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

INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE

Washington D.C., Saturday 25 April 2009

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OECD Written Statement

Dim prospects for the world economy

The world economy is in the midst of its deepest and most synchronised recession in our lifetimes.

The OECD anticipates that the ongoing contraction in economic activity will worsen this year, before a policy-induced recovery gradually builds momentum through 2010. Output in the OECD area will drop by 4.25% this year and broadly stagnate next year (on a year average basis). The major emerging-market economies also experience economic slowdowns.

This bleak economic outlook is driven by the ongoing inventory correction, the credit squeeze, negative wealth effects stemming from lower house and equity prices and a generalised loss of confidence. It also reflects the collapse in world trade and a lower appetite for risk, particularly towards emerging-market and developing economies.

The OECD forecast is conditional on the assumption that the stress in financial markets dissipates towards the end of 2009, and carries risks that remain firmly tilted to the downside. The most important risk is that the weakening real economy will further undermine the health of financial institutions.

The social consequences of the recession are large. The unemployment rate in the OECD area is projected to approach 10% by 2010 compared with 5.6% in 2007. This implies that the crisis could swell the ranks of the unemployed in the OECD by about 25 million people, by far the largest and most rapid increase in OECD unemployment in the post-war period.

International imbalances which were large, and in many cases widened in the run-up to the financial crisis, have in some cases, including the United States, Japan and oil producing countries, sharply diminished. This new constellation of imbalances is likely to persist for some time, but it remains to be seen whether the eventual full recovery will mark a break with previous saving-investment patterns.

A policy response to the crisis along two axes is required. First, the immediate priorities are to revive demand, address the social impact of the crisis and repair the financial system. Second, action to these ends should as far as possible be consistent with a general re-orientation of policies across a wide front so that the exit from the crisis is towards a stronger, more sustainable economic growth paradigm. An exit towards business as usual is not an option for the long term.

Reviving demand and addressing the social impact of the crisis

Macroeconomic stimulus, using both monetary and fiscal policy is essential in order to cushion the fall in economic activity and to prevent a deflationary downward spiral.

Governments and their monetary authorities have already taken unprecedented action through fiscal stimulus and monetary easing, averting an even more pronounced recession. Some of the effects of this policy response are now being felt and much is still in the pipeline. It remains essential to maintain these expansionary policies, and to carefully design them so that they provide maximum support to economic activity.

The remaining scope to ease monetary policy should be used fully by maintaining or bringing policy rates to near zero and committing to keep them at that level for as long as needed. At the same time, the monetary authorities should be ready to implement or expand their use of direct measures to support credit creation and enhance liquidity in markets.

In the longer term, however, expansionary monetary policies and the enormous liquidity being injected risks leading to inflationary pressures if not promptly reversed once the recovery begins. Having an 'exit strategy' is therefore important too. Coordination will be a desirable component of any exit strategy, as individual countries acting on their own may find it difficult to unwind in an orderly way the exceptional measures that are currently needed.

Fiscal policy has, and is also playing an important role in cushioning the economic downturn. The effectiveness of fiscal policy will in part depend on the design of packages. The largest short-run impact on aggregate demand is likely to come from government spending measures, but where tax cuts are implemented they are most effective if targeted at liquidity-constrained households. Choosing measures that both raise aggregate demand in the short run as well as boosting productive capacity in the long run, such as investment in infrastructure are especially desirable, provided the expected returns on projects are fully evaluated and can be swiftly implemented. The lessons from the Japanese experience with fiscal policy in the 1990s are relevant in this respect.

But fiscal policy needs to be formulated taking into account long-term sustainability considerations. On current plans and given the forecast of a deep recession, government indebtedness is projected to rise substantially. Sustainability concerns are already putting upward pressure on bond yields in many countries. Keeping such pressures in check will hinge on establishing credibility for a return to fiscal sustainability. Designing fiscal stimulus measures that are explicitly temporary or easily reversed, strengthening fiscal frameworks, and acting now to address long-term spending pressures (e.g. outlays on health care and old-age pensions) would all be helpful in establishing such credibility. Once a recovery is on track, this needs to be followed up by actual consolidation measures.

To have maximum impact, conventional macroeconomic stimulus measures should be accompanied by well-designed employment and social policies to help vulnerable workers and low-income households. In particular, while unemployment benefits will automatically step in to sustain the incomes of many job losers, coverage of such benefits is weak in some OECD countries. Urgent steps need to be taken to rectify this while seeking to minimise any work disincentives. There is also an urgent need to ensure that social assistance benefits are adequate and extended to those who only have limited access to unemployment benefits. This may include putting in place measures that provide direct payments to those families and workers most affected by the downturn, especially in those countries with no, or only limited social safety nets. In this respect, advanced economies have a duty and self interest to help the poorer countries tackle the problems of unemployment that have been accentuated by the crisis. A decisive step should also be taken to scale up resources for effective active labour market programmes so as to preserve activation and the mutual obligations principle and ensure that disadvantaged jobseekers do not lose contact with the labour market and drift into inactivity.

