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

INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE

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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.

Financial Markets

Financial markets are in turmoil. The crisis which started around mid-2007 has since deepened and spread. It has now evolved into a solvency issue, exacerbated by liquidity problems in the interbank markets, in credit markets and, by depositor fear and runs on banks. The present crisis, with its global dimensions is the largest since the Great Depression, and to date markets have not been convinced that responses on these three fronts are proceeding in an effective and coordinated manner.

The solution to financial solvency crises always have three main elements: guaranteeing liabilities; separating out the bad assets; and then recapitalising the institutions affected. Governments are taking actions to address these elements by different means, but in an increasingly coordinated way.

Deposit insurance has been extended in most jurisdictions, but not in a consistent way. The Troubled Asset Relief Program (TARP) is a critical first step towards separating out bad assets via government purchases.

This second element also fosters the revitalisation of the credit markets through reverse auctions that result in price discovery. It is important that the pricing of these transactions reflect as closely as possible the underlying value of the collateral backing of securites. Done well, the reverse auctions will help the recapitalisation efforts of banks by stabilising prices of securities. This helps to avoid continued mark-to-market losses which absorb capital and would perpetuate the crisis. Furthermore, where liquidity discounts have been present, the selling of securities at more realistic prices would allow some 'writing back' of previous 'write downs', which would be directly beneficial in the recapitalisation process.

As better price discovery begins to occur, the longer-term buyers (pension funds etc.) may well begin to join the buying process, so that ultimately it may prove unnecessary to use the full $700bn of the TARP package. At this stage a more thorough recapitalisation of the financial system would become possible.

It would help settle financial markets if all jurisdictions continue preparing a clear coordinated and consistent approach to all three of the required elements of a systemic rescue plan to avoid being forced to move by bank failures and market pressures. This would help to boost confidence and create the conditions needed to re-establish the normal operation of financial markets and to preserve economic activity.

The financial crisis has raised many economic and governance issues, and in time the financial market landscape will emerge fundamentally changed. Once the crisis has passed, it will be important to implement longer-run structural reform of the global financial system to prevent the recurrence of crises in the future. Governments will need to address a new risk culture and mechanisms to deal with major crises, as well as more effective regulation adapted to the new market profile and current regulatory gaps. They will also need to consider the long term consequences for the financial sector in terms of competition, incentives for prudent behavior and economic growth. Furthermore, consumer protection, and improved financial and risk awareness and education will be essential to restore confidence. In the area of corporate governance, implementation of agreed international standards, such as the OECD Principles of Corporate Governance, will need to be improved, through better international co-operation and coherence between national frameworks.

Such structural and regulatory issues are the raison d'etre of the OECD in its economic and financial committees. The expertise of these OECD committees, which also bring together other international organisations and the private sector and other stakeholders, will be mobilized to provide fora for discussion and analysis, helping governments find solutions to these new financial challenges. The aim is for a better regulatory framework, not necessarily a more extensive one.

Macroeconomic outlook and policies

The OECD is currently updating its *Economic Outlook* projections for public release on 25 November 2008. The OECD's assessment at this point in time is summarised below.

In addition to the financial market turmoil discussed above, housing market downturns continue to bear down on growth while recent falls in commodity prices, notwithstanding their high levels, should give some boost to real incomes in commodity-importing countries. Uncertainty remains substantial, however, with risk heavily skewed to the downside. At the same time, development in financial, housing and commodity markets are evolving rapidly:

