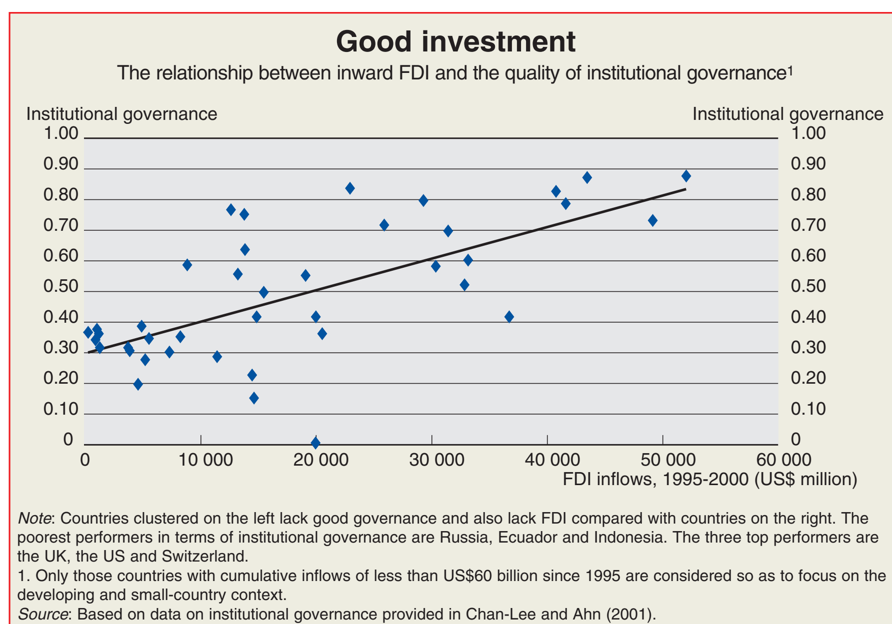
Transparency for FDI*

OECD Directorate for Financial, Fiscal and Enterprise Affairs

Investment is partly about taking risks, though not just any risk. In fact, transparent systems where the judicial framework is efficient and corruption is low tend to receive more investment.



Good investment

The relationship between inward FDI and the quality of institutional governance[1]

Note: Countries clustered on the left lack good governance and also lack FDI compared with countries on the right. The poorest performers in terms of institutional governance are Russia, Ecuador and Indonesia. The three top performers are the UK, the US and Switzerland.

1. Only those countries with cumulative inflows of less than US$60 billion since 1995 are considered so as to focus on the developing and small-country context.

Source: Based on data on institutional governance provided in Chan-Lee and Ahn (2001).

By its nature, transparency cannot be easily quantified, nor can it be isolated from other policy aspects that impinge on foreign direct investment (FDI). Owing to the links between the regulatory structure of a country and the transparency of its policies, the focus needs to be both on the nature of the rules applying to foreign investment and on the extent of transparency in their implementation.

Studies indicate that business environments often remain non-transparent even after governments have moved to enact clearer policies, simply because those measures are not actually implemented. However, except in cases where the host government maintains an outright prohibition on market access by foreign firms, the implementation of relevant legislation is likely to be more important in shaping investors' perceptions than is the actual legislation itself. National treatment, for instance, may be enshrined in legislation in many countries, but if foreign firms are effectively discouraged through discretionary decisions of the relevant national authorities, they will perceive such arbitrariness as being just as restrictive as an outright prohibition on foreign investment.

This point is brought out clearly in a major study of 55 developed and developing countries, which found that "better functioning legal systems and governance and better enforcement appear to be more important than legal origins *per se* in terms of their impact on development" (S. Ahn and J. Chan-Lee, see references). This study, path-breaking in many respects, of the informational quality of financial systems and economic development, constructs indices for various aspects of transparency for 55 countries. Of particular relevance in the context of FDI is the measure of institutional governance (see graph).

Problems with transparency are almost certainly one of the main reasons why Russia, despite having a large domestic market, abundant raw materials, an educated workforce and geographical proximity to Europe, does not rank even in the world's top 30 destinations for FDI.

There are wide variations in inflows even for countries with the same institutional governance rating – as one would expect given the multiplicity of factors behind the investment decision – but overall the relationship between the quality of institutional governance and the level of inflows is clear and positive. Thus, countries where the rule of law prevails and is enforceable, the judicial system is efficient, corruption is low and ownership is less concentrated, receive more investment.

One of the most interesting national cases relates to China, whose policies toward foreign direct investment have been quoted in literature both as examples of the virtues of raising transparency, and to point to areas where problems remain (see box).

Russia arguably provides one of the clearest examples of a divergence between regulation and implementation. A recent OECD survey of the investment environment in Russia found that the otherwise adequate rules-based legal and regulatory environment was

consistently being undermined by failures in implementation and enforcement (see references).

