If potential output estimates are too cyclical, then OECD estimates have an edge

Category: Economic outlook,Uncategorized
written by oecdecoscope | October 16, 2018
by Yvan Guillemette and Thomas Chalaux, OECD Economics Department

To assess the cyclical position of an economy, macroeconomists use a concept called potential output, which measures the economy's production rate that is consistent with stable inflation at the target. When actual output is below potential, the 'output gap' is negative, the economy is depressed and, without prompt intervention by the central bank, inflation would tend to sag below target. Conversely, a positive output gap indicates an overheating economy and portends price and wage pressures, signalling the need for tighter monetary policy.

A country's output gap is also a crucial ingredient in the estimation of the structural budget balance, which serves to assess the impulse that fiscal policy is imparting on the economy. Since the 2005 reform to the European Union's fiscal framework, the Stability and Growth Pact, the structural budget balance has been at the centre of assessments by the European Commission of member countries' adherence to the Union's fiscal rules.

The difficulty is that potential output, and measures derived from it, such as the output gap and the structural budget balance, are not directly observable but must be estimated. The objective is for potential output to capture structural changes in the economy, such as a declining working-age population associated with ageing, while letting cyclical

fluctuations, which are expected to be temporary, flow through to the output gap measure. Potential output estimation is therefore largely a matter of separating out cyclical fluctuations from structural changes. Three international organisations routinely produce such estimates for their member countries: the European Commission (EC), the International Monetary Fund (IMF) and the OECD. Despite using broadly similar methods, differences arise from a number of methodological and judgemental choices.

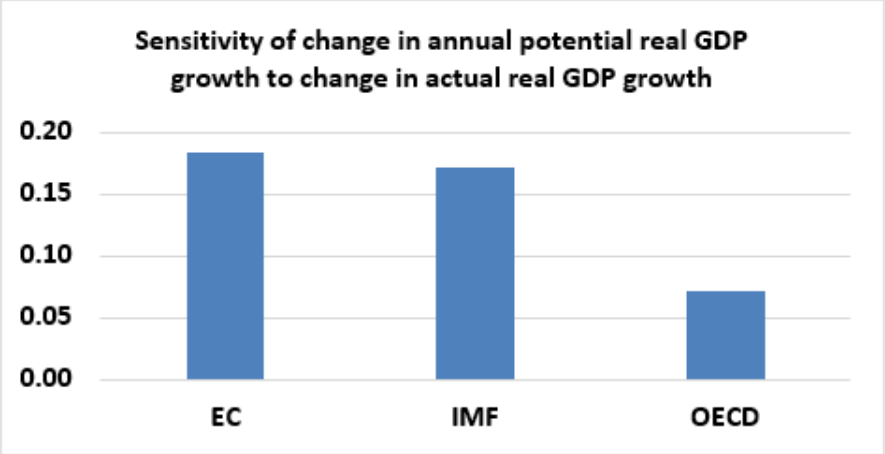
It is difficult to assess the quality of potential output estimates because there are no 'true' observed values to compare them to. Nevertheless, one criticism increasingly levelled against such estimates is that they treat too much of regular economic fluctuations as being structural. Estimated potential growth tends to be too weak when the economy is weak and vice-versa. In other words, potential output estimates are excessively 'pro-cyclical'. One consequence is that governments will tend to have a pessimistic view of the structural budget balance in bad times and, conversely, an optimistic view in good times. Too much procyclicality in potential output therefore encourages procyclicality in fiscal policy, whereas economists generally agree that fiscal policy should be countercyclical.

For instance, the economists Antonio Fatás and Lawrence Summers have argued that the financial and economic crisis of 2008 created an overly pessimistic view of potential output among policy makers, which led them to support contractionary fiscal policy (i.e. cuts in spending or increase in taxes). Fiscal austerity affected economies negatively by subtracting a vital source of demand and, via hysteresis effects, caused a reduction in potential output that not only validated the original pessimistic assessment, but also led to a second round of fiscal consolidation. As Fatás says, this succession of contractionary fiscal policies was likely self-defeating for many European countries in the sense that their public

debt-to-GDP ratios are barely better today than when austerity measures started.

A simple measure of the cyclicality of potential output series can be obtained by regressing the annual *change* in estimated potential growth on a constant and the annual *change* in actual growth. The estimated coefficient on actual growth then measures the sensitivity of potential growth to actual growth. Intuitively, this measure should be positive but small.

The chart below reports the result of this exercise for potential output estimates published by the three aforementioned institutions as part of their spring 2018 forecasting rounds, using a common panel of 24 countries over the 1980-to-2017 period. Each regression uses 682 observations, so an average of 28 years per country.



Note: The bars show the estimated coefficient $\hat{\beta}$ from the panel regression $\Delta p_{i,t} = \alpha + \beta \Delta g_{i,t}$, where $p_{i,t}$ is potential real GDP growth in country i and year t and $g_{i,t}$ is actual real GDP growth. Each regression uses 682 observations on the same 24 countries and available years spanning (at most) the period 1980 to 2017.

The results show clearly that the spring 2018 European Commission potential output series were the most cyclical. On average in the Commission estimates, a one-percentage point change in actual real GDP growth is associated with a 0.18 percentage point change in potential growth. The coefficient on the IMF estimates is only slightly smaller. On the other hand, the OECD coefficient is less than half of the two others. One reason the OECD potential output measure may be

less cyclical is that before smoothing them with a filter, the component series used to construct potential output are first cyclically adjusted by making use of other variables – such as survey measures of capacity utilisation or the investment rate – which are known to be correlated with the cycle (see Turner et al., 2016).

The above exercise does not use 'real-time' estimates of potential output so, for instance, the 2010 potential growth estimate for France is different now than it was back in 2010. The 2010 estimate was of course the relevant one for the conduct of policy at the time. Rather, the test assesses the amount of cyclicality inherent in current methodologies, which may also have evolved since 2010. And if current estimates for past years are considered too sensitive to actual growth, then it is likely that the real-time estimates being produced now with a given methodology are too sensitive as well.

The sensitivity of changes to potential growth to changes in actual growth rates is neither a perfect nor a comprehensive measure of the quality and reliability of potential output estimates. After all, simply using a fixed number for a country's potential growth would show a zero correlation but would obviously be problematic. However, in the absence of other obvious flaws, the OECD potential output estimates appear less exposed to the procyclicality criticism than those of the EC or IMF.

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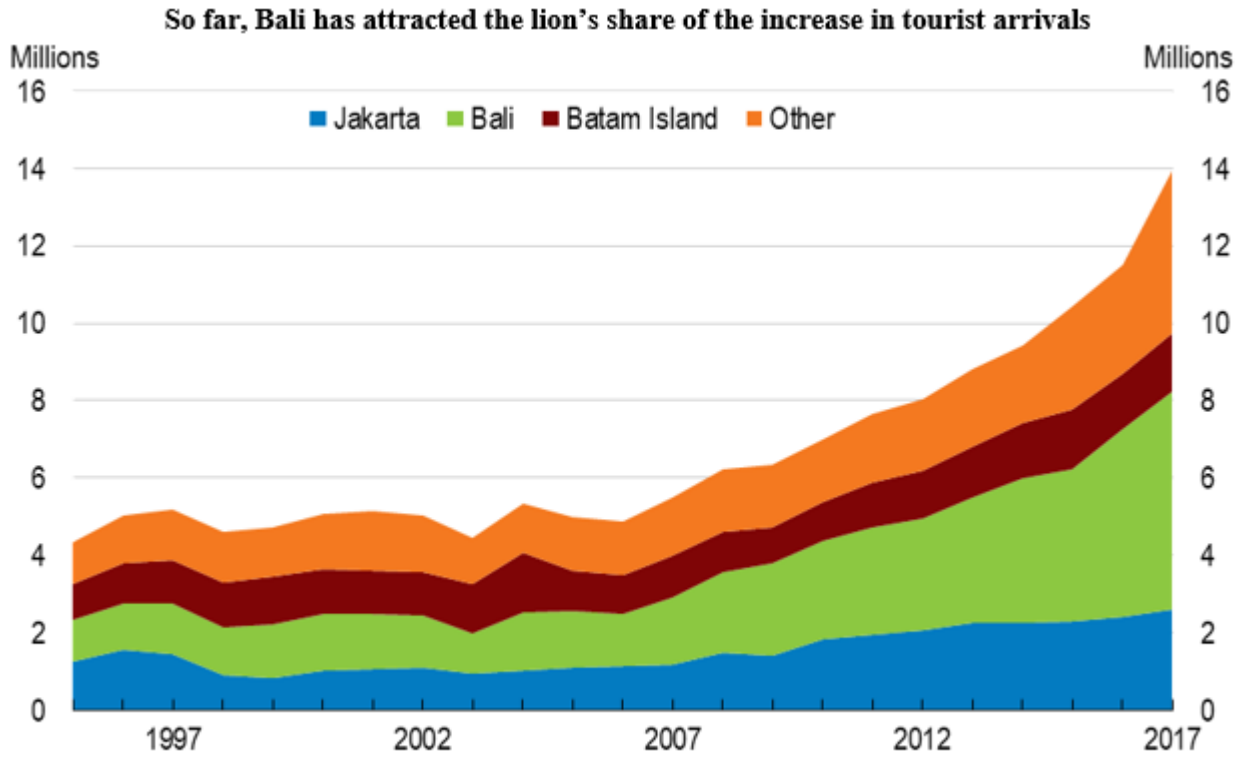
How best to keep up rapid tourism growth in Indonesia

Category: Indonesia,Uncategorized
written by oecdecoscope | October 16, 2018
by Patrice Ollivaud, Economist, Indonesia Desk, OECD Economics Department

Bali, where the 2018 OECD Economic Survey of Indonesia is being released, is emblematic of Indonesia’s success in creating a popular tourism brand. The number of foreign tourists arriving in Bali soared from 2.5 million in 2010 to 5.7 million in 2017. In 2014, the authorities committed to replicate this success in “10 new Balis” with the aim of doubling tourist numbers to 20 million by 2019. To reach that target, the government accelerated transport infrastructure development and stepped up its promotion efforts. In 2017, tourist arrivals reached 14 million and other destinations are becoming popular, such as Borobudur.



