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The OECD and the world economy 2007

Report
Committee on Economic Affairs and Development
Rapporteur: Mrs Antigoni PAPADOPOULOS, Cyprus, Alliance of Liberals and Democrats for Europe

A. Draft resolution

1. The enlarged Parliamentary Assembly, composed of delegations of the OECD and Council of Europe member states, has examined the recent activities of the OECD as they relate to the world economy, in the light of the report prepared by the Assembly's Committee on Economic Affairs and Development and the contributions from several other committees of the enlarged Assembly.

2. The enlarged Assembly welcomes the decision taken by the OECD Council meeting at Ministerial level on 16 May 2007 to invite Chile, Estonia, Israel, the Russian Federation and Slovenia to open discussions for membership of the Organisation and to offer enhanced engagement, with a view to possible membership, to Brazil, China, India, Indonesia and South Africa. The enlarged Assembly also welcomes the fact that in June 2007, the G8 asked the OECD to act as a platform for the newly established dialogue between the G8 and Brazil, China, India, Mexico and South Africa. The enlarged Assembly underlines the importance of these initiatives and believes that they will significantly enhance the OECD's capacity to provide sound policy advice to its member governments in an era of rapid globalisation, thus paving the way to a better world economy.

3. The enlarged Assembly firmly supports the OECD's current sustainable development mandate. Being aware of the threats to the environment at a global level, it stresses that the large emerging economies, in particular the Russian Federation, Brazil, China and India, should also make substantial efforts to master pollution linked to their economic development. The enlarged OECD should play a key role in supporting these countries in their development, whilst preserving the environment and the planet's natural and energy resources.

4. The enlarged Assembly calls on the present and future member states, in their co-operation within the OECD, to give special emphasis and attention to policies and practices regarding the management of working migration as well as the issue of integration and the circulation/mobility and rights, including social protection rights, of all migrant workers and members of their families.

5. In mid-2007, worldwide economic weakness as a consequence of the slowdown of the United States economy was not expected to materialise. Instead, the OECD economies looked to be undergoing a smooth rebalancing with the OECD's central forecast at mid-2007 being characterised as benign: a soft landing in the United States, a strong and sustained recovery in Europe, a solid trajectory in Japan and buoyant activity in China and India. In line with trends at that time, sustained growth in OECD economies was expected to be underpinned by strong job creation and falling unemployment. Amongst OECD members, real GDP growth - having exceeded forecasts by expanding 3.2% in 2006 - was expected to slow to 2.7% this year, and to remain at that level in 2008. Over this period, OECD-wide inflation was projected at a little over 2%, with unemployment declining from 5.9% to 5.5%.

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6. Since then, the realisation of some of the risks that were highlighted in the OECD's assessment – notably the weakness in the US housing market as well as problems in the sub-prime mortgage markets – have prompted a more general reassessment of the outlook. As noted in the OECD's *Interim Assessment* of the economic situation (published on 5 September 2007), beyond the very near term, "prospects going forward are now clearly less buoyant and more uncertain. Downside risks have become more ominous, in a context where overall financial market conditions are likely to remain durably tighter… there may be a case for some easing in the US federal funds target rate." This was cut to 4.75% on 18 September 2007.

7. In order to promote growth and prosperity, since SMEs hold the keys to economic growth, job creation, regional development, and social cohesion, it is necessary to adopt support measures bearing in mind the spirit of the OECD's Bologna Charter on SME Policies and for companies to respect the human rights of workers.

8. Amongst OECD member countries, tax revenues have generally been high in recent years, and this has relieved immediate pressure on fiscal policy. But the OECD underlines that there is a continuing, and indeed urgent, need for the world's major economies to pursue fiscal reform. Several years into a period of strong prosperity, not enough is being done to reform government policies and refashion them for the future, especially given the demographic challenge of aging populations, which will place huge pressures upon public services and entitlement programmes. The enlarged Assembly stresses with the OECD that if the opportunity posed by this relatively benign period is missed, the future costs could be very significant.

9. Along with large public deficits, inflation, energy prices, and financial and property market instability, a further risk to the economic outlook is protectionism. The enlarged Assembly endorses the OECD's renewed call for continuing efforts to achieve open, efficient and well regulated markets, both for domestic economies and in terms of international trade and investment. In response to regulatory tightening and public interventions in some countries which could deter foreign investment, OECD countries in co-operation with other key players are working together to ensure that an open and rule-based international investment environment is maintained. The European Union, it says, could achieve more sustained economic growth if it did more to deliver on the potential of the single market.

10. The enlarged Assembly stresses that concrete steps by the international community in order to implement the decent work agenda of the International Labour Organisation and well-designed domestic policies – in particular those concerning social responsibility of companies - are essential for enhancing the benefits from globalisation while addressing the adjustment and inequality concerns in the OECD economies. These policies would also help strengthen public support for freer trade and investment policies, and promote perceptions that globalisation is an opportunity for all.

11. While the biggest emerging non-OECD economies are a major driver in the growth of trade, 75% of the total is still accounted for by the OECD's 30 member countries. All in all, world trade remains strong. In fact, its growth during 2006 turned out to be slightly larger than anticipated, at 9.6%, and although the pace is expected to moderate to around 7.5% this year, there are indications of a rebound, with a forecast of 8.3% growth for 2008.

12. The enlarged Assembly stresses the global importance of achieving, even at this late stage, a trade deal during the current WTO negotiating round. The enlarged Assembly underlines that failure to conclude the Doha Development Round would jeopardise the considerable progress already made and waste the opportunity to rebalance the multilateral trading system, particularly in favour of the less developed countries, while success would result in enormous benefits to world trade and development. What is needed is political will and political pressure from parliaments to ensure the necessary compromises. The enlarged Assembly also urges the United States Congress to renew its Trade Promotion Authority with a view to facilitating the negotiation process.

13. The OECD points to the persistence of wide trade deficits, particularly in the case of the United States. It notes that a correction seems inevitable at some point, and that there is a risk this could be disorderly with rapid currency and interest rate shifts. It is difficult to predict what the circumstances of such a correction might be, but the OECD notes the massive support that is currently being applied to the United States dollar, with official purchases by central banks running at more than $0.5 trillion per year.

14. The enlarged Assembly notes that in 2006, net official development assistance (ODA) from OECD Development Assistance Committee members fell by 5.1% in real terms to $103.9 billion, including a still substantial amount of exceptional debt relief to Iraq and Nigeria. Excluding debt relief, ODA fell 1.8% in real terms. This result is a matter of some concern in the light of the 2005 G-8 and Millennium+5 Summit commitments, since reconfirmed by G-8 development ministers, equivalent to an increase in aid by $50 billion in real terms between 2004 and 2010, and to double aid to Africa over the same period. As debt relief is now expected to continue to decline further, other forms of aid will have to increase very substantially in 2007 and 2008 if there is to be a realistic prospect of meeting the 2010 targets through planned and manageable increases. The enlarged Assembly again urges OECD and Council of Europe member States to honour their funding commitments. In the meantime, it pledges support for the essential work being undertaken by bodies such as the OECD to ensure, and to demonstrate, that this funding is used in the most effective way possible. At the same time, it requests that OECD and Council of Europe member States enforce information disclosure, external audit and evaluation of operations in both ODA donors and recipients to ensure transparency and efficiency.

15. In recent years, the OECD has become one of the leading institutional campaigners against international corruption – an issue that is all the more pressing in an era of rapid globalisation, with closely interconnected markets and the free and instantaneous movement of capital. Like the Council of Europe, a close working partner in this area, the OECD sees corruption as the leading contemporary threat to good governance, sustainable economic development, and fair democratic activity. The enlarged Assembly urges all OECD and Council of Europe member States to subscribe to, and enforce, the anti-corruption standards set by OECD instruments, as well as the United Nations Convention against Corruption. Moreover, deeply concerned about the spate of counterfeiting and piracy in some countries, it invites the two institutions to extend their co-operation to addressing the problem of counterfeiting and piracy, notably by taking concrete measures through their fruitful partnership in the framework of the Council of Europe's GRECO (Group of European states against corruption).

16. The enlarged Assembly notes the growing global demand for quality education from primary school to lifelong learning. The quality of education cannot only be measured by the acquisition of knowledge and skills, but is also determined by forming the social competence necessary for the wellbeing of every individual as well as for society.

17. The enlarged Assembly welcomes the internationally recognised Programme for International Student Assessment (PISA) carried out by the OECD and the important role of the Council of Europe and UNESCO regarding the Bologna Process in Europe. Therefore, it calls upon the member governments of the OECD, UNESCO and the Council of Europe and their education ministers to draw up a framework policy for global education for the 21st century. This should aim among other things to assess the ability of the education system worldwide to introduce new information technologies, including e-learning and networking, so as to adapt to the profound and rapid changes resulting from globalisation. The enlarged Assembly invites the Secretary General of the Council of Europe to establish the necessary contacts and convene a preparatory meeting.

18. Innovation performance is a crucial determinant of competitiveness, productivity and national progress, and an important key to addressing global challenges such as climate change and sustainable development. In order to strengthen innovation performance and its contribution to growth, a strategic and comprehensive cross-government policy approach is required. Recognising the OECD's high-quality contributions in the area of innovation, the enlarged Assembly welcomes the OECD's decision to draw up an Innovation Strategy, which could make an important contribution to policymaking in OECD and non-OECD economies.

19. Recognising the importance for governments in succeeding in their reform efforts, the enlarged Assembly calls on the OECD to intensify its work on the political economy of reform and increase its support to governments in their reform efforts. The enlarged Assembly also welcomes the renewed priority that the OECD is giving to its work on migration, water and health.

B. Explanatory memorandum by Mrs Antigoni Papadopoulos, Rapporteur

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I. Background

1. In October 2007, the Enlarged Parliamentary Assembly of the Council of Europe will meet in Strasbourg to discuss 'The OECD and the World Economy'. In preparation for this annual debate, the following report offers a summary of key trends and issues, drawing upon the Rapporteur's recent contacts with OECD staff. The draft Resolution was adopted on a provisional basis by the Committee on Economic Affairs and Development on 22 June 2007, and will be submitted for final adoption at the formal session of the Enlarged Economic Committee and the Enlarged Parliamentary Assembly in October.

2. As in previous years, this report has been made possible by the insightful and expert contributions provided by a wide range of OECD specialists, and the Rapporteur would like to thank all those involved for their generous assistance. Although such a report cannot hope to reproduce the wealth of detail provided on all the issues discussed, it will aim to give a dynamic overview of the global economy, with its strengths and weaknesses, opportunities and risks, and an outline of the major questions and challenges affecting it, while also examining in more detail several areas that seem, to the Rapporteur, of special contemporary significance.

3. In particular, the report will examine the impact of rising household debt levels, as well as issues surrounding energy supply, finance and trade liberalisation, and international development aid. It will also provide an update on the OECD's anti-corruption activities, and review the latest report of their recently-devised competitiveness index, 'Going for Growth'. Finally, it will touch on the enlargement of OECD's membership in the light of the decisions taken at the May 2007 Ministerial Council.