There is no unified economic space, no "level playing field" for businesses in Russia, because of the multitude of administrative barriers and obstacles encountered by investors, particularly at regional level, often in contravention of federal legislation and regulation. As specific examples of unpredictable hurdles to be surmounted by investors at federal level could be mentioned sudden withdrawal of frequencies from telecommunication companies, or sudden unavailability of previously posted railway freight tariffs which served as a basis for feasibility calculations. At the regional level, examples abound in the form of unforeseen licensing or permission requirements, license fees in excess of what is legally required, tax payments that are negotiable rather than statutory, "voluntary" contributions to extra-budgetary funds, etc. In addition, the general burden of licensing and other policy-induced start-up difficulties at regional level is so onerous that firms specialising in helping new businesses to manage this process are becoming a new growth industry.

These manifest problems with transparency are almost certainly one of the main reasons why Russia, despite having a large domestic market, abundant raw materials, an educated workforce and geographical proximity to Europe, does not rank even in the world's top 30 destinations for FDI. Significantly, both foreign and domestic investment are low in Russia, suggesting that local investors are as discouraged by the lack of transparency as are foreign ones. ■

**This is extracted from a new OECD book,* Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs. *For more on this subject, e-mail* daf.contact@oecd.org

References

- Ahn, S., and J. Chan-Lee (2001), *Informational Quality of Financial Systems and Economic Development: An Indicators Approach for East Asia*, Working Paper, Asian Development Bank Institute, Tokyo, June.
- OECD (2001), *Investment Environment in the Russian Federation: Laws, Policies and Institutions*, Paris.

China comes into view

China's business environment has become far more transparent since Deng Xiaoping began his programme of reforming and opening up the Chinese economy at the end of 1978, but the authorities' way of dealing with private enterprises is still largely characterised by relationship-based rather than rule-based decision-making.

Laws such as the Joint Venture Law were put in place hurriedly to accommodate new forms of business enterprise. At first these were sketchy, often amounting to no more than a few pages of general stipulations. Business legislation has since become increasingly complex and precise. Law courts, which had virtually ceased to function by the 1970s as a result of the total politicisation of law, began to develop in the 1980s as lawyers and judges were trained and appointed. However, the application of law in China remains under the control of communist party leaders at all levels and is better described as rule *by* law rather than the rule *of* law.

Regulations governing inward FDI exemplify this problem. Local authorities such as the Special Economic Zones in south China and the other open coastal areas have the power to approve the establishment of foreign-invested enterprises up to established maximal values, but the process of approval is not always wholly transparent. In the 1980s it was often necessary for a foreign company to spend several years building relationships with local officials before securing such approval, though this practice has (at least in the more developed regions) become less necessary in recent years. The line between central and local approval powers has also been more blurred in practice than the regulations suggest.

Secrecy has been replaced by openness, but although information is more widely available, it is not wholly reliable. Before reforms began, most of the country was closed to foreigners and economic statistics were largely classified top secret. The whole territory (with some exceptions) is now open to all, and the National Bureau of Statistics has been publishing heavy yearbooks replete with socio-economic statistics for two decades. Serious problems, however, beset major series such as annual GDP growth, unemployment and non-performing loan ratios.

©Kenny Wu/REUTERS

China's entry into the World Trade Organization (WTO) in December 2001 has increased the pressure for transparency, initially regarding laws and regulations specifically related to commitments to the country's WTO partners, but eventually extending inevitably to all matters pertaining to business done by foreign entities in China. Leaders like the prime minister, Zhu Rongji, who are determined to use foreign competition as a weapon in reforming the inefficient state-owned enterprises, will strive to ensure such transparency.

Ranged against them are protectionist voices arguing in favour of developing "national champions", or merely defending the living standards of those employed in over-manned sectors. Local officials, pressed by central government to remit a larger share of their tax revenue to the centre, often support such protectionism (much of it regional as well as national), and prefer to maintain freedom of action in, for example, levying local charges.

- *For more on China and FDI, contact* Kenneth.Davies@oecd.org

The global business

David Turner and **Pete Richardson**, OECD Economics Department

©Philippe Wojazer/REUTERS

©Shannon Stapleton/REUTERS

Global models

Globalisation has made the world a smaller place and has changed the way of doing business in OECD countries. But did you know that a significant part of global integration reflects trade within transnational firms and industries?

With globalisation, not only are businesses exporting their goods worldwide, they are also producing them worldwide, often through complex production chains across several countries. Indeed, trade among different parts of global enterprises, such as components of a final product being manufactured by affiliates in several countries, has increased significantly since the late 1980s. Such global companies or industries can be found in a range of sectors, like designer fashion, automotive components, computers and mobile phones.

