International Monetary and Financial Committee

Twentieth Meeting
October 4, 2009

Statement by Angel Gurria
Secretary General
ORGANISATION FOR ECONOMIC CO-OPERATION

INTERNATIONAL MONETARY AND FINANCIAL COMMITTEE

Istanbul, Turkey, Sunday 4 October 2009

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

Statement by Mr. Angel Gurría
Secretary-General
Organisation for Economic Co-operation and Development
International Monetary and Financial Committee
Istanbul, Turkey, Sunday 4 October 2009

IMFC, 4 October 2009
OECD Written Statement

Financial Markets

Financial markets developments continue to be heavily conditioned by policy measures put in place to deal with the crisis – both those that are fully operational and some that have not yet been fully implemented. These include:

- Emergency measures in monetary policy, central bank loans and public guarantees.
- Measures to solve the problem of impaired assets held both on and off bank balance sheets.
- Recapitalisation of banks to get credit and other forms of financial intermediation moving again in order to support the real economy.
- Eventual exit from emergency measures.
- Decisions about the longer-run shape of the future global financial system: capital and other regulations; and competition and governance.

Emergency measures have succeeded in stabilizing financial markets. Spreads have narrowed, particularly for higher-quality securities that were not directly linked with problematic loans, but were nevertheless still affected by the general loss of confidence and liquidity. And work is currently underway at national and international levels to address many of the issues that contributed to the crisis.

However, a continuing priority is to strengthen balance sheets so that banks can engage in substantially more intermediation in support of recovery. While there has been some progress in dealing with impaired assets, through write-offs, better underlying company earnings and recent improvements in prices of securities, losses not currently marked-to-market are still very significant. While bank CDS spreads have narrowed from the crisis spike of one year ago, they remain elevated. Recent changes in how accounting rules may be applied have permitted greater flexibility or 'judgement' in valuing assets both on- and off-balance sheets, and therefore whether assets are held in asset-for-sale, trading or investment accounts. Where structured products and OTC derivatives are involved, this may serve to push loss recognition out into the future and ease current pressures on capital. However, accounting conventions do not change the underlying situation of banks and their future capital needs. As long as banks need to retain earnings or issue new capital to meet their needs, and while uncertainty about future capital rules persists, they will remain cautious in expanding their balance sheets. Further new losses may emerge too in the area of commercial real estate, where regional banks are more exposed, and in residential mortgages and credit card receivables as unemployment continues to rise.

Banks remain short of capital, and in these circumstances it will be very difficult to get lending restarted in a manner that will support the recovery of private demand. The securitization market, which in some OECD countries plays a very large financing role, has dried up. If banks are also

to ‘fill the void’ in the securitization market, they will need even more capital than simply to cover their current and prospective losses. The recent G20 meeting in Pittsburgh announced an intention to decide on better quality and higher capital levels by 2010, with a view to implementation by the end of 2012. However, the starting point for various jurisdictions is very different. The shortage of capital is most marked in Europe, for example, mainly as a consequence of past regulatory requirements. In countries where capital is scarce more time may be required to achieve ultimate equity capital goals, if ‘credit crunch’ conditions are not to be exacerbated.

Aside from credit restraint via de-leveraging and reduced securitisation, other risks of renewed financial fragility are also present and need close monitoring. A rise in funding costs for vulnerable banks is a risk if wholesale guarantees and some other measures are removed too soon, and many banks face relatively near-term rollover risks in respect to their wholesale funding. If inflation expectations begin to move up in response to current policy settings, rising bond yields would impact on security values and funding costs.

Furthermore, a ‘fault line’ is beginning to develop between countries that have been the focal point of the financial crisis and Asian and other emerging markets. To the extent that these latter countries manage their exchange rates against the US dollar (the reserve currency), they import easy monetary policy, but are not currently in a financial or economic situation that would justify such a stance. At the same time investors see advantage in investing in better Asian, Latin American and Middle East fundamentals, funding out of low dollar and other interest rates while also benefiting from relative exchange rate stability. Asian and other emerging equity and property prices have begun to advance rapidly. This issue requires the attention of policy makers now, in order to avoid sowing the seeds of future financial instability.

In thus remains urgent to address all of the above steps both to support economic activity led by private demand and financial intermediation and to avoid generating further disruptions. It is particularly important to do more to address issues that will continue to cause banks to hold back from lending and other forms of intermediation: the impaired assets issue needs to be addressed soon and market participants need a much clearer picture of the future shape of the global financial system before longer-run restructuring can proceed.

Economic outlook and macroeconomic policies

The recovery which began in a number of emerging market economies is now spreading to many OECD countries. Nonetheless, numerous headwinds imply that the pace of the recovery is likely to be sluggish for some time to come, and that labour market conditions may still deteriorate, albeit at a slower rate. Financial institutions, households and non-financial firms will have to further repair their balance sheets, households’ concern about unemployment will have to recede, and private final domestic demand to take over from other engines of growth before the output gap starts to close significantly. Nor have all the downside risks disappeared. As noted above, financial markets are not in safe territory yet, as many institutions still hold hard-to-value assets, need to strengthen their capital and can expect further losses going forward.