II. Introduction: prospects for the world economy

i. A global rebalancing seems to be underway

4. The Rapporteur's recent predecessors have been able to present a picture of continuing, non-inflationary growth for the world economy, achieved in the face of rising oil and commodity prices. Indeed, last year's report maintained a cautiously positive outlook, despite a slowdown in growth during 2005. **T**his year the Rapporteur heard an assessment that remained broadly upbeat – one in which, rather than stalling, global economic growth appears to be rebalancing. This was confirmed by OECD's Chief Economist, Jean-Philippe Cotis, in the May 2007 *Economic Outlook*: "the current economic situation is in many ways better than what we have experienced in years. Against that background, we have stuck to the rebalancing scenario. Our central forecast remains indeed quite benign: a soft landing in the United States, a strong and sustained recovery in Europe, a solid trajectory in Japan and buoyant activity in China and India. In line with recent trends, sustained growth in OECD economies would be underpinned by strong job creation and falling unemployment." The accompanying projections suggested that OECD-wide inflation was likely to remain contained, at a little over 2%, while unemployment should decline from 6% this year to 5.7% in 2008.

5. These projections are made against a background of strong world trade growth. Although the major non-OECD economies are an important driver in the growth of trade, 75% of the total is still accounted for by the OECD's 30 member countries. And within this group, growth rates have converged, as the US economy has slowed, Japan has maintained pace and the euro area has broadened its recovery. All of this is taking place against a backdrop of lower, and rather more stable, oil and commodity prices.

6. Since the publication of the *Economic Outlook* in May, a sharper-than-expected slowing in the US housing market as well as the turmoil in global financial markets triggered by growing problems in the sub-prime mortgage markets, have led to some reassessment of the outlook and associated risks. At his 5 September press conference dealing with the OECD's *Interim Assessment* of the economic situation, Mr Cotis noted that: "To date, swift and forceful central bank action has helped contain the ensuing financial turbulence. While it is too early to gauge to what extent the re-pricing observed so far – and possible further financial adjustments – will affect prospects for activity, it has happened at a point in time when world economic developments are still strong. Hence the May 2007 economic prospects [for the current year] are not revised that much…. [however] prospects going forward are clearly less buoyant and more uncertain … in a context where overall financial markets conditions are likely to remain durably tighter."

ii. Energy and commodity prices still high

7. After falling back temporarily, oil prices remain high with Brent crude averaging about $**70** per barrel. As ever, the reasons for the temporary fall are complex, but several factors are crucial:

- Mild winter conditions over much of the northern hemisphere, along with moves by consumers to reduce consumption or shift their energy demand. Natural gas, in particular, is increasingly replacing heating oil. It even seems possible that OECD oil demand will turn out to have contracted slightly during 2006 (the slowdown in US growth is also partly responsible for this).
- A reduction in the 'risk premium' factored into prices: geopolitical tensions, though hardly absent, are seen to have abated somewhat, and fears of supply disruption have not materialized. There was also a fairly low level of natural disasters; in particular, the Gulf of Mexico's hurricane season was less severe than the year before.
- Refinery shortages and transportation bottlenecks have eased, so that distribution has become more stable and reliable.

8. So will prices fall? That seems unlikely. For against these factors should be set the fast-growing worldwide demand for oil, especially in emerging economies. Spare production capacity is therefore likely to remain scarce, with recent investment decisions taking some years to pay off. The predictions made by OECD in its autumn 2006 *Economic Outlook* assumed that oil prices would remain at $60 per barrel during 2007-08, while noting that oil futures were currently priced a little above this level.

9. Up until recently, oil producers have been slow to spend their windfall revenues. Instead, there had been a tendency, as in Russia, to build up substantial reserve funds; and in fact, OECD export growth to OPEC countries has slowed over the last couple of years. This has helped the stability of world financial markets, and may be equally beneficial at lower price levels, with producers able to maintain spending and import levels.

10. The rapid acceleration in metals and commodity prices seems also to have come to an end, with some having peaked, and others predicted to fall. Despite continuing demand growth, there has been huge investment in exploration and mining, with particular increases in copper production likely. Another factor reducing costs is the shift in refining capacity, especially for aluminium, away from countries with high power costs, and towards the Middle East, India and Iceland (which is expanding its hydro-electric industry). Interestingly, this lowering of price is opposed to the emerging trend in agricultural products, as demand shifts toward bio-fuels, and toward replacing carbon-based products with natural substitutes, such as rubber. Nevertheless, prices remain high, driven by buoyant demand from China and growth in world output more generally.

iii. Financial markets have recently come under pressure

11. In the wake of the recent financial market turmoil, interest rates have moved up worldwide, and stock markets have come under downward pressure, despite the fact that corporate profits remain buoyant, as globalised production and distribution drive down costs.

12. Outside of the United States, property and housing markets remain supportive of domestic growth. Real house prices are still increasing in most OECD countries, with the notable exception of Japan and Germany, where prices have been in decline for some years, and more recently in the United States where some indices are showing declines. In some European countries, however, prices have recently still been rising fast, with a major effect on the economy – notably France, Denmark, Ireland and Sweden. In others, where increases have moved out of line with economic fundamentals, the growth has slowed markedly.

13. At this stage, house prices appear to have peaked in the United States, although this is not apparent elsewhere, despite the fact that house prices are high relative to historical benchmarks. Were a wider downturn in house prices to follow, the consequences are difficult to predict. It is possible that economic growth would be badly hit, as was recently the case in the Netherlands. However, recent experience in the UK, Australia and Finland suggests that, if other economic fundamentals prove resilient, the impact can be limited.

iv. There is a continuing need for consolidation and reform

14. Amongst OECD members, tax revenues have generally been high in recent years, and this has relieved immediate pressure on fiscal policy. But the OECD underlines that there is a continuing, and indeed urgent, need for the world's major economies to pursue fiscal reform. Several years into a period of healthy growth, not enough is being done to reform government policies and refashion them for the future, especially given the demographic challenge of aging populations, which will place huge pressures upon public services and entitlement programmes. The message is that, if the opportunity posed by this relatively benign period is missed, the future costs could be very significant.

15. Implementing reform, however necessary, is a challenge for all governments. While reforms are rarely painless, the costs of inaction are high. A key challenge is therefore to communicate effectively the need for reform to the public. Countries have much to learn from each others' experiences with reform, both successes and failures. Adjustment assistance is important, as is the need to maintain conditions for economic growth and job creation during the reform process. If governments are to succeed in their reform efforts, they need to reach out to a wider range of stakeholders and involve the social partners in reform efforts. The OECD contributes to the design, implementation and political economy aspects of reform through its high-quality, evidence-based analysis and internationally comparable data. It is well placed to identify good practices based on the wealth of experiences contained in country and thematic reviews.

16. Along with large public deficits, the OECD points to the persistence of wide – and widening – trade deficits, particularly in the case of the US. It notes that a correction seems inevitable at some point, and that there is a risk that this could be disorderly with rapid currency and interest rate shifts. It is difficult to predict what the circumstances of such a disorderly correction might be, but the OECD notes the massive support that is currently being applied to the US dollar, with official purchases by central banks currently running at more than $0.5 trillion per year.

17. A further risk to the economic outlook is protectionism. The OECD renews its call for continuing efforts to achieve deregulation, both for domestic economies and in terms of international trade and investment. The OECD countries have made great progress in dismantling barriers and improving the treatment of foreign investors, in particular through the *Codes of Liberalisation of Capital Movements and the Declaration on International Investment and Multinational Enterprises*. Recent OECD investment initiatives such as the *Policy Framework for Investment*, the *Principles for Private Sector Participation in Infrastructure* and the ongoing project on *"Freedom of Investment, National security and 'Strategic' Sectors"* seek to ensure that international investment continues to contribute to global growth and prosperity. The European Union, it says, could achieve more sustained economic growth, if it did more to deliver on the potential of the single market; and it also stresses the global importance of trying to achieve, even at this late stage, a trade deal during the current WTO negotiating round.

III. A survey of key economies

i. The United States

18. Having expanded at about 3% in 2006, the US economy is forecast to achieve only around 2 per cent growth in 2007. In part, this is an ongoing correction from previous unsustainable growth rates, and in part it is due to a combination of higher interest rates, oil prices and taxation. Specifically, there were notable falls in construction starts, as the housing market declined in some parts of the country, and in car production, with domestic manufacturers under pressure from imported models.

19. Measures of core inflation have fallen since the beginning of 2007 and are now close to the upper end of the Federal Reserve's comfort zone of 1-2% inflation. Labour costs have also remained subdued. While unemployment has fallen to cyclically low levels of around 4.6%, weaker employment growth is likely to push it higher over the next couple of years. Having risen steadily for two years to 5.25%, US interest rates were cut to 4.75% on 18 September 2007, and their future direction will depend on developments during 2007. In particular, if it were perceived that growth prospects were weakening while inflation remained contained there may be a case for some policy easing.

20. Assuming that energy prices stay at current levels, the OECD believes that inflation is likely to remain controlled, and there will therefore be scope for rate reductions, particularly in the context of rising unemployment. In fact, longer-term interest rates have already declined in anticipation of this.

21. Higher than expected tax receipts have helped to limit the federal deficit to 1.9% of GDP in 2006, compared with nearly 4% in 2004. Assuming that tax receipts grow roughly in line with GDP, the deficit is likely to remain at roughly this level over the next few years. However, the OECD points out that, in general, federal policy measures have recently tended to widen the deficit rather than reduce it, and points to major increases in entitlement spending foreseen under current legislation, which would have an 'alarming' effect on the deficit over the next two decades.

22. More immediately, growth is expected to soften during the course of 2007, particularly given recent signs of a weakening labour market, while the recent financial market turmoil has made prospects going forward less buoyant and more uncertain. That said, overseas demand should provide a stimulus to growth, helping to hold the US current account deficit, which has grown rapidly in the last decade, to around 6.5% of GDP.

23. The housing sector is now expected to exert a longer and more significant drag on the economy, while consumer confidence has weakened. If the slowdown spreads throughout the country, there would be a significant risk to the outlook. Also, buoyant stock prices have supported growth over the past few years, and it will therefore be damaging if recent stock market uncertainties persist.

24. In the United States, the monetary authorities are confronting evidence of some softening in activity as well as financial market turmoil brought on by the sub-prime loan problems. While inflation remains somewhat above levels consistent with price stability, there is a case for some easing in the federal funds target rate.

ii. Asian economies

25. Japan is now enjoying the longest sustained economic recovery in its post-war history. In 2006, GDP growth reached an exceptional 2.8%, fuelled by export growth of more than 10%, and by buoyant domestic demand. And while there was a slowing of output growth during 2006, corporate profits and business investment levels remain high, so that the OECD foresees overall growth continuing at around 2% in 2007-08, in line with the country's long-term potential growth rate.

26. The corporate sector has been strengthened by a substantial reduction in debt over recent years, and the removal of excess capacity. This in turn has stimulated capital spending, and provides a strong basis for future business investment, helping to offset the effect of reduced public investment, which has declined as a proportion of national GDP by 4.5% over the last decade.

27. Domestic consumption has continued to gain from lower household savings levels, and less downward pressure on wages. This has been particularly evident since early 2005, although actual wage growth remains limited, with a structural shift towards temporary and flexible employment still counterbalancing the tighter jobs market caused by Japan's aging demographic profile. Overall, though, firms are boosting regular employment, and unemployment is expected to reach 3.9% in 2007, its lowest level in a decade.