Source: CEIC.

However, success in numbers also poses challenges. Environmental infrastructure such as water and waste treatment remains insufficient in most of Indonesia. Growing numbers of foreign tourists are widening the infrastructure gap because their consumption is higher than that of a typical Indonesian. To wit, the increased use of plastic bottles, since tap water is typically not potable. Improperly disposed waste from land largely contributes to Indonesia's position as the second-largest contributor to plastic marine pollution in the world. Indonesia has also the most plastic-ridden coral reefs in the Asia-Pacific (Lamb et al., 2018). In Bali, the ocean carries waste onto beaches that need to be regularly cleaned.

Addressing infrastructure gaps would allow more sustainable development of tourism, and development of tourism to be sustained. Better planning, especially at the destination level, can help accommodate tourist inflows (OECD, 2018). Focusing more on attracting high-spending visitors could also limit the burden without reducing the economic benefits. The involvement of local government and stakeholders is crucial so

that plans address local needs and have the population’s acceptance.

Preserving the environment and developing tourism can be mutually reinforcing. Visitors are attracted by the richness of Indonesia’s environmental assets. Preservation of those assets is essential for sustaining Indonesia’s brand and attracting tourists. For example, forests need protection as deforestation is destroying more than just trees and wildlife but also the economic returns from properly using them for tourism. Protecting more areas would contribute to preserving those assets (OECD, 2018). More of those areas could also be opened to the tourism industry, when it is environmentally viable. Imposing fees will help control the number of visitors and contribute to the cost of maintenance.

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Making the most of Riga metropolitan area can boost wellbeing and economic growth in Latvia

Category: Latvia,Uncategorized
written by oecdecoscope | October 16, 2018

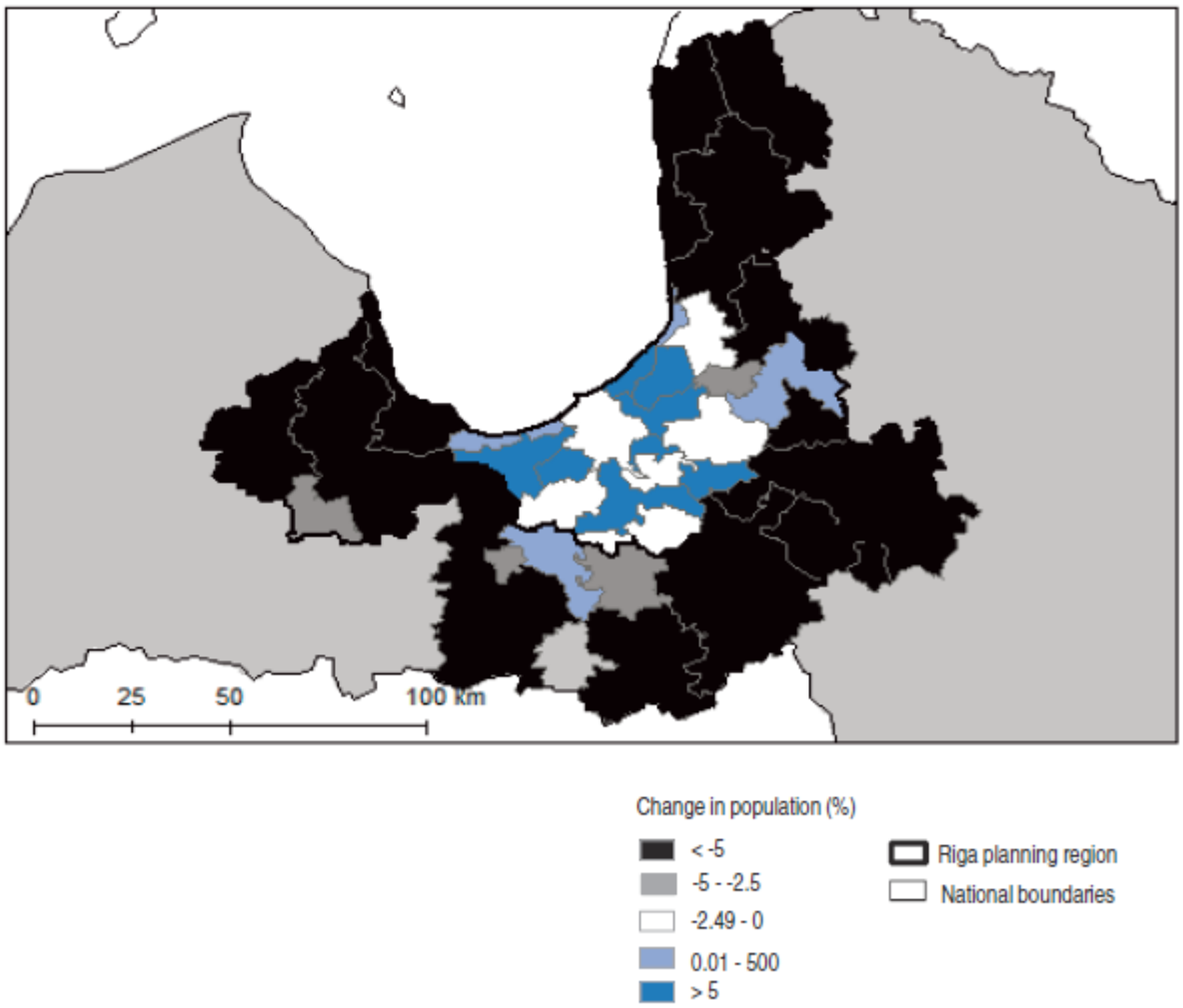
By Daniela Glocker and Andrés Fuentes Hutfilter, OECD Economics Department

Located at the centre of the Baltic States, Latvia's capital city Riga and its surrounding municipalities are a strategically important logistic centre with access to markets in Europe and Russia. It is the largest city in the Baltic States and the third largest in the Region of the Baltic Sea.The city and its surrounding municipalities are not only home to more than half of the Latvian population but also contribute about 69% to national GDP. Better urban policies improve the quality of life for a large share of the population, boost economic performance by making the area more attractive, and can help retain young people who have emigrated from Latvia in large numbers, as argued in the *2017 Economic Survey of Latvia* (OECD, 2017).

The city of Riga has lost inhabitants mostly to surrounding suburban municipalities in commuting distance, resulting in urban sprawl. Urban sprawl is driven by low density developments. It can give rise to socio-economic, transport, infrastructure and environmental concerns, with negative effects on economic performance and quality of life. Urban sprawl therefore increasingly contributes to congested roads and environmental pollution. For instance, between 2000 and 2010 the number of private vehicles in Riga increased by 60%, whereas the flow of incoming vehicles from surrounding areas of Riga doubled.

Figure 2.8. **Population has declined in many municipalities but has grown in municipalities surrounding Riga**

Population growth, 2010-15



Note: Only municipalities that are part of the Riga planning region or the Riga agglomeration are depicted.
Source: OECD calculations based on RDIM (2016), Regional development indicators (*www.raim.gov.lv*).

Urban sprawl is driven by middle to high income households, contributing to a concentration of households with similar socio-economic status in neigbourhoods. Residential segregation can result in unequal access to quality education. Residential segregation in Riga is still lower than in other European capital cities but has been increasing. Latvia's fiscal framework incentivises municipalities to follow a strategy that maximises their revenues by individually adjusting their spatial planning. This is because high income households generate more local tax revenues. Municipalities may lack incentives to provide amenities that might attract lower income households, such as social housing. While there is redistribution of tax revenue across municipalities, it

only offsets a small part of the revenue differences.

To reap the benefits that come with urban agglomeration, Riga city and the surrounding municipalities need better co-ordination and joint strategic planning. The appropriate scale of such metropolitan governance needs to match daily mobility patterns of residents and ensure good co-ordination not only across local but also regional and national governments as well as across policy sectors (OECD, 2015a). Across the OECD, good metropolitan governance has shown to be linked to higher productivity, durably higher wages and better quality of life (Ahrend et al., 2014; OECD, 2015b). For example, residents' satisfaction with public transport in metropolitan areas with a dedicated transport authority is higher and air pollution is lower. Metropolitan areas without tailor-made governance arrangements have experienced an increase in urban sprawl, whereas those with a metropolitan authority densified.

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High uncertainty is weighing on global growth

Category: Economic outlook,Uncategorized
written by oecdecoscope | October 16, 2018
By Laurence Boone, OECD Chief Economist

Less than 6 months ago, the global economy enjoyed healthy synchronised growth. Now, the landscape has changed. Global growth is hitting a plateau, uncertainties over the path forward abound, and risks from trade restrictions and tighter financial conditions have already started to materialise in some countries.

