International Monetary and Financial Committee

Seventeenth Meeting
April 12, 2008

Statement by Angel Gurría

OECD Secretary-General

Statement by Mr. Angel Gurría
Secretary-General
Organisation for Economic Co-operation & Development

International Monetary and Financial Committee
Washington D.C., 12 April, 2008

This statement concerns item 2 (The Global Economy and Financial Markets—Outlook, Risks, and Policy Responses) of the provisional agenda of the International Monetary and Financial Committee meeting.

Macroeconomic outlook and policies

The OECD is currently updating its *Economic Outlook* projections in view of their release on 4 June 2008. Our assessment at this time is summarised below.

Financial market turbulence has lasted longer than hoped-for last October. Pressures have tended to spread to new markets and institutions, far beyond the US subprime mortgages and derived products and leading to a generalised wariness and repricing of risks. In this context, near-term global growth prospects have weakened. Three sets of factors are at play – especially in the United States but also in a number of other OECD economies – whose effects are unlikely to fade soon:

- New issuances in various segments of the financial market have dried up, spreads have widened and lending standards are being tightened. The effects on demand are likely to be significant but are hard to gauge. Equity and housing price declines, particularly in the United States, are also holding back demand, with some lags.
- The housing cycle has turned in a number of OECD economies. In the United States the direct effect of the residential investment slump has been subtracting around one percentage point from real GDP growth over the past two years and will continue to do so this year.
- Household real incomes are being squeezed by soaring energy and food prices, even if in the euro area and to a lesser extent in Japan, currency appreciation has provided some offset.

Against this backdrop, short-term forecasting models taking on board the most recent dataflow, including the decline in payroll employment in the first quarter of 2008, suggest that the US economy is now essentially moving sideways, if not contracting outright. With the pace of activity so much below potential, economic slack is widening rapidly. In the euro area, the deceleration is less abrupt. Business confidence has held up better, as has export growth – despite euro appreciation. At the same time, unemployment has remained on a downward path. Even so, a spell of subpar growth lies ahead. In Japan, business sentiment as captured in the Tankan survey is weakening and the pace of underlying growth seems to be softening somewhat, notwithstanding the support from still buoyant neighbouring Asian economies.

As concerns inflation, both headline and core measures exceed comfort levels in many economies and on some indicators inflation expectations have tended to move up somewhat. US headline CPI inflation stands at 4 %, largely reflecting higher energy and food prices, and the latest core PCE reading at 2%. In the euro area, notwithstanding euro appreciation, headline HICP inflation has reached 3½ per cent, whilst statistical measures of core inflation continue to inch up, approaching 2½ per cent, and second-round effects start to materialise in the form of higher wage settlements in some countries. Japan stands out, with headline inflation at only 1% but core – excluding food and energy prices – still in negative territory.

How macroeconomic policies should react is contingent on the outlook for activity and inflation beyond the near-term projection horizon as well as on the balance of several risks. *First,* oil and other commodity prices may remain high or even continue to rise for some time from their already high levels, despite slowing activity. *Second*, the extent of any further financial turbulence and the magnitude and duration of the restraint exerted on economic activity by banks' and investors' newfound prudence, and by their need to recapitalise, is unclear. *Third*, short-run trade-offs between inflation and output may have changed in recent years, casting some doubts on the exact extent to which subdued growth will moderate inflation pressures.

In this light, the case for policy stimulus is stronger in the United States than in Europe or Japan. US policy makers have already acted with resolve and on a broad front, with a cumulative 300 basis point cut in the policy interest rate in just six months, a series of initiatives to provide liquidity in novel ways, direct intervention to contain the systemic repercussions of the collapse of a large investment bank, various measures to support housing and a sizeable, timely and targeted fiscal package. These measures have forcefully addressed some of the short term challenges arising from the current turmoil. In Europe, the monetary authorities have also taken measures to improve market liquidity but the near-term outlook for activity and inflation does not point to a need for stimulus and, insofar as output and prices will decelerate, automatic fiscal stabilisers will provide more support than in other regions. Japan has limited scope for responding to greater weakness.

Financial markets and open borders

Financial markets are bearing the brunt of the adjustment of past financial excesses that resulted in rolling asset price bubbles and excessive leverage, including with respect to house prices, subprime mortgages (and the securities based on them), some equity markets, and a "fat tail" of corporate over-borrowing related to mergers and acquisitions. A pressing worry is the deleveraging that will accompany the losses on subprime mortgages and related securities, and the risk that, if not handled well, the associated problems could spill into other asset classes, such as corporate bonds, equity derivatives and the like.

