.

Larger wage gains in response to labour shortages and faster-than-projected world trade growth could lead to stronger output growth. Downside risks to the outlook include heightened geo-political tensions in Northeast Asia and trade protectionism. On the domestic side, Japan's unprecedentedly high level of public debt is a key risk. The new fiscal consolidation plan to be announced in 2018 should lay out a more detailed and concrete strategy to reduce the debt ratio and ensure confidence in Japan's fiscal sustainability. A loss in such confidence could destabilise the financial sector and the real economy, with large negative spillovers to the world economy.

KOREA

The rebound in international trade and greater fiscal support are projected to sustain output growth at around 3% through 2019, even though construction investment is projected to slow following tighter regulations on housing and mortgage lending. High household debt and weak employment growth continue to hold back private consumption. Inflation is projected to remain close to 2%, while the current account surplus will edge up to 6% of GDP.

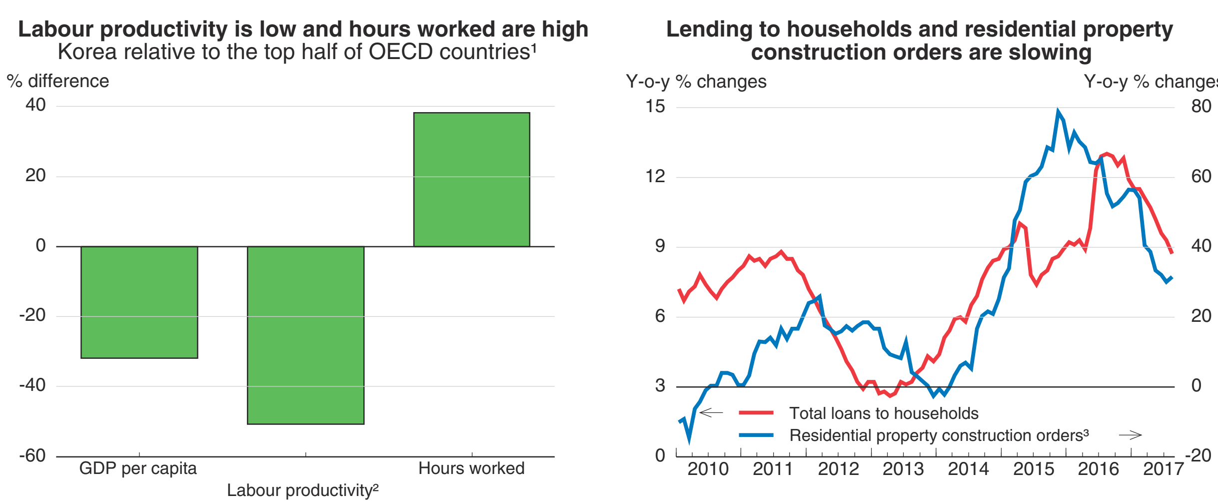
The government's strategy of "income-led growth", driven by public employment, a sharp rise in the minimum wage and increased social spending, needs to be supported by reforms to raise productivity. Fiscal policy, which is increasingly focused on income redistribution, also needs to place greater emphasis on productivity. Gradually reducing the degree of monetary accommodation by raising the policy interest rate from a record-low 1¼ per cent would help keep inflation in check and contain household debt.

Household debt is high, at nearly 160% of household disposable income, and rising. The strengthening of macro-prudential regulations and housing taxes and regulations have slowed mortgage lending, but risk creating a downturn in residential construction. Measures to put household debt on a downward trend are a priority to promote inclusive growth, in part by addressing the high debt burdens of older persons, the self-employed and low-income workers.

Exports have underpinned growth in 2017

Construction investment, the key driver of growth since 2015, is slowing but exports have picked up. The semiconductor industry has led Korea's export recovery and accounted for three-quarters of business investment during the first eight months of 2017. However, capacity utilisation in manufacturing is low by historical standards, while wage

Korea



1. In 2015 using PPP exchange rates.
2. Per hour worked.
3. A 24-month moving average.

Source: OECD Going for Growth database; and Bank of Korea.

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Korea: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices KRW trillion	Percentage changes, volume (2010 prices)				
GDP at market prices	1 486.1	2.8	2.8	3.2	3.0	3.0
Private consumption	748.2	2.2	2.5	2.3	2.5	2.7
Government consumption	224.7	3.0	4.3	3.6	4.1	4.6
Gross fixed capital formation	433.3	5.1	5.2	9.4	2.9	2.7
Final domestic demand	1 406.2	3.2	3.6	4.8	2.9	3.0
Stockbuilding[1]	1 812.4	0.7	0.0	0.3	-0.2	0.0
Total domestic demand	1 408.0	3.9	3.6	5.1	2.7	3.0
Exports of goods and services	747.1	-0.1	2.1	3.2	4.4	4.3
Imports of goods and services	669.1	2.1	4.5	7.7	3.3	4.2
Net exports[1]	78.1	-1.0	-0.7	-1.4	0.7	0.3
Memorandum items						
GDP deflator	_	2.4	1.8	2.3	2.3	2.5
Consumer price index	_	0.7	1.0	2.1	2.1	2.1
Core inflation index[2]	_	2.2	1.6	1.5	2.0	2.1
Unemployment rate (% of labour force)	_	3.6	3.7	3.7	3.5	3.4
Household saving ratio, net (% of disposable income)	_	9.3	9.3	9.1	8.8	8.7
General government financial balance (% of GDP)	_	1.3	2.1	1.8	1.7	1.5
General government gross debt (% of GDP)	_	45.7	45.5	45.8	46.3	46.9
Current account balance (% of GDP)	_	7.7	7.0	5.6	5.7	6.0

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632786

and employment growth remain sluggish. The increase in inflation from 1% in 2016 to 2%, driven by food and energy prices, has curtailed real income gains and private consumption, despite a rebound in consumer sentiment following the election of a new president in May. The continuing rise in household debt also remains a headwind to private consumption, which has lagged output growth each year since 2006.

Fiscal policy has become more expansionary

In July, the government introduced a supplementary budget equivalent to 0.7% of annual GDP. In addition, the new Fiscal Management Plan raised spending growth to 5.1% annually over 2017-20, up from 2.6% in the previous Plan, financed in part by a hike in the corporate income tax rate. Spending will boost public employment by over 0.8 million by 2021 – a 30% increase – and enhance social welfare to promote a "people-centred economy". Meanwhile, government investment in social overhead capital is to be cut by 20% in 2018, suggesting a need for more spending aimed at increasing productivity, given that labour productivity in Korea is 51% below the top half of OECD countries. Moreover, structural reforms in product and labour markets are needed to boost productivity growth, which increased at a 0.8% annual pace over 2011-15, below the OECD average.

Policies implemented since early 2016 to stabilise the housing market contributed to a small decline in house prices in real terms during the first half of 2017. The government lowered maximum loan-to-value and debt-to-income ratios further in July 2017 and cut them again in “overheated speculative districts” in August. These measures have reduced the growth of residential property construction orders and mortgage lending, helping to moderate the rise in household debt. Measures to stabilise household debt should be carefully calibrated to avoid a contraction in the housing market.

Growth is projected to edge down to 3% over 2018-19

Fiscal support and buoyant international trade in Asia are projected to sustain growth through 2019. The planned increase in public employment and social spending, while achieving the target of raising the minimum wage by 54% over 2017-20, is expected to boost household income and consumption, offsetting the continued deceleration in residential investment. Gradual hikes in the policy interest rate are projected to keep inflation near the 2% target, while the current account surplus remains large.

A broader-based export recovery that extends beyond key industries, notably semiconductors, and positive results from the government's measures to promote innovation would lead to faster output growth. However, rising wage costs driven by a hike in the minimum wage could weaken Korea's competitiveness if not accompanied by productivity gains. Another downside risk is sluggish business investment following hikes in corporate taxes, higher wages that weaken the profitability of smaller firms and the uncertainty created by the government's pledge to reform the large conglomerates that play a key economic role. Continued geo-political tension related to North Korea could weaken business and household confidence, with adverse implications for business investment and private consumption. The numerous housing-related measures could turn the slowdown in housing investment into an outright decline.

LATVIA

Economic growth is projected to remain strong and broad-based. Exports are strengthening as prospects in EU countries and Russia are improving. Stronger exports and EU structural fund transfers are boosting investment. High wage growth will underpin household consumption. Unemployment is projected to fall only gradually due to skill and regional mismatches between workers and jobs. The current account deficit is projected to increase as strong domestic demand boosts imports.

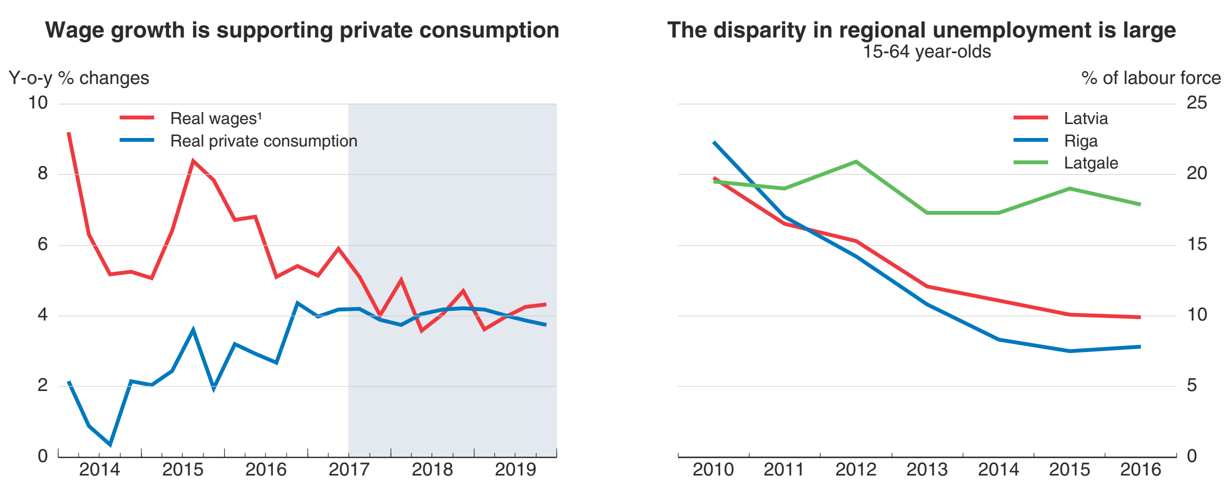
Fiscal policy will remain expansionary. Spending on social assistance transfers and healthcare services will increase. Personal income taxes will be lowered and the taxation of retained corporate profits will be abolished. Increasing the supply of affordable housing would enable low-income workers to move to areas with better job opportunities. Providing more generous grants to students from low-income families attending vocational schools and universities would boost productivity and inclusiveness.

Private sector indebtedness has fallen below the OECD average, and house prices have risen only in line with household income. Foreign deposits at Latvian banks account for 43% of total deposits and have at times been subject to large withdrawals. However, banks holding foreign deposits are subject to stronger capital and liquidity requirements.

Economic growth is broad-based

Economic growth increased in 2017, led by a recovery in exports, a rebound in investment and robust private consumption. Exports to Russia, Latvia's third largest destination, are increasing after a long decline. However, strong wage gains and appreciation of the euro weakened competitiveness and are holding back Latvia's export performance. The fast disbursement of EU structural funds is boosting investment. The unemployment rate is declining but is very high in some regions, contributing to high

Latvia



1. Real wages refer to average real labour compensation per employee (deflated by the harmonised consumer price index).
Source: OECD Economic Outlook 102 database; and Central Statistical Bureau of Latvia.

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Latvia: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	23.7	2.8	2.1	5.2	4.2	3.7
Private consumption	14.5	2.5	3.3	4.1	4.1	3.9
Government consumption	4.1	1.9	2.7	3.8	2.6	2.5
Gross fixed capital formation	5.3	-0.5	-15.0	18.5	9.3	6.4
Final domestic demand	23.9	1.7	-0.8	6.7	4.8	4.2
Stockbuilding[1]	0.1	0.5	3.1	0.9	0.2	0.0
Total domestic demand	24.0	2.3	2.3	7.4	4.9	4.1
Exports of goods and services	14.3	3.0	4.1	4.8	5.6	4.7
Imports of goods and services	14.7	2.1	4.5	8.4	6.7	5.3
Net exports[1]	- 0.3	0.5	-0.3	-2.1	-0.8	-0.5
Memorandum items						
GDP deflator	_	0.0	0.3	2.6	3.3	3.0
Harmonised index of consumer prices	_	0.3	0.2	2.8	2.9	3.0
Harmonised index of core inflation[2]	_	1.5	1.1	1.8	2.7	3.0
Unemployment rate (% of labour force)	_	9.9	9.6	8.7	8.3	8.1
Household saving ratio, net (% of disposable income)	_	-12.7	-11.2	-10.2	-9.2	-8.9
General government financial balance (% of GDP)	_	-1.2	0.0	0.0	0.3	0.3
General government gross debt (% of GDP)	_	42.0	46.0	44.6	43.2	41.9
General government debt, Maastricht definition (% of GDP)	_	36.8	40.5	39.2	37.7	36.5
Current account balance (% of GDP)	_	-0.5	1.4	-1.0	-2.0	-2.4

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

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poverty. Despite expansionary euro area monetary policy, credit growth remains subdued. The current account balance turned into deficit on the back of strong growth in imports.

Fiscal policies should promote productivity and inclusiveness

The fiscal stance will remain expansionary as health-care spending will increase and social assistance entitlements will be extended to more low-income households. Taxes on wages will be lowered, especially for low-income households, starting in 2018. Retained corporate income will be fully tax exempt. Some excise taxes will be raised and measures have been taken to enhance tax collection. Overall, these measures will decrease government revenue by 0.5% of GDP. Nevertheless, the fiscal balance will remain in surplus and government debt is projected to fall below 40% of GDP (Maastricht definition).

More government spending to increase the supply of social housing in areas with strong labour demand would enhance labour mobility and help low-income workers find better job opportunities. Exempting poor households from high co-payments for health care and avoiding the cut back of publicly funded health-care programmes towards the end of the year would reduce risks of poverty. More generous grants for students from low-income families attending vocational schools and universities would alleviate skill shortages and improve upward social mobility. Improving research cooperation between firms and research institutions would stimulate innovation and improve export competitiveness.

Exports and private consumption will support vigorous growth

Economic growth will remain robust, but will slow somewhat as disbursements of EU structural funds return to normal. Exports will expand strongly even though economic growth in European countries and Russia is projected to ease in 2019. Wage growth, boosted by a higher minimum wage in 2018, will continue to support private consumption. Unemployment will fall only slowly on account of regional and skill mismatches. Higher oil prices and unit labour costs will gradually translate into higher goods and services prices. The current account deficit will widen as import growth remains strong.

The intensification of geopolitical risks related to Russia would damp exports and business investment. Exports to the United Kingdom, one of Latvia's most important trading partners, may also weaken more than projected. On the other hand, recent reforms that improved the quality of vocational and higher education, tax collection and the transparency of the insolvency regime can encourage investment by alleviating skill shortages, moving activity from the informal to the formal sector and increasing business dynamism.

LITHUANIA

GDP growth is projected to be around 3% in 2018-19. Improving external demand and a turnaround in investment, on the back of increased EU fund disbursements, will support growth, even as the shrinking labour supply and skill shortages will constrain the supply side. The combination of strong demand and labour market tightening will push up inflation.

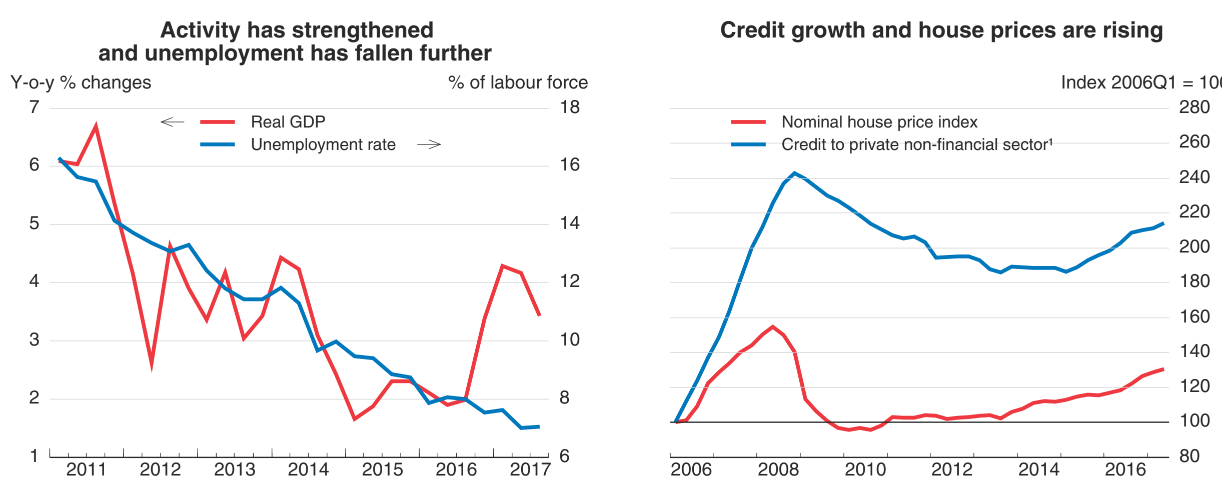
After a mild expansion in 2017, associated with a package of structural reforms, the fiscal stance is poised to remain appropriately broadly neutral over the projection period. Measures to raise productivity and reduce high inequality and poverty should focus on promoting business dynamics, including through simplified bankruptcy procedures, and making the labour market more inclusive through life-long learning strategies, effective activation schemes and enhanced education outcomes.

Lithuania's financial sector is stable, with non-performing loans on a downward trend. House prices and credit growth are rising, but they are still far below their historical highs. Macro-prudential tools need to be strengthened if signs of overheating emerge. Spillovers of external financial conditions remain a potential risk to financial stability given the high presence of foreign banks in Lithuania's banking sector.

Growth has strengthened

The economy has regained momentum after a sub-par performance in 2015 and most of 2016. A rebound in investment was aided by an increase in EU fund disbursements, and exports grew fast with the improvement in the external environment. A buoyant transport sector has boosted service exports. Private consumption remained robust amid falling unemployment, rapid wage increases and favourable credit conditions. Headline inflation edged up in 2017. A spike in energy prices and increase in some excise duties (including on tobacco and alcoholic beverages) have reinforced the inflationary pressures arising from strong domestic demand. Inequality and poverty remain high.

Lithuania



1. The private non-financial sector includes non-financial corporations and households.

Source: Bank of Lithuania; OECD Analytical House Price database; and OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933631893

Lithuania: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	36.6	2.0	2.3	3.6	3.0	2.8
Private consumption	22.8	4.0	4.9	4.2	3.6	3.5
Government consumption	6.1	0.2	1.3	1.6	1.2	1.1
Gross fixed capital formation	6.9	4.8	-0.5	5.7	6.1	4.6
Final domestic demand	35.8	3.5	3.3	4.1	3.7	3.3
Stockbuilding[1]	0.1	0.5	-0.1	-0.4	0.0	0.0
Total domestic demand	35.8	7.2	2.3	2.6	3.4	3.3
Exports of goods and services	29.7	-0.4	3.5	7.5	4.2	4.2
Imports of goods and services	28.9	6.2	3.5	8.8	2.2	4.9
Net exports[1]	0.8	-5.2	-0.1	-0.8	1.6	-0.5
Memorandum items						
GDP deflator	_	0.3	1.0	4.3	3.5	3.0
Harmonised index of consumer prices	_	-0.7	0.7	3.8	2.9	3.0
Harmonised index of core inflation[2]	_	1.9	1.7	2.8	2.8	3.0
Unemployment rate (% of labour force)	_	9.1	7.9	7.2	6.6	6.1
Household saving ratio, net (% of disposable income)	_	-3.9	-4.3	-4.1	-3.9	-3.8
General government financial balance (% of GDP)	_	-0.2	0.3	0.1	0.5	0.5
General government gross debt (% of GDP)	_	53.8	51.7	53.3	48.2	46.7
General government debt, Maastricht definition (% of GDP)	_	42.6	40.1	41.7	36.6	35.1
Current account balance (% of GDP)	_	-3.0	-1.1	-1.2	-1.4	-1.8

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632824

More inclusive growth hinges upon further reforms

Euro area monetary policy remains accommodative and credit to the private sector, including to small and medium size enterprises, is growing. Housing activity and prices are rising, especially in the large cities, amidst low interest rates and increasing incomes. Housing loans accounted for 80% of household borrowing in the first half of the year. The still modest levels of private sector debt and house prices that are well below historical highs pose no immediate risks to financial stability. Still, the authorities should stand ready to strengthen prudential measures if overheating emerges.