International trade within single firms accounts for around one-third of goods exports from both Japan and the United States, and a similar proportion of all US

goods imports and one-quarter of all Japanese goods imports. Few data are available for other countries, but given the increasing importance of foreign direct investment, it is likely that the importance of this **intra-firm trade** has increased at the global level.

The nature and extent of intra-firm trade seem to vary with the income level of the trading partners. Much intra-firm trade between high-income countries probably involves nearly finished goods destined for affiliate companies with little additional manufacturing taking place. About two-thirds of US intra-firm imports by multinationals with a foreign-based parent company go to an affiliate primarily involved in marketing and distribution, for instance. Even when the goods received are for further manufacturing, much of the production will be bound for local markets.

But intra-firm trade between rich countries accounts for a high share of bilateral trade for some middle-income economies, and here the primary role of the foreign affiliates is more likely to be manufacturing to produce goods destined for other markets, including the country of the parent company. For example, in 2000, two-thirds of US imports from Mexico were intra-firm due to extensive use of *maquiladora* – plants in Mexico under foreign control, located in the border region with the US and devoted to the assembly and re-export of goods.

Trade between different firms of the same industry is also a strong feature of OECD countries, involving the import and export of similar goods by the same country. It could be the export and import of different models of car, for example, or the import of cheap textiles and the export of more expensive ones. The extent of **intra-industry trade** is typically much higher for manufactured goods than non-manufactured goods, and is highest for the more sophisticated manufactured products such as chemicals, machinery and transport equipment, electrical equipment and electronics. This is because sophisticated manufacturing is more likely to benefit from economies of scale in production and are easier to "differentiate" to the final consumer. More complex manufactured products which rely on many components and/or processes may also benefit more readily from splitting up production across countries.

Manufacturing intra-industry trade has risen in most OECD countries since the 1980s. In some countries, it continues to rise from already high levels. For instance, in Mexico it rose from 63% of total manufacturing trade in 1988-91 to over 73% in 1996-2000. In the US, it rose from 64% to 69% in the same period. In several countries, like Austria, France and the UK, manufacturing intra-industry trade has been in the 70-75% range for over a decade. In Korea and Japan, it is lower, at around half of total manufacturing trade, and in a few countries, like Australia and Iceland, manufacturing intra-industry trade accounts for about a third of total manufacturing trade.

Manufacturing intra-industry trade has risen in most OECD countries since the 1980s. In some countries, it has been in the 70-75% range of total manufacturing trade for over a decade.

There are currently eight OECD economies – Austria, Belgium, Czech Republic, Hungary, Ireland, Luxembourg, Netherlands and Slovakia – where both imports and exports account for more than half of GDP. These countries all tend to have relatively high intra-industry trade. Economist Paul Krugman argues that the emergence of such "supertrading" economies is essentially the result of the "slicing up of the value-added chain" internationally. The number of these supertrading economies doubled over the 1990s; Mr Krugman reckoned that in 1990 there were six, but by 2000, there were at least 12.

This internationalisation of production may mean that the initial consequences of any shock to demand are more dispersed across countries. At the same time, global trade may follow trends in the world economy more closely than in the past. The recent global slowdown has been accompanied by a severe downturn in world trade growth unprecedented since the first and second oil shocks, although the slowing in global GDP growth has so far been relatively modest.

Intra-industry and intra-firm trade may have accelerated the international transmission of certain industry- or product-specific signals, including shocks. The speed of the collapse in trade in high-tech products is an obvious recent example of this, as reflected in a sharp fall in bilateral trade between the US and certain Asian countries. For countries and regions, the effects of such shocks may be asymmetric, with some feeling the pinch more than others, but the industry worldwide takes the impact.

As so much international trade takes place within firms and industries, trade levels may become less responsive to short-term changes in international price competitiveness than before. After all, if an increasing proportion of trade is in intermediate goods as part of an international production chain, then a devaluation, for instance, is unlikely to have much influence on competitiveness. But persistent exchange-rate realignments or shifts in unit labour costs between countries may lead firms to relocate entire plants to more predictable, if not more cost-competitive, countries. And if a multinational enterprise has to retrench in one market, it may cause cutbacks in other countries. All of which suggests that if globalisation has led to new ways of doing business, then policymakers have to think globally too. ■

References

- Krugman, P. (1995), "Growing World Trade: Causes and Consequences", Brookings Papers on Economic Activity Vol. 1, Brookings Institute, 1995.
- OECD (2002), *Economic Outlook*, No.71, Paris.

Ukraine: A miracle in waiting?