The OECD has increased its estimate of the ultimate mortgage losses from $300 bn last autumn to a range of $350 bn to $420 bn, depending on the assumed potential recovery rates in mortgage collateral. About $90 bn of the likely ultimate losses are directly associated with US banks that play a key role in the intermediation process. Left to itself, this could result in substantial deleveraging, like in the early 1990s. In the absence of new capital injections, it would take banks 6 to 18 months to recapitalise, depending on the extent of further central bank interest rate cuts and on dividend policies.

Despite these recent adverse developments, large US banking institutions, both in aggregate and individually, have maintained capital ratios above current regulatory requirements, in part by replenishing equity positions, with substantial contributions from a number of sovereign wealth funds (SWFs). Since last autumn, large US bank holding companies have thus raised over $50 billion in capital. However, the US banking system will continue to face a challenging environment and more capital will be required. These issues are not confined to the United States, since European institutions too bought a substantial share of the subprime securities.

As US interest rates decline, countries that peg to the US dollar, particularly in Asia and the Middle East, import monetary ease at a time when domestic conditions do not warrant it, which pushes up inflation and may fuel asset overvaluation, leading to credit events down the road. The acceleration of the revaluation of the renminbi vis-à-vis the dollar is welcome but greater exchange rate flexibility is called for both in China and in a number of other emerging markets.

Protectionist investment policies can only discourage capital inflows and retard efforts to restore financial stability. SWFs help to recycle savings internationally and have a good track record as long-term investors. On 9 April 2008, in response to a mandate from the G7 and other member countries, the OECD Investment Committee issued guidance to help recipient countries preserve an open environment for investment from SWFs while also safeguarding essential security interests. The guidance draws on existing OECD commitments to liberalisation and non-discrimination which are fully relevant for investments by SWFs. It also includes principles for addressing security related investment: transparency and predictability, proportionality and accountability. These same principles should also apply to any such measures affecting investments by SWFs. The OECD Investment Committee will continue to promote consultation and dialogue between home and recipient countries and supports IMF work on SWF governance and transparency.

The world economy is also falling short of its potential due to policies that impede trade. Yet, an important part of this gap can be closed by concluding the WTO's Doha Development Agenda trade negotiations over the next few weeks. The potential for freer trade to deliver tangible economic benefits to both developed and developing countries is well known. Almost seven years into the WTO negotiations, extensive analysis, both inside and outside the OECD, has demonstrated that multilateral trade liberalisation offers the prospect of globally inclusive economic benefits that go well beyond the scope of any regional trade accord. Now is the time to make the final push, to harvest the considerable opportunities for liberalising trade that are within reach.

With historically-high prices prevailing for many agricultural commodities, there is a unique opportunity to cut trade-distorting farm support, to open agricultural markets, and to free up the productive capacity of the sector in developed and in developing countries. The trade negotiations also cover the far larger economic sectors of non-agricultural goods and services, as well as a variety of other issues. The broad scope of the potential package means both very large and widespread economic gains – and given current global economic conditions, this would be a particularly welcome boost. As well, a positive conclusion to the Doha Development Agenda would represent an endorsement of the rules-based multilateral trading system, continued international engagement on trade and development issues, and an approach to global governance based on mutually agreed rules and concerted action.

SOVEREIGN WEALTH FUNDS AND RECIPIENT COUNTRY POLICIES

Report by the OECD Investment Committee

In recent years major changes in the environment for national security and the international economy have caused a number of OECD and other governments to reassess their investment policies. One important element in the changing global economy is the increasing prominence of Sovereign Wealth Funds (SWFs) from a wide range of home countries.

The mandate to the OECD

Since its creation, the OECD has been a strong advocate of free capital movements and their long term benefits. The OECD has been the primary international forum for policy analysis and development of guidance on good practices for investment policy. This guidance sometimes takes the form of authoritative, even legally-binding, government-backed investment instruments.

Because of this, the OECD has been asked by the G7 Finance Ministers and the other OECD members to develop guidance for recipient countries' policies toward investments from SWFs. Follow-up on this mandate has been undertaken as part of the Investment Committee's project on "Freedom of Investment, National Security and 'Strategic' Industries" and has benefited from the participation of non-OECD countries. The project is independent from, but complements efforts underway in the International Monetary Fund (IMF) to develop voluntary best practices for SWFs.