Global growth is projected to be at 3.7% in 2018 and 2019 in our latest *Interim Economic Outlook*, which remains an elevated pace. At the same time, it also reflects weaker prospects than anticipated just a few months ago, and some fragilities. Growth performance has become less synchronised across the world: while it remains strong in the United States, India and China, it has faltered in many other economies. Unemployment has continued to decline and is now below its pre-crisis level in the OECD, but wage growth remains persistently weak, raising uncertainties about how much spare capacity remains in the labour market. In other words, many workers would like to work more hours in Europe, or have left the labour force in the United States, fueling poor well-being perceptions.

GDP growth projections

Year-on-year, %

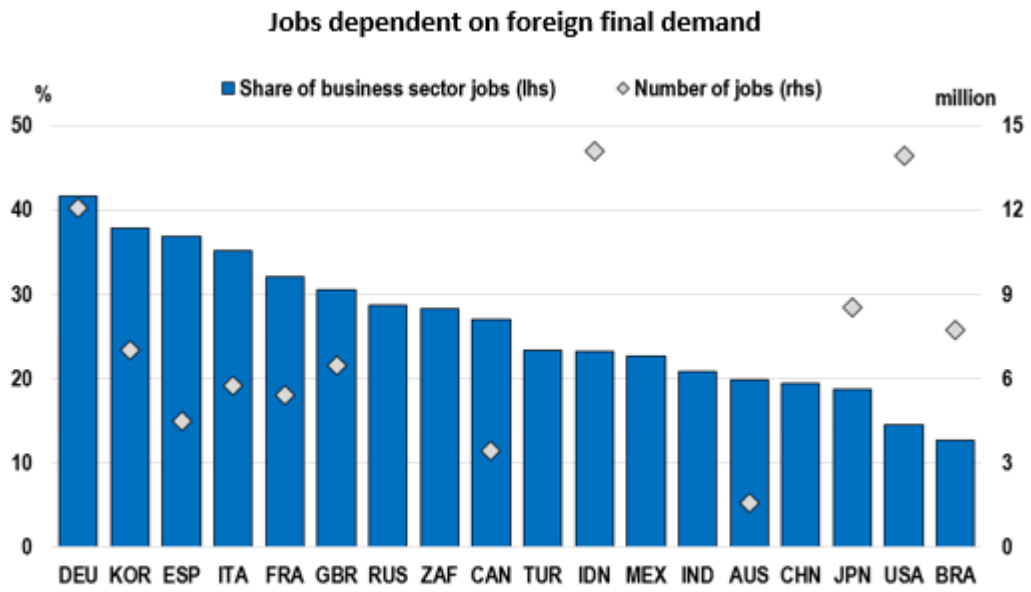
	2017	2018	2019		2017	2018	2019
World	3.6	3.7 ↓	3.7 ↓	G-20	3.8	3.9 ↓	3.8 ↓
Australia	2.2	2.9	3.0	Argentina	2.9	-1.9 ↓	0.1 ↓
Canada	3.0	2.1	2.0 ↓	Brazil	1.0	1.2 ↓	2.5 ↓
Euro area	2.5	2.0 ↓	1.9 ↓	China	6.9	6.7	6.4
Germany	2.5	1.9 ↓	1.8 ↓	India[1]	6.7	7.6 ↑	7.4 ↓
France	2.3	1.6 ↓	1.8 ↓	Indonesia	5.1	5.2 ↓	5.3 ↓
Italy	1.6	1.2 ↓	1.1	Mexico	2.3	2.2 ↓	2.5 ↓
Japan	1.7	1.2	1.2	Russia	1.5	1.8	1.5
Korea	3.1	2.7 ↓	2.8 ↓	Saudi Arabia	-0.7	1.7 ↑	2.6 ↑
United Kingdom	1.7	1.3 ↓	1.2 ↓	South Africa	1.2	0.9 ↓	1.8 ↓
United States	2.2	2.9	2.7 ↓	Turkey	7.4	3.2 ↓	0.5 ↓

Note: Arrows indicate the direction of revisions since the May 2018 Economic Outlook. Dark green and dark orange for, respectively, upward and downward revisions of 0.3 percentage points and more. Light green and light orange for, respectively, upward and downward revisions of less than 0.3 percentage points.

1. Fiscal years starting in April.

More worryingly, risks – trade, emerging economies' sensitivity to tightening financial conditions, politics, finance – are intensifying, casting shadows over the outlook for the coming months and years.

The consequences of rising trade restrictions are already visible. World trade in goods has markedly slowed in recent months, with acute impacts in the sectors directly targeted. For instance, the prices of washing machines for US consumers jumped by 20% between March and July this year after the imposition of tariffs. US imports of steel from China are sharply down, just like Chinese imports of cars from the US. Down the line, higher tariffs mean higher prices for consumers, less investment and less jobs for workers, and ultimately losses in productivity and standards of living. Just consider that 13 million jobs in the US and 8 million in Japan depend, directly or indirectly, on foreign consumption.



Note: Estimates based on data for 2014 or 2015.
Source: *OECD Science, Technology and Industry Scoreboard 2017: The Digital Transformation.*

Another risk that has started to dent growth is, in emerging market economies (EMEs), the effect of rising interest rates and US dollar appreciation. Argentina and Turkey, having significant shares of debt in foreign currency, large external financing needs and high domestic inflation, have been the most exposed to turbulence in currency markets. Other EMEs with high foreign reserves, credible monetary frameworks and prudent fiscal policies, are better equipped to withstand shifts in investors sentiment that are unavoidable as monetary policy normalises around the world. Floating exchange rates have played their cushioning role which has limited contagion so far, but measures to ensure persistent macroeconomic policy credibility and resilience in more vulnerable economies are essential to safeguard financial stability.

In Europe, political risks could harm growth and social cohesion. Brexit is an obvious source of uncertainty. It is vital that a deal is struck that maintains the closest possible relationship between the United Kingdom and the European Union. As for Italy, public finances need to respect EU rules, ensure debt sustainability while privileging productive investments badly needed to raise growth. More

largely, the EMU policy framework needs to be strengthened along the commitment made in the wake of the euro area crisis to enhance confidence, growth and ensure the euro area thrives as it should.

As we mark the tenth anniversary of the financial crisis, there is no denying that some lessons have been learned: banks are now better capitalised, and financial regulation has been stepped up thanks to a large extent to international coordination. But in other areas, financial risks have built up again. Debt has reached unprecedented highs, particularly in the public sector and for corporate debt. Less regulated shadow banking has expanded rapidly. In some countries, equity prices and housing markets are further cause for concern.

In light of the many risks, what should policymakers do?

The immediate priority is to preserve business confidence and investment by reducing policy uncertainty – including by restoring international dialogue to avoid the escalation of trade restrictions. Enhancing resilience is also key in the financial sector as well as, in the case of Europe, by completing the banking union launched in 2012.

In case risks materialise further, there is little space left for monetary policy to react in advanced economies. This makes it all the more important for countries currently enjoying strong growth not to widen fiscal deficits to support an already vibrant consumption, but instead to rebuild room for manoeuvre for those which lack it, and expand public investment to shore up the foundations for sustained growth for all.

At the same time, to foster thriving societies and provide a durable response to political tensions, structural policies should focus on ensuring all people have access to better opportunities. In the long term, the keys to healthy productivity gains and growth that benefits all lie in quality

education, from early childhood to lifelong learning, and in offering better support for all workers to find good and fulfilling jobs. This is vital to reduce political uncertainty in a sustainable manner.

Reference

OECD Interim Economic Outlook, September 2018.

Speeding up economic catch-up in the BRIICS with better governance and more education

Category: education,Uncategorized
written by oecdecoscope | October 16, 2018
by Yvan Guillemette, Macroeconomic Analysis Division, Economics Department

Economic research has established that a large part of income disparities between poor and rich countries can be attributed to differences in governance and in the quantity and quality of human capital. In the latest long-run reference scenario published by the OECD, GDP per capita growth is relatively strong in the BRIICS in the coming decades, but living standards nevertheless remain less than half those of the United States in 2060, in part because of remaining gaps in governance and educational attainment. But the BRIICS can accelerate economic catch-up by improving these aspects of the economic environment, as demonstrated in an alternative scenario.

The quality of governance depends on a cluster of related

institutions, including economic, political, legal and social aspects. In the model behind the long-run projections, institutional quality is proxied by a rule of law index, one of six governance indicators regularly updated by the World Bank. It is a perceptions-based index intended to capture "…the extent to which agents have confidence in and abide by the rule of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence". In the model, improved governance not only raises productivity in the long run, but it also boosts the speed at which the full long-run effects of reforms are attained, including in other domains, such as education.