The fiscal stance is estimated to be mildly expansionary in 2017, and projected to turn broadly neutral in 2018 and 2019. This is appropriate, despite strong economic growth, to finance important structural fiscal reforms in the budget. The increase of the non-taxable income threshold in the personal income tax system strengthens inclusiveness and work incentives, and structural measures under the "New Social Model" make labour relations more flexible. The reforms also make unemployment and social insurance benefits more generous and active labour market policies broader in scope.

Making growth more inclusive requires additional reforms to improve the employability of workers by reducing skill mismatches, lowering labour taxes on low-income earners and ensuring effective activation programmes and life-long learning strategies. Increasing financial incentives to work through lowering high effective marginal tax rates is essential for poverty reduction. Reforms should also aim to further improve the business environment. Less complex bankruptcy procedures and sufficient business financing are necessary to buttress investment. Improving innovation outcomes requires reducing the fragmentation of institutions and support schemes and strengthening evaluation efforts, including through ex-ante and ex-post evaluations of the impact of innovation programmes.

Economic growth will remain robust

Supportive financial conditions and an increase in EU-funded projects will keep investment solid, while favourable external conditions will benefit exports. A falling unemployment rate and increasing wages will support private consumption, but growth will be curbed by a shrinking labour force. The inflationary impact of higher commodity prices and excise duty increases will fade over the projection period. Buoyant demand along with labour market tightening, however, will continue to push up prices.

Weaker-than-anticipated growth in the euro area and intensified geopolitical risks would hurt exports and investment. A shrinking labour force could limit employment growth more than projected. Moreover, wage increases could lead to a higher-than-foreseen increase in unit labour costs, reducing competitiveness. On the other hand, stronger activity in the euro area would improve Lithuania's growth prospects. The implementation of the new labour code and progress with structural reforms in other areas could result in higher productivity and investment growth.

LUXEMBOURG

Growth is projected to strengthen significantly to 4% by 2019, boosted by dynamic domestic demand and growth in the domestic financial sector, which will foster exports. Wage growth, which is projected to pick up following automatic wage indexation at the beginning of the year, is a factor behind higher inflation. The unemployment rate is declining slowly, but, at around 6%, remains high, at least by Luxembourg standards.

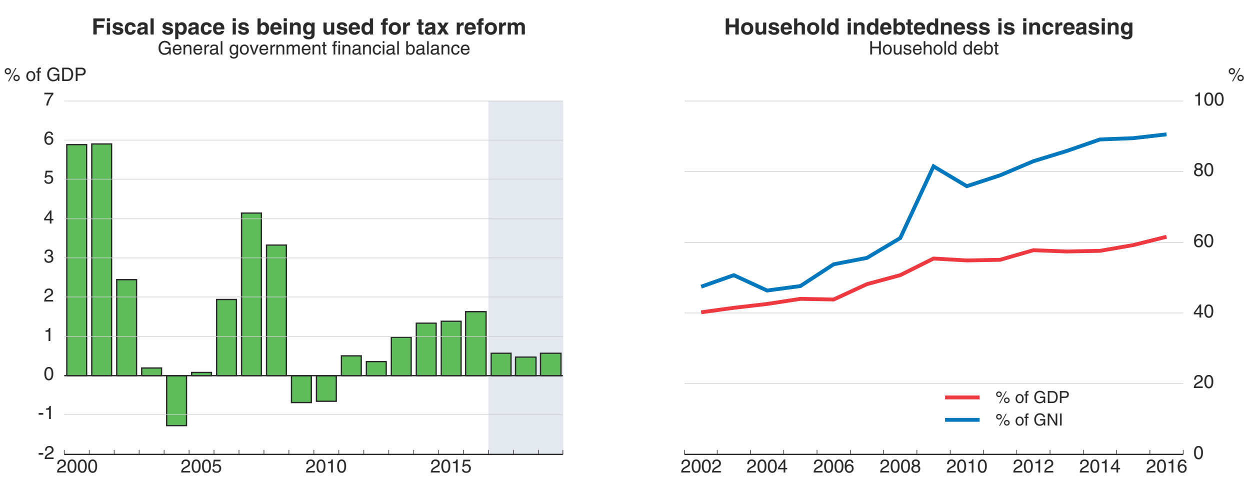
Fiscal space is appropriately being used for tax reform, introducing welcome incentives for labour market participation, such as an optional individual taxation for married or co-habiting workers. Further pension reform would help to ensure long-term fiscal sustainability, and increases in taxes on transport fuels would promote green growth. The strategic focus of the government on digital technology and renewable energy is welcome, but needs to be complemented by policies facilitating the relocation of labour and better aligning the supply of skills with labour market needs.

The high dependence on financial sector developments entails risks, and hence efforts to diversify the economy are welcome. The low level of interest rates, together with the constrained supply of housing, may contribute to strong house price increases. Risks associated with increasing house prices and high household indebtedness should be closely monitored and, if necessary, addressed by additional macro-prudential measures.

Economic growth is driven by domestic demand

Economic growth remains robust on the back of resilient household consumption and strengthening wage growth. The financial sector, particularly investment funds, is benefitting from accommodative monetary policy, and assets under management continue to grow. The unemployment rate is declining slowly, as many newly created jobs continue to be filled by non-residents. The external position remains strong, with financial services trade making up for the deficit in goods and non-financial services. The general

Luxembourg



Source: OECD Economic Outlook 102 database; and Financial balance sheets, OECD National Accounts Statistics.

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Luxembourg: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	50.0	2.9	3.1	3.0	3.8	3.9
Private consumption	15.2	3.3	2.4	1.6	2.7	3.3
Government consumption	8.3	2.6	2.0	2.4	2.9	3.0
Gross fixed capital formation	9.5	-8.0	0.5	7.7	1.6	3.9
Final domestic demand	33.1	-0.2	1.8	3.4	2.4	3.4
Stockbuilding[1]	- 0.1	1.0	-0.1	-1.2	0.1	0.0
Total domestic demand	32.9	1.4	1.6	1.6	2.6	3.4
Exports of goods and services	104.1	6.7	2.2	4.8	4.9	4.6
Imports of goods and services	87.0	7.1	2.1	4.5	4.5	4.6
Net exports[1]	17.1	1.4	0.9	2.3	2.7	1.8
Memorandum items						
GDP deflator	_	1.3	-1.3	2.0	1.9	2.3
Harmonised index of consumer prices	_	0.1	0.0	2.1	2.1	2.2
Harmonised index of core inflation[2]	_	1.7	1.0	1.5	2.1	2.2
Unemployment rate (% of labour force)	_	6.8	6.4	6.0	5.7	5.5
Household saving ratio, net (% of disposable income)	_	16.5	17.5	18.4	18.1	18.2
General government financial balance (% of GDP)	_	1.4	1.6	0.6	0.5	0.6
General government gross debt (% of GDP)	_	29.0	27.7	29.6	31.9	34.1
General government debt, Maastricht definition (% of GDP)	_	22.0	20.8	22.7	25.0	27.2
Current account balance (% of GDP)	_	5.1	4.8	3.7	3.4	3.5

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

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government budget is in surplus, gross public debt is low at 20% of GDP, and net public debt is negative, reflecting assets held by the social security administration.

Structural reforms are needed to improve housing market outcomes

A multi-year tax reform will reduce corporate income tax rates further and introduce additional corporate investment tax credits for zero-emitting cars and software acquisition. In personal taxation, the option of individual taxation for married or co-habiting workers will be introduced, alongside new tax credits for electric and hybrid cars. The reform will encourage business investment and possibly make the tax system more gender neutral, but tax revenues are likely to fall. Nonetheless, after declining significantly in 2017, the general government fiscal surplus is projected to remain stable as a share of GDP in both 2018 and 2019.

The financial sector remains the main driver of economic growth. Although the financial sector appears resilient and well-capitalised, its size and interconnectedness also give rise to vulnerabilities. Strong linkages between subsidiaries of foreign banks and their parents abroad, as well as between banks and investment funds, could lead to maturity and other mismatches and propagate shocks within the financial system. Strong increases in housing prices and rising household indebtedness, to which domestically-oriented banks are most exposed, should be addressed by additional macro-prudential measures, such as limits to loan-to-value or loan-to-income ratios.

House prices have been growing strongly, both in relation to income and the level of rents, and are likely to reflect existing supply bottlenecks. Weak incentives to use the land available for construction should be strengthened by a reform of land planning and complemented by the introduction of time-limited building permits and increased taxation of non-used constructible land. Measures to support affordable housing may eventually increase the limited supply of social housing. Existing fiscal measures that stimulate housing demand, such as the tax deductibility of mortgage interest, should be withdrawn.

Growth is projected to pick up

Growth is projected to rise to about 4% by 2019. Private consumption will benefit from firming wage growth, while private investment will be boosted by the continuing reduction in corporate income tax rates in 2018. Activity will also be supported by continuing accommodative monetary conditions in the euro area and robust financial services exports. A new round of wage indexation, which may take place in the course of 2018, would lift both inflation and disposable incomes.

Strong financial linkages between subsidiaries of foreign banks in Luxembourg and their parents abroad, possibly even outside the EU regulatory and supervisory framework, may transmit external shocks into the domestic economy. On the upside, Luxembourg's established financial centre may become even more attractive in the wake of Brexit, especially if Luxembourg keeps its attractiveness to the associated highly qualified international labour force.

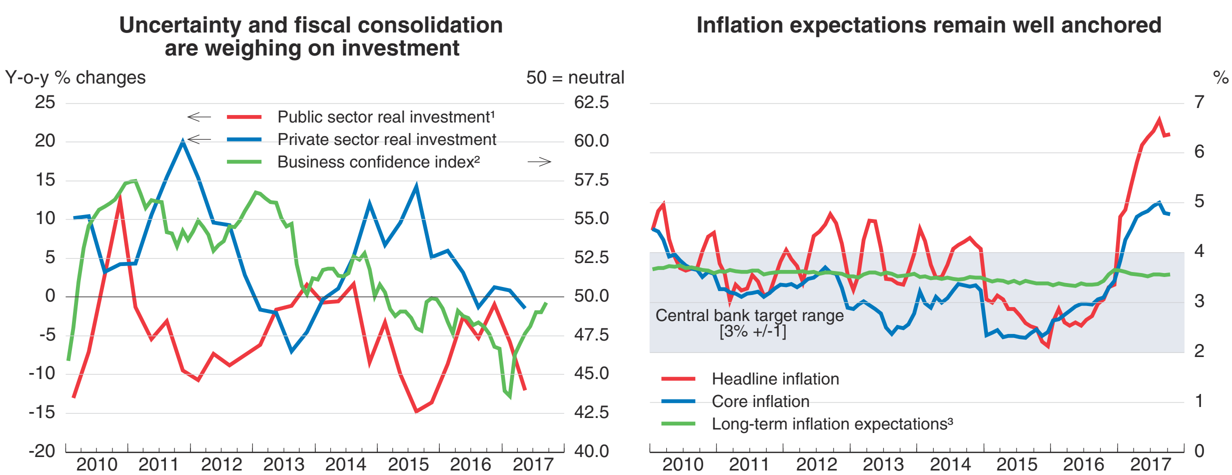
MEXICO

Growth is holding up above 2% despite the uncertain environment, fiscal consolidation and tighter monetary conditions. The economy will rebalance, with a higher contribution of exports and investment to growth while private consumption will decelerate as high inflation dents purchasing power and credit expansion slows, owing to monetary policy tightening. Construction activity will pick up from its historically low levels, reflecting reconstruction after the September earthquakes. Recent structural reforms and successful tenders in the energy sector are expected to boost private investment.

Fiscal consolidation will likely continue, putting a lid on the growth of public debt in relation to GDP and helping to keep financing costs low. The monetary policy rate will remain higher than in previous years as inflation continues to exceed the central bank's target, limiting credit growth. As inflation returns to target, the monetary authorities should ease the policy stance to support investment and growth. While recent reforms have increased job formalisation and improved financial inclusion, poverty remains stagnant and large inequalities persist, including with respect to gender. Simplifying administrative procedures for accessing cash transfers and enhancing the role of social workers in reaching out to marginalised families would contribute to reducing extreme poverty. Better enforcement of the constitutional provision on gender discrimination would reduce existing high inequalities of gender.

Corporate and household debt is low and homeowners hold large financial and non-financial assets. Supervision of financial institutions is adequate but could be strengthened by granting those supervisory agencies which are not autonomous budgetary independence in order to allow them to allocate resources according to supervisory needs and priorities.

Mexico



1. Public investment comprises central government investment, PEMEX and other state-owned enterprises.
2. Monthly Survey of Business Opinion (EMOE - Encuesta Mensual de Opinión Empresarial).
3. Forecast for one- to four-year-ahead inflation.

Source: OECD Economic Outlook 102 database; OECD National Accounts database; INEGI; and Central bank of Mexico.

StatLink http://dx.doi.org/10.1787/888933631931

Mexico: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices MXN billion	Percentage changes, volume (2013 prices)				
GDP at market prices	17 475.1	3.3	2.7	2.4	2.2	2.3
Private consumption	11 514.2	3.3	3.4	2.8	2.0	1.9
Government consumption	2 132.2	1.9	2.4	0.4	0.6	0.4
Gross fixed capital formation	3 669.1	5.1	1.1	-1.1	1.6	2.7
Final domestic demand	17 315.5	3.5	2.8	1.6	1.7	1.9
Stockbuilding[1]	371.1	-0.1	0.1	0.0	0.0	0.0
Total domestic demand	17 686.6	3.4	2.8	1.6	1.7	1.9
Exports of goods and services	5 569.5	8.5	3.5	4.6	3.3	5.0
Imports of goods and services	5 781.0	5.9	2.4	6.1	2.3	3.8
Net exports[1]	- 211.5	0.7	0.3	-0.7	0.3	0.4
Memorandum items						
GDP deflator	_	2.7	5.4	6.6	5.3	4.9
Consumer price index	_	2.7	2.8	6.2	4.0	3.2
Core inflation index[2]	_	2.4	3.0	4.9	3.7	3.2
Unemployment rate[3] (% of labour force)	_	4.3	3.9	3.6	3.8	3.9
Public sector borrowing requirement[4]	_	-4.1	-2.8	-1.4	-2.5	-2.5
Current account balance (% of GDP)	_	-2.5	-2.1	-1.8	-1.9	-1.8

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding volatile items: agricultural, energy and tariffs approved by various levels of government.
3. Based on National Employment Survey.
4. Central government and public enterprises. In 2016 and 2017, the public sector borrowing requirement includes the operating surplus of the central bank.

Source: OECD Economic Outlook 102 database.

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Weak private consumption is a drag on growth

Moderate growth has reflected weak private consumption. Private and public investment, including by PEMEX and other state-owned enterprises, has also been weak, owing to heightened uncertainty and fiscal consolidation. On the other hand, a buoyant service sector is generating employment growth, taking the unemployment rate to a 10-year low. The quality of jobs is also improving, in that job formalisation has risen. Amid an uncertain environment, non-oil exports have been robust. Although some recent structural reforms, such as those in the telecommunication sector, are already contributing to growth, the expected large boost to productivity from a wide-ranging reform package is taking time to materialise, amid uncertainty and implementation lags.

Monetary and fiscal policies are not supporting growth

Inflation has soared to well above the central bank's target as a consequence of the accumulated depreciation of the peso and progressive liberalisation of domestic fuel prices throughout 2017. The central bank raised the monetary policy rate from 3% in late 2015 to 7%, successfully preventing a de-anchoring of inflation expectations. Restrained wage increases and spare capacity are also holding down underlying inflation pressures. As inflation eases towards the target, the central bank will have room to relax its stance to support credit and investment growth.

Public debt increased steadily from 43% of GDP in 2012 to more than 58% in 2016, which prompted rating agencies to change the outlook for Mexico's sovereign credit rating from stable to negative. The government is committed to its multi-year fiscal consolidation plan set in 2013 to stabilise the debt-to-GDP ratio. Fiscal consolidation has been achieved by additional tax revenues due to an increased tax base, but also by reducing public investment, potentially curbing long-term growth. Large windfall transfers are contributing to the good fiscal performance expected in 2017, but are unlikely to materialise in subsequent years, putting additional pressure on spending. There is, however, scope to raise additional tax revenue by curbing tax evasion and diversifying the tax structure as well as to raise the ability of the tax and transfer system to reduce high inequalities. Once the debt ratio is stabilised, the authorities should consider expanding public early childcare and pre-school coverage to improve equality of opportunity, boost female labour market participation and alleviate future skill shortages. Strengthening social expenditure on programmes to eradicate extreme poverty, such as Prospera, should also become a priority. Simplification of administrative procedures for accessing cash transfers and increasing outreach efforts of social workers to marginalised families, especially those in remote areas in the south, are also crucial to tackle extreme poverty.

Moderate growth is set to continue

The economy is projected to grow at a moderate pace. Private consumption is expected to decelerate as high inflation dents purchasing power and credit conditions tighten due to the rise in interest rates. Although the September earthquakes did not affect productive capacity and hence will not impact on production or prices, construction activity will pick up from its low historical level to compensate for damaged residential buildings. Going forward, the materialisation of delayed investments, recent successful tenders in the energy sector and recent reductions in administrative burdens are expected to boost entrepreneurship and raise business investment.

The economy is exposed to external shocks, particularly those related to changes to economic and trade policies in the United States. Nevertheless, adequate policy buffers have played their role in making the economy resilient. Specifically, the flexible exchange rate has served as a shock absorber and the financial system has not been distressed. Going forward, the uncertainty generated by the NAFTA renegotiations could persist and even intensify, further delaying investment and the realisation of the gains brought by recent structural reforms. This turn of events would slow down productivity growth, which is key for stronger long-term growth. Turbulence in international financial markets, arising from, for example, a sharp slowdown in China or policy uncertainty in the United States, may lead to capital flow reversals and tighter financial conditions. On the other hand, successful trade negotiations and a strengthened commitment regarding economic integration would raise confidence and spur investment and productivity growth. Likewise, continuing to build the capacity of sub-national level entities involved in the new anti-corruption system, and boosting training, resources and technology for the judiciary, would improve the business climate and encourage investment.

NETHERLANDS

GDP growth is projected to remain strong and broad-based in 2018 and 2019. Private consumption growth will peak in 2018, reflecting a strong labour market and a looser fiscal stance, before moderating in 2019. Growth in business investment should be vibrant, driven by improved economic sentiment and solid external demand. Wage growth and inflation are projected to rise gradually. The current account surplus is set to ease gradually but remain at a high level.