28. Meanwhile, despite the fact that land prices in urban areas **are** rising for the first time in 15 years, and higher energy costs causing general inflationary pressure, core inflation – when calculated using OECD definitions – is thought to have been negative during 2006, for the eighth year in a row. Accordingly, the OECD suggests that short-term interest rates should not be raised until inflation is seen to be firmly positive. Rising levels of government debt – which reached 176% of GDP in 2006 – threaten long-run fiscal sustainability, particularly as the fiscal pressures from ageing are expected to increase. The OECD therefore recommends that current deficit reduction measures be enhanced through a detailed medium-term fiscal plan, which would be closely linked to the annual budgetary process. In addition, it calls for further structural reform and deregulation, particularly as Japan's demographic trends accelerate.

29. In Korea, strong private consumption during 2005 helped the economy to rebound from a period of slow growth, and in 2006 GDP expanded by 5%. With wage growth now under pressure because of lower corporate profits, and a slowdown in business and residential construction, the

OECD expects that GDP expansion will moderate to around 4.5% in 2007-08, in line with its potential growth rate.

30. Alongside the effects of higher oil prices, corporate profits – particularly those of exporters – have been hit by a strong appreciation in the value of the won, causing lower business and consumer confidence. Construction investment has also been slowed by government measures to restrain the real estate market, and by a tightening of monetary policy, with short-term interest rates raised five times in the ten months to August 2006.

31. The OECD foresees a strengthening of domestic demand during 2007, which will help to offset the effect on exports of slower world growth. The OECD also believes that Korea's focus on high-technology products and its close links with China will help to boost export potential. But it warns that local political uncertainties could undermine confidence, and that higher interest rates may restrain demand by more than expected, given that household debt levels grew by more than 50% between 2000 and 2005, to reach 144% of household disposable income.

32. China, which increasingly leads Asia's economic expansion, has rapidly growing influence in regions such as Africa and South America, and is by some measures already the world's second largest trading country. In recent financial quarters, China's GDP growth has consistently exceeded 10%, with the full-year result for 2006 likely to be around 10.6%.

33. Chinese exports have continued to surge, growing by 20% in value during 2005 alone, with locally-owned companies increasingly matching the export performance of foreign-owned firms. With healthy domestic demand, import levels have also risen sharply, although the current account surplus continues to increase - from around $70 billion in 2004 to an expected $210 billion in 2006 – and this trend is likely to continue.

34. In such an expansionary atmosphere, tax revenues are rising sharply and, with government expenditure under control, China's national budget is expected to be in surplus for 2006, perhaps by around 1.5% of GDP. Inflation, meanwhile, now seems subdued, having fallen back over the last couple of years. With corporate profitability very strong, investment continues to rise as a share of national GDP, boosting economic capacity to a level that makes current growth rates sustainable in the medium term. And employment gains continue to be healthy, with more than 40 million jobs created outside the agricultural sector over the last three years.

35. As previous Rapporteurs have described, China faces a formidable array of social, political and economic challenges, not least aging demographics. But on balance, its current outlook is positive. Some slackening in export expansion is likely during 2007, in line with world demand, but growth is likely to remain above 10% over the next couple of years.

36. However, the OECD once again highlights China's growing level of foreign exchange reserves, which pose the risk of a credit surge leading to inflation and economic overheating; and it points out that managing this situation via bank lending controls is increasingly inappropriate, as China's banks become more commercialized. It recommends that the currency should be allowed to appreciate more rapidly, so allowing market mechanisms to act as a corrective, thereby also restraining protectionist sentiment abroad, which remains a key external risk.

37. India's economy has recently seen exceptional growth, reporting GDP increases of 8.5% for both 2004 and 2005. This pace is thought to have slowed slightly, to 8% in 2006, primarily because of lower agricultural output. The non-agricultural sector continues to surge, however, with recent growth at or in excess of 10%, with particular strength in manufacturing, and in the recently liberalised telecoms and air travel sectors. The IT sector, too, continues to prosper, with booming exports of software and business services.

38. There are, however, some signs of overheating, with inflation picking up and the current account moving into deficit. Despite a measured series of interest rate increases, both the broad money-supply and the take-up of bank credit have increased dramatically, while urban property prices and the Mumbai stock exchange have surged. State and central government revenues are well ahead of expected levels, driven by strong tax receipts and the introduction of local VAT.

39. The OECD cautions that, while there is considerable momentum in the Indian economy, government authorities need to avoid a 'pro-cyclical' policy, whereby extra revenue is immediately

absorbed by extra spending. Instead, there should be a focus on containing budget deficits within the 3% of GDP range set out in the country's Fiscal Responsibility and Budget Management Act. This will help to keep inflation under control and enable steady GDP expansion, in line with India's growth potential of around 7.5% per year.

40. Mention may be made here of the OECD's recent closer involvement with the South East Asia region. According to the OECD's Policy Brief *Fostering Regional Integration: Peer Review in Southeast Asia* (May 2007), the region "has shown remarkable economic dynamism. Economic growth has been robust, and trade and investment flows have been soaring as a result of increasing international division of labour. In parallel, regional integration has recently deepened further and several initiatives for regional co-operation have been launched, especially since the Asian crisis in 1997. In particular, the concept of an ASEAN Community, proposed in 1997, has as its goal a single market and production base. In January 2007, the OECD held a regional dialogue about the role of peer review in fostering regional integration in South East Asia. Peer review has been a hallmark of OECD working methods for more than 40 years, and currently covers a wide range of policy areas. It has evolved over time to take account of new developments and new requests, such as involving civil society, business and labour."

iii. The euro area

41. Early in 2006, after a series of stalled recoveries, the OECD detected 'a clear, though mild, upward trend' in the euro area. This view has now strengthened, and economic recovery is seen to have taken hold. While overall, GDP decelerated in the second quarter, it is expected to pick up to a rate around potential over the remainder of the year, and growth for 2007 should reach 2.8%, with almost all economies expanding at or above their potential rate. Although falling back slightly, growth is expected to distinctly exceed potential in 2007 and to be still around trend in 2008.

42. As anticipated, exports have been crucial, with particular vibrancy in orders from Asia and the EU's new member states. Germany has consolidated its position as the world's top exporter; and with GDP growth of 3% in 2006, compared to just over 1% in 2005, its domestic recovery helped boost exports from around the region, particularly from Italy - helping to bring that country's industrial recession to an end. Exporters in the Netherlands, Ireland, Greece and Spain also continued to perform well, although there was some decline in export performance in Belgium and France.

43. All in all, 2006 saw a widespread broadening in the base of recovery, with pent-up investment demand being released. Business confidence is high, particularly in Germany and France, with strong profitability, and household consumption beginning to rise as consumer confidence also strengthens. Domestic demand is key to growth in France, for instance, where rising property prices have helped to boost sentiment (although it is still at fairly weak levels). Across the euro area, consumption growth is expected to continue at moderate levels, reaching 2.3% in 2008.

44. This performance has begun to impact the labour market, with overall unemployment falling from 8.9% in 2004 to an expected 7.9% in 2006; employment growth has been strongest in the smaller countries, particularly Spain and the Netherlands, and has been most evident in part-time and service-sector work. In the larger countries, challenges remain: reform-led employment growth has begun to make an impact in Italy, but the OECD suggests that Germany's unemployment fall remains 'largely cyclical', and that a decline in structural unemployment is not yet apparent; however, it does see the total falling back from 8% in 2006 to 7.2% by 2008, as the impetus shifts from exports to consumption, and real incomes rise. Meanwhile, in France the employment participation rate has fallen back along with unemployment, given special early retirement legislation passed in 2003. While private sector employment has increased slightly, much of it is temporary work, and the OECD suggests that regulation is still curbing employment growth.

45. Inflation is expected to remain around 2% for the euro area over the next couple of years. Wage pressure has been subdued, and most countries have been slowly reducing the economic 'output gap' that had opened up in preceding years. As that effect diminishes, and with the euro area growing at or above its potential rate, the OECD suggests that interest rates will continue their gradual upward trend during 2007, and perhaps 2008, to forestall inflationary pressure.

46. With government revenues unexpectedly high, there has also been a general improvement in public finances. The OECD points to some structural fiscal improvements, particularly in those cases

where deficits were in excess of the 3% ECB limit. In France, deficit reduction has been well ahead of plan, while in Greece there is the prospect of the deficit falling durably below 3%, for the first time in many years. While encouraging, the reforms underway in most countries still fall short of what will be needed, especially as Europe's population ages, and the OECD feels that the medium-term budget plans set out in the national Stability Programmes are not sufficiently ambitious. Euro area finances are not yet on a sustainable footing for the long term, and revenue gains during the current upswing should therefore be applied to deficit reduction rather than spending increases or tax cuts.

47. In the short term, there are some risks to demand, posed by a possible slowdown in construction as interest rates rise, or the dampening effects of tax increases, particularly the VAT rises in Germany. But it is also possible that investment will increase more than expected, while Europe's export markets continue to outperform. In this context, among the main dangers is that wage pressures might translate into a loss of competitiveness. There is also a risk that the current fairly benign outlook may slow the pace of domestic structural reform. Additionally, recent financial market turmoil adds to uncertainty and downside risks going forward.

iv. The United Kingdom

48. Helped by rising investment and strong domestic consumption, GDP picked up during 2006, with growth expected to be around 2.6%, and a similar performance expected in 2007-08. Against some expectations, the housing market has remained strong, with prices rising at 5-10%. Household savings continue on a rising trend, with interest rates relatively high, and amidst ongoing consumer anxieties about pensions. Interest rates have recently risen in response to a run-up in headline inflation earlier this year, although inflation has subsequently fallen back.

49. Labour productivity has been improving, and the OECD believes that immigration may be helping the UK to achieve a 'higher path for potential output', providing stronger growth without the risk of higher inflation. Thus the overall outlook for the UK is seen as positive, with improved skills training and implementation of the national disability scheme recommended as further incentives to growth.

50. Government revenues have recently been strong, but in the OECD's view, restraint in public spending and delivering value for money is the UK's key fiscal challenge. The OECD's own projections suggest that the government deficit will narrow less rapidly than set out in last year's budget and, based on recent experience, they suggest that the government may find it difficult to meet its 'golden rule' fiscal objective without further revenue or expenditure measures.

v. Other Key Economies

51. The Canadian economy has slowed slightly over the last couple of years, and is now thought to be growing at near to its potential rate, around 2.8% in 2006. A series of factors have combined to bring about the first decline in Canada's 'terms of trade' position since 2001 – notably, lower oil and commodity prices, slowing US growth, and an appreciation of the Canadian dollar. There has, then, been a decline in export growth, slowing from 5.2% in 2004 to 1.3% in 2006 – while imports have continued to grow at a rapid rate, last year increasing by 5.8%.

52. As this suggests, domestic demand has remained strong, supported by property markets and a series of federal tax cuts and incentives, but there are signs that this is beginning to subside – and residential investment, in particular, has begun to decline. The OECD expects to see a short period of below-potential growth, followed by an increase in activity, with GDP growth reaching 3.1% in 2008. Export demand will be a key factor, with smaller property margins curbing consumption.

