



International Monetary and Financial Committee

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September 17, 2006

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

On behalf of the Organisation for Economic Co-operation and Development



**MEETING OF THE INTERNATIONAL
MONETARY AND FINANCIAL COMMITTEE**

*Singapore
Sunday, 17 September 2006*

Statement by

**Mr. Angel Gurría
Secretary-General
Organisation for Economic Co-operation and
Development, Paris**

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The global outlook

Performance during the first half of this year turned out to be stronger than expected in Europe but weaker in the United States and Japan. However, growth is likely to slow somewhat in Europe over the second half whilst the US and Japanese expansions regain some momentum. As a result, for the OECD area as a whole, activity is set to expand at about its potential rate during the second half of 2006. Turning to inflation, upside risks dominate in the United States whereas Japan is only just starting to exit deflation. The uncertainties surrounding this baseline scenario continue to include the trajectory of oil prices, which have come down in recent weeks but remain elevated. Another prominent risk nexus involves long-term interest rates and real estate, against the backdrop of cooling housing markets in North America.

The US economy is currently running at around full capacity. In the second quarter, investment weakened, dragged down by the homebuilding sector. Household consumption slowed less and has in fact tended to accelerate in recent months, consistent with a pick-up in compensation, and so have exports, pointing to robust GDP growth in the third quarter. Unemployment has edged up in recent months but remains low. In the United Kingdom, growth continues to be resilient in the neighbourhood of potential.

In Japan, momentum is driven by business fixed investment and household consumption. Corporate sentiment is holding up well, underpinned by strong profits and orders. Consumption is buoyed by employment creation and rising compensation. As a result, the expansion is on course to become the longest in half a century.

In the euro area, activity accelerated in the second quarter, partly catching up with upbeat business confidence indicators. Several transitory factors helped, but more fundamentally domestic demand in the euro area is benefiting from the pick-up in job creation in the two largest economies, and area-wide unemployment is now under 8% of the labour force for the first time since 2001. Given the stronger-than-expected momentum to date, year-average GDP growth is slated to reach 2.7% – the strongest performance since the 2000 peak.

With most measures of inflation edging up, central banks across the G7 countries and beyond have lifted their policy rates in recent months, notwithstanding the fact that they face very different stages of the economic and interest rate cycles. In the United States, the Federal Reserve paused in August but further tightening may turn out to be warranted if activity and prices do not slow down over the next few months, as past interest rate hikes and housing market softening work their way through. In Japan, there is a strong case for waiting before further hiking the policy rate until the new series of core inflation, excluding energy and food, is more firmly in positive territory. In the euro area, the recovery now seems sufficiently robust for a return towards a neutral monetary stance, but at a measured pace, since unit labour costs remain well in check.

On the public finance front, dynamic activity and rising asset prices have produced positive revenue surprises. As a result, the fiscal deficit in the United States and in a number of other OECD countries should come in below what had been budgeted. In particular, in several euro area members, the general government deficit will pass under the 3% of GDP mark. In general, however, the extra receipts should not be spent, since the pace of fiscal consolidation during this cyclical recovery has so far failed to live up to the public finance challenges stemming from population ageing and other medium-run pressures.

Financial markets and financial stability

Turning to financial markets, the resilience of financial systems to recent shocks augurs well for the continuing stability of financial markets, although there continue to be several risks attached to this positive outlook. Among them are household debt burdens, global current account imbalances and tight risk pricing in financial market instruments. Profit and capital positions in major financial institutions continue to be strong, however, and constitute a considerable buffer to absorb any losses.

Market participants project interest rates to move upwards. Rising interest rates tend to increase household debt service payments. While financial obligations ratios of households *on average* seem not to present much cause for concern, the impact of any increase in household debt-service and/or deterioration in income depends on the distribution of debt across different income categories. While in some constituencies the bulk of household sector debt is backed by solid income positions, the participation of highly-leveraged and relatively lower-income households appears to be on the rise in mortgage markets. Some of the latter have been attracted by the features of non-traditional mortgage products, such as foreign currency, interest-only loans etc. There is also some concern that households do not fully appreciate the risks they are taking. This is exacerbated by developments regarding pension provision, which are having the effect of increasing the direct exposure of households to investment and longevity risks. Policymakers are aware of this and are already taking measures to begin to improve financial literacy levels of individuals and the information available to them. The consequences of this situation for financial stability appear to be limited, however, at least over the short to medium term.