- Dislocation in US financial markets has deepened since April, and the dislocation is spreading to a growing number of struggling European banks. Share prices have come under renewed downward pressure, especially of financial institutions, premia on bonds have widened, new capital issuances in financial institutions have virtually ceased and credit conditions have tightened. Although there is no evidence to date of a broad-based credit crunch in commercial lending, growth in credit to corporate clients is probably on the cusp of a substantial slowdown in many OECD economies.
- The downturn in housing markets is still unfolding. In the United States house prices continue to drop and have reached a level 19 per cent below their peak according to the 20-city Case Shiller index. Tighter credit conditions and forced sales associated with rising foreclosures suggest that house prices will continue to decline in 2009, further adding to pressures. There are some hints of eventual stabilisation in construction activity in the United States, however. The stock of unsold properties is falling, albeit from high levels and new home sales have stabilised. In Europe, downturns in prices and construction activity are spreading beyond Denmark, Ireland, Spain and the United Kingdom, with sharply lower transaction volumes likely a precursor of downturns elsewhere.
- The price of oil has fallen from peaks reached around the middle of the year in response to slower demand growth and record production from OPEC. Oil supply conditions remain tight, however, contributing to volatile prices. Prices of other commodities – notably food – also appear to have eased back from their recent peaks. Food commodity prices may ease further in the period ahead as droughts end in some food-exporting countries and as higher food production comes on stream. Even though commodity prices are still at high levels in historical comparison, the recent falls should provide some support to real household incomes and a fillip to consumer confidence.

Against this background, the near term growth prospects look bleak. OECD short-term forecasting models taking on board the most recent data flows point to activity stagnating through the end of this year, with quarterly growth likely to be negative in a number of cases. In the United States, where private employment has declined for nine consecutive months and unemployment risen sharply, growth in real household incomes is anticipated to weaken, curtailing consumer spending. In the euro area and its three largest economies activity is foreseen to decline, with large falls in housing construction permits and tight credit conditions likely to dent household and business investment spending. In Japan, low confidence and weak consumption portends several further quarters of weak activity. And while emerging market economies are not at the epicentre of the financial crisis, they are not immune from the effects either and will likely experience economic slowdowns, notably as world demand for traded goods eases.

Looking further ahead to 2009, we expect a sizeable accumulation of economic slack. The depth and duration of the economic slowdown will depend on how soon asset prices stop falling, when confidence in financial markets is restored and how quickly financial, household and corporate sectors adjust their balance sheet positions. At the moment, however, weakening activity is affecting the ability of households and companies to service their debts and adding to financial sector pressures.

As concerns inflation, sharp increases in energy and food prices have boosted headline inflation across the OECD area, but inflation has likely passed its peak in the cycle. The same forces have also contributed to an upward drift in measures of underlying inflation in most large OECD economies. So far, however, wage increases have mostly remained moderate, suggesting that second round effects of commodity price hikes are contained.

How macroeconomic policies should react is contingent on the outlook for activity and inflation as well as on the balance of risks. The risks are almost exclusively on the downside. With prospects for growth dim, capacity constraints should ease, putting downward pressure on prices and providing central banks room to adopt a more expansionary policy stance. As regards financial markets, the effectiveness of the TARP in the United States hinges importantly on how quickly it serves to facilitate the recapitalisation of banks and to restore more normal intermediation processes. Even if the TARP is successful in these regards, long term fiscal sustainability is becoming an important issue with US public debt set to rise to internationally high levels. In Europe, built-in fiscal stabilisers are more powerful than elsewhere and should not be curtailed. However, given the continued need for medium-term fiscal consolidation, the room for an expansionary fiscal stance is limited and in many countries non-existent. Fiscal policy also has little room for manoeuvre in Japan, where the fiscal action of the 1980s and 1990s has left a legacy of already excessive public debt.

International Trade, Investment and Sovereign Wealth Funds

Structural policy also has a role to play to strengthen resilience to economic shocks. In this regard, open markets are always desirable, but at this moment, where the global economy is facing strong headwinds, there are two undeniable imperatives for moving ahead in the WTO. First, the international community must demonstrate its ability to work together and find common ground. Second, trade liberalisation will provide an urgently needed stimulus to economic growth.

Protectionist investment policies discourage capital flows and retard efforts to restore financial stability. Sovereign Wealth Funds (SWFs) help to recycle savings internationally and have a good track record as long-term investors. Last June, Ministers representing thirty-three recipient countries adopted the OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies to express their commitment to preserve and expand an open international investment environment for SWFs. Ministers also endorsed guidelines that draw on existing OECD commitments to liberalisation and non-discrimination which are fully relevant for investments by SWFs, and 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 supports IMF work on SWF governance and transparency and will continue to promote consultation and dialogue between home and recipient countries.