Mehmet Ögütçü and **Jaroslav Kinach***

Ukraine is a large country of some 50 million people that shares a border with OECD member, Poland. It was also the Soviet Union's second largest republic after Russia. Like Russia, it has been rather slow since the Union's dissolution in undertaking decisive economic reforms. The economy is improving, though there is much to be done before Ukraine can fulfil its undoubted economic potential.

©Efrem Lukatsky/AP

Sky's the limit: Monastery of Caves, Kyiv

When Ukraine's parliament, the *Verkhovna Rada*, declared independence in July 1991, and confirmed it by a 90% majority in a referendum in December 1991, there was a widespread belief that as one of Europe's most ancient civilisations, Ukraine would quickly overcome the legacy of the Soviet Union, rebuild its economy, adopt western democratic values, and establish institutions that would support an open market economy.

There was also some fear that Ukraine's transition would be accompanied by unrest. However, the process has been unexpectedly smooth politically, with none of the conflict, invasion or insurgence that have so characterised Ukraine's turbulent history, or that of some of its neighbours. Democracy has been abused from time to time, but it is entrenched in law, and progress is being made in exercising and developing it. Three parliamentary elections have been held, most recently in March 2002. And a new constitution was adopted in June 1996 as a blueprint for developing a democratic and civil society.

All positive steps, yet there is some way to go before democracy and law become properly embedded and deep-seated corruption is stamped out. This would be helped by a stronger economy, and it is here that the going has been tougher than many expected. If Ukraine is to chase away the shadows of its history and secure its future, it really must get this dimension right too.

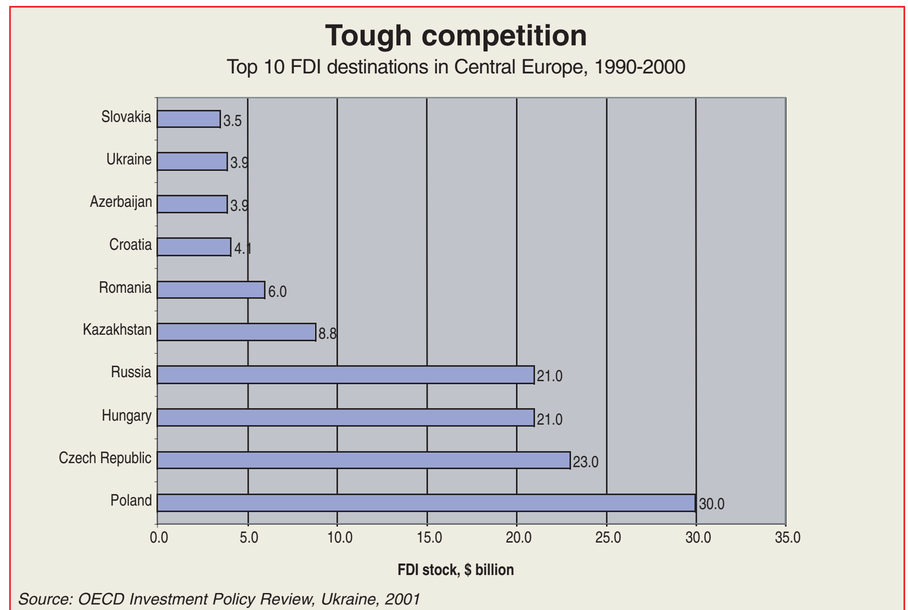
Partly to blame is nearly a century of suffocation under Soviet rule. Hangovers from that system, from cronyism to heavy bureaucracy, not to mention plain incompetence, have yet to be cured. But Ukraine's ills cannot be entirely blamed on past legacy and it too must shoulder some of the blame, as well as responsibility for change.

At last, there are encouraging signs. Ukraine's economic trends turned around in 2000 and record GDP growth of 9.1% was achieved in 2001 after a decade of decline. Inflation has also been curtailed and the national currency, the hryvnia (UAH), stabilised. These improvements have to be made sustainable.

Several factors triggered the recent impressive rate of growth. Obvious ones include devaluation of the hryvnia after the Russian financial crisis in 1998. This provided a major boost to exports of goods like metals and chemicals, taking advantage of a period of strong growth in world trade. A shift of small firms from the shadow to the formal economy led to growth in the private sector, which now accounts for about 65% of GDP.

However impressive this turnaround, the short to medium-term outlook is for some slowing in line with that of the global economy. A recent wave of import restriction measures by Russia, the EU and the US (on steel particularly) will not help exports, which account for roughly 60% of Ukraine's GDP growth. Russia is Ukraine's largest single trading partner, accounting for 22% of exports and 34% of imports, and because the ruble is sensitive to fluctuations in oil prices, Russia's exchange rate policy will also directly impact on Ukraine's economy.