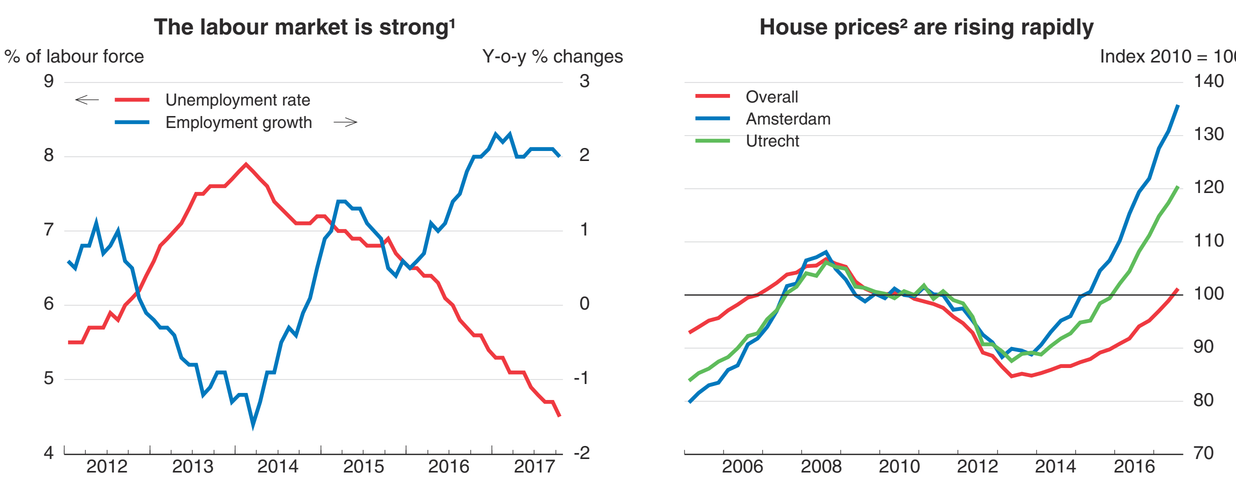
Accommodative euro area monetary policy will continue to support demand. Fiscal measures outlined in the recent government coalition agreement will also be supportive, especially in 2018. To ensure more inclusive growth, labour market reforms should make it easier for workers to attain good quality jobs. Avenues to reduce reliance on non-standard jobs include lowering the cap on severance payments and ensuring that the dismissal system works more efficiently. Improving credit flow to SMEs and increasing public spending on R&D would lead to higher rates of investment and help to reduce one of the largest current account surpluses in the euro area.

House prices have recovered and in major cities have surpassed the level reached before the global financial crisis. High levels of mortgage debt make households vulnerable to decreases in house prices. The reduction in the maximum loan-to-value ratio for new mortgages and the lowering of mortgage interest relief should proceed at a faster pace than planned to reduce fragilities. Easing the strict regulation of the private rental market would improve housing supply and damp excessive house price growth.

Strong domestic and external demand are driving growth

Economic growth continues to be firm. Robust consumption and strong business investment growth reflect high levels of consumer and business confidence. Solid external demand, particularly from other euro area countries, is driving rapid export growth.

Netherlands



1. Data are seasonally adjusted and refer to the population aged between 15 and 75.
2. Price index of existing own homes that are located on Dutch territory and sold to private individuals.

Source: Statistics Netherlands (CBS).

StatLink http://dx.doi.org/10.1787/888933631950

Netherlands: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	663.1	2.3	2.1	3.3	3.1	2.4
Private consumption	296.7	2.0	1.5	2.3	2.5	1.8
Government consumption	172.0	-0.2	1.1	1.1	3.1	2.8
Gross fixed capital formation	119.5	11.0	5.2	6.1	4.0	3.2
Final domestic demand	588.2	3.2	2.2	2.8	3.0	2.4
Stockbuilding[1]	3.0	0.1	-0.4	-0.2	-0.2	0.0
Total domestic demand	591.2	3.3	1.8	2.6	2.8	2.4
Exports of goods and services	547.7	6.5	4.1	5.8	5.0	4.8
Imports of goods and services	475.8	8.4	3.9	5.3	4.9	5.2
Net exports[1]	71.9	-0.7	0.6	1.0	0.6	0.2
Memorandum items						
GDP deflator	_	0.8	0.6	0.8	1.6	2.0
Harmonised index of consumer prices	_	0.2	0.1	1.3	1.7	2.0
Harmonised index of core inflation[2]	_	0.9	0.6	0.8	1.6	2.0
Unemployment rate (% of labour force)	_	6.9	6.0	4.9	4.5	4.2
Household saving ratio, net[3] (% of disposable income)	_	6.5	6.4	6.1	5.3	5.5
General government financial balance (% of GDP)	_	-2.1	0.4	0.6	0.6	0.9
General government gross debt (% of GDP)	_	77.5	75.3	73.1	70.7	68.3
General government debt, Maastricht definition (% of GDP)	_	64.6	61.8	59.6	57.2	54.8
Current account balance (% of GDP)	_	8.7	9.0	9.4	9.3	9.2

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
3. Including savings in life insurance and pension schemes.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632881

Growth in residential investment remains solid, despite softening somewhat recently. Consumer price inflation is below 2%.

Labour market conditions remain strong, with the unemployment rate falling further to new lows. However, the rising share of workers on temporary contracts or who are self-employed could indicate a weakening of work quality. Reducing the cap on severance payments and ensuring the dismissal system works efficiently would help to narrow the gap between workers on permanent contracts and those on temporary ones. Further lowering the cap on unemployment benefits would enhance the job search incentives for high-skilled individuals, making the allocation of labour more efficient.

There is scope for further fiscal measures

Measures announced in the recent coalition agreement will have a positive short-term impact on activity but also on longer-term growth. Increased health-care and social expenditures will ensure an immediate stimulatory impact, while the effect of a gradual lowering of corporate income taxes will have a more lasting impact. Given healthy public finances, the structure of tax and spending measures should continue to be adjusted with a focus on improving long-run growth potential. Further lowering taxes on low-income workers and second-earners with young children would reduce inequalities and support women's participation in paid work. More direct government funding of R&D, to complement existing tax relief for private R&D spending, would bolster the capital stock. The fiscal cost of such measures should be offset by reducing less growth-friendly expenditures or raising less distortionary taxes, such as further reducing the gap between low and high VAT rates in addition to the planned increase in the low rate in 2019.

High levels of household debt, particularly mortgage-related debt, make households particularly vulnerable to a fall in house prices. To address this challenge, the lowering of the maximum loan-to-value ratio for new mortgages should be accelerated and the pace of reduction of the tax relief for mortgage interest payments, which the new government plans to accelerate, should be increased further. In order to improve the supply of housing and slow price growth in overheating markets, strict regulations associated with the private rental market should be eased.

Growth will remain robust

Business investment growth is projected to remain healthy, reflecting low borrowing costs, strong producer confidence and robust domestic demand. Household consumption growth is projected to pick up in 2018 owing to favourable labour market conditions and steady growth in real wages, before easing in 2019 in response to a planned increase in the reduced VAT rate. Inflation is projected to rise above 2% at the end of the projection period as labour and product markets tighten. The fiscal stance is assumed to be expansionary in 2018, and broadly neutral in 2019. The current account surplus will remain large in the absence of significant changes to saving or investment.

The main downside risk is the uncertainty surrounding the negotiations and the eventual exit of the United Kingdom from the European Union. The Netherlands is more exposed than many other European countries due to its strong trade and financial linkages with the United Kingdom. The possibility of a sharp correction in house prices is another important risk to the projections, and could result in a fall in residential investment and weaker consumption growth. A downturn in the housing market could also have sizeable financial stability implications, reflecting domestic banks' exposure to the market. On the upside, reduced levels of uncertainty could lead to stronger-than-expected growth in business investment and household consumption. Stronger global trade growth would further strengthen economic growth over the projection horizon.

NEW ZEALAND

Economic growth should increase to over 3% in 2018-19, reflecting stronger investment and exports. Capacity constraints, high profitability, low financing costs, housing shortages and government demand should support investment, while agricultural exports should recover following adverse weather and temporary price weakness. Inflation is projected to rise to 2.4% by late 2019.

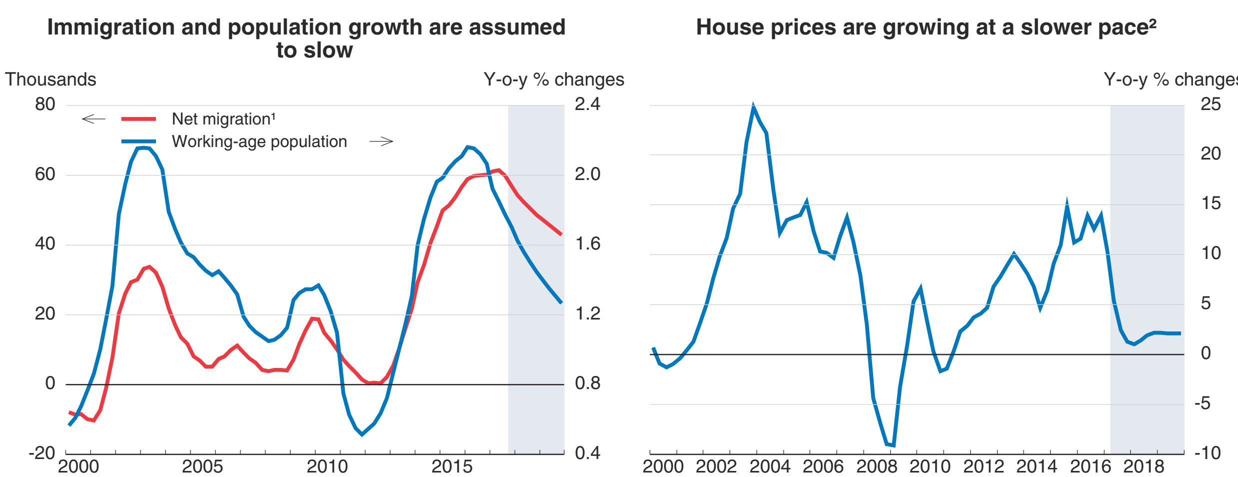
Fiscal policy is to become expansionary in 2018-19, reflecting both measures retained from the May 2017 budget and the new government's plans to increase government consumption, investment and transfer payments. Although monetary tightening is projected to begin in late 2018, policy will remain highly accommodative.

House prices and household debt have soared in recent years to high levels in relation to incomes. Households are highly exposed to interest rate risk. Macro-prudential regulation should be tightened if there is a resurgence of debt-fuelled house price inflation. A maximum debt-to-income ratio should be considered if expected benefits exceed costs.

Economic growth remains robust

Economic growth continues to be buoyed by record net immigration and housing wealth gains, both of which spur consumption, and strong terms of trade and tourism. Profits and capacity utilisation are high and interest rates are low, boosting business investment. Residential investment has been weak of late, but a strong rebound in building permits points to an imminent recovery. Employment gains have outpaced strong labour force increases, lowering the unemployment rate to 4.6%. Despite widespread labour shortages, wage pressures remain subdued except for care workers, who are benefiting from large, regulated increases. The 25% rise in the minimum wage by 2021 is estimated to

New Zealand



1. Cumulative data for the past 12 months for migrants aged 15-74 years old.
2. Reserve Bank of New Zealand projections.

Source: Statistics New Zealand; OECD Economic Outlook 102 database; and Reserve Bank of New Zealand (2017), *Monetary Policy Statement*, November, Figure 5.5.

StatLink http://dx.doi.org/10.1787/888933631969

New Zealand: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices NZD billion	Percentage changes, volume (2009/2010 prices)				
GDP at market prices	239.5	3.2	3.5	2.6	3.2	3.0
Private consumption	138.1	2.9	4.3	4.1	3.3	2.7
Government consumption	44.8	2.6	2.2	3.8	3.4	2.2
Gross fixed capital formation	52.9	2.1	5.5	3.0	4.4	5.2
Final domestic demand	235.8	2.7	4.2	3.8	3.6	3.2
Stockbuilding[1]	1.1	-0.4	-0.1	-0.3	-0.1	0.0
Total domestic demand	237.0	2.2	4.7	3.8	3.5	3.2
Exports of goods and services	67.9	6.9	1.6	2.3	3.0	3.6
Imports of goods and services	65.3	3.7	3.4	5.3	4.4	4.3
Net exports[1]	2.6	1.0	-0.5	-0.7	-0.3	-0.2
Memorandum items						
GDP deflator	_	0.1	1.7	2.4	1.8	2.2
Consumer price index	_	0.3	0.6	1.9	1.9	2.3
Core inflation index[2]	_	1.1	1.3	1.5	2.0	2.3
Unemployment rate (% of labour force)	_	5.4	5.1	4.7	4.4	4.4
Household saving ratio, net (% of disposable income)	_	-2.2	-0.7	-0.3	0.8	1.5
General government financial balance (% of GDP)	_	0.0	0.0	0.5	0.1	-0.2
General government gross debt (% of GDP)	_	40.7	38.4	36.8	36.6	36.8
Current account balance (% of GDP)	_	-3.1	-2.5	-3.0	-3.2	-3.3

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632900

add about 0.4% to annual wage inflation. The Reserve Bank's preferred estimate of annual core inflation remains around 1.5%.

Macroeconomic policies are expansionary

The policy interest rate has been progressively cut to a record low in recent years, stimulating economic activity but also boosting housing demand. Combined with a big increase in net immigration and infrastructure and regulatory barriers to increasing supply, this has contributed to large increases in house prices. Household debt has risen to high levels relative to income. The Reserve Bank has sought to limit financial stability risks by imposing loan-to-value restrictions since 2013, with the latest tightening occurring in late 2016. This has helped to slow house price increases. Should this cooling trend continue, housing wealth gains will diminish, slowing consumption. If not, macro-prudential measures will need to be tightened and possibly strengthened through the addition of a debt-to-income limit. The policy rate is projected to begin to rise in late-2018 to stabilise medium-term inflation at around 2%.

Fiscal policy is projected to become expansionary, reflecting measures announced in the May 2017 budget except the income tax cuts, which are to be cancelled, and the new government's plans. These include increases in government consumption, investment and transfers to low-income households and progressively implementing free tertiary education. The underlying primary budget balance is estimated to fall by 1.2% of GDP over 2017-19, of which 0.2 percentage point reflects the new plans.

Economic growth will strengthen

Stronger investment and exports are projected to increase growth to slightly over 3% in 2018-19. Residential construction should soon rebound from recent weakness but start slowing again in 2019 as the unwinding of Canterbury earthquake reconstruction continues, net immigration eases and the gap between house prices and replacement costs narrows. The unemployment rate is not projected to fall much from the current rate, owing to large increases in the minimum wage. Consumer price inflation is projected to increase to 2.4% by late 2019.

The biggest downside risk to these projections is a sharp housing correction. Most mortgages have interest rates that are floating or will be repriced within two years. Shocks that reduce households' debt-servicing capacity could cause a sharp fall in property prices, depressing consumption and investment and threatening financial stability. A larger-than-assumed fall in immigration could also reduce growth, especially if it accentuated a decline in house prices, as could the planned increases in the minimum wage. There is also a risk of higher inflation should capacity limits prove to be more binding than assumed and imported inflation higher. The main upside risk is that government policies result in a greater deterioration in the budget position than assumed, temporarily increasing growth.

NORWAY

Output growth in the mainland economy is projected to be sustained by the expansion of private consumption and investment, despite the slowdown in the housing market. Employment growth will further reduce the unemployment rate and consumer price inflation will gradually increase as the upturn in economic activity proceeds.

Given improved economic growth, the switch from an expansionary to neutral fiscal stance implied by the adjusted fiscal rule is appropriate. So too is the central bank's signalling of policy rate increases. Structural policy needs to focus on improving the business environment, including further reforms to taxation financed by efficiency drives in public spending.

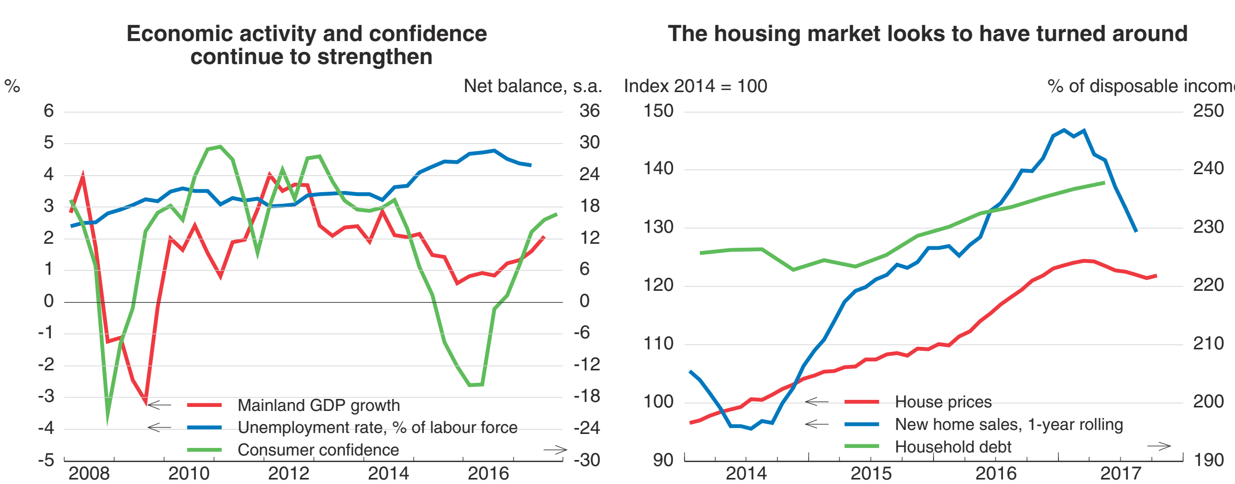
House prices now appear to be adjusting downwards after a prolonged period of growth, and their potential impact on the financial sector and the wider economy is the chief financial vulnerability. Close vigilance needs to continue and the authorities should be prepared to make a wide-ranging response in case of a hard landing in the housing market. This should include, as necessary, delay to monetary policy normalisation and targeted fiscal policy.

The housing market looks to have turned

Mainland output growth (that is, growth abstracting from oil and gas production) has gained some momentum. Support from monetary and fiscal policy and the relatively low value of the Norwegian krone have been boosting aggregate demand. The decline in petroleum-sector investment is slowing. Employment growth has picked up and the unemployment rate is falling. Meanwhile, consumer price inflation has dropped as the impact from currency depreciation has dissipated.

House prices have fallen somewhat and the volume of new home sales has also fallen, particularly in the Oslo area. Past macro-prudential measures to curtail housing credit and

Norway



Source: OECD Economic Outlook 102 database; Thomson Reuters; Real Estate Norway (Eiendom Norge); and Norges Bank.

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Norway: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices NOK billion	Percentage changes, volume (2015 prices)				
GDP at market prices	3 146.7	2.0	1.1	2.1	1.8	1.9
Private consumption	1 288.4	2.6	1.5	2.5	2.6	2.3
Government consumption	692.0	2.4	2.1	1.9	2.0	2.0
Gross fixed capital formation	749.5	-4.0	-0.2	3.9	2.8	2.4
Final domestic demand	2 729.8	0.7	1.2	2.7	2.5	2.3
Stockbuilding[1]	133.7	0.0	1.4	-0.8	-0.4	0.0
Total domestic demand	2 863.5	0.7	2.7	1.7	1.9	2.2
Exports of goods and services	1 220.4	4.7	-1.8	2.2	1.2	1.8
Imports of goods and services	937.2	1.6	2.3	1.1	1.4	2.6
Net exports[1]	283.2	1.3	-1.4	0.4	0.0	-0.2
Memorandum items						
Mainland GDP at market prices[2]	_	1.4	1.0	1.9	2.3	2.1
GDP deflator	_	-2.8	-1.1	3.0	0.5	2.1
Consumer price index	_	2.2	3.5	1.9	1.6	1.9
Core inflation index[3]	_	2.6	3.3	1.7	1.4	2.0
Unemployment rate (% of labour force)	_	4.3	4.7	4.3	4.0	3.7
Household saving ratio, net (% of disposable income)	_	10.3	7.0	6.6	6.2	5.7
General government financial balance (% of GDP)	_	6.1	4.0	5.4	5.8	6.0
General government gross debt (% of GDP)	_	38.9	42.8	42.7	41.8	42.3
Current account balance (% of GDP)	_	8.0	3.9	4.5	4.6	4.6

1. Contributions to changes in real GDP, actual amount in the first column.
2. GDP excluding oil and shipping.
3. Consumer price index excluding food and energy.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632919

adjustment of banks' safety margins via the counter-cyclical capital buffer mechanism have also played a role.