53. Inflationary pressures are, in the OECD's view, under control in Canada, and it advises the Bank of Canada to maintain steady policy rate conditions, placing emphasis on the need to focus on reducing the national debt, given the country's aging demographic profile. The main risks to Canada's economic outlook are seen as external, particularly that US growth fails to regain momentum, or that there might be sharp falls in commodity prices.

54. Mexico has been similarly affected by weaker US demand and lower oil prices. Exports have performed strongly in recent years, but the OECD foresees export growth slowing from 11.1% in 2006 to 5% in 2007, before beginning to rebound. Domestic demand, however, supported by higher levels

of formal employment, migrant receipts and bank credit, should remain robust, while foreign investment remains healthy, and should be encouraged by reduced political uncertainty.

55. High revenues in recent years have meant that a tight fiscal stance, with public sector borrowing falling to 2% of GDP in 2006, could be combined with extra public investment. The draft 2007 budget foresees a substantial oil-related revenue decline, in line with OECD forecasts, but aims for a further reduction in borrowing, along with moderated public investment and restrained government spending.

56. Overall, GDP growth is likely to fall from 4.7% in 2006 to 3.6% this year, and will begin to edge up again in 2008. With lower growth and oil revenues, Mexico's fiscal conditions will become more challenging, but the OECD urges that policy not be loosened. Rather, it suggests reforms to improve education, encourage business operations, and to widen the tax base, to reduce economic distortions and improve the long-term conditions for essential spending programmes.

57. In Brazil, there are signs that the economy is recovering from a brief downswing, with private consumption balancing a slower rate of export growth. GDP is expected to increase by 3.1% in 2006, and 3.8% in 2007. The country's trade and current accounts remain in surplus, and with the exchange rate having stabilised and interest rates lowered, both confidence and investment are likely to bounce back in coming months.

58. Employment continues to grow, with recorded rises in unemployment accounted for by a rising participation rate. Inflation has remained subdued, at around 3% in 2006, compared with its high point of over 16% at the end of 2002, and this position is expected to continue, paving the way for further interest rate cuts.

59. The OECD describes Brazil's management of public debt as 'exemplary', and views current fiscal policy as being well on target, although it believes that options for restraining the real-terms rise of public expenditure should feature more strongly in the government's agenda.

60. However, with regard to some other countries in Latin America, for example in Venezuela and Bolivia, the Rapporteur has noted the concern that has been expressed in the Committee about the trend towards nationalisation of certain sectors of the economy, including oil and gas.

61. Poland's economic performance has been very strong, with inflation and unemployment falling rapidly, investment surging, and exports up by more than 15% during 2006. GDP growth for the year is expected to exceed 5%, and similar levels are likely in 2007-08.

62. It is this very pace of growth that represents Poland's chief risk at present, with a danger of wage inflation, especially in the public sector. The government is urged to rationalize public finances, reduce public-sector employment and improve efficiency, so as to improve the prospects for non-inflationary wage growth.

63. The Czech Republic has recently recorded GDP growth even higher than that in Poland, but this is now on a slight downward trend, and expected to moderate from 6.2% in 2006 to 4.6% in 2008. Foreign Direct Investment has driven a huge increase in manufacturing and exports – with car production rising 50% in a single year – bringing lower unemployment, higher confidence, and a strong rise in imports.

64. But the OECD believes that the current atmosphere of political stalemate is damaging the Czech Republic's prospects, particularly the delay in implementing reforms needed to reduce the government deficit. It reports that no progress is being made in key areas such as pensions and healthcare reform, and this situation, coupled with the postponement of entry into the euro area, is leading to a risk of serious fiscal problems.

65. There are similar challenges in Hungary, where the government deficit is thought to exceed 10% of GDP. While there has been a general welcome for the adjustment measures announced so far, there remains the 'serious risk' of a breakdown in confidence, and much depends on the government's determination to carry through reforms that involve sizeable cuts in spending. In this context, growth is expected to fall from around 4% in 2006 to 2.2% in 2007, despite the continuing strength of exports.

66. Russia's economic growth, thought to have reached 6.8% in 2006, is expected to slow to around 5.5% in 2007, given recent appreciation in the rouble and the lower level of oil prices. Household consumption – which is growing at double-digit rates – will continue to be a key driver of economic expansion, although investment growth is also relatively strong. Government spending is also growing rapidly, though from relatively low levels; in real terms, recent federal spending has been rising at the rate of around 15% per year.

67. The OECD cautions that, while understandable in the context of recent windfall revenues, such rapid increases will tend to reinforce inflation and currency appreciation, and will threaten competitiveness. However, it also notes that Russia has now paid off some $22 billion of foreign debt early, and has placed a large share of its oil profits in a Stabilisation Fund, much of which is being invested abroad, and which is subject to increasingly effective management. All of this should help to improve Russia's long-term fiscal position.

68. Across the economy, structural reform remains variable, with progress in some areas, such as the introduction of a new competition law and new rules for oil-sector taxation. The OECD welcomes these measures, but warns that their effective implementation cannot be taken for granted, and points to increasing state intervention in key sectors, together with preferential treatment for state-owned operations.

69. Mention may be made here of the Middle Eastern economies that form part of the OECD's Middle East and North Africa (MENA) Initiative on Governance and Investment for Development, a regional effort, initiated and led by countries in the region. The aim is to promote reform designed to improve the investment climate, modernise governance structures and operations, strengthen regional and international partnerships, and promote sustainable economic growth. The aim is also to strengthen countries' capacity to design and implement policy reforms. The MENA Initiative consists of two pillars: the Governance Programme – aimed at modernising public governance structures and processes - and the Investment Programme – aimed at improving the investment climate and policies.

70. Since its official launch in 2005, the MENA Initiative has, among other things, created a unique mechanism for results-oriented policy dialogue and capacity building among practitioners from MENA and OECD countries; promoted the formulation and endorsement of National Action Plans for improving governance and investment by several participating MENA countries; supported the implementation of these National Action Plans; and led to suggestions for establishing regional public management and investment capacity building centres which have the critical size to disseminate best practices in a cost efficient way. Bahrain has for example created a regional Centre for Investment and the UAE has established a regional Institute for Corporate Governance to support the work of the MENA Initiative. The Initiative has acted as facilitator for partnerships among Arab governments and bilateral and multilateral donors, and worked in close co-operation with the World Bank, the Arab League, the European Union, UNIDO and other international and regional organisations.

71. Building on achievements so far, the primary focus of the Initiative for 2007 is to support the implementation and further development of MENA countries' National Action Plans through deepened capacity building and peer-advice as well as monitoring and measurement of progress.

IV. A look at key future challenges

72. As the OECD's Secretary-General has said: "Enlightened leaders should see the broader picture and realise that what is at stake is mankind's capacity to deliver a better world". He points to the wide array of current global challenges, many of which are new, uncertain in nature and difficult to tackle. Beyond the old enemies of war and poverty, we face an immense challenge from climate change, including water and food shortages, the spread of disease, mass migration, social strife and an increase in the force and frequency of natural disasters, which in turn is putting the global insurance industry under unprecedented pressure. When set alongside the threat of terrorism, the surging demand for, and price of energy, and the trend towards older populations, this is not a time, he points out, for retrenchment or protectionism.

i. Climate change

73. Climate change is an excellent example of the complexity of today's challenges, since it has multiple causes, multiple impacts, and while its existence is now widely accepted, its precise effects and long-term extent remain uncertain. But clearly, given the questions of energy demand (discussed

below), the problem of greenhouse gases can only be addressed by collective action. In the OECD's view, a global carbon price would be an excellent mechanism for cost-effective reduction of greenhouse gases. This could be created through applying a carbon tax worldwide (ideally across all countries and sectors) or by linking up and extending existing policies such as national carbon taxes or emission trading schemes. The EU and a number of countries, regions, and sub-national regions – including some US states - already have, or are planning to launch such schemes, and are considering links with one another. The OECD has studied the potential for such linkages, and advises its governments on how to work toward broadening and deepening the carbon market to stimulate innovation and new technologies.

74. There is also an increasing focus on the economic aspects of climate change. Both the OECD Economic Surveys and the Environmental Performance Reviews have included policy studies in member countries to address climate change, and provided specific recommendations. A number of non-member countries have already been reviewed. At the request of the Chinese government, the OECD has conducted during 2006 a review of its environmental performance, and the final report will be published in summer 2007. This is seen as a significant opportunity for China and OECD countries to work together, on issues of crucial importance to China and the whole world. In March 2008, OECD will release an OECD Environmental Outlook to 2030 which, *inter alia*, will provide analysis of the impacts of specific climate change policies on greenhouse gas emissions, the costs of these policies, and the distribution of these costs. This work will be extended through joint analysis by the OECD Economic and Environment Policy Committees in 2007-2008, focused on the economics of climate change action in a post-2012 framework.

ii. A question of energy

75. Despite the resilience of the world economy in the face of recent increases in oil (and natural gas) prices, there has inevitably been an impact on growth. While the prices have stabilized, predictions of a price decline have proved unfounded and, as discussed earlier, the OECD does not foresee this happening in the medium term. Although, as noted earlier, transport and distribution bottlenecks have eased, questions of energy security are being increasingly voiced across the world. In the US, President Bush has laid emphasis on ethanol, renewables and increased domestic production to reduce dependency on overseas supply; in Europe, where local production is declining, there have been concerns over the reliability of external supply, prompting the development of alternative pipelines, and plans to ship liquefied natural gas from the Middle East.

76. Energy security is, increasingly, a source of global competition and political tension. China, for instance, has been very active in building trade and investment partnerships with key energy suppliers, perhaps most sensitively with Sudan, while current tensions surrounding Iran are complicated by its status as a major oil producer. And as demand for gas soars, there has even been recent talk of establishing a gas cartel, modelled after OPEC.

77. Even with the switch to gas and other energy sources, there is no doubt that we face increasing oil demand. Total use has increased by 15% since 1995, with the US and China accounting for nearly half of that increase, and this is expected to increase by another two-thirds over the next 30 years, with China likely to become the largest consumer. Reserves are thought to be adequate to meet this level of demand, but the costs of exploration, extraction and distribution are uncertain. Moreover, Chinese oil demand has been consistently underestimated in recent years - one of the reasons for the price rises already experienced – and with so many developing economies now growing strongly, this could very well happen again, on an even bigger scale.

78. On top of this, of course, is the debate over climate change and global warming, now escalating as the first effects of climate change are felt, and the warnings of the Intergovernmental Panel on Climate Change (IPCC) begin to command a political consensus. The EU has led the way here, with its commitments to reduce greenhouse gas emission levels, but there is an increasing groundswell in the US too, with individual states setting their own environmental standards and emission controls. In fact, the last year has seen a surge in climate-change measures across the world: recently Australia, a country already suffering exceptional drought, became the first country to announce the phased withdrawal of conventional light bulbs.

79. What should be our response to this complex series of issues, which are likely to be the great policy challenge of our times? In its latest 'World energy Outlook', the OECD's International Energy

Agency (IEA) suggests that we face a choice between a future that is 'under-invested, vulnerable and dirty' or one that is 'clean, clever and competitive'.