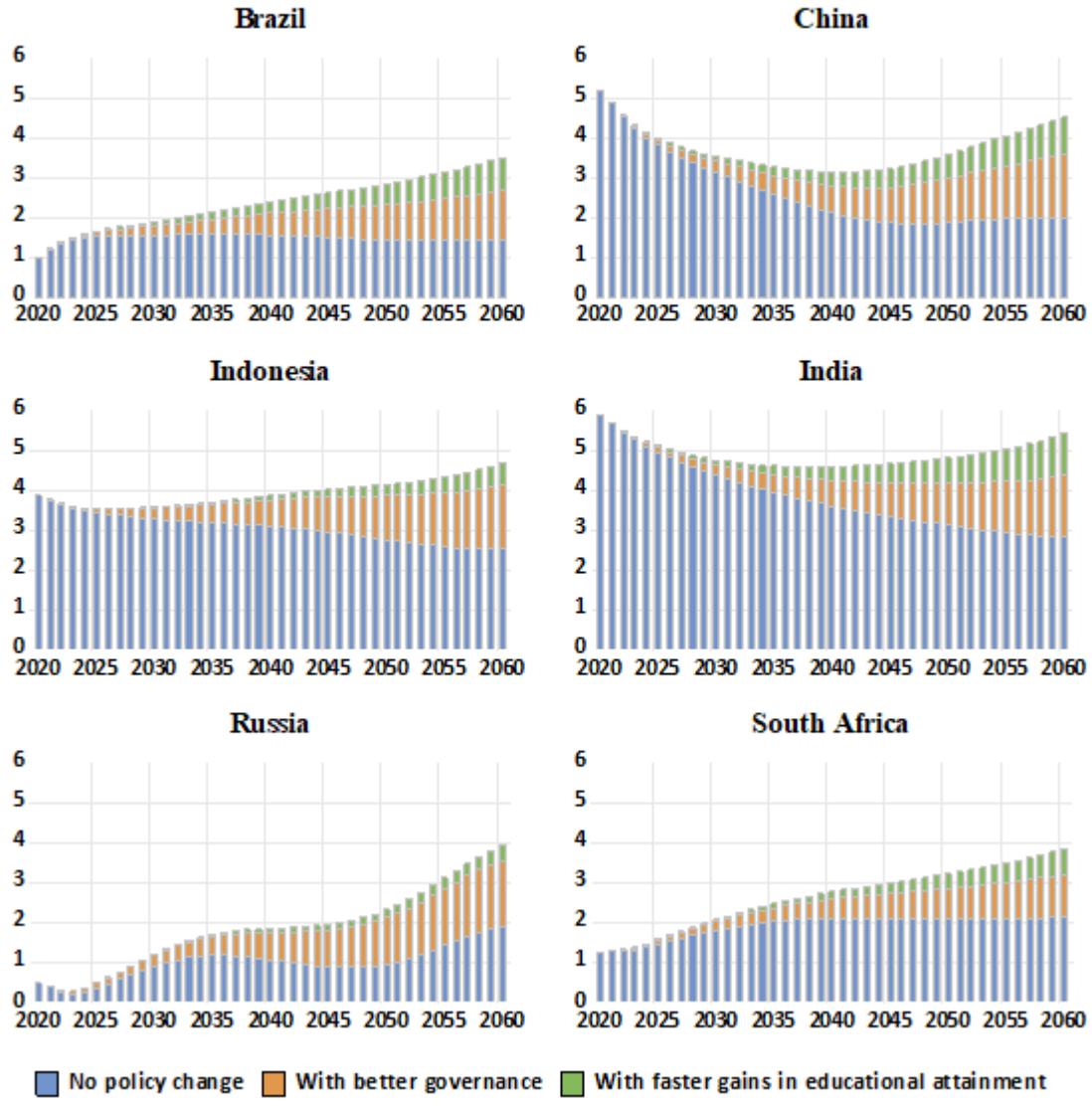
Education not only embeds knowledge and skills in individuals, raising their productivity, but it also encourages participation in groups, opens doors to job opportunities, develops social interactions, makes individuals better aware of their rights, improves health, reduces poverty and facilitates the sharing and transmission of knowledge needed for developing new technologies.

The potential for reforms in these areas to improve long-run economic prospects in the BRIICS can be illustrated by comparing the reference scenario – featuring no change to governance and only a "most likely" evolution of educational attainment – with an alternative scenario in which governance is strengthened and bigger gains in educational attainment are made. The alternative scenario assumes that rule of law scores and mean years of schooling in the BRIICS catch up to the OECD medians over the 2020-to-2060 period.

Better governance and higher educational attainment raise an economy's productivity, allowing living standards to rise. The gains build up slowly over time but by 2060, annual growth in living standards in the BRIICS is roughly 2 percentage points higher than in the reference scenario (see figure), and levels are between 30% and 50% higher. The positive *growth* impacts

from the reforms would start tapering off gradually after 2060 while the *level* impacts would continue to accumulate, corresponding to the long lags involved in benefitting fully from structural reforms. In terms of relative importance, strengthening governance makes the largest contribution in this alternative scenario, with two thirds of the aggregate BRIICS effect. It is particularly important in Russia, while Brazil, China and India also have much to gain by improving educational attainment.

Projected annual growth in living standards (real GDP per capita) in the BRIICS, per cent



The results underscore the importance for the BRIICS of targeting education and governance as areas for improvement, and of taking a long-term view of their importance for growth

and well-being. And while the BRIICS are used here for illustrative purposes, other countries could similarly benefit from faster gains in education and from governance reforms. Notably Argentina, Colombia, Mexico and Turkey score relatively low on governance.

Further reading:

Guillemette, Y. and D. Turner (2018), "The Long View: Scenarios for the World Economy to 2060", *OECD Economic Policy Papers*, No. 22, OECD Publishing, Paris, https://doi.org/10.1787/b4f4e03e-en.

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Statistical Insights: An x-ray view of inflation

Category: Statistical Insights,Uncategorized
written by oecdecoscope | October 16, 2018

By Pierre-Alain Pionnier, Francette Koechlin, Anne-Sophie Fraisse and Elena van Eck.

Inflation may be present in some parts of an economy but not others. Contributions to annual inflation show how much different product groups contribute to overall inflation in a given year.

The measure is a useful tool to understand where inflation is occurring in different countries, analyse trends in inflation over time, and identify volatile and stable components of inflation. It may also help explain why consumers' perceptions of inflation sometimes differ from official figures.

This Statistical Insight uses figures for Germany, Japan and the United States (US) to illustrate the usefulness of data on contributions to inflation.

Analysing inflation by component

In addition to aggregate national Consumer Price Indices (CPIs), the OECD provides data on the contributions to annual inflation of 12 standard product groups and special aggregates.

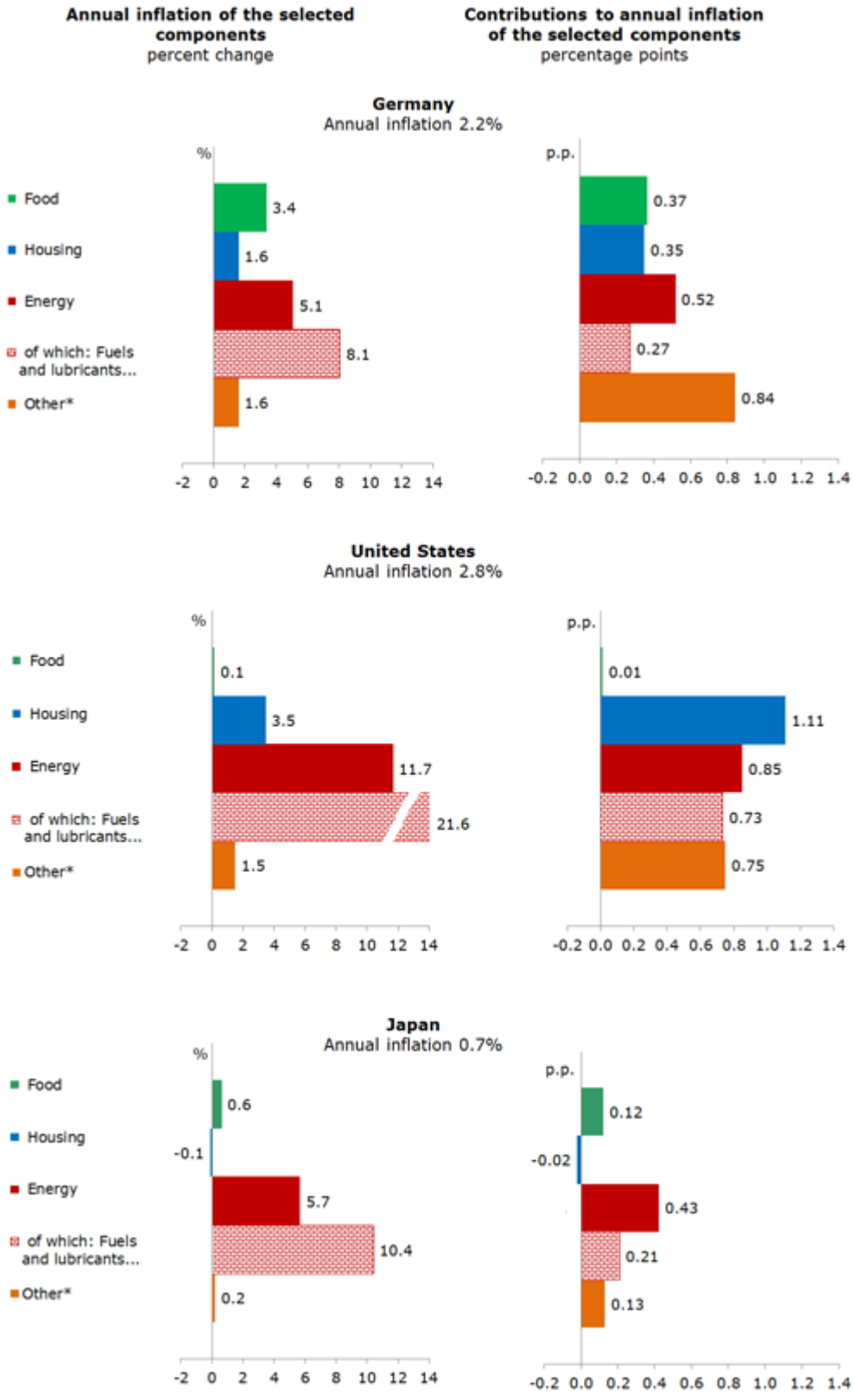
Figure 1 shows that in Germany, Japan and the US, aggregate

inflation hides wide variations in price movements across product groups. In Germany, while overall prices increased by 2.2% in the year to May 2018, food and housing prices increased by 3.4% and 1.6% respectively. In the US, energy prices increased by 11.7%, and gasoline prices by 21.6%, while overall prices only increased by 2.8%.