If Ukraine had a more robust economic foundation it might be able to deal with these problems. But substantial restructuring will have to be carried out if Ukraine is to achieve sustainable growth. At just US$720 per capita annual income is very low compared with US$1,750 in Russia and US$4,240 in OECD member Poland (World Bank estimates at purchasing power parties, 2001 exchange rate). Growth from this low base is surely feasible. With the right economic policies and provided political stability continues, the next 10 years could prove to be the decade of Ukraine's economic resurgence.



Source: OECD Investment Policy Review, Ukraine, 2001

Slow and uncertain transition

It would be foolhardy indeed to expect the legacy of over 70 years of distorted central economic planning, and all the institutional and cultural legacy that goes with it, to be removed overnight. Ukraine's economy was deeply integrated with that of the Soviet Union and its extensive military industrial complex.

Dealing with the complexities of a free market economy, and making sure institutions operate openly and efficiently, remain daunting challenges even today for some OECD countries. But the problems are deeper in transition countries, where institutions and government apparatus may be inadequate, especially experience in policy formulation and execution. Nor could Western institutions provide a magic formula, particularly as they too had to acquire experience of transition.

Change is inconvenient, even when for the better, and so pockets of resistance were always going to make Ukraine's transition difficult, particularly from those that benefited from the previous regime or profited from disorder and cronyism. Even where intentions have been honest, the instincts of functionaries and other policymakers were more disposed to control economic activity than to create mechanisms to support private sector development and initiative.

Thankfully, changes are now happening. Macroeconomic stability has been restored and reforms have begun to make operations in the electricity sector more transparent; barter and inter-enterprise arrears have been reduced substantially; wage and pension arrears have been mostly eliminated;

One ingredient Ukraine needs plenty of is foreign direct investment to boost capital, improve skills and raise its economic performance generally. This goes for almost every sector of the economy.

corporate tax privileges have been reduced, and so on. All these have been major steps in transforming structure as well as minds, and probably contributed to the recent acceleration in economic growth. The new and challenging Land Code, which came into effect on 1 January 2002, has also been a catalyst, as it introduces a formal mechanism for private land ownership. And from 1 January 2005, it will allow agricultural land to be traded and used as collateral.

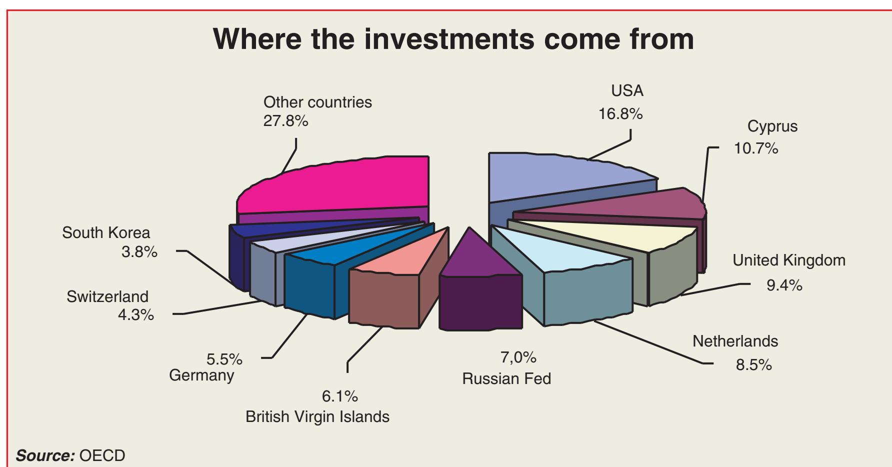
Further deep changes in the economy are inevitable. Restructuring is needed in heavy and light manufacturing industries to draw in new technologies, streamline existing capacity and generally improve cost, quality and competitiveness. Continued privatisation of large-scale enterprises is crucial, including in the energy sector, together with continued reforms of the agricultural sector, and strengthening of the weak and undeveloped financial services sector.

However, institutional and regulatory reforms are also needed, partly to squeeze out corruption and red tape, and to establish fair and transparent rules of the game. In addition, comprehensive bankruptcy, corporate governance, and securities laws must be implemented.

FDI

One ingredient Ukraine needs plenty of is foreign direct investment (FDI) to boost capital, improve skills and raise its economic performance generally – just as in other successful transition countries. This goes for almost every sector of the economy, from agriculture to banking. FDI flows directly influence the balance of payments and constitute a major source of foreign currency, especially useful for servicing external debt.

Where the investments come from



Source: OECD

Unfortunately, Ukraine's record of attracting FDI has been very poor. From independence to the end of 2001, the stock of FDI reached only $4.4 billion or $88 per capita, less than 10% of per capita FDI in neighbouring countries like Hungary or Poland (see graph).

The need for investment capital is particularly acute since net outflow of capital from the economy has been estimated at $20 billion since independence, although some of it has slowly begun to come back.