The measures taken to assist job losers during the economic downturn should be timely, targeted and temporary. It is doubly important that income and re-employment support be timely. A rapid expansion of these measures not only contributes to stabilising aggregate demand, but it also assures that job losers receive help when they most need it. For distributional reasons, it is important that income support and re-employment support be targeted to the workers in greatest need. It is also important that active labour market programmes target the job seekers who can most benefit from each type of service for efficiency reasons. Finally, initiatives to provide additional income support during the downturn – or to relax certain behavioural requirements associated with activation regimes –should be temporary since they would otherwise undermine efficient labour market functioning once the recovery begins.

Repairing the financial system

The most important issue in public policy right now is to improve the ability and willingness of banks to extend credit in order to stem inflows into unemployment and related further loan impairment—a 'vicious circle' mechanism. A comprehensive global approach to dealing with the toxic assets on banks' balance sheets remains critical. In March the US put in place the public-private investment program (PPIP) for dealing with such assets; an approach that also reduces risks for the taxpayer. The *legacy loan purchase program* should attract ample distressed-asset private fund investors, given the possibility of funding with FDIC guarantees (with the very attractive feature of essentially switching these from the banks to private manager entities without adding to the total). The *legacy securities purchase program* also uses private asset management skills, but may eventually not have sufficient funds to deal both with current balance sheet holdings of toxic assets and those that may yet have to be consolidated from off-balance-sheet entities. If this proves to be the case, more up-front public funds and/or funding guarantees could prove necessary. Other countries have opted for alternative approaches to dealing with toxic assets. Some (like the Swiss) have used a publicly-funded asset management approach, while others (like the UK) are ring-fencing toxic assets and guaranteeing them. Each has advantages and disadvantages with respect to timing, taxpayer risks and level playing field considerations.

Markets rallied somewhat in late-March/early-April on positive sentiment because: (i) the US toxic assets issue would be addressed soon; (ii) widespread nationalisation — that would have permanently raised the political *risk premium* for investments in the financial sector — will be avoided; and (iii) a few early signs of lessening momentum in the global economic downturn emerged. However, it is a fragile situation, and markets could retreat once more on adverse economic news and policy disappointments. In coming months it will be important to get the PPIP up and running quickly and ensure that it has sufficient funds, and confront the exposure of some European banks both to US dollar funding gaps and to some struggling Baltic and South-East European countries.

Once the PPIP and other country approaches are well advanced, and as stress testing of banks is completed, it will become clearer how much capital banks will need to raise. In the main, this will be a matter for the private sector. There will, however, be a residual quantity of non-conforming legacy securities that cannot be dealt with through the PPIP and other mechanisms. This may leave some institutions still in a difficult position. Advance planning for this possibility would prevent any potentially disruptive effects.

Looking ahead, the way that governments exit from the emergency measures, as well as new regulation, will shape the future global financial system and how well it meets the needs of the real economy. 'Getting it right' will be more important than 'speed'. Financial stability will be reinforced if the key reforms affecting incentive structures are announced alongside a sensible time line for exiting from emergency measures. Markets will be looking for clarity on mutually reinforcing policies that strike the right balance between prudential risk concerns, competitive level playing fields and incentive structures in corporate governance and tax regimes.

Policies to build a stronger and more resilient economy

In addition to these macroeconomic and financial policy actions, there is a need to rethink how the world economy operates. This is the second axis of the policy response, and where the OECD's *Strategic Response to the Crisis* is making a contribution towards building a stronger, more resilient global economy. There are a number of dimensions to this effort.

First of all, keeping markets open and avoiding new protectionism is crucial to strengthen prosperity throughout the world. It is imperative to avoid the risk that the economic crisis leads to a tit-for-tat escalation of barriers to trade and investment. Some features of economic emergency measures pose dangers in that respect. At the same time, there is considerable potential for both OECD and non-OECD countries to exploit further market opening. A quick, successful completion of the Doha Round would contribute to supporting world growth, boost confidence and demonstrate a commitment to competitive and open markets.

But one cannot pursue market opening and growth policies as if business continues as usual. There is a need to restore trust in globalisation, and to strengthen the functioning of not just financial markets, but labour and product markets as well. The OECD, through its analytical work and by bringing together policy experts from member and major non-member economies is identifying across an array of policy fields good policy practices and reforms that support a better functioning market-based economy. Examples of this, include OECD work on strengthening corporate governance, fighting corruption and money laundering and combating tax evasion. On the latter, the OECD's framework for promoting the exchange of tax information is the benchmark being used by an increasing number of jurisdictions.

At the same time, the crisis should not be an excuse to relax or weaken our efforts to tackle global challenges like climate change. Action is needed now and it is necessary to ensure that the interventions made today do not interfere with the outcomes strived for later on. It is thus important to ensure that economic stimulus packages do not lock-in inefficient or polluting energy technologies or dirty modes of production and consumption, but instead promote clean alternatives. At the same time, the pursuit of greenhouse gas emission reductions by means of revenue generating instruments (e.g. carbon taxes, auctioning of tradeable emission permits) can assist the fiscal consolidation that will be necessary once the crisis is over. OECD work on the economics of climate change is providing governments with evidence-based analysis on how to design cost effective climate change policies.