80. Firstly, it is clear that the use of fossil fuels is not going to be eliminated soon. In fact, we need to ensure that investment in exploration and production remains sufficient to meet the world's needs. For practical purposes, the focus must be on ever-increasing efficiency – Japan is something of a model for this, with an energy-intensity far lower than its developed world equivalents - and the rapid development of clean technologies. Crucially, these developments need to be shared across the world, rather than treated as sources of competitive advantage. And it is encouraging that many emerging economies are taking this issue very seriously: China, which is immensely vulnerable to climate change, has set car emission standards that are more stringent than those in the US. However, its population requires rapid economic growth, which is currently dependent on oil and coal-fired power; if this can be done more efficiently, the whole world will benefit. Otherwise, the IEA predicts, China's greenhouse gas emissions could surpass those of the United States by 2009 or 2010 and double those of the world's richest countries combined within 25 years. China still considers that as a developing country it should not have to accept quantified emission reduction targets.

81. It is clear that a wide range of solutions need to be explored, and invested in. Bio-fuels, for instance, help to reduce demand for oil, but also have a knock-on effect in agriculture, and even in the destruction of rainforests. In the long-term, hydrogen may prove a better fuel source, but much more work is needed. Nuclear power, recently regarded is anathema in many countries, is now making a comeback; in the US and the UK, for instance, there are moves to expand capacity in new-generation reactors, and there is debate in Germany about the earlier decision to phase it out. There is potential, too, in wave, wind and solar generation systems, but each is still some way from providing significant capacity.

82. In short, to meet this challenge the world community needs to invest, experiment and display enterprise – coupled with a sense of enlightened generosity. For Europe, in particular, which has shown leadership on these issues so far, in particular on emissions-trading, this should be a natural formula.

iii. Has household indebtedness reached dangerous proportions?

83. With greater consumer access to credit and rising homeownership, many countries have seen increased levels of household debt. The OECD has conducted a detailed analysis, based on 15 countries for which data were available, to investigate this trend and to assess the vulnerability of households to economic shifts, particularly changes in interest rates.

84. The survey examines ten European countries, plus Canada, the US, Japan, Australia and New Zealand. Overall, household debt has risen from an average of 40% of GDP in 1985 to around 80% in 2005, with every country except Japan showing growth in the last few years. There are wide variations, however, with debt levels still lower than 40% in Italy, lower than 60% in France, around 80% in Ireland and Japan, 100% in the US and the UK, and higher still in Denmark and the Netherlands. The rate of growth has been least noticeable in Germany, where debt levels remain below average.

85. The share of debt accounted for by mortgages has been steadily rising, and is now around two-thirds of the total in most countries. While credit card debt has surged in some countries, such as the US, the UK and Australia, it remains less than 5% of the total.

86. This predominance of mortgage debt stems from a self-supporting combination of buoyant housing markets and financial liberalisation. Transaction and search costs have been lowered in some markets, while innovative financing has become more widely and cheaply available, in particular flexible and extended-period loans, and borrowing against existing collateral. This is especially true in Australia, the Netherlands, New Zealand and Spain. In Europe, rising wealth levels among new EU entrants has been a factor, as has the convergence toward generally lower interest rates associated with the euro.

87. But are these higher debt levels healthy? On the one hand, rising property values have brought a substantial increase in net household wealth. In France, Spain, the UK and Australia, net wealth has risen from around 5 times the level of disposable income in 1995 to more than 7 times in

2005. Such growth has been barely evident in the US, where there is greater investment in stock markets, or in Japan and Germany, where property prices have declined for a number of years.

88. So the OECD found that increases in mortgage debt have, for the most part, coincided with gains in housing wealth, in turn giving households greater capability to fund consumption or service additional debt in case of adverse economic circumstances, except if housing prices fall.

89. On the other hand, of course, there are risks. In most of the countries surveyed, debt leverage seems pretty healthy – but in several, notably the US, the Netherlands and Australia, the ratio of debt to assets has risen sharply, increasing their vulnerability should asset values fall. This has partly been driven by earlier rapid gains in value, which have encouraged households to borrow more, but also by borrowing undertaken to fund pensions or other spending. Their exposure will be all the greater, then, if these additional investments fail to provide the expected returns.

90. How big, then, are the risks? So far, there have been few signs that households are having difficulty in meeting their debt obligations, with the exception of the so-called "sub-prime" mortgage market in the United States which caters for borrowers with a limited or poor credit history. Mortgage delinquency rates have been declining in most countries over recent years, and stand at less than 2% overall. In fact, house equity withdrawal has even proved helpful in managing credit, since it allows households to raise money from a tax-favoured sector, to reduce their debt on credit cards and other high-interest borrowing. Also, flexible markets have enabled mortgages to be refinanced at lower rates or using different repayment models, including a pronounced shift from variable to fixed rate borrowing in countries such as the US and the UK.

91. Among the countries surveyed, there is a wide variation in the proportion of households holding debt, with Italy and Germany at the lowest levels, and New Zealand, the UK, the Netherlands and the US at the highest. The percentage of indebted households tends to peak between the ages of 30 and 45 years old, where the proportion regularly exceeds 70%. Debt levels decline dramatically among older households, particularly in those countries that have traditionally used variable-rate mortgages, such as the UK, Italy and Spain.

92. Equally, borrowing still tends to be undertaken by those households that have the highest incomes – in the upper incomes category, the proportion is often 80%. A similar pattern is evident in terms of the amount of debt held. Even in Italy, where overall borrowing levels are low, the income bracket of the top 10% borrows almost double the amount of the income bracket below. This distribution of indebtedness tends to lessen the vulnerability of the market as a whole, and seems to be lending stability during the current period of higher interest rates.

93. However, it is interesting to note that it is the share of indebted households in the lowest income group that has increased most rapidly since the 1980s. In particular, as the pool of homeowners has grown, its composition has changed. Many new homeowners, who would previously have rented, have highly-geared mortgages, and have high debt levels relative to their income. This increases the exposure of the market as a whole to economic shocks – and in the extreme, a range of non-conventional, or 'sub-prime' mortgage products have appeared in some countries, aimed at those who would not normally obtain credit. Already, as interest rates have risen, a much higher proportion of such borrowers have been falling behind on their payments. In the US, where this is most common, the delinquency rates for sub-prime mortgages are thought to be around 7 times those of conventional mortgages.

94. So has the rise in debt made households more vulnerable? Yes, concludes the survey, but the degree of risk involved depends only partly on fluctuations in asset values, such as house prices, which tend to grab the headlines. It is the ability of debt-holders to service debt that will be crucial in adverse circumstances, particularly in the case of mortgages, which account for most of the debt. Of course, if there were a sharp and unanticipated rise in interest rates, there would be particular challenges for those holding variable rate mortgages and substantial credit debt, with knock-on effects to the wider economy. But given that current debt levels seem well controlled, that by far the largest amount of debt is held by those best able to afford it, that net wealth has generally increased substantially and that liberalisation has improved the ability of individuals to manage their financial positions, the risk factors do not currently seem excessive.

iv. Financial markets: latent fragility?

95. Stock markets around the world have performed strongly in recent years. In developing countries, the pace of growth and the easing of access to capital have brought about boom conditions, as seen in Mumbai and Shanghai. And in developed countries, strong economic fundamentals have protected the markets, even as interest rates have risen and amidst oil-price concerns. Crucially, it has been the healthy state of corporate balance sheets, and the high level of profitability that have underpinned this confidence.

96. A key reason for this is the combination of communications technology and free investment that characterizes globalisation. About $12 billion is invested internationally each week, with companies being able both to source each aspect of their activity in the most cost-effective location, and to sell their products or services in the most profitable location. It is interesting, for instance, that France's major corporations have become leaders in many global markets, and achieved huge profitability, despite the relatively slow growth of France's own economy. Around the developed world, corporate profitability is at record levels.

97. But this position is more vulnerable than it looks. As this report describes, markets are subject to a variety of geopolitical, energy-related and financial market concerns, and any temporary loss of confidence has the potential to become a full-blown crisis. More recently, equity markets have come under pressure as investors, uncertain of the extent of the sub-prime mortgage market problem, have begun to move into safer assets, in particular government bonds. If this were to spread further and halt the momentum of profitability and investment, the consequences could be severe – and most of all for emerging economies. As Jeffrey Sachs has pointed out, most of the progress made in reducing global poverty over the last twenty years has been the result of economic growth rather than aid.

98. As reported last year, recent disasters such as the Asian financial crisis have brought about new systems of international co-operation, to promote stability of the global financial system. The Financial Stability Forum, established by the G7, represents governments and institutions, including the OECD, and seeks to improve co-ordination, address vulnerabilities and promote common standards and controls. Your Rapporteur wholeheartedly supports these efforts, and shares the OECD's view that a strong commitment to corporate governance is essential for market confidence, and for more stable investment patterns in the long term.

v. Prospects for multilateral trade

99. So far, world trade has proved remarkably resilient and continues to show record growth - but there is no room for complacency about future prospects. Like the world's financial markets, today's open trading system is more fragile than it may appear, and results from several decades of effort and negotiation. Last year's report contained an assessment of the difficulties involved in reaching an agreement at the WTO's Doha negotiating round, launched in November 2001, and unfortunately the outcome is still in doubt. During 2006 and notably in July 2007, repeated efforts to strike a deal have foundered, with continuing tension between the EU and the US, and between developed and emerging economies. However, intensive multilateral negotiations were resumed in September 2007 in Geneva.

100. The OECD believes that a successful resolution of the Doha round is possible, and that the opportunity should not be allowed to slip away. The talks reportedly collapsed largely because of disagreements over agriculture, with some developed countries unwilling to accept larger tariff cuts or bigger reductions in trade- distorting subsidies for farm products. In addition, some felt that emerging market countries were offering only minor changes in access for goods and services. In the OECD's view, however, there is sufficiently wide agreement on a range of important issues, so long as the most contentious agricultural questions, particularly centred on cotton, can be resolved.

101. If there is no agreement, all countries will lose out but the poorest countries will lose out most. The OECD has estimated at nearly $100 billion the gains in terms of increased economic activity, if there were full tariff liberalisation for industrial and agricultural goods. In addition, the benefits from liberalising trade in services – the fastest-growing sector of the world economy - could be five times higher, at around $500 billion. A Doha agreement on trade facilitation, by clearing away procedural barriers, could contribute at least $100 billion more. Developing countries are projected to account for up to two-thirds of these gains.

102. Specifically, an OECD study published last year concluded that a successful conclusion to the Doha Round would bring about a benefit equivalent to a 3% increase in GDP for developed countries,

with a cumulative effect on average earnings equal to between 1 and 2 years additional income, across a working lifetime. In the developing world, tariff reductions will have the most impact: indeed, it is often trade barriers and tariffs that prevent these countries turning cash crops into the basis of more sophisticated industries, and thus developing rural economies. Trade liberalisation, therefore, helps developing countries – and especially their rural communities - to move up the 'value chain' of production. To quote OECD's Secretary-General, "The Doha Development Agenda is an opportunity to re-balance trade rules in favour of developing countries while boosting the world economy."

103. So a resolution to the Doha round is of great importance – but at this late stage, how is it to be reached? The OECD offers some suggestions:

- Although politically sensitive, agriculture accounts for a small share of developed countries' economies. Moreover, OECD research suggests that agricultural tariffs and price support mechanisms do a poor job of simultaneously providing income support, protecting the environment and maintaining healthy rural economies. Political sensitivity shouldn't translate into irrational economic policies. In their view, then, this is an area where the developed world can show leadership, by accepting reform.

