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OECD Business and Finance Outlook 2018
Summary in English

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Connectivity, both among institutions within the global financial system and among countries, is an integral part of globalisation and a key component of how complex societies operate in their quest to become more productive. This year's Outlook addresses connectivity, both among institutions within the global financial system and among countries. With respect to the latter, the Outlook looks at the increasing weight of China in the global economy. It examines, in particular, the impact of the international development strategy known as the "Belt and Road Initiative" (BRI) on China's global trade and investment partners and the policy approaches that would help to broaden out its benefits to the whole global economy.

The outlook for the global financial system

Monetary authorities in jurisdictions that are home to globally systemic important banks (G-SIBs) have provided support for the global financial system in the form of ultra-low interest rates and large scale purchases of securities since 2008, initially to support dysfunctional markets and then to support economic recovery. As the economic backdrop has improved, the US Federal Reserve has begun to normalise its policies. Central banks in other advanced countries seem likely to follow. This has contributed to sharp movements in asset prices in 2018, particularly during the early months of the year. Managing this process will be a challenge.

As this process gets underway, the reform of the regulatory framework governing internationally-active banks, widely known as Basel III, has been finalised by the Basel Committee of Bank Supervisors. The reversal of monetary ease will test whether Basel III has achieved its goal of ensuring safety and soundness in the financial system in the face of stresses, particularly where the liquidity of products is a driver of volatility. Basel III achieved progress in the area of strengthening capital rules but leaves the G-SIBs and their business models similar to what they were before the crisis of 2008 - certainly stopping short of full separation of investment banking from deposit-insured consumer banking. The vulnerabilities resulting from their interconnectedness remain an important feature of the system. One gauge of interdependence, the notional value of over-the-counter derivatives, remained at USD 532 trillion in the second half of 2017, only slightly below its pre-crisis peak of USD 586 trillion in late 2007. There has been some shifting of where these risks sit as investors have responded to the low-interest rate environment.

The financial outlook will also be shaped by China's ability to manage risks relating to high indebtedness and leverage in its banking, shadow banking and wealth management industries. While China is not directly linked to the risks in advanced economies, due to the closed nature of its financial system, any problems there could see Chinese authorities shedding holdings of US securities. This would increase liquidity pressures in advanced economies. The extent of non-performing loan problems in China is obscured by the lack of information about which assets are sitting in off-balance sheet vehicles. But it is clear that these vast off-balance sheet exposures have increased leverage risk and could lead to destabilising credit events. They have the potential to disrupt growth beyond China if further changes to the structure of financial markets and institutions are not considered in major advanced and emerging economies.

The BRI in the global trade, investment and finance landscape

China's BRI is an ambitious development strategy to build connectivity and co-operation across the six main economic corridors shown in Figure 2.3. The Asian Development Bank estimates that Asia needs USD 26 trillion in infrastructure investment to 2030, and China can certainly help to achieve some of this. The BRI, which prioritises the funding of infrastructure, is also a strategy to achieve a number of longer-term objectives: connectivity; energy and food security; balanced regional development and better capacity utilisation; freer trade; sustainability goals; and cultural and scientific exchanges.

China is investing in technology transfer to move toward higher value activities and, in the longer term, aims to follow what other major countries have done in technology standards, innovation and trading value chains. Connectivity is an important element of the strategy, particularly regarding energy, given the numerous and varied sources along the BRI corridors. More generally, empirical analysis in this Outlook suggests that connectivity among both advanced and emerging markets enhances the benefits of trade and investment. However, the infrastructure funding needs of developing Asia are large and China's own financial issues at home point to limits on what China alone can do. This means significant contributions from OECD countries will be needed if the BRI is to succeed. This will require an increasing role for markets in resource allocation decisions. Property rights, competition, level playing fields and sound governance will need to be strengthened to make this possible.

Towards levelling the playing field for sustainable growth

The BRI is a phase of globalisation that is long term in nature that, as with similar issues in the world economy, needs a transparent foundation of sound principles conducive to cost-effective solutions and fairness to all stakeholders.

Five broad areas that could benefit from greater alignment with international standards stand out:

- The growing role of state-owned enterprises (SOEs) in the global economy calls for ways to ensure a level playing field that discourage subsidies and non-transparent processes and allow recipient countries to benefit from investments based on widely accepted practices of corporate governance. Recipient economies must address national security concerns, especially those involving strategically sensitive technology and gaps in the legal accountability of SOEs.
- Open and transparent arrangements for procurement, especially for large infrastructure investments, are needed.
- The heavy costs that bribery and corruption can impose must be avoided, both in the case of large infrastructure projects and elsewhere. Social and environmental costs need to be taken into account by ensuring responsible business conduct that minimises disruption to local communities.
- Complementing what is expected of companies in respecting the environment, governments need to conduct environmental impact assessments prior to implementing proposed projects for facilities and infrastructure.
- Open and transparent regimes for cross-border investment are needed to reduce costs and increase options regarding technology. These will work to encourage the connectivity and economies of scale that the infrastructure strategies are intended to build.

In all five areas, OECD and other international standards provide essential guidance for both infrastructure-recipient economies and supplying economies.

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