International Monetary and Financial Committee

Twenty-Third Meeting
April 16, 2011

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Organisation for Economic Co-operation and Development

G20 FM/CBG & IMF/WB meetings

Written Statement for IMFC meeting

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13 April 2011 - 18 April 2011

Washington, United States

Economic outlook. The global recovery is becoming more firmly established, self-sustained and broad-based. Activity is strengthening in the OECD area, driven by improving household and corporate balance sheets, thus boosting consumption and investment growth, and by a pick-up in world trade growth. The major emerging-market economies outside the OECD area continue to grow vigorously.

Despite encouraging signs, there are downside risks to the near-term outlook. Inflation has picked up on the back of soaring energy and food prices and is taking its toll on disposable income, which could damp activity in the near term. In addition to devastating social and human impacts, the economic consequences of the earthquake and tsunami in Japan on infrastructure, housing and business capital and through supply chain disruptions and power shortages are uncertain. A broadening of social unrest and political tensions in North Africa and the Middle East could exacerbate concern about supply disruptions and push up energy prices further. Continued sovereign market duress in the euro area would pose another risk to the recovery.

Having narrowed during the recession from pre-crisis historical highs, global imbalances are unlikely to narrow further in the absence of fundamental policy reforms at the global level. While the external balances of the major OECD economies remains broadly stable, the external surpluses of the oil-producing economies are now rising in tandem with the sizable energy price gains. The Chinese current account surplus has narrowed.

Policy challenges and requirements. The unevenness of the recovery calls for differentiated policy responses across countries and regions. The risk of deflation is receding because of the surge in commodity prices and as the economic recovery continues. In most OECD economies, monetary policy will need to deal with higher inflation and counter the associated risk that expectations may become unanchored. At the same time, monetary policy will have to continue to provide economic support against a background of still substantial slack, ongoing fiscal consolidation and lower purchasing power due to higher commodity prices. In the fast-growing emerging-market economies, inflationary pressures are stronger due to supply constraints and a higher weight of commodities in consumption baskets. Monetary policy is therefore already being tightened in some countries.

Public finances remain in a precarious state in many OECD countries. In many countries, this is in part a result of the contingent liabilities incurred during the crisis in association with support measures for their banking sectors. Based on recent OECD projections, headline fiscal balances would improve on average by 1½ per cent of GDP in both 2011 and 2012. Nonetheless, for most OECD countries general government debt is to continue to rise in relation to GDP over the next couple of years due to a combination of continuing high deficits, still weak economic growth and mounting interest payments. Indeed, OECD-wide government debt will exceed annual GDP in 2011, about 30 percentage points higher than before the onset of the crisis. Fiscal positions vary considerably in the emerging-market economies outside the OECD area and are in general better than in the majority of OECD countries.

Labour market conditions have been improving in most of the major OECD countries in recent months, although the OECD-wide unemployment rate remains over 2 percentage points higher than at the onset of the crisis. Youth unemployment is a particularly serious problem, at two to three times the average unemployment rate in many OECD countries.

The priority for many OECD countries is therefore to boost growth and jobs, while consolidating budgets. The key to achieve this balancing act is to establish credible and growth-friendly consolidation medium-term plans, starting in 2011, and to embark on a new round of growth-enhancing structural reforms.

Structural policies to facilitate fiscal consolidation and global growth rebalancing. The tasks of monetary and fiscal authorities would be facilitated if pro-growth structural reforms were to be implemented. OECD analysis shows that well-designed growth-enhancing reforms would have beneficial side-effects on budget consolidation, debt dynamics and external balances. In an environment of moderately-paced growth and impaired fiscal positions in most OECD countries, priority should be given to implementing reforms that offer comparatively strong short-term gains and facilitate fiscal consolidation.

Productivity-enhancing reforms in the public sector could contribute markedly to strengthening fiscal positions in many countries. Reforms to pension and unemployment insurance systems that reduce incentives for early retirement and inactivity would foster employment growth. This would in turn improve fiscal positions by raising tax revenues and/or lowering public spending. Other structural fiscal reforms that facilitate growth and improve welfare include reductions in tax expenditures and subsidies, and the introduction of pollution-pricing mechanisms, such as carbon taxes or the auctioning of emission permits. In addition, measures to improve product-market competition have relatively large effects on output and employment.

Structural labour market policies will have an important role to play to prevent high cyclical unemployment in many OECD economies from becoming structural. While measures taken during the crisis to prevent hardship for the unemployed and to limit lay-offs will need to be scaled back as the outlook for growth improves, new initiatives could be taken to strengthen the job content of the recovery. They include activation and training policies, as well as reform to achieve more balanced protection between permanent and temporary workers, which holds the promise of more and better jobs for marginalised groups, such as youths, low-skilled females or migrants. A main challenge for several emerging-market economies is to tackle labour informality, which can be addressed by strengthening the marketability of low-skilled workers, especially by improving their educational achievement.