As concerns inflation, substantial spare capacity and the collapse in commodity prices until mid-year have led to negative or zero headline inflation in all major economies. Increased economic slack has also damped somewhat measures of underlying inflation and will continue to act as a brake on inflation. Nonetheless, as long as inflation expectations remain well anchored and given

the recent rebound in commodity prices, the risk of sustained deflation appears to be small outside Japan.

How macroeconomic policies should react is contingent on the outlook for activity and inflation as well as on the balance of risks. With substantial slack combined with the prospect for a weak recovery, policy stimulus will continue to be needed in the near term. Regarding monetary policy, taking the first steps towards normalisation of policy interest rates from their current exceptionally low levels should in most cases and on current prospects wait until well into 2010. It is also important that central banks communicate their intentions explicitly, even if these intentions remain conditional to price and demand developments, so as to affect interest rates at longer maturities more effectively. There is also a need for coordination between central banks, given that the phasing-out of a number of financial interventions and quantitative easing measures will entail cross-country externalities through international financial markets.

On fiscal policy, it is important that announced stimulus measures be implemented promptly. However, the possibility of a recovery taking hold a little sooner than envisaged only a few months ago diminishes the likelihood that further fiscal stimulus will be needed in those countries having scope for such action. At the same time, fiscal policy needs to avoid a premature or an overly rapid phase-out of support. Withdrawing policy support now would, as the experience of the Great Depression or Japan in the 1990s showed, risk prolonging the downturn.

However, fiscal positions have become unsustainable in many countries due to the cost of stimulus packages, the detrimental effect of the crisis on growth and unemployment, previous budget weakness that had been hidden by buoyant revenue during the bubble years, and the pre-existing ageing challenges. The June *OECD Economic Outlook* projected an average 2010 deficit corresponding to some 8-9 per cent of GDP. In consequence, it is crucial that governments develop now a concrete, credible and comprehensive consolidation plan to bring government finances back onto a sustainable footing, even if actual implementation will only commence later. Striking the right balance between care for a fragile recovery and the need for fiscal consolidation will be a challenge when preparing the 2011 budgets. Moreover, the size and the synchronization across countries of the required fiscal adjustment are likely to make it more painful than in most previous episodes of consolidation.

Consolidation efforts should thus aim to be undertaken in a way that minimizes its impact on demand and on long term growth potential. In this regard, action now to decide the reforms of pension and health systems that are anyway required in a context of ageing and spending pressures can help to create confidence and thereby facilitate keeping long term interest rates low while not hurting near-term demand prospects.

Structural policies to boost growth and support a sustainable reduction of global imbalances

Global imbalances have been sharply reduced since the crisis. But a sustainable and orderly rebalancing of global saving and investment imbalances will not happen without a change in those structural policies that contributed to them. In deficit countries, addressing the policy distortions that led to insufficient saving is part of the answer. Reformed financial regulations should help bring investment more in line with saving, but there is still more that can be done to get incentives right. In surplus countries, part of the accumulation of saving is precautionary, reflecting the interaction between rapid growth in income and weak social safety nets, including health and pension systems, and limited access to financial markets. Developing financial markets

and extending social safety nets in emerging market economies should help avert future unwarranted increases in domestic saving.

In the medium and long term, the *rate* of growth will go down in most countries for reasons unrelated to the crisis, mostly ageing. Additional pressures, such as those stemming from the need to reduce global imbalances, may also influence the growth rate in some countries over a significant period of time.

In addition to these pre-existing pressures, the productive capacity of OECD economies has been durably hit by the crisis. The *level* of output is expected to be reduced by about 3% on average in the long term among OECD countries as a result of the current crisis. Most of this reduction will already have happened by end 2010. About two thirds of the expected drop in long-term output is accounted for by the end of easy financing of capital, which will durably reduce the capital intensity of production. The rest is linked to the fact that higher unemployment usually translates into higher structural unemployment, as workers lose attachment to the labour force and their skills deteriorate during lengthy spells of inactivity. The size of this latter effect depends on the functioning of labour markets. It is likely to vary considerably across countries and could be mitigated by appropriate employment policies.

Structural reforms thus have a crucial role to play in reducing the long-term costs of the crisis and preventing a repeat. Beyond the reform of the financial sector, structural policies that boost productivity, responsiveness and innovation in our economies are particularly urgent. Reforms that facilitate the reallocation of labour and capital across sectors and that limit the rise in structural unemployment are a priority. This involves striking the right balance between a sufficient social safety net and preservation of work incentives – a trade-off that can be eased through reliance on activation policies. Conversely, some past mistakes must not be repeated, such as erecting barriers to trade or encouraging early retirement, which would both harm growth badly and for long.