- If the current trade talks were taken alongside discussion of other necessary domestic reforms, and more effective development assistance, the scope could be created for larger tariff and subsidy cuts, thereby closing the gap between previous negotiating positions. Then, once the agricultural divide is overcome, work could advance in other areas, where even greater benefits can be achieved, and where the more advanced developing countries should be prepared to be flexible in improving market access.

- Critically, the OECD believes that politicians in developed countries, and in the most advanced developing countries, need to promote the benefits of the Doha round to their citizens. The least developed countries, meanwhile, need to be guaranteed support in other areas, for example through development assistance to help them streamline their customs services, and to build the roads, ports and air infrastructure that they need in order to trade effectively.

104. Without an agreement, there is a danger that the WTO will in future tend to proceed by litigation instead of legislation, and that dispute settlement will take the place of rule making. Existing distortions to trade and economic activity could become entrenched, making it increasingly difficult for developing countries to compete fairly in world markets. Moreover, bilateral and regional trade deals would proliferate, a trend that is already apparent. Amongst others, proposals are now being made in Asia for an "APEC only" Free Trade Agreement (FTAAP), given the stand-off over the Doha round.

105. To the OECD, the Doha Development Agenda represents the 'low hanging fruit' of the world's multilateral architecture, as well as a low-cost insurance against the revival of protectionism and trade wars. By successfully concluding the Doha Round, governments can deliver a boost to the world economy and contribute to a fairer distribution of wealth. Time is, however, pressing, and the OECD warns that the US President's Trade Promotion Authority from Congress expired in July 2007, with renewal only likely if there is a clear framework for a deal. The enlarged Parliamentary Assembly of the Council of Europe should support the WTO's and OECD's efforts to inspire a successful resolution to the Doha round, and call upon member governments to seize the opportunity that Doha represents.

vi. The progress of international development aid

106. The world's current focus on development aid can be traced to the UN's Millennium Summit in 2000, where a series of Millennium Development Goals were agreed, to be implemented fully by 2015. This strategy was confirmed two years later at the International Conference on Financing for Development at Monterrey, with participants stressing their mutual responsibility for a successful outcome. Most developed countries made pledges at or around the Monterrey conference to boost aid levels. The EU agreed to scale up its aid to 0.39% of its members' combined national income by 2006 and 0.56% by 2010. By the same date, Canada agreed to double its aid. The 2005 Millennium+5 summit extended donors' commitments. The 15 countries that had been members of the EU at the time of Monterrey promised to reach the UN's long-standing aid target of 0.7% of national income by 2015. Australia announced that it would double its spending to about 4 billion Australian dollars by 2010. Japan indicated it would increase development aid by $10 billion in

aggregate over 2005-2009, compared to 2004 levels. The United States promised substantial increases in individual aid programmes.

107. If the current promises are met, aid should increase by about $50 billion in real terms, from $80 billion in 2004 to $130 billion in 2010 at 2004 prices and exchange rates. However, this will require donors to increase aid faster than any other public expenditure. Total funding, which has risen by an average 4% per year between 2002 and 2006, would need to rise by 12% a year between 2006 and 2010. So the scale of the required increase is substantial.

108. The OECD contribution will be vital, since its members provide over 90% of the world's official development assistance. Preliminary data on aid in 2006, published in April, highlight the challenges in boosting aid spending. The 22 countries that are members of the OECD Development Assistance Committee provided $103.9 billion in aid in 2006, a fall of 5.1% in real terms from 2005. This is the first time that development aid has declined since 1997, although it should be said that the 2005 total was the highest ever recorded. Moreover, this headline result is somewhat misleading, for 2005 was a year of exceptional debt relief operations, particularly for Nigeria and Iraq. If one excludes debt relief from the picture, aid totals declined by 1.8%.

109. In 2006, 16 of the DAC member countries met the targets set at Monterrey, while the only countries to reach or exceed the UN's target aid level were Sweden, Luxembourg, Norway, the Netherlands and Denmark. The largest single donor in 2006 was the United States, followed by the United Kingdom, Japan, France and Germany (the contributions of the fifteen members of the DAC that are EU members accounted for 57% of the total). The US was also the country showing the largest fall in aid – down 20% - largely due to smaller debt cancellations, although its aid to the world's least developed countries reached an all-time high of $5.5 billion.

110. Bilateral aid to sub-Saharan Africa rose by 23%, to about USD 28 billion, with US aid to the region reaching a record level of $5.6 billion; but of this amount, $1.4 billion was debt relief, almost half of which was to Nigeria, although there was also increased funding for education, HIV/AIDS and malaria programmes. Disappointingly, when debt relief is excluded, total DAC aid to sub-Saharan Africa only increased by around 2% - far short of the rate required to meet the Gleneagles G8 commitment to double aid to Africa by 2010.

111. Aid flows are fortunately being supplemented by increasing transfers from other sources. According to the World Bank, the capital flows from migrant labour are nowadays at least twice the total of official development aid (though these figures include large flows between developing countries). Meanwhile, the recent efforts of the Gates Foundation, among others, have impressed many by their focus on the most urgent issues and regions, their speed of response and business-like approach. The OECD welcomes the efforts of bodies such as these, which are without doubt helping to make progress towards the Millennium Development Goals.

112. There are signs of increased regional targeting of aid, with donors paying closer attention to the circumstances of the world's most fragile states. By and large, these are countries left behind by globalisation, where conditions are actually worsening, while other emerging economies such as China, India and Thailand are themselves becoming aid donors. For instance, aid now equals more than half the Gross National Income of Liberia, the Solomon Islands, and of Sao Tome and Principe. The OECD notes that such levels of aid can create dependency, making governments less responsive, and less likely to collect taxes. It recommends that donors encourage more representative governments and lend support to civil society and a more independent judiciary and media.

113. The challenge for public bodies would seem to be the creation of a 'virtuous circle' for aid spending – if funds can be more effectively deployed, and if their effectiveness can be shown, more funds will be made available and more can be achieved. And here the OECD feels that the Paris Declaration on Aid Effectiveness can make a significant contribution.

114. Agreed in March 2005, the world's key donor and recipient countries agreed 'to reform the ways we deliver and manage aid'. The details of the Declaration involved commitments to harmonise aid delivery, by strengthening national development strategies, eliminating duplication of effort, simplifying donor policies and agreeing common criteria and measures of performance. Overall, it is designed to tackle what many see as the key operational challenge to the delivery of the Millennium Development Goals: increasing the capacity of recipients to make best use of new resources, through a process of 'country-owned change'.

115. The OECD is supporting these aims through the DAC, which oversees the publication of the Development Cooperation Report, and in partnership with major institutions such as the World Bank. In March 2007, the OECD hosted its first Global Forum on Development in Paris, following preliminary meetings in Lisbon and Berlin. Meanwhile, it has recently begun piloting a series of 'principles for good international engagement in fragile states', which recognise that a lasting solution for such countries will need to be driven by their own leadership and people, but that 'real improvements in donor behaviour' can also help to promote better results.

116. In May 2007, the OECD produced a special report on aid effectiveness, with the co-operation of 34 countries that have provided data that can be used to establish new systems of monitoring. While it is fair to say that this represents a process of dialogue at this stage, rather than a strict measurement of improved aid delivery, follow-up reports will be issued in 2008 and 2011.

117. Projects such as this are much to be welcomed, and should be an important means of demonstrating to the governments (and voters) in developed countries that there are real and lasting benefits to be gained by committing themselves to international development. This complements annual monitoring of progress towards the Millennium Development Goals, by monitoring the effectiveness with which increasing volumes of aid are delivered in line with country strategies. Moreover, as called for in the Paris Declaration, the monitoring process will be complemented by an independent evaluation of the implementation of the commitments contained in the Paris Declaration which will provide practical lessons on implementation performance in time for the next High Level Forum in Accra in September 2008.

118. For governments in the developed world, in a time of unprecedented trade and prosperity, the urgency of international development should be clear. The enlarged Parliamentary Assembly of the Council of Europe should therefore reaffirm its support for the Monterrey principles, and urge that the funding commitments set out at that time should be honoured, if not exceeded. In the meantime, it should pledge support for the essential work being undertaken by bodies such as the OECD to ensure, and to demonstrate, that this funding is used in the most effective way possible. The international community cannot afford to fail in these commitments, and future Rapporteurs will, doubtless, keep the Assembly informed as to progress achieved.

vii. Addressing the imbalances of globalisation: rural renewal

119. In today's world, one of the clearest symptoms of globalization is economic divergence, and the growing inequalities within and between countries. The world's thousand richest people, for instance, are said to have a personal wealth greater than the poorest 600 million. Even in the wealthiest countries of Europe, there is an increasing generational split, with the old gaining a significant wealth advantage over the young, amidst competition for secure employment. Elsewhere, notably India and China, there is a yawning gap between the urban middle classes and the rural poor. And some regions, notably in Africa, are being left behind altogether.

120. The OECD believes that, to seize the opportunities that globalization undoubtedly offers, innovation is vital. The capacity of any region to support learning and innovation is perhaps its key source of competitive advantage, and most significant multiplier of economic activity, employment and development.

121. Specifically, one of the most important current trends is the transformation of rural areas, given intensified competition in agricultural markets, the expansion of urban areas, and the declining weight of agriculture in rural economies (which now employs less than 10% of the rural workforce and accounts for around 2% of GDP across the OECD). Given the greater importance of agriculture in developing economies, these changes are having a striking effect in the developing world, and finding effective solutions will be crucial to addressing global imbalances overall.

122. Indeed, successful change is crucial for national and regional policymakers. Even amongst OECD countries, rural areas account for three quarters of the land and are home to a quarter of the population of OECD countries. The policy challenges have also become more complex, as countries have tended to decentralize government and decision-making over recent years.

123. Too often, a combination of geographical isolation, unemployment, lack of services and depopulation has created a vicious cycle that leads to economic decline. There are many examples of

rural regions across the OECD that trail in all indicators: between 1995 and 2000 GDP per capita in rural regions as a percentage of national averages declined in more than half of OECD studied countries (in 13 out of 23 countries with data). In these regions, GDP per capita represented about 83% of the national average in 2000.

124. But this need not be so. In fact, in more than a third of OECD countries, the highest rate of employment creation has been recorded in a rural region. Mostly, innovative policies are seen to have made the difference. Speaking in March, at the fifth OECD conference on rural development, the organization's Secretary-General pointed out that globalisation is making traditional rural development policies less and less effective. He suggested that the goal must be to move beyond agricultural subsidies, which still amount to about 1.2% of the OECD's GDP, and to adopt a positive, rather than defensive, approach, that focuses on places, rather than sectors, and on investments instead of subsidies.

125. By examining examples of success around the world, the OECD has identified three key elements in developing rural strategies. First, an understanding is needed that rural policy has multiple objectives, and requires a range of different approaches. Second, policies should be place-specific, and encourage local public-private cooperation, involving new partners in the community, and thirdly they should foster cross-sector activity at all levels of government, while spreading awareness of the variety of rural needs and opportunities. To create such policies, the Secretary-General outlined four ingredients:

- The need to develop the rural resource of human capital. Although the 'flight to the cities' phenomenon is well known, there is also a reverse trend, that of the "neo-rurals", people of different ages and profiles who decide to move back, or simply to move for the first time to rural areas. OECD research has highlighted, for instance, the importance of the "creative class" (such as architects, artists, engineers, software developers, designers etc.), that is able – and eager - to move to places that offer a better quality of life. This trend should be encouraged – for instance, by an improved transport and communications infrastructure.