Fiscal and monetary support is set to lessen

Proposals for the 2018 government budget indicate a switch to a neutral fiscal stance, following several years of strong expansion. The switch reflects improved economic growth and the adjustment to the fiscal rule - that the structural deficit over time should be equal 3% (previously 4%) of the value of the oil fund (the Government Pension Fund Global). Norges Bank has maintained the policy rate at 0.5% since early 2016 but has signalled, through its policy rate forecasts, an earlier start to rate rises.

The switch to a more neutral fiscal stance increases the importance of improving Norway's value for money in public spending. For instance, investment in transportation infrastructure is marked by large projects where costs are not always matched by benefits. Improving public spending efficiency will make room for further tax reforms, beyond those already proposed in the budget. The budget proposal has another reduction in the "ordinary" rate of tax (from 24% to 23%) that applies to both household and business incomes, partly offset by cuts in household tax deductions.

Fiscal reform should not aim to significantly reduce the scope of Norway's comprehensive welfare programmes and public services. These are integral to its socio-economic model, playing a key role in making economic growth inclusive and keeping well-being high. Given the fiscal rule, this means that taxation will remain high compared with many countries. Consequently, a pro-growth tax mix, strong labour skills and easier regulations for doing business are needed for the business sector to thrive in global markets.

Higher growth is projected to continue

Mainland output growth is projected to reach 2.3% in 2018 and wind back slightly in 2019 as capacity constraints begin to temper activity. Oil-related investment will become positive and will be accompanied by growing non-oil investment and robust household consumption growth. Employment growth will gather strength, lowering the rate of unemployment further. Consumer price inflation and wages will gradually increase as spare capacity diminishes.

A critical uncertainty is the impact of the turnaround in house prices and sales on the economy through reactions by lenders, indebted households and businesses. As soft landings in housing and credit markets are rare, there are no grounds for complacency. Norway's external risks, as always, include upside and downside risks from the global oil price. As elsewhere, external risks have also been heightened by the increase in political and economic uncertainty.

POLAND

GDP is estimated to have grown by over 4% in 2017 but is projected to slow somewhat in 2018-19. Domestic demand is driving growth, underpinned by rising social transfers, an increasingly tight labour market and an investment recovery led by faster disbursements of EU structural funds. Inflation will gradually increase in line with accelerating wages.

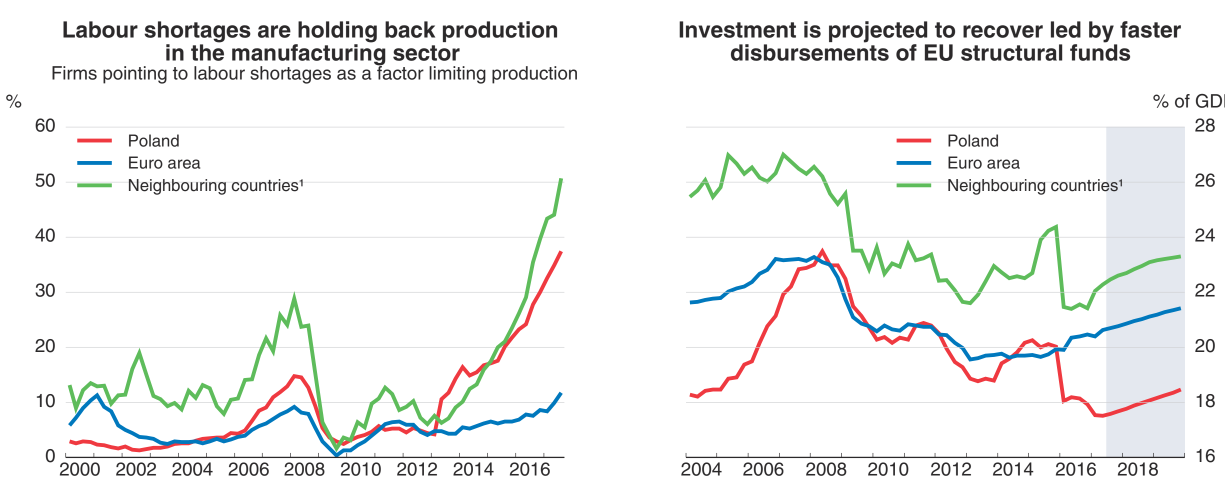
Public spending is increasing, reflecting rising social transfers, the recent decision to lower the retirement age and an increase in investment, suggesting a need for additional revenues. Given the economy's strength and the increased spending, now is a good time for tax reform. Monetary policy is assumed to tighten gradually from early-2018 to mitigate inflationary pressures. To address demographic challenges, policies should aim at increasing labour force participation and making Poland more attractive for workers of both Polish and foreign origin.

Bank profitability has declined, reflecting depressed interest margins as well as tax and regulatory changes. The potential compensation imposed on banks for the holders of foreign-currency-denominated mortgages may further erode their profitability. Ensuring a swift implementation of the Financial Stability Committee's recommendations would help alleviate regulatory uncertainty.

Growth is firming and the labour market tightening

Economic growth accelerated in 2017, driven by the strongest consumption growth since 2008. The labour market is tightening: the unemployment rate has reached a record low and job vacancies a historical high. Labour shortages are emerging, particularly in manufacturing, and the first signs of accelerating wage pressures have emerged. After contracting sharply in 2016, investment has grown modestly in 2017. Consumer price inflation has risen, reflecting increases in food and energy prices as well as buoyant consumption growth.

Poland



1. Unweighted average across Hungary, and the Czech Republic and the Slovak Republic.

Source: OECD Economic Outlook 102 Database; and Eurostat, Business Survey Database.

StatLink http://dx.doi.org/10.1787/888933632007

Poland: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices PLN billion	Percentage changes, volume (2010 prices)				
GDP at market prices	1 719.8	3.8	2.9	4.3	3.5	3.2
Private consumption	1 032.6	3.0	3.9	5.1	4.0	3.3
Government consumption	312.1	2.4	1.7	2.3	3.2	2.8
Gross fixed capital formation	339.4	6.1	-7.9	1.7	5.9	6.0
Final domestic demand	1 684.1	3.5	1.0	3.9	4.2	3.7
Stockbuilding[1]	10.9	-0.2	1.2	1.3	0.0	0.0
Total domestic demand	1 695.0	3.3	2.2	5.2	4.1	3.7
Exports of goods and services	818.4	7.7	8.8	5.7	6.3	5.4
Imports of goods and services	793.6	6.6	7.9	7.3	7.1	6.4
Net exports[1]	24.8	0.6	0.7	-0.6	-0.2	-0.3
Memorandum items						
GDP deflator	_	0.8	0.4	1.5	2.0	2.7
Consumer price index	_	-0.9	-0.7	1.9	2.0	2.7
Core inflation index[2]	_	0.5	-0.2	0.8	1.8	2.7
Unemployment rate (% of labour force)	_	7.5	6.2	4.8	4.3	4.0
Household saving ratio, net (% of disposable income)	_	-0.6	1.2	2.1	1.9	2.3
General government financial balance (% of GDP)	_	-2.6	-2.5	-2.1	-2.3	-2.3
General government debt, Maastricht definition (% of GDP)	_	51.1	54.1	53.9	53.9	53.7
Current account balance (% of GDP)	_	-0.6	-0.3	-0.5	-0.8	-1.0

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632938

Strengthening innovation is needed

Public spending is increasing: 2017 is the first full year of the 500+ programme, a generous child benefit package estimated to cost about 1.5% of GDP. The recent lowering of the minimum retirement age will also boost public spending by about 0.5% of GDP. Both measures will heighten the challenges of an ageing population by making it more difficult to continue raising older workers' and women's employment rates. Public investment is accelerating with faster disbursements of EU funds. The authorities have introduced measures to enhance tax compliance. This seems to have succeeded in limiting the public deficit in 2017, but the fiscal stance will be expansionary in 2018-19. The central bank has kept its policy rate at a record low of 1.5% since March 2015, which is appropriate given that underlying inflation remains below the target. However, inflationary pressures are projected to build steadily, based on the wage acceleration emanating from the ever tighter labour market. The central bank is accordingly projected to initiate a tightening cycle in early-2018.

Poland’s increase in living standards has been remarkable. Still, supporting innovation to boost productivity growth will be essential to maintain rising well-being and social protection. Additional funding should be channelled to universities and research institutions. Strengthening university-science collaboration to help the commercialisation of public research is needed. Developing external financing options to support innovation, such as venture capital investments, would also foster innovation. Policies targeted at attracting skilled migrants would help to address demographic challenges, while boosting innovation and productivity. Additional revenues will be needed – e.g. by broadening tax bases and increasing green taxes – to finance higher social spending and investment in education and research.

Strong domestic demand will drive GDP growth

Consumption is expected to decelerate as the effects of rising social transfers start to fade. By contrast, investment should pick up despite policy uncertainty, as public and private agents gradually learn to draw on EU structural funds and take advantage of ultra-low real interest rates. Inflationary pressures are set to strengthen in line with accelerating wages. However, the large inflow of Ukrainian workers will damp wage increases. Poland will continue to gain export market shares, particularly in business services, thanks to strong quality and cost competitiveness.

A stronger-than-projected outcome in the euro area, Poland's main export market, would boost exports and the current account balance. Inflation could accelerate even more if wages increase faster than projected. A combination of rising labour shortages, lower immigration of Ukrainians and a decrease in labour force participation arising from policy measures could bolster wages with knock-on effects on inflation dynamics.

PORTUGAL

Economic growth is projected to remain above 2% in 2018 and 2019, driven by both domestic demand and exports. Consumption growth will remain solid in response to further declines in the unemployment rate and stronger wage growth. Investment will be supported by a pick-up in major export market growth and increased public investment. Increased exports will be matched by higher imports as a result of the pick-up in domestic demand, leaving the current account balance relatively unchanged.

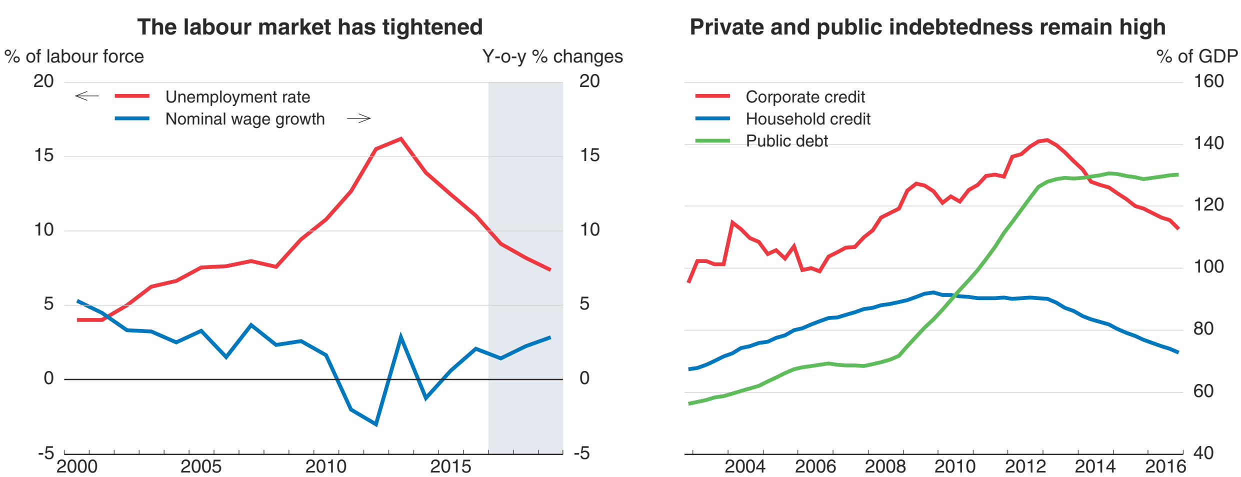
The stance of fiscal policy is projected to be mildly expansionary in 2017 and 2018. Any further fiscal expansion should be avoided given the need to reduce public debt, but there is scope to make fiscal policy more growth-friendly by adjusting the composition of spending and taxes. Productivity-enhancing reforms that ease entry barriers to professional services would reinforce the strength of the recovery.

The private sector, especially corporations, remains heavily indebted despite having deleveraged over the past four years. This adds to the vulnerability of the banking system which continues to suffer from weak profitability and non-performing loans. Policy measures that support the development of distressed debt markets would reduce financial vulnerabilities, support long-term growth and bolster fiscal stability.

The recovery is becoming well entrenched

The economic recovery gained traction through 2017 due to past structural reforms and strength in private demand. Rising private consumption has reflected a notable increase in real disposable incomes and accelerating employment. At the same time, there are signs that the business sector is responding to increased demand and improvements in profitability: private investment has expanded rapidly and indicators of hiring intentions have been rising.

Portugal



Source: OECD Economic Outlook 102 database; and OECD Resilience Indicators database.

StatLink http://dx.doi.org/10.1787/888933632026

Portugal: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2011 prices)				
GDP at market prices	173.1	1.8	1.5	2.6	2.3	2.3
Private consumption	114.1	2.3	2.1	1.8	1.7	2.1
Government consumption	32.2	1.3	0.6	-0.2	-0.6	-0.9
Gross fixed capital formation	26.0	5.8	1.6	9.1	5.3	5.6
Final domestic demand	172.3	2.6	1.7	2.5	1.9	2.2
Stockbuilding[1]	0.5	0.1	-0.1	0.0	0.1	0.0
Total domestic demand	172.8	2.7	1.6	2.5	2.0	2.1
Exports of goods and services	69.4	6.1	4.1	7.6	4.9	4.6
Imports of goods and services	69.0	8.5	4.1	7.1	4.3	4.4
Net exports[1]	0.3	-0.9	0.0	0.3	0.3	0.1
Memorandum items						
GDP deflator	_	2.0	1.4	1.2	1.4	1.4
Harmonised index of consumer prices	_	0.5	0.6	1.5	1.1	1.4
Harmonised index of core inflation[2]	_	0.6	0.9	1.2	1.1	1.4
Unemployment rate (% of labour force)	_	12.4	11.0	9.1	8.2	7.4
Household saving ratio, net (% of disposable income)	_	-3.2	-2.3	-2.1	-1.7	-1.6
General government financial balance[3] (% of GDP)	_	-4.4	-2.0	-1.5	-1.0	-0.3
General government gross debt (% of GDP)	_	150.6	147.7	145.3	142.7	139.5
General government debt, Maastricht definition (% of GDP)	_	128.8	130.1	126.2	123.5	120.2
Current account balance (% of GDP)	_	0.1	0.7	-0.3	-0.3	-0.3

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
3. Based on national accounts definition.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632957

Growth will be held back by further necessary deleveraging

Fiscal policy is expected to be mildly expansionary in 2018 (as in 2017), with public investment picking up. This reflects a rise in the absorption of EU structural funds as well as a cheaper cost of financing, which was reinforced by the decision of a major ratings agency to increase the Portuguese sovereign debt rating to investment grade in September 2017.

While additional public investment should help ensure the recovery is firmly entrenched, further fiscal expansion may risk undermining fiscal sustainability. Public debt remains very high and constrains the ability of the government to respond in the event of future external shocks. Although the stability of the financial sector has improved over the past few years, low-quality assets and weak profitability reduce its capacity to withstand an adverse economic shock.

The majority of firms are optimistic about the economic outlook and private investment funding has become cheaper with the continued reduction of interest rates on loans to non-financial corporations. Nevertheless, corporate spending is being held back by borrowing constraints and slow productivity growth. To promote the latter, reforms that improve business dynamism, including through reducing barriers to entry into professional services should be a focus.

The recovery will continue

Economic growth is projected to be 2.3% in 2018 and 2019. Private investment will be underpinned by a pick-up in export market growth and this will be compounded by stronger growth in public investment in 2018. Continued robust employment growth will cause the labour market to tighten further, fuelling wage growth that will eventually translate into somewhat higher inflation.

A stronger-than-expected recovery in Portugal's trading partners may lead to a larger boost in exports and investment than projected. Nevertheless, a further decline in productivity growth may reduce Portugal's cost competiveness. Given the elevated stock of non-performing loans in the banking system and high public debt, any new negative external shocks to the real economy may be particularly challenging.

RUSSIA

Economic growth is projected to continue its moderate pace. Assumed stable oil prices, better business sentiment and improved credit conditions will support investment and consumption. Unemployment will remain low, but inflation will decline further on the back of sluggish demand and low import prices. However, low productivity, a shrinking workforce, a relatively strong rouble and international sanctions weigh on the outlook. Income inequality and poverty remain high.

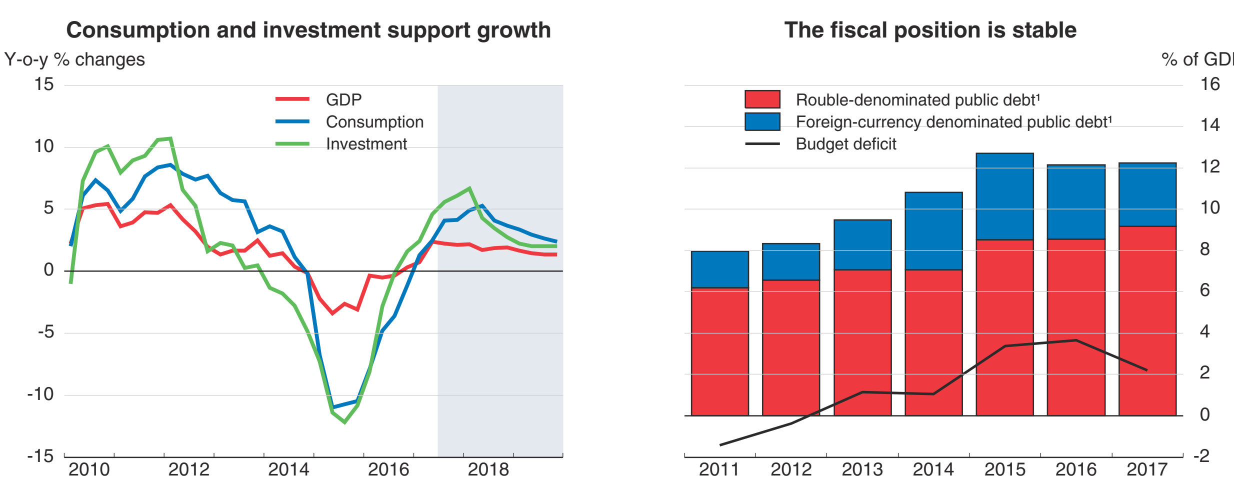
The central bank has space for further easing. The new fiscal rule will reduce budgetary volatility stemming from oil price fluctuations. The announced fiscal tightening is projected to be gradual. This should limit the impact on growth and inequality, but there is scope for more spending, especially to raise growth and well-being. A higher VAT rate and lower labour taxes would reduce informality and improve productivity. Energy sector tax reform would help increase revenue, and fund infrastructure investment.

Household borrowing has picked up in line with the economic recovery, while corporate borrowing is sluggish. Better domestic and external conditions have decreased both rouble and foreign-denominated overdue loans. The high loan-to-income ratio among households with low incomes could pose a vulnerability. The central bank should actively use macro-prudential tools. The central bank's takeover of two major private banks in mid-2017 helped maintain stability, but increased the already large state influence in the banking sector.

Growth continues but some drivers are temporary

The economy has continued to grow slowly. Investment and consumption have picked up on the back of higher oil prices and low inflation. With business confidence improving, firms have started to invest. Households have reduced saving and are consuming more thanks to the economic recovery and improved credit conditions. Both inflation and

Russia



1. The 2017 numbers are projections based on debt-to-GDP ratios for the first half of the year.
Source: Ministry of Finance of the Russian Federation; OECD Economic Outlook 102 database; and OECD calculations.

