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Statement by Angel Gurria
Secretary General
Organisation for Economic Co-operation and Development

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Financial markets

Financial market conditions appear to be improving amidst still considerable uncertainty. Short-term money market spreads have stabilised at low levels in the United States and the euro area. Corporate bond markets have been buoyant, with large issuances by non-financial corporations, and despite the Dubai and Greek bond turmoil, which interrupted the fall in yields that started at the end of 2009. After the sharp rally at the end of 2009, equity markets have ground slowly higher in 2010, as the recent sovereign bond stress does not appear to have resulted in a reassessment of risk. Together with bond issuance, equity has been an important source of corporate funding in 2009.

Outside the OECD area, financial markets in emerging economies have proved very resilient to recent financial market turbulence. Exchange rates have not experienced large shifts and equity markets have gained ground following some consolidation in January.

Banks have strengthened their capital positions, despite large losses and write-downs, including by raising equity. Nevertheless, vulnerabilities remain. Banks will likely continue to suffer credit losses on their loans and portfolio holdings because of the lingering effects of the downturn on borrowers' repayment capacity, especially in relation to commercial property mortgages. Some banks have also accumulated exposure to interest-rate risk by using short-term, low-cost funds to purchase longer-term, higher-yielding assets.

As the recovery progresses, credit creation will be affected by both supply- and demand-side developments. Although lending conditions appear to be easing, the supply of credit by banks is likely to remain restrained. Uncertainty about the new bank capital rules currently under consideration will also affect lending decisions. At the same time, demand for bank loans will continue to be constrained by ongoing deleveraging, as households and enterprises work to strengthen their balance sheets.

Uncertainty about the resolution of sovereign debt tensions in Europe will weigh on the outlook for financial markets. Sovereign bond spreads have come down, although they remain exceedingly high in the more heavily indebted countries, reflecting concern about the sustainability of their public finances.

Economic outlook

The world economy is recovering, albeit hesitantly and at different speeds across countries and regions. Economic activity gathered momentum in the major OECD economies in the last quarter of 2009, with the notable exception of the euro area. Underlying inflation has been tame due to still considerable economic slack, although expectations have edged up in some countries. The OECD area has benefited through trade linkages from robust growth in emerging-market economies. Global current-account imbalances have begun to widen again, with the notable exception of the now much smaller Chinese current-account surplus, which nearly halved during the recession.

Notwithstanding some encouraging signs, the recovery will likely remain weak and bumpy in the OECD area for some time. Sluggish credit growth and weak labour markets will continue to bear down on private demand, and some fiscal stimulus measures are expected to come to an end. Headwinds coming from financial markets should not be ruled out, not least because banks remain vulnerable to credit losses and interest-rate risk.

Exit strategies

The withdrawal of policy stimulus will need to proceed gradually because of the frailty of the recovery. Central banks are removing unconventional support, while preparing the groundwork for conventional policy normalisation, which will need to be carried out in a cautious, transparent manner that is contingent on the pace of recovery and the associated outlook for inflation.

Liquidity management by central banks around the world has been exemplary. A number of special provisions have now been scaled back or announcements to that effect have been made, with no evidence of an adverse effect on money market spreads. The phasing-out of remaining liquidity facilities will nevertheless need to be guided by financial market conditions. A case can be made for retaining some of the existing instruments, while gradually increasing access costs, for use in situations of duress, should they re-emerge.

Asset purchase programmes have been completed, or are scheduled to close in the near term. Less liquid assets nevertheless remain in central bank balance sheets, notably in the United States and the United Kingdom. From a longer-term perspective there is a strong case for divesting these assets to avoid a misallocation of resources. However, in the short term, divestiture will need to be decided on the basis of macroeconomic conditions and the functioning of the underlying asset markets.

It is also imperative to lay the groundwork for fiscal consolidation. Budget deficits are projected to rise to over 8% of GDP in 2010 in the OECD area on the back of fiscal stimulus measures, cyclical revenue losses and expenditure hikes, the disappearance of revenue buoyancy driven by asset price bubbles, and increased government debt. Based on the projections reported in the November 2009 issue of the *Economic Outlook*, OECD-wide government debt is set to exceed annual GDP by 2011, about 30 percentage points higher than before the onset of the crisis.

While substantial consolidation is needed in most countries to prevent further debt build-up and to restore room for fiscal manoeuvre, the pace and magnitude of adjustment will depend on individual country conditions and the state of public finances. The international dimension of consolidation also needs to be taken into account, given the magnitude and synchronicity of fiscal adjustment in many countries. The G20 *Framework for Strong, Sustainable and Balanced Growth*, offers an instrument for addressing this challenge by facilitating policy coherence across countries.

Fiscal consolidation should involve instruments that minimise its adverse impact on trend growth. Public sector efficiency should be given priority as there is much scope for making government spending more cost-effective, for example in the areas of health care and education. Growth-enhancing programmes, such as on human capital accumulation, innovation and infrastructure development should be preserved from cuts to the extent possible. Where revenue hikes are needed, emphasis should be placed on the least distortive taxes, such as those on consumption or property. Greater recourse to green revenue, including receipts from green taxes and carbon permit auctioning, would contribute to fiscal consolidation while encouraging green growth.

Structural policies to support strong, jobs-rich growth

The global crisis has left most OECD countries with an unenviable legacy of high unemployment and lower potential output.

Amidst considerable variations in labour market performance across countries, the OECD-wide unemployment rate rose to a post-war high of 8.8% in December 2009 from a 25-year low of 5.6% in late 2007. Even where employment losses have been relatively moderate, there have been large reductions in hours worked, in part because governments have encouraged adjustment through short-time working subsidies.

Partly due to higher unemployment, the level of potential output has fallen by some 4% in the OECD area as a whole as a result of the crisis. A major risk is that the unemployed will drift into long-term joblessness and fall gradually into inactivity. Should it happen, the cyclical increase in unemployment due to the crisis may become structural in nature, which is a source of concern from the viewpoints of social cohesion and growth.

OECD countries have so far steered clear of the serious policy mistakes of previous crises. An escalation of trade protectionism during the Great Depression and misguided labour market policies that reduced the labour supply in the 1970s, especially in Europe, made the recovery from those crises much more difficult than needed.

Pro-growth structural reform will be needed to spur labour productivity and to ensure that labour resources are fully utilised. Some initiatives that have been put in place in response to the crisis and have the potential for improving the labour market performance during the recovery should be strengthened. Measures would include not least job search and training programmes, and activation policies more broadly, in particular in support for those workers who are most vulnerable to the long-lasting effects of the crisis. Pro-competition reform in product and labour markets would facilitate the reallocation of capital and labour in support of stronger long-term growth.

An orderly and sustainable resolution of global current-account imbalances requires a combination of macroeconomic and structural policies. Greater flexibility in exchange rates would facilitate a rebalancing of domestic and external demand, where appropriate. Structural measures are needed to raise public and private savings in deficit countries. In surplus countries, otherwise desirable policy initiatives, such as a strengthening of formal social safety nets and improved access to financial markets, could have the side-effect of reducing private savings in many emerging market economies, where high savings are in part precautionary. Measures to raise investment in some surplus countries through a liberalisation of services would also be needed and could yield a double dividend of reducing current account imbalances and boosting long-term growth.