Keeping markets open to international trade and investment is key to sustained recovery. Investment policy monitoring at the OECD shows that, over the past year, investment liberalisation has slowed and governments' attempts to shape outcomes of international investment decisions are on the rise. Tightened review mechanisms for inward investment are being proposed or introduced, and existing regimes are applied more restrictively. Selective support of domestic industries, first introduced as emergency crisis response, has outlived the crisis and has become a more entrenched feature used to influence investment decisions in "strategic", especially "green" technologies, and traditional industries in sectors exposed to declining demand or increasing global competition. Governments should resist protectionist pressures. They should also make a decisive effort to conclude the Doha round, which would boost business confidence, income and employment, at no fiscal cost.

OECD analysis shows that a sustained reduction in global imbalances could be achieved through a combination of macroeconomic policies and structural reforms. Reforms to facilitate fiscal consolidation can help directly in this respect, since consolidation needs are generally larger in external deficit countries than in external surplus ones. Policy action that aligns movements of real exchange rates with economic fundamentals would contribute. So would structural reforms that are already desirable on efficiency and/or equity grounds. Recent OECD analysis indeed shows that pro-investment reforms, such as initiatives to enhance competition in sheltered sectors, would help to narrow external surpluses in mature economies in the years ahead. It also shows that an increase in social spending of 1 percentage point of GDP could reduce private savings by about 1.5 per cent of GDP: for countries with low levels of social spending, notably in large surplus emerging economies, the multiple is even higher.

Structural reforms can also equip countries with the needed policy levers to make the most of capital inflows in support of long-term growth and to reduce associated vulnerabilities. OECD analysis indicates that improved structural policies could help to modify the composition of capital inflows towards more stable and productive sources of balance-of-payments financing and reduce the potential risks associated with capital flow reversals.

Reintroducing capital controls can play a role but only as a last resort and temporary measures in specific circumstances. : "beggar-thy-neighbour" approaches to controls can have negative collective outcomes. In the event of recourse to controls, countries should align to the principles of transparency, non-discrimination, proportionality and accountability that are embodied in the OECD Code of Capital Movements, which for 50 years has provided a framework for co-operation on capital flow management. But the first line of defence to avoid destabilizing capital inflows is to have in place an appropriate mix of macroeconomic and structural policies.

Financial markets. The economic recovery is no excuse to stall the agenda of financial reforms. Weaknesses of financial regulation and supervision have been part of the causes for the financial crisis and the recognition of this effect has induced policymakers to undertake several significant efforts to address many of the issues that created incentives for excessive risk-taking on the part of financial institutions both at the national and the international level. As a general principle, reform efforts should be (and typically are) guided by the principle that financial institutions should not be allowed to return to business as usual.

Policymakers need to maintain the momentum of the various initiatives taken over the past two years or so and implement envisaged reforms in a decisive and speedy manner. That said, policymakers need to be wary that "getting it right" is more important than "getting it done quickly". Speed however can be helpful to combat "reform fatigue", which could arise given that the list of regulatory reform issues still outstanding – e.g. tackling SIFI/TBTF or enhancing the supervision of the shadow banking system - is long.

Close policy co-ordination as regards the scope and speed of regulatory reform is imperative to avoid an uneven playing field for internationally operating financial institutions. But in some areas, policy coordination may not be as close as desired. For example, as regards the crucial issue of how to tackle the too-big-to-fail issue, significant differences exist between the major areas. The United States has taken relatively more ambitious measures vis-à-vis banking conglomerates towards a separation of commercial from some investment banking activities, the barring of public money to bail out entities that engage in certain swap activites and the use of simple leverage ratios in their capital adequacy assessments, which the OECD Secretariat sees as an important complement to the Basel III capital requirements. By contrast, the European Union has placed a sharper focus on regulation related to rating agencies and alternative investors, such as hedge funds and private equity funds. More generally, the OECD believes that the idea of separation of retail and investment banking activities remains a critical issue, and has not been taken far enough in any OECD country.

Progress in strengthening bank balance sheets differs among countries and, some have made little progress at all. Moreover, compared to the pre-crisis situation, in several European markets a “new normal” exists consisting of both higher sovereign and banking risks, as well as greater linkages between the two. Both sovereign and banking risks need to be addressed at the same time, and measures reducing one of them will be beneficial for the other. In this context, an important challenge will be to avoid “fiscal consolidation fatigue” as well as to accompany the process by decisive structural reforms, which should allow economies to realize greater potential growth.

Countries with large potential banking sector liabilities need to assess and report related risks carefully in their stress testing exercises. The outcomes of such stress tests could help inform financial supervision and regulation and crisis preparedness, as well as reduce uncertainties on the part of market participants. As regards the parameters of the stress tests, policymakers should contemplate including a larger group of banks and both trading and banking book exposures. It is also imperative to use simple measures of equity capital as opposed to risk-weighted capital and, perhaps, to run joint stress test for financial institutions and sovereigns.

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