StatLink http://dx.doi.org/10.1787/888933632045

Russia: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices RUB trillion	Percentage changes, volume (2016 prices)				
GDP at market prices	79.2	-2.8	-0.2	1.9	1.9	1.5
Private consumption	42.3	-9.7	-4.4	3.0	4.5	2.8
Government consumption	14.2	-3.1	-0.5	0.3	-0.2	-1.9
Gross fixed capital formation	16.2	-10.4	-2.5	4.7	4.3	2.1
Final domestic demand	72.7	-8.6	-3.2	0.8	0.0	0.0
Stockbuilding[1]	1.4	-0.8	0.9	0.7	-0.3	0.0
Total domestic demand	74.1	-9.3	-2.2	3.4	2.9	1.6
Exports of goods and services	21.4	3.7	2.4	5.5	3.5	3.3
Imports of goods and services	16.4	-25.8	-3.1	14.6	8.8	4.5
Net exports[1]	5.1	6.3	1.3	-1.6	-0.9	-0.1
Memorandum items						
GDP deflator	_	8.2	3.6	5.6	4.2	3.1
Consumer price index	_	15.5	7.0	3.7	3.8	4.0
Private consumption deflator	_	14.0	6.4	3.3	3.9	4.0
General government financial balance[2] (% of GDP)	_	-1.5	-3.7	-2.2	-1.4	-1.0
Current account balance (% of GDP)	_	5.0	1.9	1.7	1.2	1.0

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consolidated budget.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632976

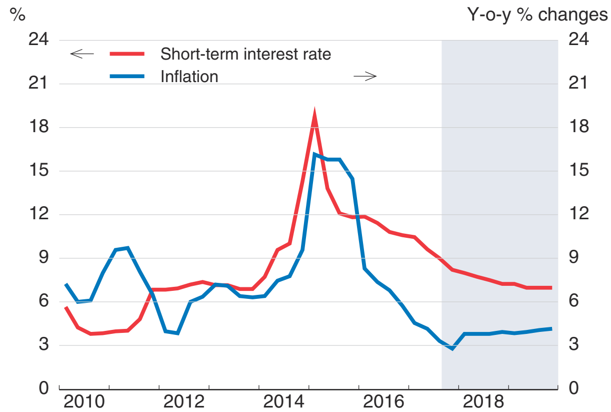
unemployment reached historical lows in the second half of 2017. Increased oil and gas revenues have reduced the budget deficit substantially.

The recovery is partly driven by temporary factors. Investment growth was led by a surge of public infrastructure spending in the first half of 2017. Consumption is driven by rising credit rather than real income growth. Industrial production is stagnating and trade competitiveness has decreased because of the strengthening of the rouble. Despite some wage increases, real household incomes continue to decline slightly. Inequality is high and poverty is declining only slowly especially as pensions and other social benefits remain low. The ongoing budget consolidation limits social spending.

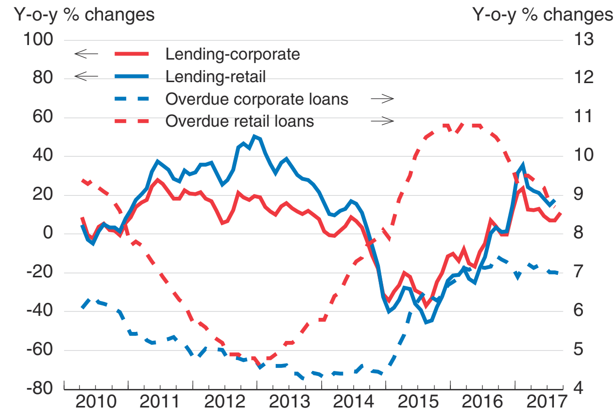
The Russian banking system shows some signs of vulnerability. In mid-2017, the central bank took over two private banks, including the fifth-largest one, in a move to avoid systemic risks. Lower interest and mortgage rates have stimulated the credit market. Credit performance has improved, and the percentage of overdue loans has declined. Household debt is low and largely rouble-denominated, although low-income households are highly indebted. The corporate sector is less exposed to foreign-exchange risks as the share of foreign currency denominated corporate debt has substantially declined since 2015. The central bank should continue using macro-prudential tools to address imbalances in the financial system, while maintaining a level-playing field between public and private banks.

Russia

Low inflation allows for gradual monetary easing



Credit is expanding



Source: Central Bank of the Russian Federation; and OECD Economic Outlook 102 database.

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Fiscal policy is too tight

Inflation has undershot the 4% target, allowing the central bank to cut interest rates further. Low inflation is driven by sluggish demand and low growth in import prices on the back of a strengthening rouble. However, in the context of slack being eliminated, low unemployment and high volatility of food prices, inflationary pressures may reappear. Monetary policy should thus continue to ease gradually but remain vigilant.

A new fiscal rule will underpin fiscal consolidation in 2018 and 2019. The rule is also expected to shield the budget from oil price fluctuations. Oil and gas revenues are budgeted on a USD 40 per barrel benchmark and extra revenues have to be saved in the sovereign wealth fund. The public debt-to-GDP ratio is low and stabilising. Therefore, the budget cuts in 2018 and 2019 may be too contractionary. More gradual fiscal tightening would be appropriate to foster growth and to reduce inequality and poverty.

The labour force will continue to decline, labour productivity will remain low and international sanctions will limit trade, competition and the acquisition of new technologies. To enhance potential growth and productivity, considerable investments in infrastructure and education are needed over time. Fiscal reforms, including higher value-added taxes to finance lower social insurance contributions or an energy tax reform, could also support productivity and investment.

Growth is projected to be moderate

Growth is expected to be around 2% in 2018 and 1.5% in 2019. Investment will continue to recover but at a slower pace. High real interest rates will continue to boost capital inflows. Household consumption will increase, backed by real income growth and improved access to credit. Fiscal consolidation will weigh on GDP growth. The strong rouble bears on competitiveness and the growth of non-oil exports. Higher domestic demand will translate into stronger import growth. Real incomes will increase and poverty will decline; however, the share of vulnerable households will remain high

Risks stem from adverse oil price developments and other external conditions. The "OPEC+" agreement may not be sustainable after March 2018 or may fail to maintain a high oil price. The oil price heavily influences the financial cycle as it affects both the exchange rate and capital inflows. Global monetary tightening could slow down global growth and hurt Russian exports. Finally, the outlook assumes that sanctions remain in place, with an equal probability that they are either strengthened further or lifted.

SLOVAK REPUBLIC

The Slovak economy is maintaining its rapid expansion and growth is projected to exceed 4% in 2018 and 2019. Low interest rates and strong labour market outcomes will fuel consumer spending. Unemployment has already fallen to record lows, and intensifying labour shortages will boost wage growth. Investment should pick up, supported by an improving business climate and new infrastructure investment. Exports will continue to benefit from the expansion in the automotive sector, allowing the current account to reach a modest surplus. Tightening labour and product markets will push consumer price inflation above 2%.

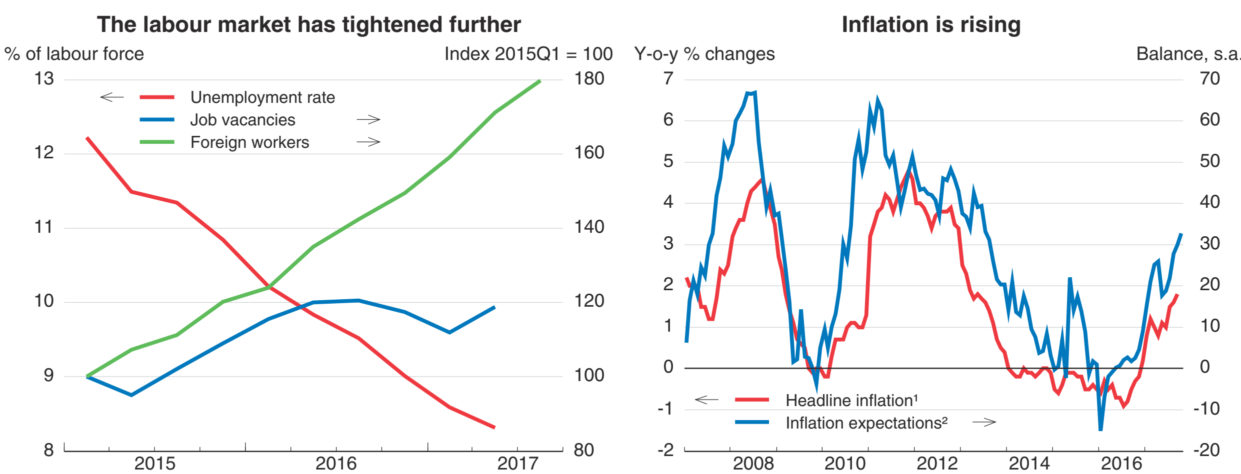
The government intends to reach a balanced budget by 2020, implying modest consolidation in 2018-19. In order to finance inclusiveness-friendly reforms, particularly in education, the government should enhance public-sector efficiency and continue to improve tax collection.

The financial sector remains stable with profitable and well-capitalised banks and relatively few non-performing loans. Household indebtedness is low, but it has been increasing sharply in recent years due to new mortgage lending. In this respect, the central bank took several pre-emptive macro-prudential measures to reduce the risks of a housing bubble and strengthen financial stability. The authorities should stand ready to strengthen these measures if systemic risks increase.

Household consumption is underpinning growth

Economic growth remains strong, driven mainly by robust household spending supported by improving consumer confidence and favourable labour market developments. Wage pressures have been building as unemployment continues to fall, and the number of vacancies has reached historic highs. Persistent labour shortages are

Slovak Republic



1. Headline inflation refers to the harmonised index of consumer prices (HICP).
2. Based on consumer opinion survey of future tendency.

Source: OECD Economic Outlook 102 database; OECD Main Economic Indicators database; Statistical Office of the Slovak Republic; and Centre of Labour, Social Affairs and Family.

StatLink http://dx.doi.org/10.1787/888933632083

Slovak Republic: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	75.9	3.8	3.3	3.3	4.1	4.3
Private consumption	42.3	2.2	2.9	3.4	3.8	4.0
Government consumption	14.4	5.4	1.6	0.3	1.7	1.9
Gross fixed capital formation	15.5	16.9	-9.3	-0.1	5.1	5.5
Final domestic demand	72.3	6.0	-0.3	2.0	3.6	3.9
Stockbuilding[1]	1.0	-1.1	1.2	1.1	0.0	0.0
Total domestic demand	73.2	4.7	1.0	3.2	3.6	3.8
Exports of goods and services	69.7	7.0	4.8	4.6	7.9	8.8
Imports of goods and services	67.0	8.1	2.9	4.6	7.5	8.5
Net exports[1]	2.7	-0.7	1.8	0.2	0.6	0.6
Memorandum items						
GDP deflator	_	-0.2	-0.4	1.0	1.9	2.3
Harmonised index of consumer prices	_	-0.3	-0.5	1.3	1.9	2.2
Harmonised index of core inflation[2]	_	0.5	0.9	1.4	1.8	2.2
Unemployment rate (% of labour force)	_	11.5	9.6	8.3	7.5	6.6
Household saving ratio, net (% of disposable income)	_	3.1	3.4	3.7	3.7	3.6
General government financial balance (% of GDP)	_	-2.7	-2.2	-1.8	-0.9	-0.4
General government gross debt (% of GDP)	_	59.3	59.1	59.0	58.3	56.5
General government debt, Maastricht definition (% of GDP)	_	52.5	51.9	51.9	51.2	49.4
Current account balance (% of GDP)	_	-1.8	-1.5	-1.4	-0.1	0.8

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632995

attracting growing numbers of foreign workers. However, investment activity has decreased due to a fall in public investment. Exports slowed in recent months due to temporary weakness in the automotive sector. Inflation has picked up of late, underpinned by rising demand pressures and higher food prices.

Fiscal policy will remain prudent

The fiscal deficit in 2016 was slightly higher than planned, but the consolidation will continue with an annual structural balance adjustment of 0.5% of GDP in 2017-19. This is an important step towards reducing the risk of being forced to take pro-cyclical fiscal measures in case of any unexpected large negative shocks, and economic buoyancy provides an opportunity to strengthen public finances. In order to finance much needed reform in education and Roma integration, the government should enhance public-sector efficiency and continue to improve tax collection. Monetary policy in the euro area will remain accommodative, boosting investment and consumption through low lending rates.

Financial vulnerabilities have decreased considerably since the financial crisis, and the financial sector is now stable. The banks are well capitalised and profitable, and the share of non-performing loans is comparatively low. However, strong growth and very low interest rates have led to rapid increases in bank lending, particularly for housing. Household indebtedness has risen more sharply than elsewhere, although its level remains relatively low. In response, the National Bank of Slovakia has correctly taken pre-emptive macro-prudential measures. Now, banks must have an additional 0.5% counter-cyclical capital buffer and limit new housing loans with a loan-to-value ratio exceeding 90%. The authorities should stand ready to tighten these measures if risks to the financial system increase.

Economic activity will remain strong

Growth is projected to exceed 4% in 2018-19. Domestic demand will accelerate, while the launch of new production lines in the automotive sector will boost exports. Private consumption is projected to expand further on the back of the buoyant labour market and supportive financial conditions. Unemployment is expected to fall below 7% in 2019. As EU-funded projects take off and the government will start new infrastructure projects, investment growth will rise. Wage pressures will remain strong, fuelling higher inflation, which should exceed 2% in 2019.

Both upside and downside risks to the outlook are related to the external environment, as exports (notably of cars) will depend in large part on developments elsewhere in Europe. Increased political uncertainty in the European Union would have a negative impact on investment and economic activity, while a more robust EU recovery would boost already strong exports. At the same time, activity could be stronger if labour market tightening and high wage growth boost private consumption more than expected.

SLOVENIA

The strong and broad-based economic expansion is projected to moderate in 2018 and 2019, though with growth remaining above potential. Private consumption and housing investment will be supported by continued employment gains and faster real wage growth. Robust investment growth will decelerate as a new cycle of EU structural funds matures. Growth of exports, and imports of intermediary inputs, should ease as external competitiveness deteriorates due to the intensification of labour market tensions.

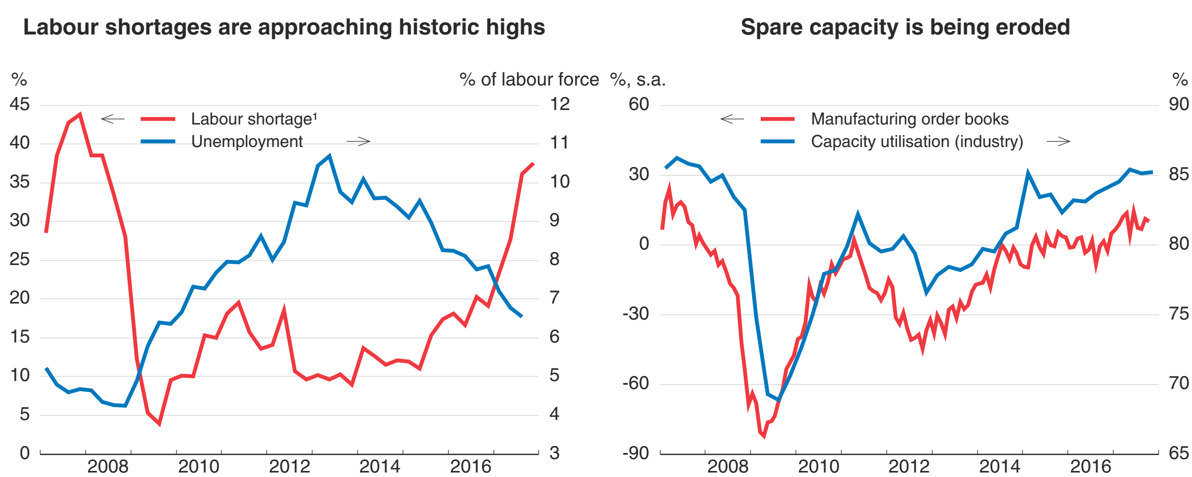
The fiscal stance is broadly neutral, with the budget deficit narrowing for cyclical reasons. Fiscal policy may have to be tightened to contain inflationary pressures. Greater privatisation efforts would reduce the debt-to-GDP ratio in anticipation of future ageing-related spending, while also helping to fund measures to boost inclusiveness, productivity and competitiveness.

Financial vulnerabilities have diminished considerably since the 2013 domestic banking crisis. However, the low interest-rate environment poses risks to banks' future stability by reducing their scope to boost interest margins. In addition, banks' greater reliance on short-term funding to finance long-term fixed-rate loans poses a risk to profitability if interest rates should rise.

Domestic drivers are underpinning growth

Growth has gathered pace as faster expansion in export markets has coincided with gains in market share, resulting from past improvements in competitiveness, and as domestic demand has strengthened. Investment continues to grow strongly, as producers seek to increase capacity and a new cycle of EU structural fund disbursement has begun. In addition, the improved health of Slovenian financial institutions has eased credit conditions and lending rates continue to fall, further supporting investment. Private

Slovenia



1. Percentage of manufacturing firms pointing to labour shortage as a factor limiting production.
Source: Eurostat, industry database; OECD, Main Economic Indicators database; and OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632102

Slovenia: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	37.6	2.3	3.1	4.9	4.3	3.4
Private consumption	20.5	2.1	4.2	3.1	3.7	4.3
Government consumption	7.0	2.7	2.5	1.1	1.0	0.9
Gross fixed capital formation	7.3	-1.6	-3.6	9.1	8.0	6.9
Final domestic demand	34.8	1.5	2.2	3.9	4.0	4.2
Stockbuilding[1]	0.1	0.3	0.7	0.0	0.0	0.0
Total domestic demand	34.8	1.8	2.9	3.8	3.9	4.1
Exports of goods and services	28.5	5.0	6.4	9.7	9.1	6.6
Imports of goods and services	25.7	4.7	6.6	9.3	9.4	7.9
Net exports[1]	2.8	0.6	0.5	1.2	0.6	-0.3
Memorandum items						
GDP deflator	_	1.0	0.9	2.4	2.4	2.3
Harmonised index of consumer prices	_	-0.8	-0.2	1.5	1.6	2.5
Harmonised index of core inflation[2]	_	0.3	0.7	0.8	1.6	2.5
Unemployment rate (% of labour force)	_	9.0	8.0	6.7	5.7	4.9
Household saving ratio, net (% of disposable income)	_	4.7	5.6	6.2	7.1	7.3
General government financial balance (% of GDP)	_	-2.9	-1.9	-0.6	0.1	0.3
General government gross debt (% of GDP)	_	102.5	97.2	95.7	93.8	92.0
General government debt, Maastricht definition (% of GDP	_	82.6	78.5	74.8	70.5	70.0
Current account balance (% of GDP)	_	4.4	5.2	7.2	7.8	6.9

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933633014

consumption has stabilised following a new cycle of spending on durables, while government spending has increased as austerity measures are relaxed.

Sustained employment increases, together with an ageing workforce, have led to the emergence of labour shortages, with unemployment and capacity utilisation reaching levels last seen prior to the global financial crisis. Despite this, wage growth has so far been moderate, with firms increasingly recruiting workers from abroad. Core inflation has been stable at around 1%, but headline inflation has risen to 1.5%.

Policies remain supportive

Fiscal policy is broadly neutral, but the pace of the economic recovery is projected to be sufficient to eliminate the budget deficit by the end of the projection period, although the structural deficit remains above 1.5% of GDP. The supportive euro-area monetary policy stance is projected to remain in place. Thus, macroeconomic policies will not counter emerging labour market bottlenecks.

Additional pension reform could boost labour supply, especially if combined with expanded life-long learning to retain older workers in the labour force, increasing inclusiveness and damping inflationary tensions. In addition, wage pressures could be mitigated by greater privatisation efforts. More generally, enhancing the competition framework through greater resources and staff expertise at the competition authority and simplifying judicial procedures in competition cases could further improve resource allocation. Nonetheless, in the short term, prudent fiscal policy would help to prevent overheating as well as to improve fiscal sustainability.