- The value of basic education and training as a focus for investment; this often proves to be even more important than a concentration on Research and Development.

- An innovation strategy that plays to local strengths: rural regions may find it hard to compete in the production of emerging technologies, but can excel in the development of mature technologies and alternative methods. In addition, these regions have a competitive advantage that is unique, and can be more precious than an industrial R&D process: nature. There are, for instance, opportunities in areas such as tourism or food-processing.

- Financial institutions play a crucial role in promoting innovation and development, and policy should seek to encourage their involvement and collaboration. The availability of financial resources can be the critical determinant of whether innovations emerge and are turned into marketable products and services or not.

126. Globalisation can be a positive force, the OECD says, both for the relationship between developed and developing countries, and also for the relationship between rural and urban regions. As the Secretary-General has set out, the OECD will continue to develop its role as provider of advice for rural development policies and to promote constructive policy dialogue amongst its member countries and beyond.

viii. Tackling international corruption and promoting good governance: a shared priority

127. In recent years, the OECD has become one of the leading institutional campaigners against international corruption – an issue that is all the more pressing in an era of rapid globalization, with closely interconnected markets and the free and instantaneous movement of capital. Like the Council of Europe, a close working partner in this area, the OECD sees corruption as the leading contemporary threat to good governance, sustainable economic development, and fair democratic activity.

128. Compounding this challenge, it is the world's emerging economies that are most vulnerable to the destructive effects of corruption, since many are still in the process of developing accountable governmental and administrative systems. Among their challenges are weak judicial structures,

incomplete criminal legislation and anti-corruption mechanisms, a lack of police resources, and an absence of facilities for international investigation and extradition. In some cases, these systems now have to cope with a rapidly rising volume of international transactions, as globalization and high commodity prices bring strong growth. And in other cases, the challenge is to successfully manage an increasing flow of development aid.

129. Accordingly, the OECD has developed a range of anti-corruption tools and expertise, particularly in the fields of international business, taxation, export credits and development aid. It has also focused on encouraging co-operation amongst governments, since fostering genuine political will is crucial to success in combating corruption.

130. Perhaps the best-known of the OECD's initiatives in this field is the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions of 1997 which entered into force in 1999. Its signatories – currently all 30 OECD members and 6 other governments – are bound to implement a comprehensive series of legal, regulatory and policy measures designed to prevent, and to detect and prosecute, the bribery of foreign public officials. It also requires the confiscation of bribes and any profits involved. All parties also agree to work together to ensure that the Convention's objectives are met, for instance through the gathering and sharing of evidence, and by facilitating extradition.

131. The Convention includes a unique peer-review mechanism through the Working Group on Bribery in International Business Transactions, designed to maintain the momentum of its enforcement activities, and this has helped to make it one of the most respected and far-reaching legal instruments in this field. Since its entry into force, there has been a notable increase in the number of international investigations (now around 50), and prosecutions (around 30), with prison sentences and fines of up to 2 million euro have been imposed in some cases.

132. Steadily, the anti-bribery work of the OECD has been strengthened, notably by the 2006 OECD Recommendation on Bribery and Officially Supported Export Credits which steps up efforts to avoid giving official support to export contracts which are tainted with bribery. In 2007, OECD published "Bribery in Public Procurement: methods, actors and counter-measures" to throw light on patterns of bribery and help governments and international organisations in the fight against bribery. And beyond this, the OECD has a range of associated anti-corruption activities. Key initiatives include:

- The 1996 Recommendation on the Tax Deductibility of Bribes to Foreign Public Officials, which resulted in the creation of a Bribery Awareness Handbook for Tax Examiners, now available in 16 languages on www.oecd.org/ctp/nobribes.

- The production, in 2000, of Guidelines for Multinational Enterprises, which covers issues of business ethics, international information disclosure and transparency. Forty participating governments encourage local companies to participate in this process, which includes a mediation facility (that has been used nearly 130 times since inception).

- An operating guide, now in preparation, that will focus on public procurement, and is intended to help government agencies combat corruption in this process. Parties to the Anti-Bribery convention will review the conditions for participating in public bids, and the penalties related to corrupt public procurement.

133. These measures reflect a continuing emphasis on promoting good governance in the public sector, with the OECD seeking to provide a public forum that can identify good practices and work out what they call an 'ethics infrastructure'. Additionally, this process led to the 1998 Recommendation on Improving Ethical Conduct in the Public Service, and the 2003 Recommendation on Guidelines for Managing Conflicts of Interest in the Public Service. Since the adoption of this latter initiative, 23 member countries have updated and revised their rules and processes, and strengthened supervision. Recently the OECD has mapped out good practices for enhancing corruption resistance in the entire public procurement cycle, from the definition of needs to contract management, and has developed principles for enhancing transparency and accountability in lobbying.

134. A further initiative aimed at promoting good governance is GOVNET, which is led by the OECD's Development Assistance Committee, and was examined in detail by last year's Rapporteur. GOVNET is an international group that brings together experts from development organisations and

aid agencies, as well as representatives from partner countries, with the aim of strengthening donor support for good governance. As the only inter-governmental forum on international donor assistance, GOVNET has a unique role in building the foundations of country-owned change, as outlined in the Paris Declaration.

135. The Council of Europe wholeheartedly supports the OECD's work in this area, and has itself developed a set of anti-corruption principles, linked to a code of conduct, and its members have agreed a series of specific conventions relating to corruption. The two organisations work closely together on many aspects of this issue, particularly focusing on areas such as money-laundering and economic crime. Additionally, the OECD is represented in the Council of Europe's GRECO (Group of European states against corruption) project, which now includes 44 countries, with Russia having joined in February of this year. A further reminder of the two Organisations' dynamic co-operation is the signature by the United Kingdom on 24 May 2007 of the Joint OECD-Council of Europe Convention on Mutual Administrative Assistance in Tax Matters.

ix. Innovation, growth and equity

136. Recognising the role of innovation as a fundamental determinant of growth, the OECD is launching an Innovation Strategy. As the Secretary-General of OECD said in opening the OECD Forum 2007 devoted to this theme, "the creation, dissemination and application of knowledge will continue to be the main engine of national and global economic expansion for many years. And not only in the OECD."

137. Mr Gurría focused on the three elements that are essential to fostering innovation: highly accessible quality education; investment in science and technology; and an innovative business-oriented environment.

138. "Quality education breeds innovation", he said. "A well performing and accessible education system facilitates the adoption and diffusion of innovative activities. Investment in the education and training of highly skilled workers is a major factor of competitiveness, productivity and growth. But access to quality education is also the main driver for reducing economic inequalities. The OECD has paid special attention to improving human capital, developing internationally standardised tools for the assessment of educational systems. The Programme for International Student Assessment (PISA) has become a key reference for the improvement of educational systems and achievements in member countries."

139. Investment in science and technology is also crucial. He continued: "One of the most eloquent indicators of the health and potential of a national economy is the level of research and development (R&D) it generates. OECD countries have so far provided most of the world's R&D capacity, accounting for over 80% of global R&D expenditure. ...However, R&D average annual growth rates have been slowing down and many OECD countries have seen little improvement in productivity performance in recent years despite the new opportunities offered by globalisation and new information and communication technologies. We certainly have a challenge there."

140. Also important is improving the business environment, since business is the main driver of innovation. Mr Gurría called for further liberalisation of the services sector and of network industries so as to encourage innovation and productivity improvements, more innovation-friendly regulatory regimes, combined with flexible labour markets and lower barriers to trade and FDI, likely to enhance competition and foster the flow of technology and knowledge across borders. "The reform of financial markets can also boost innovation and growth", he said

141. Intellectual property rights (IPR) are another important challenge, in Mr Gurría's view. "Recent transformations in the economic context, not only globalisation but also the emergence of new technologies in software and the internet have facilitated collaboration among creators and inventors, but have also made it easier to copy and have thus challenged the effectiveness of the IPR system. Governments have reacted to these changes by strengthening the rights of IPR holders. Firms are increasingly applying for the protection of this investment in innovation. At the same time, the innovation process itself has become more open; ideas and knowledge for innovation are now drawn from many, often global sources, and linkages and cooperation are also of growing importance. The key policy question remains how to strike an appropriate balance between providing incentives and protection to innovators and providing access to new knowledge for users." Recent court decisions in

the United States have moved towards rebalancing patent rights by making it more difficult for patent holders to obtain large damage settlements for patent infringement.

142. However, warned Mr Gurría, "the concentration of innovation capacity in a small number of countries has a direct impact on the global distribution of income and opportunities, and it also affects the distribution of benefits within countries. Innovation fosters productivity and growth because it attracts highly qualified people and capital, but also because innovation looks for a favourable and secure environment to invent, register patents, produce and sell. The majority of human beings live in countries which lack this attractive environment. We run a great risk if we don't change this pattern.... We still have much to do to transform this force into development. A very eloquent example of how can we turn innovation into a development tool is the "One Laptop per Child" project. In this initiative, experts from both academia and industry designed an ultra low-cost and durable lap-top for the world's poorest children."

143. Information and communications Technologies (ICT) will be a major driver of future innovation and productivity improvements. In addition, emerging technologies such as nanotechnology and biotechnology could play an increasing role in economic growth and provide solutions to many pressing environmental problems. Based on current trends, the OECD estimates that almost all major new crop varieties in the near future are likely to be developed using genetic knowledge based on biotechnology, for instance through the use of marker assisted selection. These crop varieties will have improved levels of drought and pest resistance, both essential characteristics for addressing climate change and population growth. Similarly, the number of new biopharmaceuticals that receive market approval is expected to increase from approximately nine per year between 2000 and 2006 to 14 per year between 2008 and 2013. These and other advances in health biotechnology such as personalized medicine could create disruptive change in health care delivery systems. The OECD is developing solutions to several barriers to the adoption of biotechnology and evaluating how the efficiency and effectiveness of biotechnological innovation can be improved. This includes identifying sustainable business models and institutional systems for biotechnology that can help manage disruptive change and ensure that both developing and developed countries can benefit from the innovative application of biotechnology to agriculture, health and industry.

V. An update on the OECD's 'Going for Growth' initiative

144. In 2005, the OECD launched a new system of multi-country benchmarking, entitled 'Going for Growth', and designed to test the performance of individual member countries against a range of structural and policy indicators. It is hoped that this will address the widening divergence in living standards apparent amongst member states, and that its practical recommendations will be useful to individual countries, rather than serving as some sort of competitive index.

145. With Going for Growth now in its third year, the 2007 report contains a fascinating wealth of detail, for the OECD area as a whole, and for each individual member. Focussed on labour and product markets, productivity, regulation, training and competition, it measures performance against previously-stated priorities, and offers recommendations for future progress. It is in part thanks to the progress already made in reforming labour and product markets that unemployment has begun to fall in Europe, claims the report. But more needs to be done to boost long-term growth.