Russia's influence is enormous in the context of FDI. Russian (and Ukrainian) businesses use offshore companies in Cyprus, British Virgin Islands, Switzerland and other countries to repatriate and invest their capital back home. Russian companies now control Ukraine's aluminum and oil refining sectors, while their presence is increasing in the processed foods, metallurgical and machinery sectors, banking and transportation.

Kyiv and its surroundings received a little over 40% of cumulative FDI, with Donetsk, Dnipropetrovsk, Odessa, Poltava and Zaporizhya accounting for another third. Crimea has attracted only 4% since independence.

Without reforms, Ukraine's prospects for FDI will not improve. Some of the key obstacles which confront investors were identified by the OECD in its recent publication *Ukraine: Progress in Investment Reform 2002*.

Poor and uncertain administration is a major disincentive. Foreign investors, even those used to poor service elsewhere, frequently complain that no one appears to be in charge to take decisions, resolve disputes or grant approvals. Investors shuffle from ministry to ministry in a seemingly endless bureaucratic maze, while facing the prospect of dealing with an onerous tax regime, and poor accounting standards and practices.

Governance is not up to scratch either. The lack of transparency in privatisation, not to mention asset stripping and insider dealing, are major disincentives for all investors. Corruption is also a real problem; according to Transparency International 2001 "Corruption Index", Ukraine ranks in 83rd position, ahead of only eight countries.

Rule of law is also a problem. Reform of the judiciary is under way to improve efficiency and transparency, and especially enforcement of judgements (particularly necessary to enforce contractual obligations).

Complex **tax laws and regulations**, combined with capricious administration, also top the list of investment disincentives. Unexpected changes to existing tax legislation have also damaged the government's credibility; for instance, in December 2001 parliament passed a new law abolishing tax privileges for enterprises with foreign investments in a bid to establish equal treatment between domestic and foreign firms.

Another area in need of action is the **banking system**. Despite a large number of banks (over 150 registered), the top 10 represent over 70% of all banking activities, worth

Ukraine: Key economic and social indicators

Capital:	**Kyiv**
Population:	**49 million**
Area:	**604 thousand sq km**
Currency:	**Hryvnia (UAH)**
Adult literacy:	**98%**
Urban pop.:	**68%**
No. of households:	**8 million**
Avg. no./ household:	**6.1**

©University of Texas

Key Economic Indicators:	2000	2001
Nominal GDP (current US$ bn)	31.3	37.6
Real GDP growth %	5.8	9.1
Inflation (CPI) %	25.8	6.1
Current account (US$ bn)	1.5	1.3
FDI (Net) (US$bn)	0.6	0.8
Gross international reserves (US$bn)	1.5	3.1
Fiscal balance, cash basis % GDP	-1.3	-1.6
Total public debt %GDP	45.3	37.9
Exchange rate US$ avg	5.4	5.4
Credit ratings: EIU: D		
Other:	**industry/GDP**	**40.6%**
	agriculture/GDP	**14.7%**
	investment/ GDP	**20.4%**

Sources: Derzhkomstat, Ministries of Finance and Economy, Institute for Economic Research and Policy Consulting ; World Bank/IMF ; EIU.

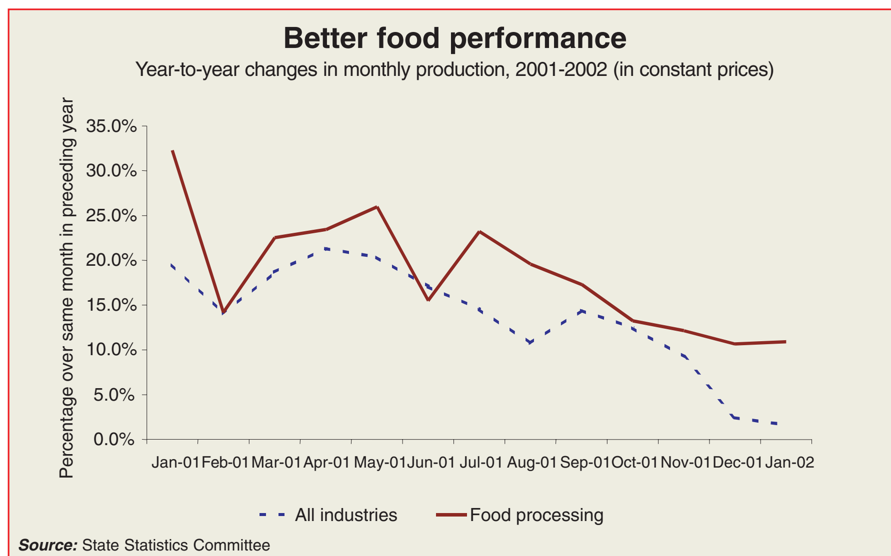
some UAH58 billion in mid-2002. The total capital of the banking system at UAH8.7 billion is very low, as are household deposits, despite double digit growth which has taken them to UAH15.2 billion at mid year 2002. While major regulatory and legislative improvements have been made, and improved bank supervisory and monitoring standards are being developed and implemented, the banking system still has not won over the full confidence of the public at large.