The contribution of a given product group to overall inflation depends both on the price change of the relevant product group and on its share in consumers' expenditures. The shares vary between countries. For example, households spend around 20% of their incomes on housing in Germany and Japan, but over 30% in the US. The high share of housing costs in US households' budgets meant that price changes in those costs contributed most to overall US inflation in the year to May 2018, even though energy prices rose much faster than housing prices. In fact, energy prices shot up everywhere, but only in Japan was energy the largest contributor to overall inflation.

It may also be the case that consumers are more sensitive to movements in the prices of items they purchase frequently. For example, they may feel that inflation is high if the prices of food items are rising quickly, even though food products and non-alcoholic beverages represent less than 10% of households' expenditures in the US, around 10% in Germany, and less than 20% in Japan.

Figure 1. Annual inflation rate (%) and contributions of selected components May 2018, Germany, United States and Japan



* Alcoholic beverages, tobacco and narcotics (COICOP 02), Clothing and footwear (COICOP 03) Water supply and miscellaneous services relating to the dwelling (COICOP 0404); Furnishings, household equipment and routine household maintenance (COICOP 05); Health (COICOP 06); Transport (COICOP 07 less COICOP 0702); Communication (COICOP 08); Recreation and culture (COICOP 09); Education (COICOP 10); Restaurants and hotels (COICOP 11); Miscellaneous goods and services (COICOP 12).

Source: OECD (2018) Consumer prices (database)

Recent trends in overall and core inflation (2012-2018)

Because food and energy make volatile contributions to inflation, economists often focus on a consumption basket that excludes them in order to better understand and forecast long-term developments in inflation. The resulting numbers are called underlying, or core, inflation.

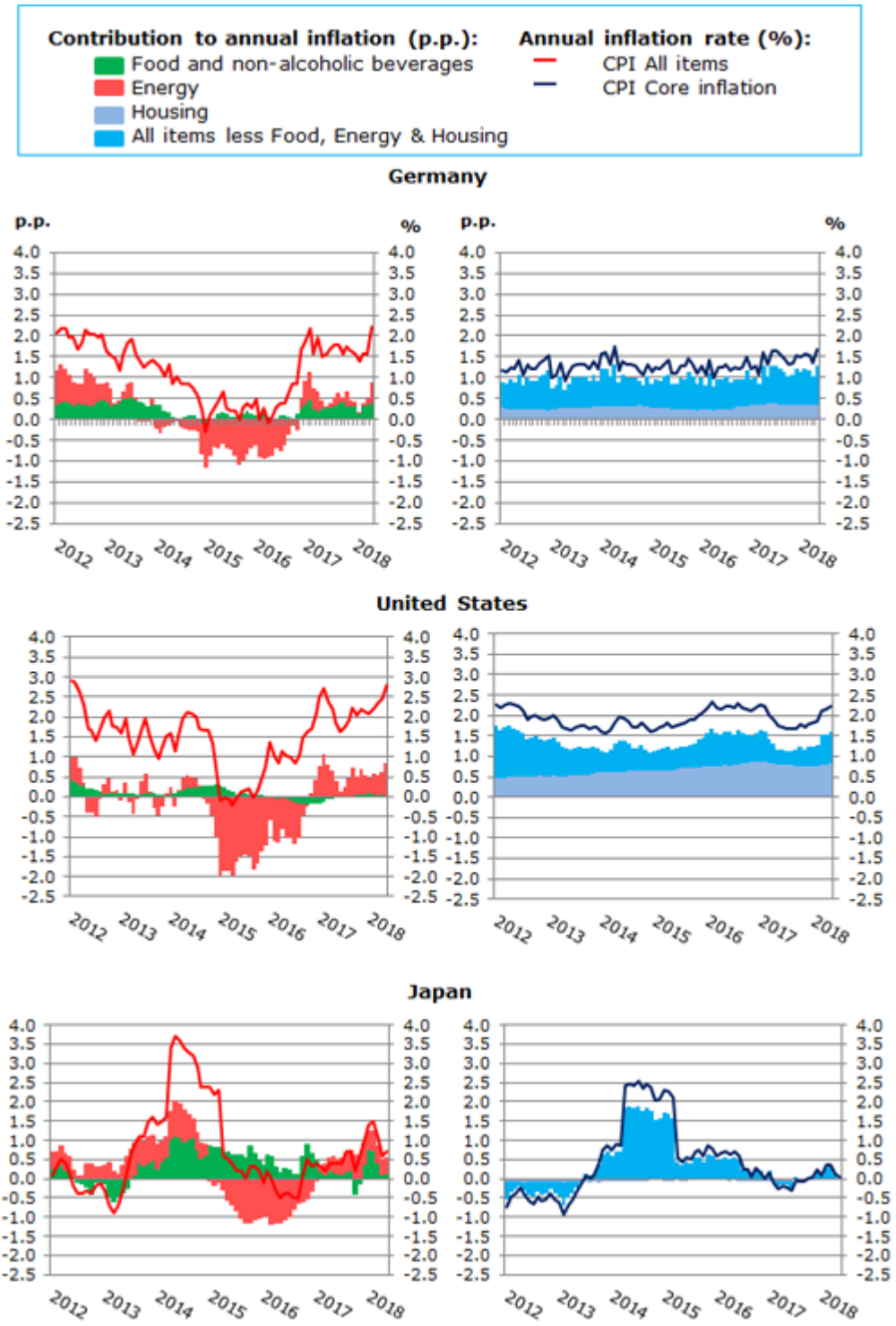
Figure 2 shows that energy contributed to the bulk of inflation fluctuations between 2012 and 2018. Changes in energy prices are dominated by movements in world crude oil prices, but exchange rate fluctuations also play a role because oil prices are usually fixed in US dollars. In 2015, for example, oil prices fell but at the same time the euro and the yen depreciated against the US dollar, so that oil prices in those currencies did not fall as much as they did in dollars. This meant that falling oil prices did not reduce inflation as much in Germany and Japan as in the US.

Even after excluding volatile food and energy prices, core inflation rates vary significantly across countries. Figure 2 shows that core inflation in Japan has long been lower than in Germany and the US, except for a blip in 2014-15 caused by a hike in value-added tax. Since 2016, core inflation in the US has also been consistently higher than in Germany. The major contributor to these differences is housing prices, which have risen faster in the US than in Germany, and faster in Germany than in Japan. Note that housing prices correspond to housing rentals (including imputed rentals for owner-occupied dwellings) and maintenance costs. This ignores the purchase prices of houses and apartments, which are considered as investments rather than consumption and are covered by separate price indices.

Figure 2. Annual inflation rates (%) and contributions of

selected components (percentage points)

2012-2018, Germany, United States and Japan



Source: OECD (2018) Consumer prices (database)

The measure explained

Contributions to annual inflation represent the contributions to overall inflation in percentage points by different product groups. The contribution of each product group depends both on the price change in the relevant product group and its weight

in households' expenditures.

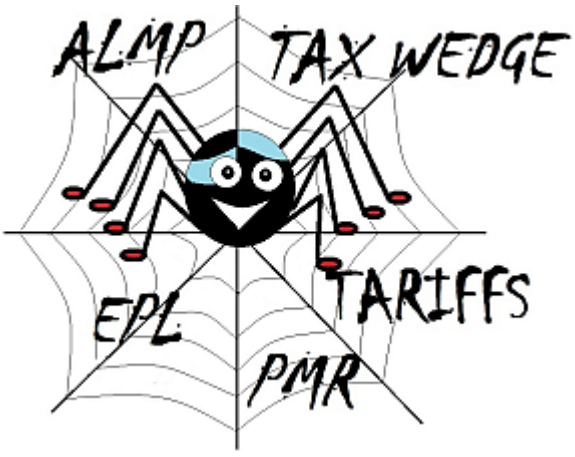
The OECD calculates contributions to inflation based on national data for all countries except Austria, Chile, Finland, Mexico, the Netherlands, Poland, Sweden, and the United Kingdom, whose National Statistics Offices provide the data directly. For further information please see OECD CPI FAQs.

Where to find the underlying data

- Access contributions to annual inflation

Structural Policy Indicators Database for Economic Research: SPIDER on the web

Category: Structural reform,Uncategorized
written by oecdecoscope | October 16, 2018
by Égert Balázs, Peter Gal and Isabelle Wanner, OECD Economics Department



Researchers looking for empirical evidence on the relative impact of policy and non-policy drivers of economic growth know how much time and efforts can go into assembling a large database of policy variables and other determinants covering as many countries and years as possible. Even when such database can be patched-up

from tapping into earlier studies, up-dating the series often requires going through a vast number of different data sources. Thanks to a recent OECD initiative, such task could be greatly facilitated from now on. A new OECD's Structural Policy Indicators Database for Economic Research (SPIDER) is now available online and provides a broad range of data to researchers in ready-to-use formats to facilitate empirical/econometric research investigating the nature and the impact of structural policies. Available as a text file (TXT), STATA (.dta) and Eviews (.wf1) formats, the database includes about 500 policy and institutional indicators from almost 50 different OECD and non-OECD data sources. The policy variables stored in the database are annual or less frequently available (every five years or only once). The database will be updated on a yearly basis.