146. In his preface to the report, the OECD's Chief Economist, Jean-Philippe Cotis, cautions that cyclical buoyancy in continental Europe and Asian OECD countries must not lead to complacency, saying that "Governments should resist the temptation to ease up on reforms aimed at boosting productivity and creating more jobs".

147. Here are updates on a few examples highlighted by last year's Rapporteur:

- The UK has introduced a 'Pathways to Work' initiative to reform current disability benefit rules, which should be available to all claimants by 2008, has revised its skills training infrastructure, including special courses for adults with low skill levels, and announced an increase in transport spending.

- France has introduced the "contrat nouvelle embauche" (CNE – new employment contract) to make employment legislation more flexible and proposed lower social security contributions.

- Discussions with social partners are underway in Spain to enhance wage-bargaining flexibility, while Italy has announced the liberalisation of a wide range of professions, and is preparing a series of privatizations. Germany, meanwhile, is using revenue raised from its VAT increase to lower social charges, has reduced spending on some ineffective labour policies, and has raised the retirement age.

148. Overall, the report welcomes the improvement in economic prospects experienced by many OECD members, particularly in Europe, but comments that this can be 'ambiguous' for the cause of reform. Although change becomes easier, it says, it can also seem less necessary – but the temptation to ease up should be resisted. And while much of the current upswing may be cyclical, some of it – in particular, falling unemployment – is due to reforms recently undertaken by member countries. Looking forward, though, much remains to be done. In particular, improved competition in product and financial markets are still needed, particularly in Continental Europe and Asia, and such reforms could also help to shift the basis of national incomes away from business profits toward higher labour incomes and employment.

149. In this year's recommendations, measures to improve labour market performance account for most of the policy priorities in Continental European economies. For low-income countries, meanwhile, as well as in Japan and Switzerland, raising productivity is the main challenge and so the focus is on liberalising product markets and services. English-speaking countries have generally good labour market performance, but share in common the need to raise their skills levels.

150. There are, therefore, many shared priorities. For example:

- Given aging demographics, improving the prospects for older workers is a key issue, with Greece being advised to reform its pension system so as not to discourage older workers, to better link benefits to lifetime contributions, and define disability pensions more rigorously, which is an issue for Australia and the Netherlands too, while Austria and Belgium are urged to curtail the implicit tax on older workers.

- To increase the productive potential of younger people, tertiary education is a priority, with specific recommendations for countries such as Italy, France, Austria and Greece. In Australia and the UK, raising secondary education standards is emphasised.

- To open up restricted markets and improve economic capacity, many countries – including Australia, Greece, the Netherlands and Austria – are advised to raise the level of competition and access to services in network industries such as energy and telecommunications.

151. In two special studies, the report looks in detail at product market competition. The first sets out OECD findings that those countries which have opened their markets have benefited most from new information and communication technologies – and that the lowering of barriers stimulates innovation, by encouraging companies to take market leadership, or at least to match their rivals. For the immediate future, the OECD sees the energy, transport and communications industries, as well as professional services and agriculture, as priorities for liberalisation amongst member countries. It also points out that restrictions on foreign ownership are still too prevalent, whether formally or informally.

152. The second chapter examines the types of policy that promote openness, noting that competition law is still weak in some countries, and stressing the importance of independent and powerful regulators, especially in network industries, where regulation often restrains true competition.

153. A further section describes the skills and training challenges faced by many OECD countries, calling for raised education levels – and in particular, noting that improved tertiary education graduation rates are a common objective for the OECD area. Inequalities in education, it suggests, are leading to a widening gulf in opportunity, as labour competition becomes global – thereby creating 'insiders' and 'outsiders' within a country. It links this question with labour market reform, pointing out that attempts at reform 'by stealth' have had little impact, and may only increase the public's sense of insecurity.

154. Stating that rigorous employment protection rules tend to crowd out young people and women from the workplace, the report suggests reforming current systems of permanent work contracts, while also providing reasonable income support and effective re-employment services, as undertaken recently by several of Europe's smaller countries.

VI. OECD institutional reform: the enlargement issue

155. The OECD Council, meeting at Ministerial level on 16 May 2007, decided to invite Chile, Estonia, Israel, Russia and Slovenia to open discussions for membership of the Organisation and offered "enhanced engagement", with a view to possible membership, to Brazil, China, India, Indonesia and South Africa.

156. The Council also invited the Secretary-General to develop recommendations on how to expand the OECD's relations, including through enhanced engagement, with selected countries and regions of strategic interest to the OECD. In light of its growing importance in the world economy, it was agreed that priority should be given to South East Asia with a view to identifying countries for possible membership.

157. These decisions are clearly a major breakthrough which will have a significant impact on the Organisation's future. The OECD explains that global reach has always been an integral part of the OECD mission from its creation in 1961. Article 1 of its founding Convention states that members "should contribute to sound economic expansion in member as well as non-member countries in the process of economic development." At that time OECD economies accounted for a vast share of world production and trade. But as more countries have become integrated into the global economy, that share is diminishing. In order to remain an influential voice in the world economy, through policy analysis, dialogue and rule-making, the OECD sees itself obliged to strengthen its links with other countries.

158. These decisions were supported by the fact that in June 2007, the G8 asked the OECD to act as a platform for the newly established dialogue between the G8 and Brazil, China, India, Mexico and South Africa, with this Heiligendamm Process due to make a final report back to the G8 in 2009. This is the first time the G8 has asked for such a Follow-up Support Unit to be formed at the OECD and preparations are now underway to set up this platform for dialogue.

159. The accession procedure is complex and can be long, as it involves a series of examinations to assess a country's ability to meet OECD standards in a wide range of policy areas. This makes it difficult to bring in more than a small number of new members at the same time. That is why the OECD wishes to start accession negotiations with a few countries now, while at the same time strengthening its relations, with a view to possible membership, with other major economies in a process that it refers to as "enhanced engagement".

160. The OECD explains that "enhanced engagement" is intended to be offered to a few selected partners whose engagement in the work of the OECD is particularly important for the fulfilment of the Organisation's mandate to promote policy convergence and global economic development. Partners should be willing and able to engage with the OECD and contribute to its work in a sustained and comprehensive manner. A central element of enhanced engagement, says the OECD, is direct, active participation in the work of substantive bodies of the Organisation. Each Enhanced Engagement programme will contain a mix of several elements, notably Committee participation, Economic Surveys, adherence to instruments, integration into the statistical reporting and information systems, sector-specific peer reviews and other policy dialogue initiatives. The actual mix and the sequencing of the elements will be subject to the availability of funding and decided on by the OECD Council in agreement with each partner.

161. In addition, the OECD says it intends to develop actively, with some regions of special interest, a few "comprehensive regional programmes". These will constitute, besides enhanced engagement and enlargement through new accessions, a third distinct means of strengthening the relevance and the impact of OECD activities at a global level.

162. The OECD already engages with a large number of non-member **economies.** Many are actively involved in core OECD activities, for example as observers in OECD Committees, and main Working Groups or Expert Groups, where representatives of each of the 30 member countries review progress and discuss policy in specific areas. Currently this is the case of 25 non-members in 43 Committees and main Working Groups.

163. The OECD has developed close relations with various countries, notably Brazil, China and Russia, through specific country programmes. An OECD-Russia Programme launched in 1992 has conducted work across a wide range of areas relevant to Russia's market reform process, including

regulatory reform, taxation, competition, anti-corruption, and investment. In 1996, the Organisation launched a programme of dialogue and co-operation with China, reflecting the common interest of both sides in China's stable and effective integration into the world trading system. Since then, the OECD has contributed to policy reform in China by sharing its member countries' experiences in a broad range of areas, such as investment, governance, the environment, innovation policies and agriculture. In 1998, the OECD launched a co-operation programme with Brazil which has led to the publication of a series of studies covering such areas as agriculture, competition policy, tax and securities market reform as well as insurance and private pensions. Co-operation with India is developing, with a first *OECD Economic Survey of India* to be released in October.

164. In parallel, programmes such as the MENA-OECD Initiative on Governance and Investment for Development in the Middle East and North Africa (discussed in paragraphs 69-71 above) and the NEPAD-OECD Africa Investment Initiative provide a basis for relations between the Organisation and other countries using a regional approach. These initiatives aim to strengthen countries' capacity to design and implement policy reforms, by means of policy dialogue and the sharing of experience among policy makers. The OECD works with African countries within the framework of the New Partnership for Africa's Development (NEPAD) and with countries in South East Europe through the Investment Compact for South East Europe.

165. The OECD's main vehicle for policy dialogue with other non-member economies is a set of specialized initiatives with global participation: the OECD Global Forums. Created in 2001, these enable participants to exchange experience on a range of issues transcending national frontiers.

166. Your Rapporteur underlines the importance of the current enlargement initiative and believes that it will significantly enhance the Organisation's capacity to provide sound policy advice to its member governments in an era of rapid globalisation, thus paving the way, in the OECD's slogan, to "a better world economy". That said, it is perhaps regrettable that only 23 of the 47 Council of Europe member States are also members of OECD, not including such members of the European Union as Bulgaria, Cyprus (which will join the Euro zone in January 2008), Latvia, Lithuania, Malta, and Romania. Among these, only Estonia and Slovenia are envisaged for membership of the OECD at the moment.

VII. Conclusions

167. The state of the world economy in 2007 shows strengths, weaknesses, opportunities and threats. As for the strengths, first of all the OECD's analysis suggests that rather than stalling, global economic growth appears to be rebalancing. The OECD's central forecast, published in May before the recent bout of turmoil in financial markets, was that of a soft landing in the United States, a sustained recovery in Europe, a solid trajectory in Japan and buoyant activity in China and India. In line with recent trends, sustained growth in OECD economies should be underpinned by strong job creation and falling unemployment. Growth for the OECD area as a whole is set to continue relatively strongly through 2007 and in 2008. As for world trade, it is expected to maintain momentum, driven by the major emerging market economies.

168. Turning to the weaknesses, while the consequences of recent turmoil in financial markets are at present unclear, they do suggest that risks to growth are biased on the downside, particularly should turbulence in financial markets continue or deepen. In addition, some long-standing global imbalances remain a risk. With regard to the balance of payments, the current account deficit remains an underlying problem in the United States, while the surplus continues to soar in China and Japan, unmitigated by household demand. Housing markets may also have developed imbalances, with housing investment at or near ten-year highs in many OECD countries, while in the United States the downturn may be more protracted than previously expected.

169. As for the opportunities, certainly the most important is that represented by a successful conclusion of the Doha Round of trade negotiations, the tantalising "low hanging fruit" that seems so near, yet still not quite within sufficiently easy reach in mid-2007. The benefits to world trade and development would be enormous. What is needed is political will and political pressure from parliaments to ensure the necessary compromises.

170. Conversely, one of the main threats to world economic prospects is that of failure to conclude the Doha Round, because that would jeopardise the considerable progress already made and waste the opportunity to rebalance the multilateral trading system, a failure of the first round of trade

negotiations conducted under the auspices of the WTO. Even more important in the longer term is the threat represented by global warming. More radical measures need to be taken in a spirit of mutual responsibility for the future of the planet.

Reporting committee: Committee on Economic Affairs and Development

Reference to committee: Standing mandate

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