Trade and investment

While near-term growth prospects are generally favourable, sustaining robust growth over the longer run calls for significant progress with respect to the liberalisation of trade and investment flows. Indeed, trade and FDI work together as channels for expanded availability of resources and productivity-enhancing technology. With appropriate economic framework conditions, trade in particular can boost innovation and competition, and facilitate international technology transfer. Substantial barriers to trade remain and there is room for sizeable gains from further multilateral liberalisation under the Doha Development Agenda.

More specifically, well-designed multilateral trade liberalisation – including meaningful improvements in market access for industry, agriculture and services – is a win-win for both developed and developing countries. With respect to merchandise trade, developing countries could add 0.5 to 0.8% to their baseline income, and developed countries 0.1 to 0.6%. Services trade liberalisation can deliver even larger benefits. In addition, trade facilitation and steps to address non-tariff and technical barriers to trade can further magnify the gains.

Trade liberalisation calls for economic adjustments on the part of all participants, but with appropriate policy reforms this challenge can be addressed. In fact, these reforms are often among those more generally needed to promote growth, including the establishment of sound economic framework conditions (e.g., enabling entrepreneurship and innovation), the development of human resources (e.g., through education and training), and the provision of assistance to facilitate adjustment for those individuals at risk of losing out. In some cases, aid for trade can play a role in enabling developing countries to address constraints and position themselves to capitalise on the new economic opportunities arising from liberalisation.

A successful outcome to the Doha Development Round trade talks is still possible. The benefits from a successful round are of great consequence for the world economy. The OECD has estimated at nearly \$100 billion the gains in terms of increased economic activity – and hence prosperity – that could be obtained from full tariff liberalisation for industrial and agricultural goods. 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 reap as much as two-thirds of these gains. The failure of Doha would mean that these benefits are lost. More importantly, it risks undermining the multilateral trading system and unleashing a wave of protectionism that reasonable politicians will find hard to counter.

There is also the danger of litigation replacing legislation, with dispute settlement taking 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. Bilateral and regional trade deals would proliferate, adding complexity to the international trading system and producing more limited gains.

The global economy is also facing a resurging risk of international investment protectionism. Foreign corporate takeovers have been made subject to tighter political scrutiny in major countries, both members and non members of the OECD. These actions are taken to protect essential national security interests, but their effect is to create new uncertainties that damage the investment climate and dampen economic growth. The OECD is therefore spearheading an effort, jointly with non-member economies, to strengthen international co-operation and ensure that national policies towards international investment are guided by transparency and openness.

The Millennium Development Goals

We welcome the Managing Director's report on Fund policy for helping low-income countries achieve the Millennium Development Goals, which contains some significant steps forward.

First, there is the forward-looking debt sustainability framework, designed together with the World Bank to help low-income countries make their financing decisions. This framework addresses the challenge of avoiding new debt crises in countries who after debt relief now have capacity to take on new debt. We see a challenge too in the area of lending. As past experience in the OECD Group on Export Credits suggests official and private lenders need to take a more prudent approach to their individual and collective lending decisions and practices. And major non-OECD lenders to low-income countries must also accept their responsibilities.

Second, we welcome the Fund's readiness to help low-income countries manage the macroeconomic challenges of the scaled-up aid required to meet the MDGs and to tackle these by working closely with the donor community on the ground, in dialogue with the developing country finance minister. The checklist on the macroeconomics of scaling up aid in Africa published by the Fund staff is extremely helpful in this regard. For donor country finance ministers there is an explicit message – to encourage and enable their aid ministers to supply predictable, medium-term aid. This is an essential basis for the fiscal scenarios needed to make scaling up feasible in both sectoral planning and macroeconomic terms.