Growth will moderate and inflation will rise as capacity constraints bite

Economic growth is projected to moderate to a more sustainable rate, as capacity constraints begin to take hold. Household incomes should rise as the lapsing of austerity measures, combined with labour shortages, lead to wage increases in both the public and private sectors. This will result in sustained growth in private consumption and more house building as well. Business investment will be sustained by the need to bolster capacity as demand rises and to boost productivity to preserve competitiveness. Public investment will benefit from the renewed disbursement of EU structural funds. Export growth will begin to show signs of moderating as the benefits of a strengthening euro area economy are offset by cost pressures, slowing gains in export market share. Inflation will rise to around 3% by the end of the projection horizon.

However, if infrastructure investments lead to faster-than-expected productivity growth, sustaining external competitiveness, the gains in export market share could be higher than projected. Alternatively, weaker-than-projected euro area growth could harm FDI inflows, reducing technology transfers and productivity growth. Also, a failure to rein in domestic demand through tighter fiscal policy could cause higher-than-expected wage increases, undermining competitiveness.

SOUTH AFRICA

Economic growth is projected to pick up moderately in 2018-19, as stronger activity in trading partners boosts exports. Investment will support growth in 2019 on the assumption that business confidence increases and policy uncertainty fades. Despite persistently high unemployment, private consumption will expand as wages increase moderately and food prices stabilise.

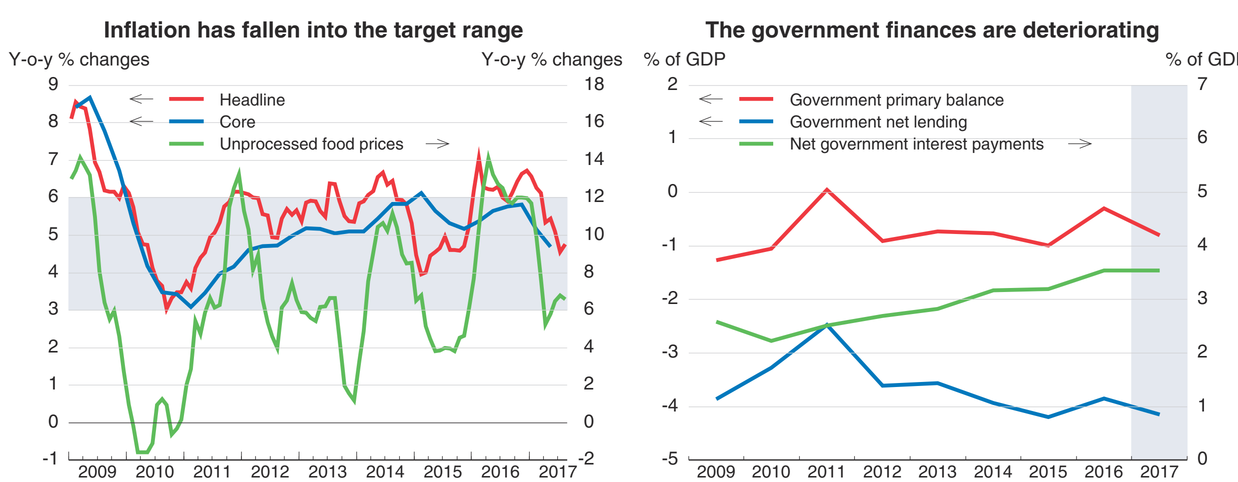
Falling inflation leaves room for a moderately expansionary monetary policy to support activity. Unexpected slippage of the budget deficit is contributing to growth in the short term, but is also creating more pressure to contain rising public debt and is raising the risk of a further credit downgrade. Improving the efficiency of public spending and better controlling the deficits of state-owned enterprises are necessary to raise fiscal credibility and create room for public investment to foster growth and reduce social inequality.

The high dependence on external financing is the main source of financial vulnerability. Low investor confidence and credit rating downgrades in 2017 have contributed to a net outflow of foreign investment. To cushion the transmission of external shocks to the financial system, implementation of the financial sector regulatory reform should be accelerated and foreign-currency-denominated debt issued by private entities further monitored.

Growth is weak as policy uncertainty persists

Economic growth is slowly improving following the drought in recent years, driven by a recovery in agriculture and favourable commodity prices. However, political uncertainty has eroded business and consumer confidence. The deterioration of the fiscal stance will not help to bring back confidence. Unemployment remains high, reflecting skill shortages and weak investment, and weighs on household consumption. Inequalities in opportunities and incomes remain high.

South Africa



Source: Statistics South Africa; and OECD Economic Outlook 102 database.

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South Africa: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices ZAR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	3 797.2	1.3	0.3	0.7	1.0	1.5
Private consumption	2 281.5	1.7	0.8	1.0	1.5	1.8
Government consumption	788.6	0.5	2.0	0.9	1.5	1.0
Gross fixed capital formation	784.4	2.3	-3.9	-0.8	1.0	3.1
Final domestic demand	3 854.5	1.6	0.1	0.6	1.4	1.9
Stockbuilding[1]	9.0	0.2	-0.9	0.5	0.0	0.0
Total domestic demand	3 863.5	1.8	-0.8	1.2	1.4	1.9
Exports of goods and services	1 188.2	3.9	-0.1	3.2	4.3	4.5
Imports of goods and services	1 254.5	5.4	-3.7	4.5	5.4	5.6
Net exports[1]	- 66.3	-0.5	1.1	-0.4	-0.4	-0.4
Memorandum items						
GDP deflator	_	4.9	6.8	5.2	5.0	5.4
Consumer price index	_	4.6	6.3	5.3	4.9	5.4
Core inflation index[2]	_	5.6	5.7	4.7	4.9	5.4
General government financial balance (% of GDP)	_	-4.2	-3.8	-4.8	-4.6	-4.7
Current account balance (% of GDP)	_	-4.4	-3.3	-2.6	-3.6	-3.8

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933633033

Policy reforms are needed to boost growth

The fall of inflation into the target range (3% to 6%) has opened up space to adjust policy rates to provide stimulus for investment. The central bank already reduced its repurchase rate from 7% to 6.75% in July 2017. A further adjustment is projected in 2018 as inflation remains within the target range.

The government budget deficit is overshooting due to significant shortfalls in tax revenue and high spending, particularly in the areas of debt-servicing costs, education and defence. The government will have to prioritise expenditure. Although the widening deficit will support short-term growth by partially sustaining household consumption through social grants, the rising debt makes consolidation imperative to maintain market confidence.

Increasing the efficiency of public investment in infrastructure is much needed to boost productivity. Reforms to ease the cost of doing business, boost entrepreneurship, lift competition barriers in many sectors and facilitate the expansion of firms in the neighbouring region would boost productivity and help create jobs.

Growth is projected to increase

Favourable terms of trade are projected to continue to drive export growth. The introduction of the proposed minimum wage can boost consumption slightly and reduce income inequality. However, investment will remain weak in 2018 as political uncertainty remains high. Inflation is expected to remain in the upper half of the target range, driven by a stabilisation of food prices and a moderate oil price development that counterbalances a potential rise in electricity tariffs.

The main risks to growth are policy uncertainty and external factors. Foreign-owned debt is relatively high compared to other emerging market economies; indeed, the majority of the external debt of state-owned enterprises, banks and corporations is in foreign currency. Further credit rating downgrades could increase the cost of hedging or raise collateral requirements for foreign currency risk. Uncertainty surrounding Brexit may affect exports and financial flows with one of South Africa's largest European trading partners. On the upside, the growth outlook could be better if higher-than-assumed commodity prices or capital inflows would provide further impetus to domestic demand. A stronger-than-expected recovery of business confidence could provide a boost in investment.

SPAIN

Economic growth has been strong and balanced in 2017, and is projected to moderate but remain robust in 2018 and 2019. Domestic demand will ease, as the support provided by low oil prices and lower taxes dissipates. On the other hand, political tensions in Catalonia have increased uncertainty. Competitiveness gains will continue to support exports, even as external demand growth declines slightly. Inflation is projected to fall to 1.3% in 2018, before bouncing back somewhat in 2019.

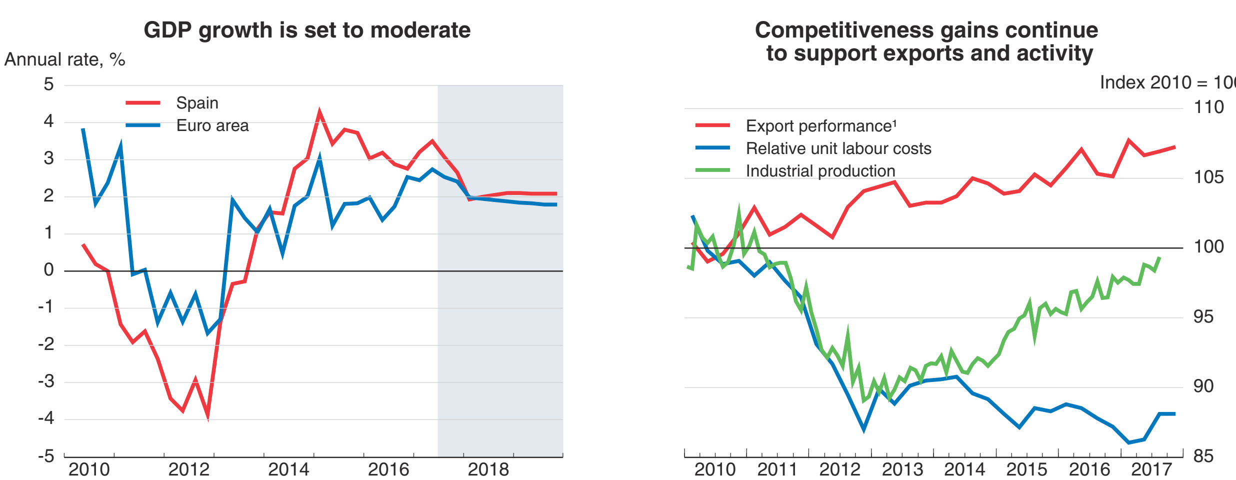
Accommodative euro area monetary policy will continue to support growth, but the fiscal stance will be broadly neutral in the projection period, allowing the public debt ratio to decline slightly. To increase Spain's productivity growth, additional structural reforms to foster investment in innovation and increase the skills of the labour force should be prioritised.

Corporates and households have reduced their combined debt by nearly 55% of GDP since mid-2010. However, deleveraging is not complete, especially for firms in the construction sector and for low-income households. The banking system is stronger, but faces some challenges over the medium term due to low credit demand and profitability. Non-performing loans have declined markedly, but remain relatively high in a few financial institutions. To lower risks of medium-term credit supply constraints, the strengthening of bank balance sheets should be continued.

Growth is robust and broad-based

Economic growth remains robust and is set to reach over 3% in 2017 for the third consecutive year, outpacing most euro area countries. A more balanced growth pattern than in the pre-crisis years is supporting the recovery, with both domestic and external demand contributing to growth. Strong employment gains underpin household incomes and solid consumer spending. Business investment continues to grow, supported by stronger confidence and improved profit margins. Residential investment has increased,

Spain



1. Ratio between export volumes and weighted import volumes in the country's export markets.

Source: OECD Economic Outlook 102 database; and OECD Main Economic Indicators database.

StatLink http://dx.doi.org/10.1787/888933632140

Spain: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	1 037.8	3.4	3.3	3.1	2.3	2.1
Private consumption	608.7	3.0	3.0	2.6	2.0	1.7
Government consumption	202.0	2.1	0.8	1.0	0.8	0.7
Gross fixed capital formation	200.3	6.5	3.3	4.3	3.4	4.0
Final domestic demand	1 011.0	3.5	2.6	2.6	2.1	2.0
Stockbuilding[1]	1.6	0.4	0.0	-0.1	0.0	0.0
Total domestic demand	1 012.6	4.0	2.6	2.6	2.1	2.0
Exports of goods and services	339.5	4.2	4.8	6.0	4.6	4.3
Imports of goods and services	314.3	5.9	2.7	4.6	4.0	4.2
Net exports[1]	25.2	-0.4	0.7	0.6	0.3	0.2
Memorandum items						
GDP deflator	_	0.6	0.3	0.8	1.6	1.7
Harmonised index of consumer prices	_	-0.6	-0.3	2.0	1.3	1.6
Harmonised index of core inflation[2]	_	0.3	0.7	1.4	1.5	1.6
Unemployment rate (% of labour force)	_	22.1	19.6	17.2	15.4	14.0
Household saving ratio, net (% of disposable income)	_	2.8	1.7	1.1	0.9	0.9
General government financial balance (% of GDP)	_	-5.3	-4.5	-3.2	-2.4	-1.5
General government gross debt (% of GDP)	_	116.4	116.6	116.8	116.0	114.4
General government debt, Maastricht definition (% of GDP)	_	99.4	99.0	98.6	97.2	95.7
Current account balance (% of GDP)	_	1.1	1.9	1.6	1.6	1.6

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933633052

reflecting employment gains and favourable financing conditions for both households and non-financial corporations. Structural reforms have contributed to improved competitiveness and supported export growth, together with strong trading partner demand.

Further structural reforms are key for sustainable growth and lower debt

The budget deficit is expected to decline to 3.2% of GDP in 2017 from 4.5% in 2016. The broadly neutral fiscal stance planned for 2018 and 2019 is appropriate, as it balances the need for continued growth and job creation with the sustainability of public debt. To ensure a steady reduction of the high ratio of public debt to GDP, the government should stick to its medium-term fiscal targets, notably in structural terms. Favourable financing conditions have contributed to higher demand for bank credit, but it remains subdued, partly reflecting the continuing deleveraging of the private sector.

The unemployment rate is gradually falling, but remains high, particularly among the youth and long-term unemployed. Reducing the gap in termination costs between permanent and temporary contracts would reduce labour market duality and improve job quality, which has deteriorated during the crisis. Well-designed and targeted active labour market policies and improved access to vocational education and training could help low-skilled workers to improve their labour market prospects, lowering inequalities. Productivity growth would be supported by improving the skills of the labour force.

Growth will continue, but at a slower pace

GDP growth is projected to moderate to slightly above 2% in 2018 and 2019, as the pace of domestic demand growth slows. The expansionary effect of spending by firms and households due to the release of pent-up demand and temporary supporting factors, such as low oil prices and lower taxes, will gradually recede. However, a continuation of job creation and favourable financing conditions will support private consumption and business investment. While the contribution of net exports to growth will gradually decline, the current account will remain in surplus. The unemployment rate is projected to edge down to 13.5% by late 2019, which is well above that of the euro area. Inflation will slowly increase as the output gap closes, but will remain subdued.

Persistent tensions in Catalonia could lower consumer and business confidence significantly, hampering domestic demand more than projected. International trade would suffer from an increase in global protectionism and a stronger-than-assumed impact of Brexit. On the upside, domestic demand could prove more resilient than expected, if the slowdown in the pace of job creation is more moderate. Stronger demand from Europe, Spain's main export destination, could boost growth more than projected.

SWEDEN

Low interest rates, a brightening global outlook and rapidly growing public spending are fuelling a booming economy. Growth is expected to remain solid over the coming years, albeit slowing somewhat as capacity constraints bite. The unemployment rate is levelling off as difficult-to-hire low-skilled workers make up a rising share of jobseekers. A lack of constructible land and pronounced labour shortages in the construction sector will slow residential investment.

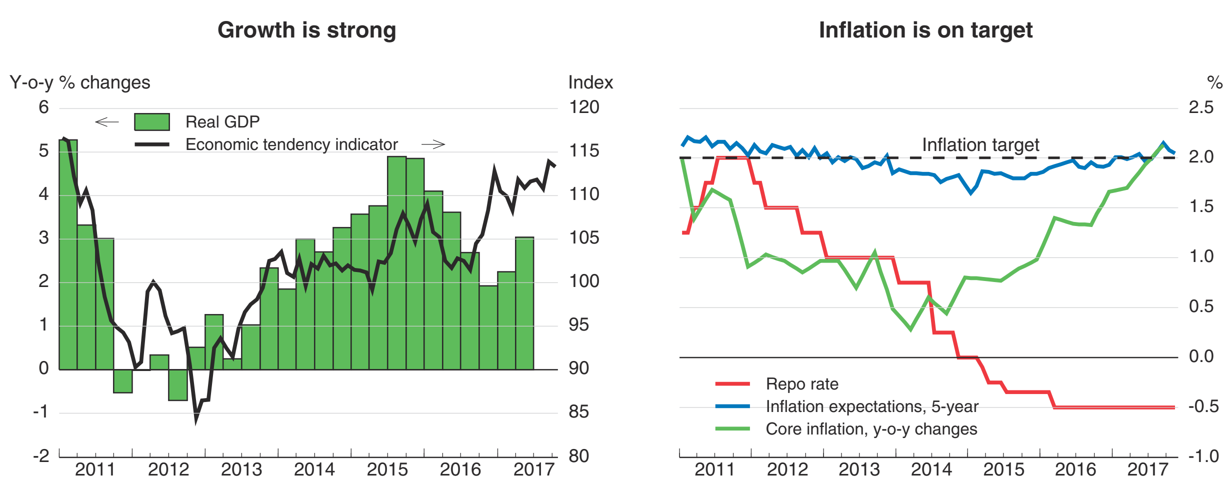
Both fiscal and monetary policies are expansionary during a strong upturn. The ongoing investments in skills, the welfare system and humanitarian migrants' integration, notably women, are necessary and the fiscal position is strong, with a budget surplus and low public debt. Nevertheless, spending increases risk amplifying the business cycle. Expansionary monetary policy has succeeded in bringing inflation close to 2% and expectations are well-anchored. The central bank is projected to begin withdrawing monetary stimulus in 2018, which will help contain the rise in household debt.

Easy financing conditions continue to fuel a credit-driven housing boom, despite a damping effect from macro-prudential policy. Easing planning and rental regulations and reforming housing taxation would help stabilise house prices, increase labour market mobility and improve equality.

Expansionary policies stimulate already strong growth

The economy is growing strongly, with expansionary fiscal policy reinforcing solid demand from continued investment growth, labour force expansion, rising productivity and a brightening international outlook. However, shortages of qualified labour are intensifying, notably in construction. Unemployment is declining only gradually, as the unemployed increasingly consist of harder-to-employ individuals, including recently arrived immigrants. Slow wage growth relative to the strength of the economy and high

Sweden



Source: OECD Economic Outlook 102 database; Sveriges Riksbank; and National Institute of Economic Research.

StatLink http://dx.doi.org/10.1787/888933632159

Sweden: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices KRW trillion	Percentage changes, volume (2016/2017 prices)				
GDP at market prices	3 943.0	4.3	3.1	3.1	2.8	2.3
Private consumption	1 817.6	3.0	2.1	2.5	2.5	2.5
Government consumption	1 030.9	2.1	3.0	1.0	2.5	2.0
Gross fixed capital formation	909.8	6.6	5.3	7.7	3.3	2.7
Final domestic demand	3 758.3	3.6	3.2	3.4	2.7	2.4
Stockbuilding[1]	15.0	0.4	0.0	0.1	0.0	0.0
Total domestic demand	3 773.3	4.1	3.1	3.5	2.7	2.4
Exports of goods and services	1 779.2	5.2	3.0	3.7	4.2	3.9
Imports of goods and services	1 609.4	4.8	3.1	4.5	3.9	4.2
Net exports[1]	169.7	0.4	0.1	-0.1	0.3	0.1
Memorandum items						
GDP deflator	_	2.1	1.6	2.3	2.0	2.0
Consumer price index[2]	_	0.0	1.0	1.9	2.1	2.3
Core inflation index[3]	_	0.9	1.4	2.0	2.1	2.2
Unemployment rate[4] (% of labour force)	_	7.4	6.9	6.6	6.0	5.9
Household saving ratio, net (% of disposable income)	_	15.1	15.8	15.1	15.3	15.0
General government financial balance (% of GDP)	_	0.2	1.1	1.5	1.7	1.9
General government debt, Maastricht definition (% of GDP)	_	44.2	42.3	39.9	37.1	36.4
Current account balance (% of GDP)	_	4.7	4.5	4.7	5.2	5.1

1. Contributions to changes in real GDP, actual amount in the first column.
2. The consumer price index includes mortgage interest costs.
3. Consumer price index with fixed interest rates.
4. Historical data and projections are based on the definition of unemployment which covers 15 to 74 year olds and classifies job-seeking full-time students as unemployed.

Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933633071

saving continue to hold back private consumption. Although inflation is close to 2% and expectations are anchored, monetary policy remains highly expansionary, which continues to fuel investment and asset prices. House prices continue to rise, notwithstanding signs of price stabilisation in the market for flats.

High house prices and high debt create vulnerabilities

The repo rate has remained at -0.5% since February 2016. Together with easy access to credit and rapid income and population growth, this has fuelled demand for housing and associated debt. Residential investment is booming, but housing shortages remain, especially in the larger cities. Land-use planning restrictions have been loosened somewhat, but tight rental regulations and weak competition in construction should be addressed to improve the functioning of the housing market. Macro-prudential measures, including the mortgage amortisation requirement introduced in June 2016, seem to have damped house price growth somewhat, but may need to be tightened or supplemented by a debt-to-income cap if prices continue to rise. Further measures are needed, including easing planning and rental regulations, increasing property taxes and phasing out mortgage interest deductibility, to moderate house price exuberance, improve the allocation of housing and capital, promote mobility and increase redistribution.

Fiscal policy is expansionary, with new discretionary spending measures exceeding structural increases in government revenue. Even though investments are needed in the areas of education, health, defence and environment protection, fiscal policy fuels already solid growth, and is financed by temporarily high tax revenues. However, fiscal sustainability is not threatened, with gross public debt below 40% of GDP and the headline fiscal surplus expected to exceed 1% of GDP in 2018-19.

Growth will soften somewhat as the economy is at full capacity

GDP growth is set to moderate going forward. Residential investment will slow because of shortages of qualified labour and construction land. Consumption will continue to grow less than GDP as a result of slow wage increases set in collective bargaining with an eye on competitiveness, together with continued high saving. The unemployment rate continues to decline, but will level off, as the unemployed are increasingly low-educated or recent immigrants who will need time to acquire the skills demanded by Swedish employers. The Riksbank has officially begun targeting core inflation. Inflation will stay close to target going forward, but monetary policy is projected to remain highly expansionary, with gradual tightening only starting from mid-2018.

With interest rates set to stay low for some time, a failure to rein in household debt would heighten financial risks and households' vulnerability to house price declines and interest rate increases. Sweden is a small, open economy, strongly integrated into global value chains, and hence particularly exposed to currency movements, international trade growth, protectionism and developments in its trading partners. The increasingly tight labour market could increase wage growth and inflationary pressures more than projected going forward.

SWITZERLAND

Economic activity is picking up after a weak 2017 outturn. An improving external environment and competitiveness gains will revive activity, raising export growth and invigorating investment. Domestic demand should provide additional stimulus as unemployment decreases and incomes rise. Inflation is projected to remain low given excess capacity. The large current account surplus will persist.

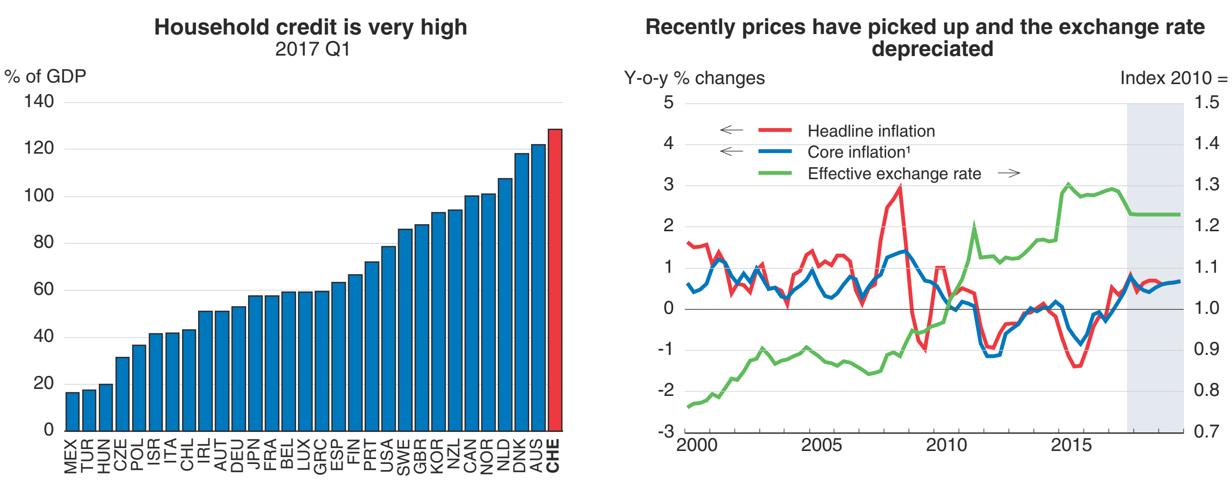
Accommodative monetary policy remains appropriate in the near term. As growth strengthens and deflation risks fade, the central bank will eventually be able to begin interest rate normalisation, probably in 2019. The fiscal stance is broadly neutral. Further efforts should be pursued to remove constraints on women's full participation in the economy, as they overwhelmingly work part-time. In particular, more affordable childcare is needed.

Negative policy rates raise financial-stability risks. The ratio of household debt to GDP is the highest amongst OECD countries, mostly due to the mortgage debt needed to pay for costly housing. A framework should be established for setting mortgage lending limits that incorporates affordability considerations and is enforced. Sizeable net foreign assets imply exposure to interest-rate, credit and exchange-rate risks.

Activity has been weak

GDP growth is unlikely to have exceeded 0.8% in 2017, even though activity in the European Union picked up significantly. Exports and imports were nearly stagnant. Domestic demand has been weak, and household saving rose to 19% of disposable income. However, recent indicators, notably confidence surveys, point to greater momentum. Headline and core inflation have edged up, away from zero. The effective exchange rate depreciated over the summer after a period of relative stability since mid-2015. During that time, upward pressures on the currency were contained by Swiss National Bank (SNB)

Switzerland



1. Excluding fresh and seasonal products, energy and fuels.

Source: OECD, Vulnerability Indicators database; OECD Economic Outlook 102 database; and Swiss National Bank.

StatLink http://dx.doi.org/10.1787/888933632178

Switzerland: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices CHF billion	Percentage changes, volume (2010 prices)				
GDP at market prices	649.8	1.2	1.4	0.8	1.7	1.8
Private consumption	345.1	1.8	1.5	1.3	1.4	1.6
Government consumption	77.8	1.2	1.6	1.4	1.1	1.2
Gross fixed capital formation	155.1	2.3	3.0	2.1	2.4	2.6
Final domestic demand	577.9	1.8	1.9	1.5	1.6	1.8
Stockbuilding[1]	- 4.7	0.5	-1.4	-1.3	-0.3	0.0
Total domestic demand	573.3	2.4	0.2	0.1	1.3	1.9
Exports of goods and services	418.1	2.2	6.5	0.5	5.3	4.0
Imports of goods and services	341.6	4.5	6.0	-0.7	5.5	4.6
Net exports[1]	76.5	-0.9	1.0	0.7	0.5	0.1
Memorandum items						
GDP deflator	_	-0.6	-0.5	0.4	0.7	0.8
Consumer price index	_	-1.1	-0.4	0.6	0.6	0.6
Core inflation index[2]	_	-0.5	-0.3	0.3	0.5	0.6
Unemployment rate (% of labour force)	_	4.8	4.9	4.8	4.5	4.4
Household saving ratio, net (% of disposable income)	_	17.6	18.8	19.1	19.1	18.9
General government financial balance (% of GDP)	_	0.6	0.3	0.3	0.4	0.4
General government gross debt (% of GDP)	_	44.8	44.4	44.1	43.6	43.1
Current account balance (% of GDP)	_	11.2	9.8	10.2	10.7	10.9

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933633090

interventions, resulting in sizeable increases in already ample foreign reserves. The large current account surplus has persisted.

Monetary policy is supporting the economy

With inflation still very low, the SNB should maintain its accommodative stance. But as the economy strengthens, it would be appropriate to start removing extraordinary policy stimulus. Accordingly, this process is not likely to begin until early 2019. The budget balance is projected to show a continued small surplus, but efforts should be pursued to avoid underspending and to better co-ordinate procedures at federal and sub-national levels. To meet long-term challenges, productivity needs to accelerate, including through improving inclusiveness. More efficient public spending could free resources for more affordable childcare to boost full-time employment of women. Lower restrictions on trade in goods and services would improve competition and productivity. Reform of the pension system is also needed to ensure the system’s sustainability.

The financial sector, including banks and pension funds, remains under pressure after nearly three years of negative rates that have weighed on profitability and returns. The housing market still needs vigilance, given high levels of mortgage debt and the recent revival of house price growth. High household saving rates explain the persistence of the current account surplus. One consequence is that net foreign assets of the private sector are enormous and exposed to external risks, as is the SNB's balance sheet.

Growth is projected to pick up

A return to nominal wage increases, the confidence-enhancing decrease in unemployment and the continuation of negative interest rates will boost private consumption and lower the household saving ratio. Investment will also gain some momentum through the projection period. The recent currency depreciation together with stronger growth in the United States and Europe will boost exports. Consumer price inflation will remain low. The current account surplus will increase slightly, driven by rising interest rates on foreign assets, even though imports are expected to gain some traction from buoyant domestic demand.

The Swiss economy depends heavily on growth outcomes in the rest of the world, especially in Europe. There might be positive or negative risks from the euro area. If geopolitical risks were to trigger safe-haven capital inflows, they would push up the exchange rate substantially, weighing on growth and inflation. On the positive side, a return to long-term average household saving rates would boost private consumption and revive growth.

TURKEY

Economic growth is estimated to have exceeded 6% in 2017, driven by strong fiscal stimulus and an export market recovery, and is projected to edge down but to stay between 4½ and 5% in 2018 and 2019. Consumer price inflation remains far above the target and disinflation is projected to be slow.

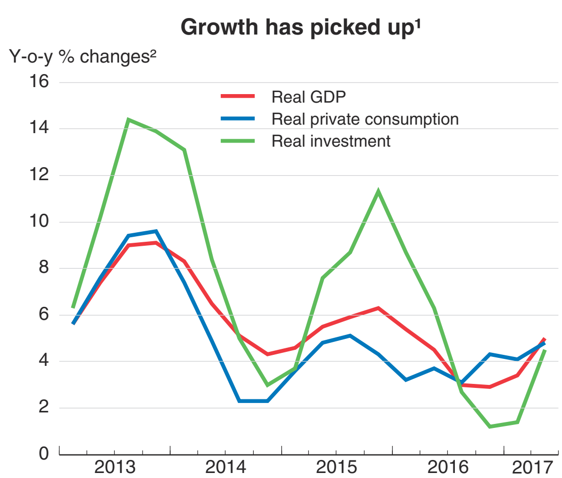
As fiscal stimulus is scheduled to be withdrawn in 2018, against the backdrop of continuing regional and domestic uncertainties, strengthening business and household sentiment will be essential for maintaining growth momentum. Effective progress with the announced structural reforms, fiscal transparency and disinflation goals of the Medium-Term Economic Programme 2018-20 would bolster confidence and boost domestic and foreign private business investment.

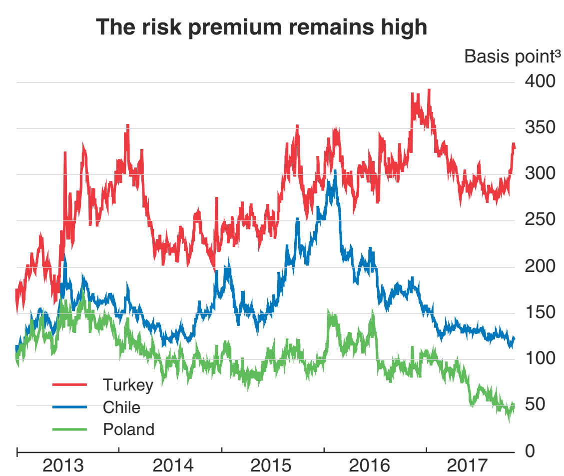
Financial vulnerabilities stay high owing to the magnitude of foreign financing needs stemming from a persistently high current account deficit. Debt leverage in many non-financial firms has also increased considerably, limiting their capacity for additional borrowing and investment. The large government credit guarantee scheme introduced in 2017 alleviated short-term financial strains and is assumed to remain in force in the coming two years. However, to increase resilience, the ecosystem for equity participation by domestic and international investors in firms of all sizes should be upgraded.

The recovery is driven by public investment and exports

Growth has gathered momentum in 2017 on the back of temporary tax measures stimulating consumption and employment, massive government credit guarantees and a strong recovery in export demand. Employment has increased rapidly, but the labour force is expanding faster still, by 3% annually even without including the informal jobs held by refugees. As a result, the unemployment rate is around 11%.

Turkey





1. Public and private business investment are not separately reported in the Turkish national accounts.
2. Three-quarter moving average.
3. EMBI spreads.

Source: OECD Economic Outlook 102 database; and Thomson Reuters.

StatLink http://dx.doi.org/10.1787/888933632197

Turkey: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices TRY billion	Percentage changes, volume (2009 prices)				
GDP at market prices	2 044.5	5.9	3.3	6.1	4.9	4.7
Private consumption	1 242.2	4.7	3.9	5.5	5.7	4.6
Government consumption	288.1	3.9	9.5	0.0	1.9	6.2
Gross fixed capital formation	590.7	9.3	2.2	7.0	7.2	6.4
Final domestic demand	2 121.1	5.9	4.2	5.2	5.6	5.3
Stockbuilding[1]	2.8	-1.5	0.0	-1.2	-0.1	0.0
Total domestic demand	2 123.9	4.5	4.5	4.7	5.7	5.4
Exports of goods and services	485.9	4.3	-1.9	13.9	8.6	6.1
Imports of goods and services	565.3	0.9	3.8	7.2	12.2	8.2
Net exports[1]	- 79.4	0.8	-1.4	1.3	-1.3	-0.9
Memorandum items						
GDP deflator	_	8.1	8.0	7.9	9.4	8.5
Consumer price index	_	7.7	7.8	10.7	9.9	8.9
Core inflation index[2]	_	8.0	8.5	9.6	9.3	8.9
Unemployment rate (% of labour force)	_	10.3	10.9	11.1	11.0	11.3
Current account balance (% of GDP)	_	-3.7	-3.8	-4.0	-4.9	-5.4

1. Contributions to changes in real GDP, actual amount in the first column.
2. Consumer price index excluding food and energy.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933633109

The vigour of infrastructure investment, including via public-private partnerships, contrasts with entrepreneurs' "wait-and-see" attitudes, which are holding back private business investment, notwithstanding a large government credit guarantee scheme introduced in 2017. Many firms start to be constrained by a high level of debt. Exports are fuelled by robust demand from Europe, notably from global value chain partners. The number of tourists has recovered to its pre-2016 levels, but the composition of visitors has changed and average revenues per visitor have declined.

Strengthening the confidence of investors is crucial

The Medium-Term Economic Programme (MTEP) 2018-20 announced in September 2017 sets relatively conservative macroeconomic and public finance objectives. If wholly implemented, it may reduce policy uncertainties in the run-up to the 2019 presidential, parliamentary and municipal elections. This would help reduce the recently heightened volatility of the exchange rate. The envisaged fiscal consolidation may have a slight negative impact on growth in the short term, but insofar as it helps improve confidence, it would reduce risk premia, lessen firms' and households' financing costs, and support consumption and investment. The MTEP's new incentives for high value-added manufacturing activities and foreign direct investment may also help to boost capital spending.

The orientation of economic policy remains subject to uncertainties. On the monetary policy side, headline inflation has been running at double-digit rates, far above the 5% target, and inflation expectations are not anchored. Policy credibility and predictability would improve if the central bank used its benchmark one-week repo rate, rather than liquidity adjustments through exceptional windows at special rates, as its standard instrument of monetary policy. On the fiscal side, some of the planned tax increases have already been challenged and are being revised. The future of government loan guarantees, most of which were granted in 2017 within a short period and which will expire in 2018, has yet to be settled. Any extension should be reserved to investment loans, to support the revival of business investment. In the medium term, a downsizing schedule of this exceptionally large guarantee programme would contribute to fiscal transparency and policy predictability.

Turkey's yearly foreign funding needs approach 25% of GDP, making the economy vulnerable to tensions in international financing conditions. The foreign debt stock is being rolled over smoothly, but at comparatively high cost. Banks and non-financial firms have accumulated high debt levels, notably in foreign currency. More rigorous monitoring of private sector foreign liabilities is in the offing, as are specific prudential rules to contain them. More generally, domestic saving should be increased and greater recourse to equity as opposed to debt financing is warranted. Such balance sheet strengthening requires a better ecosystem for equity participations by domestic and international institutional investors as well as private equity providers.

Uncertainties remain

Provided that expectations stay stable amid uncertain regional geopolitical events, that export performance remains strong, and that economic policy stays the course in the pre-electoral period, GDP growth is projected to edge down but to remain between 4½ and 5% in 2018 and 2019. If regional and domestic uncertainties were to be reduced, including through progress in the updating of the Customs Union agreement with the European Union, a stronger acceleration in domestic and international business investment could lift growth onto a stronger path. If, in contrast, uncertainties grow in these areas, confidence would weaken, international financing conditions may tighten and growth would be slower.

UNITED KINGDOM

Economic growth will continue to weaken in 2018 and 2019. Private consumption is projected to remain subdued as higher inflation, pushed up by the past depreciation of sterling, holds back household purchasing power. The unemployment rate is at a record low, but with slower growth this is unlikely to persist. Exchange rate depreciation should support exports, while import growth is projected to fall owing to weaker private consumption. An agreement about a transition period linked to the EU exit after March 2019 is assumed and should support growth in 2018 and in 2019, reducing the extent to which uncertainty weighs on domestic spending. Prospects of maintaining the closest possible economic relationship between the United Kingdom and the European Union would further support economic growth.

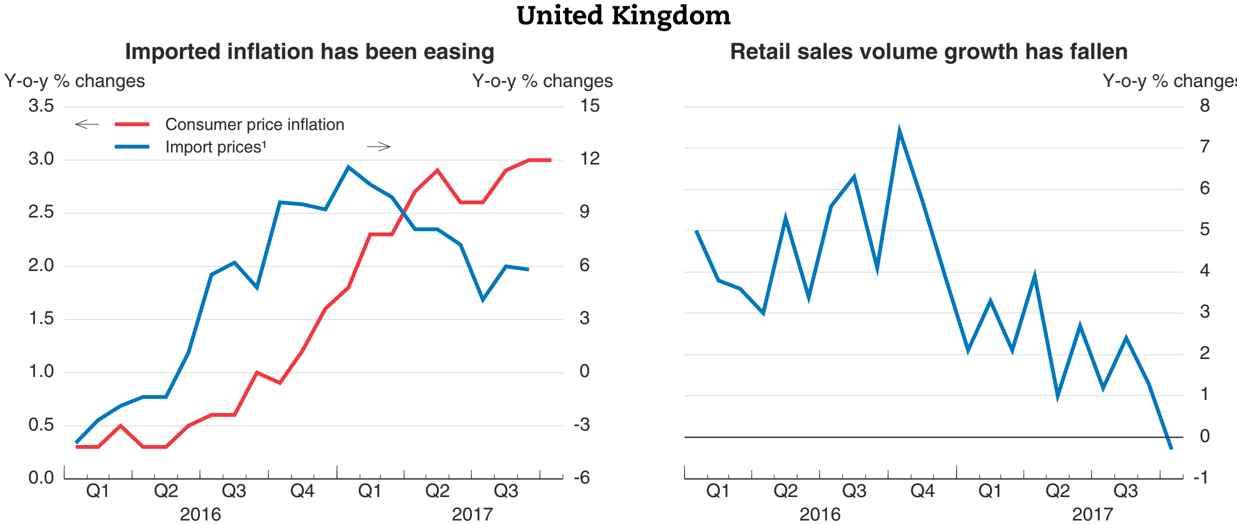
Monetary and fiscal policies need to remain accommodative. Inflation has risen to 3%, but in the absence of wage pressures the central bank should look through the temporary inflationary impact of currency depreciation. Fiscal consolidation of less than 1% of GDP is planned for 2018 and 2019, but the authorities should stand ready to further increase productivity-enhancing measures to support investment if growth weakens significantly ahead of Brexit.