This note explains the general context for this work, reports on its preliminary findings and describes the next steps.

SWFs bring benefits to both home and host countries

The rapidly growing number and size of SWFs reflect the growth in foreign exchange assets that accrue mainly via revenues from commodity markets or intervention in the foreign exchange market. Budget revenues are also important in some cases. SWFs represent efforts by owners of these assets to manage them in a more proactive and sophisticated way.

SWFs have much to offer. SWFs' recent injections of capital into several OECD financial institutions were stabilising because they came at a critical time when risk-taking capital was scarce and market sentiment was pessimistic. They help to recycle savings internationally and generally have a good track record as long-term investors. They contribute to the economic development of their home countries; for example, they help to shield their economies from volatility in commodity markets, improve the risk-return profile of government-controlled portfolios and may boost financial and fiscal management capacities. In recipient countries, SWFs can also bring the benefits normally associated with foreign investment such as stimulating business activity and creating jobs. As one of the world's main proponents of an open investment system, the OECD welcomes these benefits for home and host countries.

Existing OECD principles call for fair treatment of SWFs

But, as is often the case, when new actors emerge on the international financial scene, the players need to become better acquainted. The growing role of SWFs raises issues regarding the smooth functioning of financial markets and they raise investment policy questions, including legitimate concerns in recipient

This report was adopted by the OECD Investment Committee on 4 April 2008. The non-member countries participating in the "Freedom of Investment" project include: the 10 non member adherents to the OECD Declaration on International Investment and Multinational Enterprises (Argentina, Brazil, Chile, Egypt, Estonia, Israel, Latvia, Lithuania, Romania, and Slovenia). In addition, Russia attended all of the discussions and other countries (China, India, Indonesia and South Africa) attended one or more. On 31 March 2008, the OECD and City of London co-hosted an event which gave sovereign wealth funds an opportunity to provide in-puts to OECD work.

countries about protecting national security. Intergovernmental dialogue will increase understanding and contribute to well-informed policy development, and thereby help to avoid protectionist responses which undermine economic growth and development. It will enable SWFs and recipient countries to design and implement policies upon which mutual confidence and trust can grow.

The OECD's existing investment instruments already contain fundamental principles for recipient country policies needed for the required guidance. Through their adherence to the OECD investment instruments, OECD and other adhering governments have committed to the principles of transparency, non-discrimination and liberalization. These principles are summarised in Box 1. These instruments: 1) express a common understanding of fair treatment of foreign investors, including SWFs; 2) commit adhering governments to build this fair treatment into their investment policies; and 3) provide for "peer review" of adhering governments' observance of these commitments.

Box 1. The OECD acquis – established investment policy principles

The key OECD investment instruments are the OECD Code of Liberalisation of Capital Movements, adopted in 1961, and the OECD Declaration on International Investment and Multinational Enterprises of 1976, as revised in 2000. They have procedures for notification and multilateral surveillance under the broad oversight of the OECD's governing Council to ensure their observance. The instruments embody the following principles:

- *Non discrimination*. Foreign investors are to be treated not less favourably than domestic investors in like situations. While the OECD instruments protect directly the investment freedoms of those SWFs established in OECD member countries, they also commit members to using their best endeavours to extend the benefits of liberalisation to all members of the International Monetary Fund. Experience has shown that, in practice, OECD governments nearly always adopt liberalisation measures without discriminating against non-OECD countries -- investors from non-member countries reap the same benefits of free market access as OECD residents. Outright discrimination against non-OECD based investors would be a major departure from OECD tradition.

- *Transparency*. Information on restrictions on foreign investment should be comprehensive and accessible to everyone.

- *Progressive liberalisation.* Members commit to the gradual elimination of restrictions on capital movements across their countries.

- *"Standstill".* Members commit to not introducing new restrictions.

- *Unilateral liberalisation.* Members also commit to allowing all other members to benefit from the liberalisation measures they take and not to condition them on liberalisation measures taken by other countries. Avoidance of reciprocity is an important OECD policy tradition. The OECD instruments are based on the philosophy that liberalisation is beneficial to all, especially the country which undertakes the liberalisation.

National security is a legitimate concern but should not be a cover for protectionist policies

The OECD investment instruments recognize the right of member countries to take actions they consider necessary to protect national security (Article 3 on Public Order and Security of the OECD Codes of Liberalisation of Capital Movements and Current Invisible Transactions).