The database covers the following broad categories of policy variables: i) ***legal infrastructure and institutions*** describe features of the political system, the underlying legal institutions and indicators measuring the quality and various aspects of public governance; ii) ***framework condition policies*** include policies that condition the environment in which firms operate and make decisions such as the product market regulation (PMR/ETCR) indicators, the competition law and policy (CLP) indicator and a number of labour market institutions; iii) s***pecific policies*** cover policies relating for instance exclusively to specific segments of the labour market (older workers, women or the youth) and include family benefits, policies influencing decisions to retire. Examples of other specific policies are measures primarily designed to support R&D investment or exports. Table 1 gives an overview on the main categories of variables included in SPIDER.

Table 1. **The main categories of variables included in SPIDER**

LEGAL AND POLITICAL INSTITUTIONS	CHANNEL-SPECIFIC POLICIES & INTERMEDIATE OUTCOMES
Political system	Innovation policies (proxies for)
Judicial system	Unemployment benefits
Governance	Activation policies
FRAMEWORK CONDITIONS, REGULATIONS AND POLICIES	Pension system
Labour market regulation	Family and child policies
Product market regulation	Immigration
Doing business	Gender
Competition, Law and Policy	Financial development
Housing	Health
Wage setting	Education and skills
Non-labour taxation	**COUNTRY CHARACTERISTICS**
Labour taxes	Geography
	Social values
	Demography
	History
	Language/Ethnicity/Religion

Aimed primarily at helping researchers to kick-start empirical analysis by keeping the costs of assembling the required data very low, the usefulness of the SPIDER database to economic research can be demonstrated through the range of possibilities it offers in terms of assessing the impact of institutions and policies in growth regressions. For instance, it allows for runing cross-country time series growth regressions for OECD countries including indicators of product and labour market regulations with about 20 to 30 years of data. As an illustration, the scope of variables that can be included in several variants of growth regressions.

The analysis can also be extended to non-OECD countries, although in that case the time series dimension of the data will likely to be shorter and regulations and institutions will be measured by indicators available from non-OECD data sources. Finally, for purely cross-sectional regressions, with a very large set of indicators that also capture the geographical, social and cultural aspects, the number of

observations reach about 90. These examples indicate the scope of the database for such an exercise.

Aside from facilitating cross-country/time-series empirical analysis, the new database is a one-stop shop where a large set of internationally comparable policy variables can be found and used to gauge in a more descriptive manner the magnitude of structural reform actions in specific countries and areas over a broad range.

References:

The database is described in more detail in Égert, Gal and Wanner (2017), “Structural policy indicators database for economic research (SPIDER)”, OECD Economics Department Working Paper No. 1429.

The UK productivity puzzle through the magnifying glass: A sectoral perspective

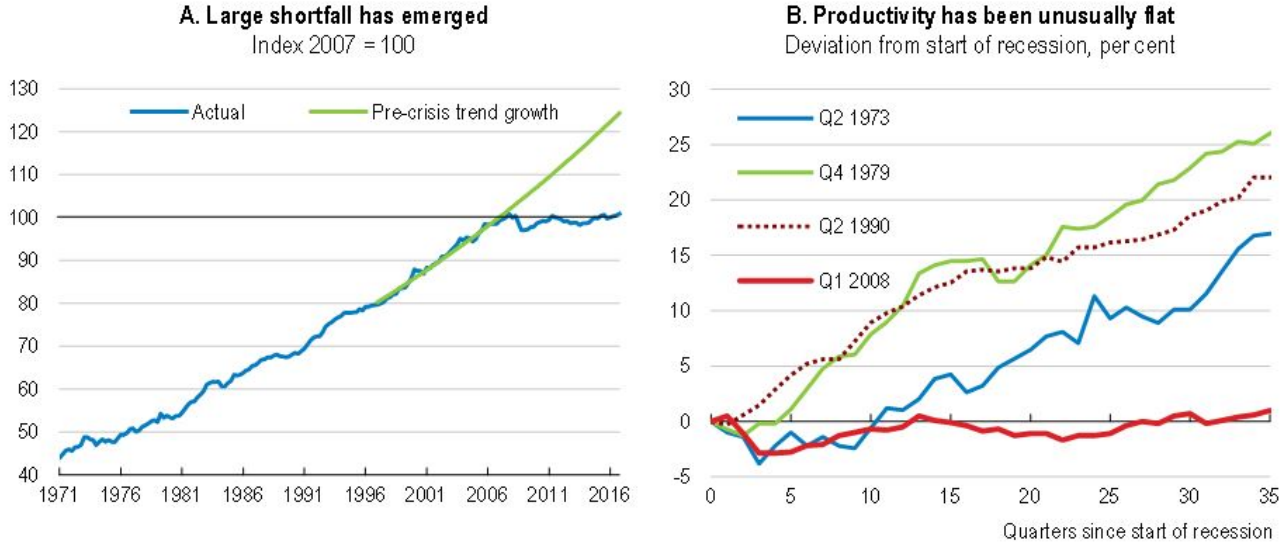
Category: Labour markets,Productivity,Uncategorized,United Kingdom
written by oecdecoscope | October 16, 2018
Rafał Kierzenkowski, Gabriel Machlica and Gabor Fulop, Economics Department.

Labour productivity has flatlined since the global financial crisis, which contrasts with its recovery profiles from past recessions over the last decades (Figure 1). The productivity shortfall, defined as the gap between actual productivity and the level implied by its pre-crisis trend growth rate, reached nearly 20% at the end of 2016. This unprecedented levelling

off represents the so-called productivity puzzle, with the level of output being surprisingly weak relative to high total hours worked in the economy. At the aggregate level, the weakness in productivity is driven by subdued investment developments and total factor productivity, and this underperformance appears to be mainly structural rather than cyclical.

Figure 1. Labour productivity has disappointed since the financial crisis

Output per hour[1]



1. Output refers to real gross value added. Pre-crisis trend growth is calculated between 1997 and 2007, and is projected from 2008 onwards.

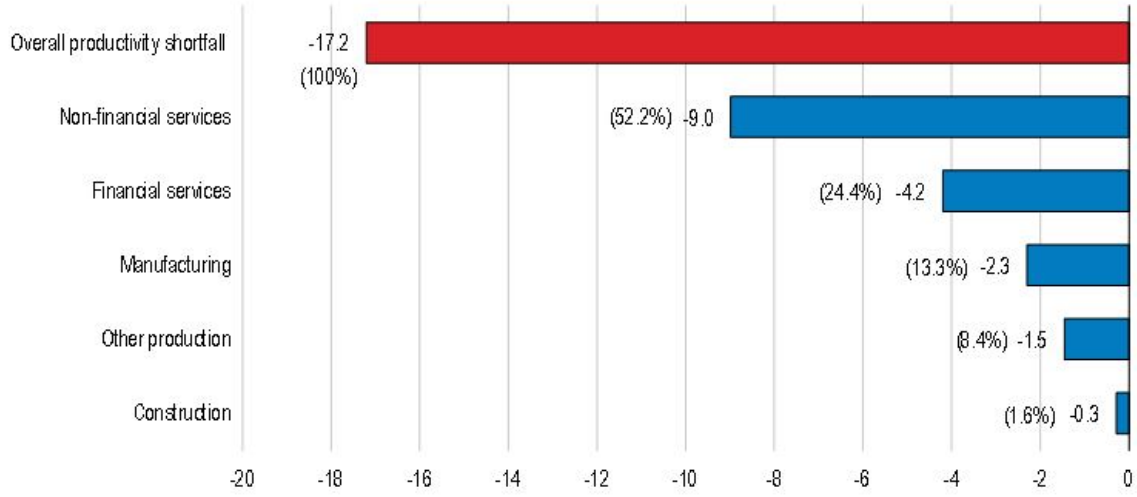
Source: OECD calculations based on ONS (2017), "Labour productivity: Oct to Dec 2016", Office for National Statistics, April.

Using disaggregated data at the sectoral level provides additional insights about the determinants of the productivity puzzle, as shown in a recent OECD Economics Department Working Paper (Kierzenkowski et al., 2018). There has been a marked increase in the dispersion of productivity performance across UK sectors since the crisis, with sectors lagging behind becoming even more disconnected from the best-performing sectors (at a given point in time). Moreover, the aggregate productivity slowdown appears to be mainly driven by the weakness in productivity within each sector, which suggests sector-specific determinants of the productivity shortfall.

To investigate the issue further, it is possible to calculate the contribution of each sector to the aggregate productivity shortfall since 2007. Such calculation shows that half of the gap is explained by non-financial services (with information and communication being the largest contributor), a fourth by financial services, and another fourth by manufacturing, other production and construction (Figure 2). All but non-financial services and the construction sectors contribute disproportionately to the productivity shortfall compared to their shares in overall output and hours worked of the UK economy.

Figure 2. Services sectors account for a large share of the productivity shortfall

Contributions of sectors to the productivity shortfall relative to 1997-2007 trend growth, percentage points and percentages in brackets, Q4 2016[1]



1. Other production refers to agriculture, forestry and fishing (section A), mining and quarrying (section B), electricity, gas, steam and air conditioning supply (section D) and water supply, sewerage, waste management and remediation activities (section E). Imputed rental is excluded from the gross value added of real estate activities.