High consumer debt growth, coupled with stagnant household incomes, is a major financial stability risk. Household debt has been rising gradually, reaching 140% of household disposable income. Banks' exposure to consumer loans is rising and write-off rates on such loans have been ten times higher than on mortgages over the past decade and defaults are much more sensitive to economic conditions. Introducing measures to ensure that household balance sheets remain sound, such as maximum debt-to-income ratios depending on borrowers' financial buffers, would bolster financial stability.

Economic growth has weakened

GDP growth has eased to 1.5% in 2017. Private consumption growth is held back by a pick-up in inflation and household confidence has been moderating towards its long-run

United Kingdom



1. Import prices of total trade in goods.
Source: Office for National Statistics.

StatLink http://dx.doi.org/10.1787/888933632216

United Kingdom: **Demand and output**

	2014	2015	2016	2017	2018	2019
	Current prices GBP billion	Percentage changes, volume (2015 prices)				
GDP at market prices	1 837.1	2.3	1.8	1.5	1.2	1.1
Private consumption	1 200.5	2.6	2.8	1.7	1.2	0.8
Government consumption	359.0	0.6	1.1	0.6	0.9	0.8
Gross fixed capital formation	301.0	2.8	1.3	2.3	-0.6	-1.3
Final domestic demand	1 860.5	2.2	2.2	1.6	0.8	0.5
Stockbuilding[1]	13.4	0.2	-0.1	-0.6	0.1	0.0
Total domestic demand	1 873.9	2.5	2.1	1.0	1.0	0.5
Exports of goods and services	518.9	5.0	1.1	4.5	2.5	2.9
Imports of goods and services	555.8	5.1	4.3	2.9	1.4	0.8
Net exports[1]	- 36.8	-0.1	-0.9	0.4	0.3	0.6
Memorandum items						
GDP deflator	_	0.5	2.0	2.1	1.9	2.0
Harmonised index of consumer prices	_	0.1	0.6	2.7	2.6	2.2
Harmonised index of core inflation[2]	_	1.1	1.2	2.3	2.6	2.2
Unemployment rate (% of labour force)	_	5.4	4.9	4.4	4.4	4.6
Household saving ratio, gross (% of disposable income)	_	9.2	7.1	5.1	4.8	4.5
General government financial balance (% of GDP)	_	-4.3	-3.3	-2.3	-2.1	-1.9
General government gross debt (% of GDP)	_	111.7	121.9	121.0	120.3	119.5
General government debt, Maastricht definition (% of GDP)	_	88.2	88.3	86.8	87.2	87.3
Current account balance (% of GDP)	_	-5.2	-5.9	-4.7	-4.4	-3.5

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

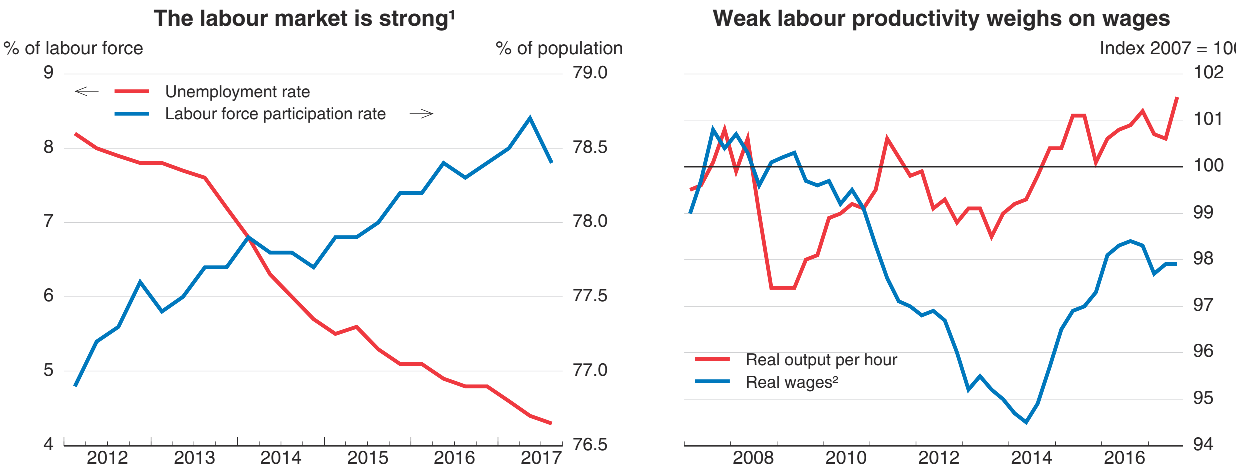
StatLink http://dx.doi.org/10.1787/888933633128

average. Weaker aggregate demand and high uncertainty weigh on capital expenditure growth. The depreciation of sterling has increased input costs and led to pressures on corporate margins and private sector wages.

The trade deficit has been narrowing due to an increase in exports of goods. The current account deficit was around 4.5% of GDP in the second quarter, but it is expected to shrink as domestic demand weakens. As there were net outflows of both direct and portfolio investments, this deficit was financed by other capital flows. Equity divestment by foreign investors was significant, and the total net direct investment position fell by around 1% of GDP, reducing the net asset position to a low level.

Job creation is losing momentum and the unemployment rate has stabilised at 4.3%. The number of vacancies has remained high, but nominal wage growth has been steady at about 2%, consistent with subpar labour productivity growth. Self-employment has continued to rise to 15% of employment and its share could continue to expand. This form of work supports labour market flexibility, entrepreneurship and higher labour market participation of older workers. Its rising incidence could stem from a lower tax wedge relative to employees and exemption from the minimum wage, which continues to increase. The self-employed could contribute to the weakness of total earnings growth if they are less productive, have a lower bargaining power and are paid below the minimum wage. If it is involuntary, self-employment could reduce job quality.

United Kingdom



1. Data for the unemployment rate refer to the population aged 16 and over. Data for the labour force participation rate refer to the population aged between 16 and 64.
2. Real average weekly earnings excluding bonuses.

Source: Office for National Statistics.

StatLink http://dx.doi.org/10.1787/888933632235

The policy mix needs to remain supportive

The budget deficit has fallen to around 2.5% of GDP and further consolidation of less than 1% of GDP is planned over 2018 and 2019. The automatic stabilisers should continue to work fully and the authorities should continue to identify in advance productivity-enhancing fiscal initiatives on investment that could be implemented swiftly, such as spending on repair and maintenance or soft investment, should growth weaken significantly ahead of Brexit. If possible, spending financed from the National Productivity Investment Fund, which has recently been increased, could also be brought forward.

Large monetary stimulus has continued to support the economy but consumer price inflation has picked up to 3%, as sterling's depreciation has raised import prices. The Monetary Policy Committee increased the policy rate by 25 basis points to 0.5% in November 2017, judging that a further erosion of slack and a gradual rise in underlying inflationary pressure warranted some withdrawal of monetary stimulus. However, wage pressures are low and monetary policy should continue to be supportive amidst the ongoing slowdown in the economy induced by Brexit.

Household debt remains high and slightly over 40% of outstanding mortgage loans are at variable interest rates. Moreover, consumer lending growth has been vibrant and the Bank of England's Prudential Regulation Authority has recently found that some aspects of underwriting standards are weakening, notably with falling interest rates (including longer interest-free periods), lower average risk-weights and higher lending into high-risk segments. The policy response has been to bring forward stress tests to assess banks' exposure to consumer credit. Banks' capital buffers are planned by the regulator to be adjusted accordingly, so that each bank has sufficient loss-absorption capacity against consumer loan defaults. Adopting caps on debt-to-income ratios for all types of debt, with further affordability tests to assess household buffers to absorb shocks, would be welcome.

Growth is projected to stabilise at a low rate

Economic activity is set to grow at just above 1% in 2018-19, with the negative impact of uncertainty about the final outcome of Brexit negotiations being partly countered by an assumed agreement on a transition period after March 2019. However, this pace of growth will not be sufficient to prevent a moderate rise in the unemployment rate. Private consumption growth is projected to slow further, as higher inflation holds back real earnings, but households are expected to continue to smooth their consumption by reducing their saving ratio. Business investment is projected to contract amid longer-term uncertainty and reduced domestic demand growth, with exports projected to be the main engine of growth.

The major risk for the economy is the uncertainty surrounding the exit process from the European Union, which could hold back private spending more than projected. However, prospects of maintaining the closest possible economic relationship with the European Union would lead to stronger-than-expected economic growth. Inflationary pressures could be greater than projected if the supply side of the economy weakens more than the demand side, leading the Monetary Policy Committee to further raise interest rates at a gradual pace.

UNITED STATES

The economic expansion is projected to continue in 2018 and 2019. Buoyant asset prices and strong business and consumer confidence will support consumption and investment growth. The impact of slowing employment growth on consumption will be partly offset by wage growth acceleration as the labour market tightens further.

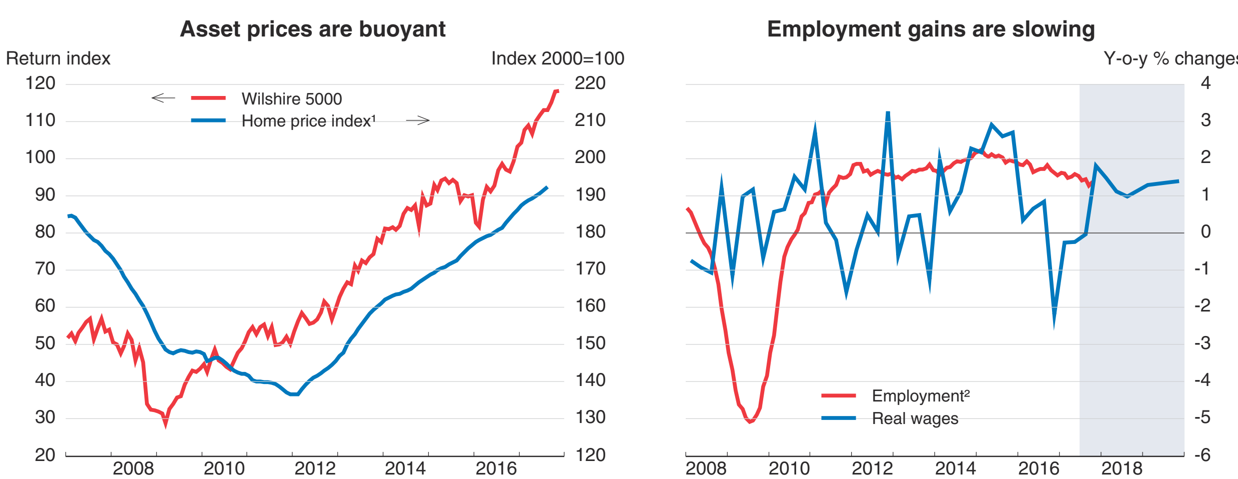
Fiscal policy is projected to become more supportive in 2018 as measures are assumed to be introduced lowering tax rates on corporate and personal income and stimulating investment and consumption. At a time when unemployment is at its lowest level since 2000, the assumed fiscal boost will also contribute to further wage growth, thereby providing the conditions for monetary policy to continue normalising gradually. Policies to help people return to employment would underpin stronger growth of activity while reducing inequalities. Deregulation and tax reform would support stronger investment and help lift productivity.

Financial stability has strengthened since the crisis and regulatory oversight has improved considerably, but vulnerabilities have emerged during the extended period of exceptional monetary easing. In particular, asset prices are elevated and high leverage exposes the corporate sector to shocks. House prices exceed pre-crisis levels in several big cities. Although regulatory oversight imposes a burden on some financial firms, reforms to minimise these burdens need to ensure that vulnerabilities are not allowed to build up further.

The expansion continues

As the drag of past exchange rate appreciation and oil price movements abated, economic growth picked up pace in mid-2017. Reconstruction after recent major hurricanes will boost GDP in the short term, largely offsetting the damage caused by the storms to households and firms in the affected areas. At the national level, private

United States



1. S&P/Case-Shiller national home price index, sa.
2. Employment refers to payroll employed in the non-farm industry.
Source: Thomson Reuters; and OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632254

United States: **Demand and output**

	2014	2015	2016	2017	2018	2019
	Current prices USD billion	Percentage changes, volume (2009 prices)				
GDP at market prices	17 427.6	2.9	1.5	2.2	2.5	2.1
Private consumption	11 863.7	3.6	2.7	2.7	2.4	1.9
Government consumption	2 562.7	1.3	1.0	0.1	2.0	2.4
Gross fixed capital formation	3 432.8	3.5	0.6	3.0	3.8	3.9
Final domestic demand	17 859.1	3.3	2.1	2.4	2.6	2.4
Stockbuilding[1]	78.0	0.2	-0.4	-0.1	0.1	0.0
Total domestic demand	17 937.1	3.5	1.7	2.3	2.7	2.4
Exports of goods and services	2 373.6	0.4	-0.3	3.2	3.4	3.4
Imports of goods and services	2 883.2	5.0	1.3	3.4	4.4	4.9
Net exports[1]	- 509.5	-0.8	-0.2	-0.1	-0.2	-0.3
Memorandum items						
GDP deflator	_	1.1	1.3	1.8	2.1	2.2
Personal consumption expenditures deflator	_	0.3	1.2	1.6	1.9	2.1
Core personal consumption expenditures deflator[2]	_	1.3	1.8	1.5	1.7	2.1
Unemployment rate (% of labour force)	_	5.3	4.9	4.4	3.9	3.7
Household saving ratio, net (% of disposable income)	_	6.1	4.9	3.7	3.8	3.8
General government financial balance (% of GDP)	_	-4.3	-5.0	-4.6	-4.5	-4.5
General government gross debt (% of GDP)	_	105.0	106.9	105.2	106.1	107.2
Current account balance (% of GDP)	_	-2.4	-2.4	-2.4	-2.6	-2.8

1. Contributions to changes in real GDP, actual amount in the first column.
2. Deflator for private consumption excluding food and energy.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933633147

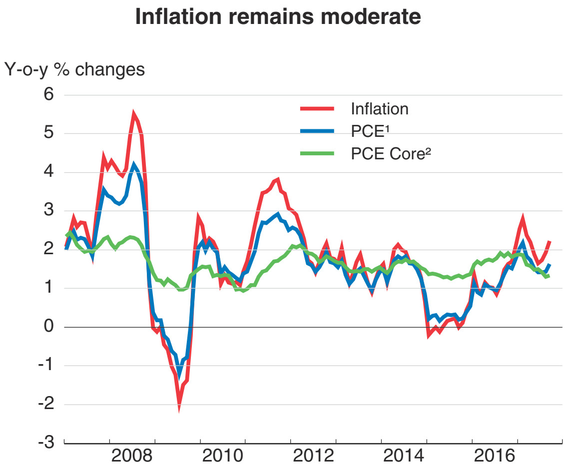
consumption remains robust, supported by wealth gains from buoyant asset prices and stronger income growth. In the business sector, confidence remains strong and measures of activity and expectations appear to have been little affected by the hurricanes. Business investment is rebounding from the lull following the fall in oil prices and past exchange rate appreciation. On the other hand, residential investment remains relatively subdued.

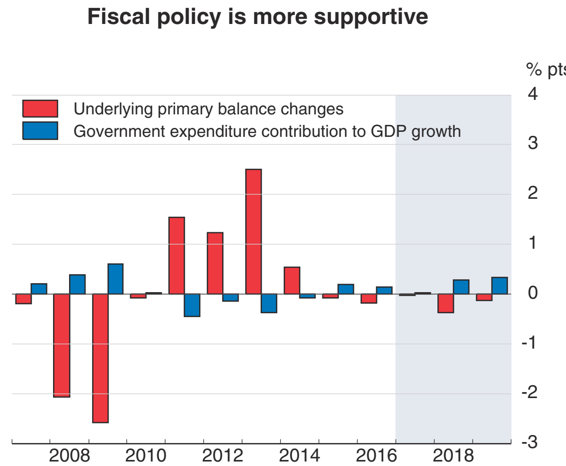
The unemployment rate is now near rates last recorded in 2000, employment continues to grow and participation in the labour force has edged up (especially for women), even though demographic pressures are slowing labour force growth. These trends have helped reduce poverty and raise household income. Several measures of average wage growth remain moderate, in part due to compositional changes as higher-skilled higher-paid baby boomers have begun to retire in larger numbers. As this process continues, labour force growth will slow, gradually reducing the pace of private consumption growth. Measures that assist people on the side-lines of the labour market transition into employment could help mitigate demographic pressures and further boost incomes, particularly of lower-income households.

Macroeconomic policy is rebalancing

The Federal Reserve has raised its policy rates and begun to reduce slowly the size of its balance sheet. The Fed is projected to continue to remove policy accommodation at a

United States





1. Personal Consumption Expenditures price index.
2. Personal Consumption Expenditures price index excluding food and energy.

Source: OECD Economic Outlook 102 database; and Federal Reserve Bank of St. Louis.

StatLink http://dx.doi.org/10.1787/888933632273

gradual pace as the labour market tightens further and stronger wage growth becomes apparent. It faces challenges in managing this process. Inflation continues to run below the longer-term objective of 2% and measures of inflation expectations remain relatively weak. Moving too quickly could further entrench weak inflation expectations, making the attainment of the objective more difficult. On the other hand, sustained low interest rates may exacerbate existing financial distortions. In particular, leverage in the corporate sector has increased and in some vulnerable firms is close to historic highs. Financial stability is protected by the capital buffers held by financial firms and regulation. Hence, efforts to reduce regulatory burdens should be mindful not to re-introduce vulnerabilities.

As the monetary authority's stance gradually becomes less accommodative, the federal government's fiscal stance is becoming mildly expansionary. Tax reform is assumed to be implemented in the second quarter of 2018 with a reduction of tax rates for personal and corporate income. The measures will stimulate business investment and personal consumption during 2018 and 2019. Overall, the underlying general government primary deficit is assumed to increase by 0.5 percentage points of GDP between 2017 and 2019, reflecting the actions of the federal government. State and local government spending is assumed to pick up gradually as the expansion continues, but their overall fiscal stance remains broadly neutral.

Growth is projected to pick up in 2018

GDP growth is projected to increase temporarily in 2018 due to the tax reform. Household spending remains robust although slowing labour force growth will gradually constrain consumption in 2019. Accelerating wage growth, as the labour market tightens further, is projected to support real disposable income. In addition, the fiscal measures introduced in 2018 will underpin higher wages as well. Higher wage growth will create stronger inflationary pressures which will allow monetary policy to continue reducing accommodation. The tax measures will buttress business investment. The widespread improvements in external demand strengthen export growth, even though this is largely offset by higher imports of investment goods.

Risks to the outlook remain sizeable. The size, structure and timing of the fiscal stimulus remain uncertain. A sustained and widespread global upturn could lift activity further through global value chain linkages, underpinning stronger export growth and investment. Stronger business investment may support a stronger-than-projected pick-up in productivity growth and may boost wages further. In these cases, even stronger labour market tightening may stoke wage pressures, ultimately requiring the Federal Reserve to tighten more rapidly. On the other hand, there are also a number of financial market risks. Elevated leverage ratios in the corporate sector need careful monitoring and action to ensure that these risks are contained. Emerging interest rate differentials between the United States and other major currency areas may contribute to an appreciation of the dollar and possibly increased financial market tensions and turbulence due to unpredictable currency flows. Finally, a rise of trade protectionism could disrupt global supply chains and dent growth.

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