Privatisation trouble

The 2000-2002 privatisation programme clearly illustrates Ukraine's problems. The programme aims to sell off most of the 200 large enterprises holding over 80% of assets in the industrial and utilities sectors by attracting long-term strategic investors and foreign investors in particular. Naturally, the government sees privatisation as a way of bringing in not just capital, but new management and know-how, as well as being a major source of revenue. In 2001, revenues from privatisation constituted 11.3% of the total consolidated planned revenues to government and FDI generated some 60-70% of total privatisation receipts.

A major problem is how to manage the powerful, sometimes corrupt, economic power groups that privatisation has bolstered or created with control over metals, chemicals, gas, etc. Tax exemptions and the discretionary application of regulatory requirements clearly cannot continue, especially if the government is to improve the country's fiscal position. Receipts from recent sales of large companies have been disappointingly low, generating only UAH3 billion (about US$566 million) in 2001, which is half of what was planned. Prospects of meeting the 2002 target of UAH5.5 billion are remote since privatisation of the remaining nine *oblenergos* (regional electricity distribution companies) and the energy generating companies is still under review, while privatisation of the national telephone company, Ukrtelecom, has been postponed because of poor market conditions.

The Ukrainian government recognises the shortcomings in the investment climate. Its "Programme on Development of Investment Activity in Ukraine in 2002-2010" which introduces a complex set of measures aimed at further improvement in the investment climate, including further deregulation and liberalisation of business activities; creation of a stable and predictable legal environment; better banking and improved bankruptcy procedures.



Source: State Statistics Committee

The programme is in line with the **OECD investment policy recommendations** for Ukraine, and it is clear that more work is needed to advance private sector development, for instance, and put privatisation on to a predictable and stable, case-by-case, footing. The benefits and costs of investment incentives have to be better assessed and distorting tax privileges stamped out. International arbitration of disputes is needed, as are courts of appeal for economic disputes. And Ukraine's accounting and auditing practices have to be aligned with international standards, in particular for publicly-traded companies. Other initiatives like a "one-stop-shop" agency to facilitate foreign investor licences, approvals and so on, would also be valuable.

A major problem is how to manage the powerful, sometimes corrupt, economic power groups that privatisation has bolstered or created with control over metals, chemicals, gas, etc.

With a list like this, it may appear as an exaggeration to call Ukraine a "miracle in waiting". But it is a large and untapped market. It has a highly educated, yet inexpensive, labour pool; over 1,300 scientific and technical institutes specialising in artificial intelligence, metallurgy and aerospace, to name just a few areas. The country is endowed with vast mineral deposits, including 27% of the Earth's most arable and fertile top soil (chernozem). And, its location straddling central Europe, the Black Sea and Russia provides an important crossroads for the region and also a gateway to Asia. These are all attributes the country will no doubt be putting on the table in present entry talks to the WTO and in a future bid for EU membership.

Ukraine might not quite be a miracle economy now, but by taking advantage of favourable growth and following a course of aggressive reforms, it has the potential to become one in the future. ■

** Mr Öğütçü is head of the Non-Members Liaison Group and OECD Global Forum on International Investment (e-mail: mehmet.ogutcu@oecd.org). Mr Kinach is adviser to the prime minister of Ukraine (e-mail: jn@kinach.kiev.ua). Previously, Mr Kinach served as the EBRD's resident representative for Ukraine, 1995-1999. The opinions expressed in this paper are the authors' and do not necessarily represent those of the OECD secretariat or its member countries, nor those of the government of Ukraine.*

Banking on the euro

Carl Gjersem, OECD Economics Department

The introduction of the cash euro on 1 January 2002 has changed the lives of more than 300 million people. The second *OECD Economic Survey* of the euro area looks at budgetary policies and pressures in member countries, the prospects for economic recovery in the currency zone and the performance of the European Central Bank. But it also takes a special look at whether, with a single currency available across 12 countries, switching your bank account or mortgage to another euro area country is now an option or still a daunting task.

© Jean-Michel Clajot/REPORTERS/REA

Travellers in the euro area complained bitterly early this year when they found that the long-awaited dream of unfettered cross-border shopping had remained costly. True, the euros they drew out of bank cash machines abroad were the same as the euros at home, making it easy to compare prices. But when the travellers received their bank statements they found they were being charged far more than back home for the privilege of using their cash cards. That practice was ended before the holiday season by an EU directive, but integration in the banking sector still has a

long way to go to catch up with the integration that is taking place in other financial markets.