Source: OECD calculations based on ONS (2017), "Quarterly National Accounts: Oct to Dec 2016", Office for National Statistics, March; and ONS (2017), "Labour Productivity: Oct to Dec 2016", Office for National Statistics, April.

In non-financial services, large increases in self-employed with no employees may have reduced the economies of scale and scope of organised work (Figure 3, Panel A), while the production of the sector has become less capital-intensive at the same time. Greater mismatches between changing skills and

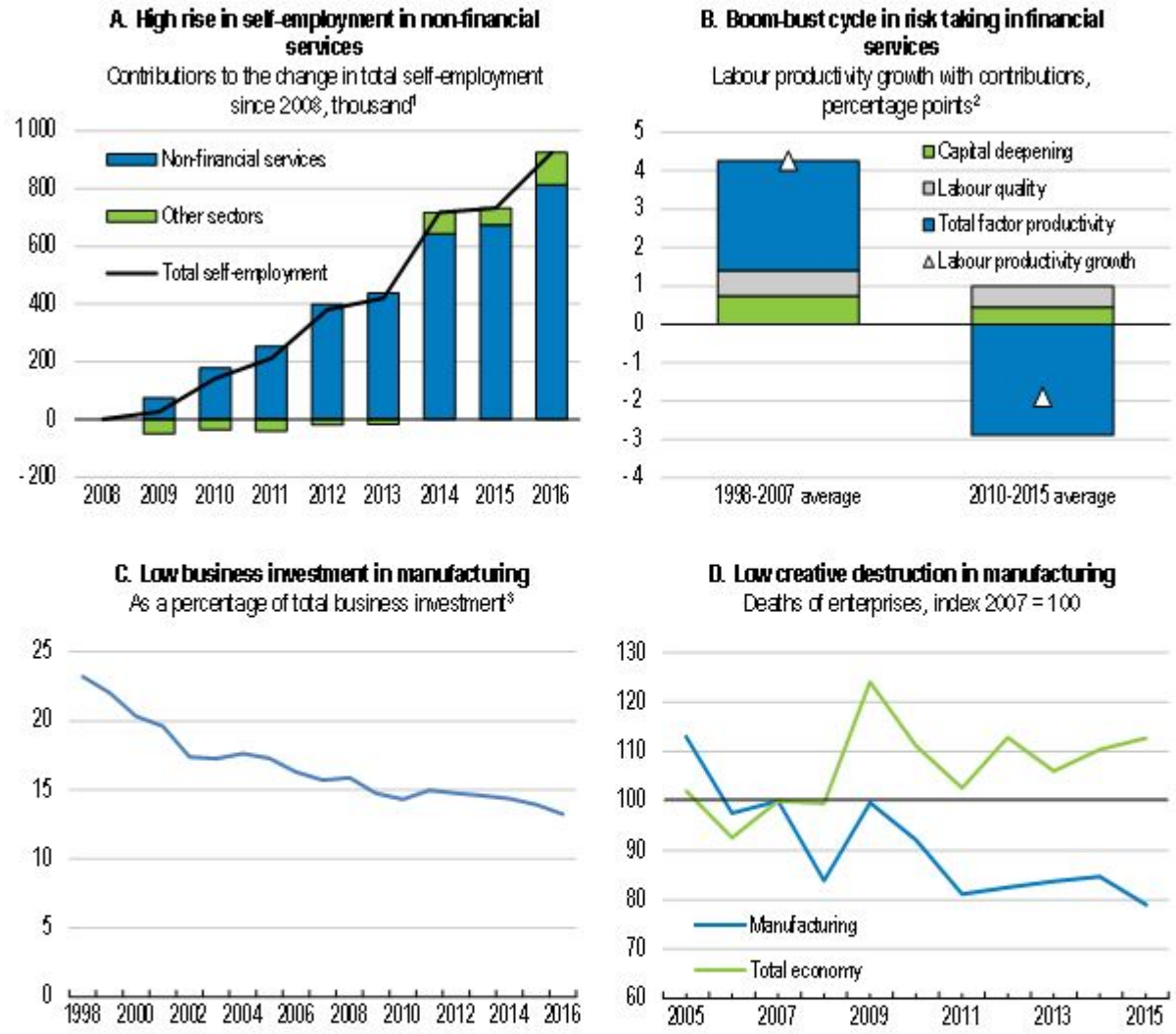
created jobs may have also curbed productivity growth, in particular in the information and communication sector where many high-skilled occupations have been created but where increases in labour quality have been comparatively weak.

In financial services, stagnant labour productivity is mainly linked to reduced risk-taking and leverage, as reflected by the decline in total factor productivity following its steep increases in the run-up to the crisis (Figure 3, Panel B). Although the measurement of output of the financial sector is difficult, this finding is corroborated by the relative size of the financial sector, which was expanding quickly to become significantly larger than in the rest of the G7 in the run-up to the crisis. Looking ahead, the key issue is the extent to which the financial sector can add to productivity growth of the UK economy without undermining financial stability.

In manufacturing, low accumulation of the capital stock (Figure 3, Panel C), suggests a greater substitution from capital towards labour in the production process and a drag on the productivity of the sector. Also, there are indications that weak corporate restructuring may have been another driver, with company exits being smaller than in the overall economy (Figure 3, Panel D). Particularly, in low-tech manufacturing , the percentage of capital and labour that is held up by zombie firms (defined as firms which persistently fail to cover their interest payments from current profits) is estimated to be respectively at around 18% and 13% (OECD, 2017).

The UK productivity puzzle is also partly explained by pre-crisis developments, which include a low tangible investment in comparison with other OECD countries, a too rapid expansion of the financial sector despite the comparative advantage of the City, productivity gains in the manufacturing sector that were insufficiently “offensive” (driven by innovation), and a secular decline of the oil and gas sectors with dwindling resources in the North Sea.

Figure 3. Some possible drivers of the UK productivity puzzle at the sectoral level



1. Data refer to population aged 15 and over.
2. Labour productivity is defined as output (i.e. real gross value added) per hour worked. Contributions to labour productivity growth are calculated using a factor augmenting production function with a weight of 0.59 for hours worked and labour quality while total factor productivity is calculated as a residual. Capital deepening refers to net capital stock per hour worked. Labour quality is measured as the difference between the quality adjusted labour input (QALI) and hours worked.
3. In real terms. Data refer to private sector investment.

Source: Eurostat (2017), "Employment and Unemployment (Labour Force Survey)", *Eurostat Database*, May; and OECD calculations based on data from Office for National Statistics.

References:

Kierzenkowski R., G. Machlica and G. Fulop (2018), "The UK productivity puzzle through the magnifying glass: A sectoral perspective", *OECD Economics Department Working Papers*, No 1496, OECD Publishing.

OECD (2017), *OECD Economic Surveys*: United Kingdom 2017, OECD

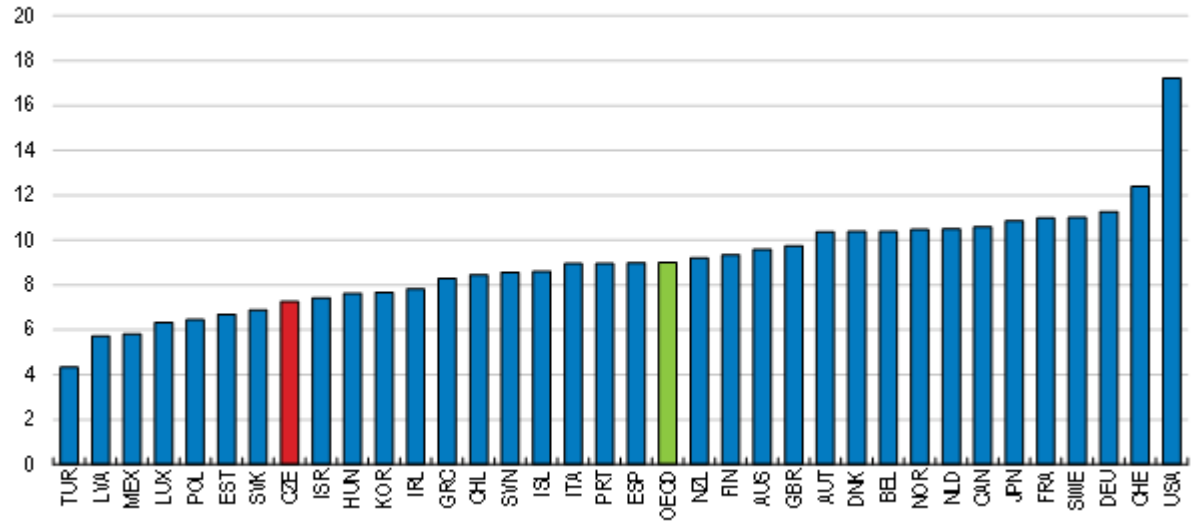
Publishing.

Improving the Czech health care system

Category: Czech Republic,Uncategorized
written by oecdecoscope | October 16, 2018
by Falilou Fall, Czech Republic desk, OECD Economics Department

Health outcomes in the Czech Republic have improved considerably over the last decade. Life expectancy rose by 2.6 years to 78.7 years between 2005 and 2015 towards the OECD average of 80.6 years. This was achieved with relatively low expenditures on health care of about 7% of GDP. However, the population is ageing challenging the financial sustainability of the health care system. As the old-age dependency ratio deteriorates, so do revenues of the health care system as they rely heavily on social security contributions of the working population. Ageing is expected to account for roughly half of the future rise in health care spending, which would reach about to 40% of the government budget by 2060 (OECD 2018).