Investments controlled by foreign governments, such as those by SWFs, can raise concerns based on uncertainty regarding the objectives of the investor and whether they are commercially based or driven by political or foreign policy considerations. They can raise concerns with respect to foreign government control or access to defence related technologies -- for example, that such investments could provide a channel for the acquisition of dual-use technologies for military purposes by the acquiring country or for denying technology or other assets critical for national defence to the recipient government itself, or for aiding the intelligence capabilities of a foreign country that is hostile to the host country.

However, OECD members have agreed that the national security clause of the OECD investment instruments should be applied with restraint and should not be a general escape clause from their commitments to open investment policies.

Security-related investment safeguards should be made as open as possible

Since 2006, OECD and non-OECD countries have been discussing appropriate means to address legitimate national security concerns while preserving and extending the open international investment system. These discussions have taken place in the context of the OECD Investment Committee's project on "Freedom of Investment, National Security and 'Strategic Industries'" through a series of discussions held in conjunction with regular meetings of the Investment Committee. Best practices for recipient county policies toward SWFs are being taken up in the context of this broader discussion.

Surveys of the policies of participating countries and related analyses and discussions have revealed that most countries have one or more investment measures designed to safeguard national security. However, few presently have explicit policies regarding foreign government-controlled investors, such as SWFs. Four of the thirty members have laws restricting foreign government-controlled investors. One includes foreign government control as a public interest test for merger reviews under its competition law. Two explicitly mention such control as a factor to consider in their investment review processes. Several others have investment review processes that, because of their broad mandates, could include foreign government control as a factor, even though it is not explicitly identified.

Participants in the project have agreed on a number of key principles that should guide governments in the design and implementation of measures intended to address national security concerns in the context of foreign investment. These are transparency and predictability, proportionality and accountability. Participants consider that these principles are equally relevant to addressing national security concerns that arise in the context of investment from SWFs. Box 2 describes these principles and provides preliminary policy guidance based on the discussions to date.

The project includes a process of regular peer monitoring within which countries report measures in place or under consideration and receive feedback from their peers in light of the principles of transparency/predictability, proportionality and accountability and of OECD members' commitments under the OECD investment instruments. The process has revealed that six OECD countries took new measures and that these measures were designed to codify or clarify existing laws. As part of its on-going work, the Committee will continue to monitor developments in this regard.

Box 2. Investment policy guidance from the freedom of investment project

Participants have agreed on the following guidance for investment policy measures designed to safeguard national security:

Non-discrimination – Governments should be guided by the principle of non-discrimination. In general governments should rely on measures of general application which treat similarly situated investors in a similar fashion. Where such measures are deemed inadequate to protect national security, specific measures taken with respect to individual investments should be based on the specific circumstances of the individual investment which pose a risk to national security.

Transparency/predictability – while it is in investors' and governments' interests to maintain confidentiality of sensitive information, regulatory objectives and practices should be made as transparent as possible so as to increase the predictability of outcomes.

- *Codification and publication*. Primary and subordinate laws should be codified and made available to the public in a convenient form (e.g. in a public register; on internet). In particular, evaluation criteria used in reviews should be made available to the public.
- *Prior notification*. Governments should take steps to notify interested parties about plans to change investment policies.
- *Consultation*. Governments should seek the views of interested parties when they are considering changing investment policies.
- *Procedural fairness and predictability*. Strict time limits should be applied to review procedures for foreign investments. Commercially-sensitive information provided by the investor should be protected. Where possible, rules providing for approval of transactions if action is not taken to restrict or condition a transaction within a specified time frame should be considered.
- *Disclosure of investment policy actions* is the first step in assuring accountability. Governments should ensure that they adequately disclose investment policy actions (e.g. through press releases, annual reports or reports to Parliament), while also protecting commercially-sensitive and classified information.

Regulatory proportionality. Restrictions on investment, or conditions on transaction, should not be greater than needed to protect national security and they should be avoided when other existing measures are adequate and appropriate to address a national security concern.

- *Essential security concerns are self-judging*. OECD investment instruments recognize that each country has a right to determine what is necessary to protect its national security. This determination should be made using risk assessment techniques that are rigorous and that reflect the country's circumstances, institutions and resources. The relationship between investment restrictions and the national security risks identified should be clear.
- *Narrow focus.* Investment restrictions should be narrowly focused on concerns related to national security.
- *Appropriate expertise*. Security-related investment measures should be designed so that they benefit from adequate national security expertise as well as expertise necessary to weigh the implications of actions with respect to the benefits of open investment policies and the impact of restrictions.
- *Tailored responses*. If used at all, restrictive investment measures should be tailored to the specific risks posed by specific investment proposals. This would include providing for policy measures (*especially* risk mitigation agreements) that address security concerns, but fall short of blocking investments.
- *Last resort*. Restrictive investment measures should be used, if at all, as a last resort when other policies (e.g. sectoral licensing, competition policy, financial market regulations) cannot be used to eliminate security-related concerns.