As the *OECD Economic Survey* of the euro area found, even the massive merger and acquisition activity in recent years might not advance matters as much as some might expect, since this has served mainly to concentrate national banking markets. In fact, there have been relatively few cross-border tie-ups. It is also virtually impossible to make comparisons about mortgages since lending systems for house purchases are very different from one country to another, while barriers to foreign entrants into local insurance and pension markets also remain considerable.

For consumers, transferring money from one euro area country to another is still generally much more expensive than transferring money within a country. The banks have argued that this is because there is no integrated pan-European retail payment system, so that transactions have to be processed manually and are therefore more costly. But they also say that the volume of such transactions is too small to make an integrated system worthwhile. From next year, EU authorities have ordered banks to charge the same for card use anywhere in the euro area from July 2002. But only time will show whether the lower costs will raise the volume of such transactions enough to make a cross-border system profitable, the *Survey* says.

When it comes to day-to-day experience, euro zone banking still very much begins – and ends – at home. Banks do not seem to reach out for prospective customers beyond national borders, while consumers do not go cross-border shopping around for credit either.

EU authorities have been inclined to let market forces do the work. As the survey notes, the fact that no common system has been developed to facilitate cross-border transfers of small sums even after decades suggests it is time for the authorities to adopt a more pro-active role. ■

References

- OECD (2002), *OECD Economic Surveys: Euro Area*, Paris.

Composite Leading Indicators: helping forecasters forecast

How reliable can economic forecasting be? It depends on several factors, like the quality of data and models, skill and judgement, etc. A key problem is anticipating turn-arounds, those sometimes elusive points when rising growth begins to slow or a downturn becomes an upswing.

The OECD Composite Leading Indicators (CLIs) are designed to provide early signals of turning points (peaks and troughs) between expansions and slowdowns of economic activity. CLIs are calculated by combining component series that cover a wide range of key short-term economic indicators. These include observations or opinions about economic activity, housing permits granted, financial and monetary data, labour market statistics, information on production, stocks and orders, foreign trade, etc.

The component series selected are those known to provide an indication of future economic activity: building permits, for instance, are an indication of possible future construction, whereas unemployment, by contrast, is a lagging indicator in that it reflects decisions prompted by past economic activity. The number of component series used for the compilation of the OECD CLIs varies for each OECD country, but ranges between 5 and 11 series.

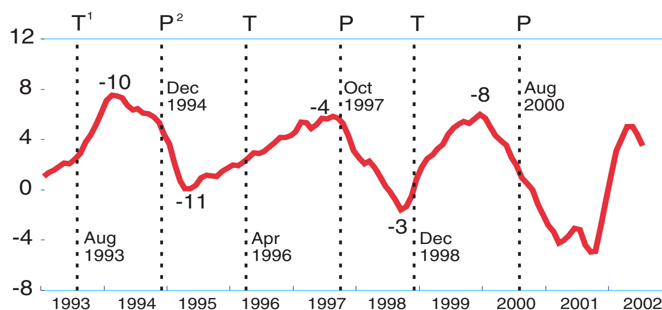
The OECD uses a six-month rate of change for CLIs as its preferred pointer to possible turning points as this is less volatile and provides earlier, clearer signals for future turning points. As the graph shows, the CLI provides early signals for the turning points in total OECD economic activity. For example, a peak in the six-month rate of change (annual rate) of the CLI for the total OECD occurred 10 months before (*i.e.* –10) the actual peak in economic activity in December 1994. The CLI turned downwards in June-July 2002; however, two months of evidence is not sufficient to be able to use this drop as a forewarning of a downturn in economic activity.

CLIs provide an important aid for short-term forecasts (6 to 12 months) of changes in direction of the economy, and so help economists, businesses and policymakers to improve their analysis of current trends and anticipate economic developments. However, CLIs are one instrument of analysis and are no substitute for quantitative or long-term forecasts based on econometric models. They are designed to provide qualitative information so that judgements can be made about short-term economic movements, rather than providing quantitative measures.

The OECD CLIs are calculated for 22 member countries and seven aggregate geographical zones (total OECD area, G-7, NAFTA, OECD-Europe, European Union, Euro area and the Big Four European economies). The data are published monthly in *Main Economic Indicators*. The latest CLI updates as well as further information on the compilation of OECD CLIs are available at http://www.oecd.org/std/cli and by e-mailing stat.contact@oecd.org

Composite Leading Indicator

Total OECD, six-month rate of change (annual rate)



1. Trough (T) observed in the economic cycles
2. Peak (P) observed in the economic cycles

Source: OECD Main Economic Indicators