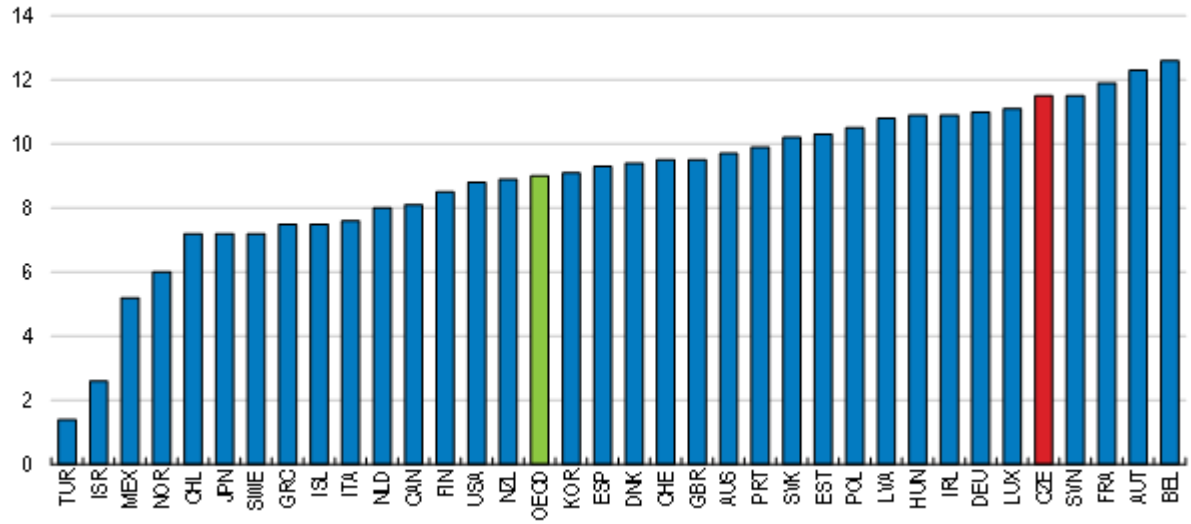
Figure 1. Total health care expenditure, 2016, % of GDP



Source: OECD (2017), Health at a Glance 2017: OECD Indicators, OECD Publishing, Paris

To maintain and improve health outcomes and to set a basis for healthy ageing, healthier lifestyles need to be promoted. Risky behaviour, such as smoking, alcohol consumption and obesity are close or above the OECD average. Excise taxes on alcohol are among the lowest in the OECD, contributing to the relatively high alcohol consumption that reached 11.5 litres per capita in 2015 – compared to an OECD average of 9 litres per capita. Price incentives through higher taxation of tobacco, alocohol and unhealthy food and beverages could reduce consumption. Policy measures to promote healthier lifestyles should however follow an integrated approach beyond tax incentives and include further development of health education, disease prevention and screening programmes.

Figure 2. Alcohol consumption, litres per capita, 2015



Source: OECD Health Statistics 2017

A well functioning primary care sector can bring both efficiency gains through reducing avoidable use of hospital facilities, and better quality of care through better management of patients' pathways. However, in the Czech Republic, the efficiency of delivery of primary care is suffering from lack of co-ordination. Patients' ability to access specialist care without a prior general practitioner (GP) consultation, poorly defined mutual responsibilities of outpatient specialists and GPs and current payment systems mean that primary care's potential to lead for instance chronic disease management is not being fulfilled. GPs should be entrusted with a greater gate-keeping and co-ordination role to ensure that patients are better directed to the most appropriate place for their treatment. User fees for specialist visits without referral could be introduced to strengthen GP's gate-keeping role.

As the economy is doing well, reforms to the health care system and its financing should be adressed now. The Czech health system is heavily regulated by the government through the Reimbursement Decree. Through this decree, most prices and volume limitations of activities of health providers are set. Having a genuine negotiation process between health care providers and insurance funds would help reduce some of the

inefficiencies in service delivery. Overall, there is a need to rebalance the system towards more competition between health providers and insurance funds and private funding to improve quality, efficiency and reduce the reliance on public funding.

References:

OECD (2018), OECD Economic Surveys: CZECH REPUBLIC 2018, OECD Publishing

OECD (2017), Health at a Glance 2017: OECD Indicators, OECD Publishing, Paris

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Rising financial integration amplifies the global impact of financial market shocks

Category: Economic outlook,Uncategorized
written by oecdecoscope | October 16, 2018
by Nigel Pain and Véronique Salins, OECD Economics Department

Stronger cross-border economic and financial integration implies that macroeconomic shocks in one country are increasingly likely to spill over into other economies. This is particularly true in national financial markets, where developments increasingly reflect common underlying factors, as shown in the special chapter of the latest OECD Economic Outlook. Thus, a change in risk sentiment in a major market, such as the United States, may

spread quickly to other markets, with implications for activity and economic policy.

This is illustrated below, using simulations based on the global macro model NiGEM. The shock considered is a 1 percentage point rise for two years in the US equity risk premium – the compensation investors require for taking on more risk by investing in equities. To isolate financial transmission channels we assume that agents have adaptative expectations and exchange rates are fixed[1]. By itself the shock is relatively modest, reducing US equity prices (relative to baseline) by around 10%. However, linkages between financial markets around the world mean that the shock spreads to other markets, to an increasing extent over time as the linkages deepen.

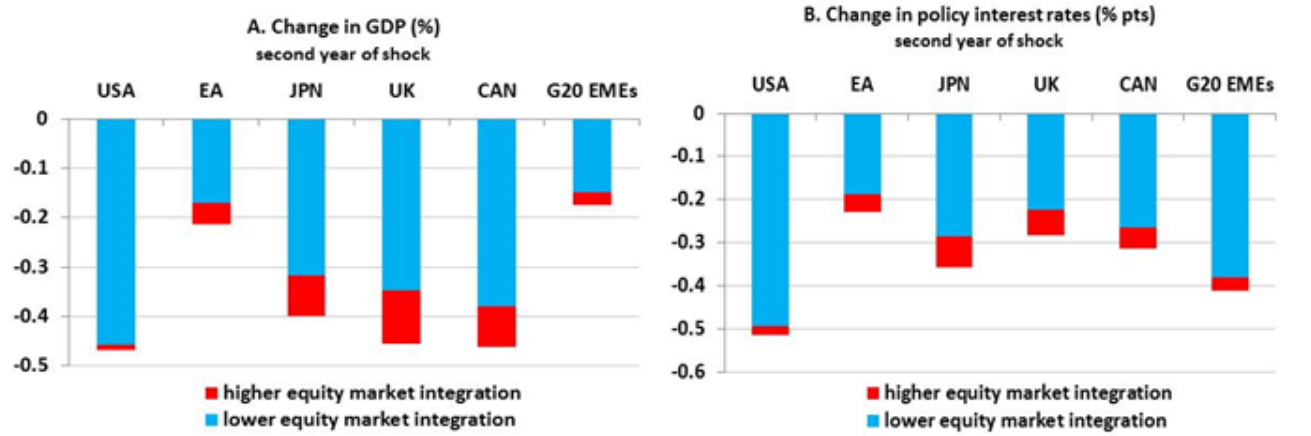
Two different scenarios are considered to reflect the change over time in the importance of global factors in the equity markets, as estimated in the OECD Economic Outlook 103. In a lower integration scenario, based on the strength of equity market linkages up to the mid-1990s, equity risk premia also rise by 60 basis points in the major advanced countries, and by 40 basis points elsewhere. In a higher integration scenario, reflecting the estimated strength of linkages over the past decade, equity risk premia rise by 80 basis points and 60 basis points, respectively.

GDP declines in all major economies in both scenarios, reflecting the impact of lower net wealth on household spending and the hit to investment from the higher cost of (equity) capital (Panel A in figure). The adverse effects are greater in the higher integration scenario, particularly in open economies where the importance of equity finance for investment is relatively high, such as Canada and the United Kingdom.

The impact of the shock and the cross-border spillovers would be larger still if they were not cushioned by monetary policy

easing. Since, in NiGEM, central banks react to the deviation of inflation and nominal GDP from their target levels, the fall in GDP leads them to cut policy interest rates by around ¼ percentage point in the major advanced economies by the second year, and by around ½ percentage point in the United States (Panel B in figure).

Spillovers from a rise in the US equity risk premium



Notes: Based on a rise of 1 percentage point in the US equity price risk premia for two years. The scenario with lower equity market integration is based on estimated linkages between global markets over 1984-95, and the scenario with higher equity market integration on estimated linkages over the past decade. Policy interest rates are endogenous in all areas. All shocks begin in 2018. The G20 emerging market economies are weighted together using PPPs.

Source: OECD calculations

Statlink http://dx.doi.org/10.1787/888933729439

In practice, there could be challenges for monetary policy if this type of shock, or a larger one, were to occur at a time when policy interest rates are very low. If monetary policy did not respond to the shock at all, the fall in GDP would be steeper by between one-quarter and one half relative to the case where shocks are cushioned by monetary easing.

Increased financial integration brings benefits including more efficient resource allocation, but it also strengthens cross-border shock transmission channels. This exposes countries to greater harm from negative shocks abroad increasing the need for stronger monetary and fiscal buffers.

[1] Allowing for flexible exchange rates would soften the effect of the shock on GDP over the short term in all countries but increase its persistence in most G20 emerging markets.

Reference:

OECD (2018), OECD Economic Outlook, Volume 2018 Issue 1, OECD Publishing, Paris.