Accountability – procedures for parliamentary oversight, judicial review, periodic regulatory impact assessments, and requirements that decisions to block an investment should be taken at high government levels should be considered to ensure accountability of the *implementing* authorities. Discussions of accountability under the "Freedom of Investment" project will take place in late 2008.

Investors and home countries can ease concerns through transparency

Although the OECD work focuses on host country policies, observance by SWFs of high standards of transparency, risk management, disclosure and accountability can affect the political and policy environment in which recipient countries act. In particular, observance of high standards by investors should positively influence how recipient countries implement their OECD obligations and OECD's s policy recommendations when they design and implement policies to address national security concerns while maintaining their commitment to open markets. The availability of adequate and timely information from SWFs, including their investment goals, facilitates this objective. In addition, to contributing to greater confidence by recipient governments, observance of high standards of governance by such investors will also enhance their financial management and, more generally, their effectiveness in fulfilling their fiduciary responsibilities to their owners and shareholders and the expectations of other stakeholders.

Next steps

The OECD also supports the work underway at the IMF on best practices for sovereign wealth funds, calls attention to OECD's voluntary standards on corporate governance and good business conduct, and notes their relevance to work underway at the IMF. These include the OECD Guidelines on Corporate Governance of State-Owned Enterprises, the OECD Guidelines for Multinational Enterprises and OECD pension fund-related guidelines. The OECD looks forward to the outcome of the IMF's work and may consider the results in weighing any proposals made for future work in this area at OECD.

OECD will continue addressing this issue as part of the "Freedom of Investment" project in order to deepen consideration of how governments can maintain their long-standing commitment to open international investment policies -- including for SWFs -- while also protecting essential security interests.

The work programme will include further clarification of best practices regarding the implementation of the three guiding principles, especially "accountability", and any additional work which may seem appropriate in light of the results of the IMF's work.

The resulting framework will foster mutually-beneficial situations where SWFs enjoy fair treatment in recipient country markets and recipient counties can confidently resist pressures for protectionist responses. To this end, the spirit of cooperation that has characterised FOI discussions to date will continue through consultation and dialogue between home and recipient countries and between the IMF and the OECD.

Discussions under the Freedom of Investment project, which take place three times a year, will include a special session on government-controlled investors. Reports summarising the discussions held under the project will continue to be published. A final report on the Freedom of Investment project -- bringing together all of the findings of the discussions -- will be completed in mid-2009.

The resulting policy guidance will take the form of a menu of best practices which are consistent with existing OECD instruments and with the principles of transparency and predictability, proportionality and accountability. Its recommendations may also contain suggestions for appropriate revisions/clarifications to existing OECD instruments. ■

FURTHER READING

The following material is available on the OECD website at www.oecd.org/daf/investment/foi, unless specified otherwise.

Freedom of Investment, National Security and "Strategic" Industries: Progress Report by the Investment Committee, April 2008

OECD Roundtable VI on *Freedom of Investment, National Security and "Strategic" Industries*, 13 December 2007

Tour d'horizon of recent developments, OECD Official Use documents (October 2007, December 2007 and March 2008)

Protection of 'critical infrastructure' and role of investment policies relating to national security, May 2008

Transparency and predictability for investment policies addressing essential security interests: A survey of practices, April 2008

Proportionality of measures: A survey of practices, May 2008

Competition, International Investment and Energy Security, April 2008

Consultations on Freedom of Investment, National Security and "Strategic" Industries: Submissions by BIAC www.biac.org and TUAC www.tuac.org

Identification of Ultimate Beneficial Ownership and Control of a Cross-Border Direct Investor, *International Investment Perspectives, OECD, 2008 (forthcoming)*

Freedom of Investment, National Security and "Strategic" Industries: 2007 Interim Report by the Investment Committee, *International Investment Perspectives, OECD, 2007*

Economic and other impacts of foreign corporate takeovers in OECD countries, *International Investment Perspectives, OECD, 2007*

Essential Security Interests under International Investment Law, *International Investment Perspectives, OECD, 2007*