Economic Council of Finland

Global imbalances and how to tackle them

**Remarks by Angel Gurría,
Secretary-General
OECD**

10th February 2011, Helsinki, Finland

Prime Minister, ladies and gentlemen,

It is my great pleasure to be in Helsinki today and to speak to you about the issue of global imbalances and the key policy challenges to tackle them.

The global crisis has left the OECD area with a legacy of lower potential output, high unemployment and a high government debt burden. Finland was also hard hit by the crisis, but, in contrast to many other OECD countries, the impact on the labour market was extremely muted. Through the worst of this recession the unemployment rate increased by 3 percent points despite a massive fall in output. This, compared to other countries, is a testament to excellent policy making. I would like to commend the Finnish authorities and the responsible attitude of the social partners on this.

Like Finland, the world economy is now recovering. But many challenges remain to eliminate existing global imbalances. The OECD perspective is that macroeconomic rebalancing requires resolute and collaborative policy actions on two broad fronts. One is the need to address the crucial question of capital moments; the other is the commitment to structural reforms.

Let me go through these key issues in turn.

First, the Hot Issue of Capital Movements

The configuration of economic activity and monetary policy stances across the globe has shifted dramatically after the crisis. Slower growth and loose policy stances in most developed economies, contrast with higher growth and tighter stances in emerging economies. This is fostering capital flows from the former to the latter, as 'carry traders' and institutional investors such as pension funds, search for higher yields.

As the capital inflows are increasing fast, many target countries "feel the heat". This materialises in upward pressures on the recipients' property and stock markets, as well as on the currencies. Where such pressures are resisted, official reserve positions expand. As we speak, several countries are putting in place capital controls.

Today, policymakers around the world look at these developments with increasing concerns. The fundamental question they are looking at is: what is the role of capital controls as part of macro-prudential policies?

The standard recommendation of the OECD is that controls should be temporary and carefully targeted. We do think, in addition, that governments should announce an early end to interventions in the foreign-exchange market. Otherwise, unwinding them can prove to be problematic. More worrying is the possibility of spiralling counter-measures and a progressive fragmentation of international capital markets.

That said capital markets also require a great deal of supervision, which only international cooperation can foster. This is well understood in the international community. We welcome the fact that this is a key priority to the G20 French Presidency.

Throughout its 50-years the OECD has developed a far reaching and comprehensive experience with capital movements. The *OECD Code of Liberalisation of Capital Movements* provides a framework for policy makers in designing and carrying out sound policies to facilitate the circulation of capital and investment across national frontiers. Examples of the *Code*'s provisions include:

- ✓ the right to proceed gradually towards liberalisation through a process of lodging and maintaining reservations;
- ✓ the obligation not to discriminate;
- ✓ exceptions for reasons of public order and security;
- ✓ derogations in case of temporary economic difficulties;
- ✓ provisions to ensure compatibility with regional arrangements such as the European Union and its special processes;
- ✓ A system of notification, examination and consultation run by the OECD Investment Committee.

The *Code* forms a very rich and powerful body -- the only multilateral instrument promoting liberalisation of the full range of international capital movements, other than the rules of the European Union.

The provisions of the *Code* are legally binding on OECD governments. They are, however, open to adherence by non-members. Indeed, it is explicitly recognised within the *Code* that the state of sophistication of the economy, including its infrastructure and financial markets, varies across countries. Only a balanced and comprehensive approach to liberalisation can guarantee benefits to society as a whole in the long run.

The systematic and coherent framework defined by the *Code* is offered by the OECD to the G20 and all its countries. If the question here is one of timeliness, we do not have to "reinvent the wheel". It is much more effective to build on what we have already. The OECD Code is not written in stone, it can be refined, updated and upgraded.

Second, the Essential Role of Structural Reforms

Structural reforms can also contribute to the rebalancing of global growth. What all countries require is a mix of structural reforms. OECD analysis allows identifying a suite of reforms that, if enacted and implemented as a package, would help to reduce global imbalances without any notable reduction in long-term growth.

These structural reforms include:

- ✓ Reducing precautionary saving in emerging-market economies with large current-account surpluses, such as China, by strengthening social safety nets,
- ✓ And encouraging saving formation in deficit countries, such as the US, by removing distorting features of the tax and mortgage systems.

Equally important, structural reforms such as these will entail the double dividend of consolidating government finances, while providing for a better balanced growth pattern.

Some of the reasons for the imbalances in external positions and of distortions in internal growth patterns also relate to conditions of market access. So, these should be reviewed. Another critical variable is whether exchange rates are market-driven. Finally, international cooperation to maintain open trade and investment flows should continue.

Another tier of reform concerns financial sector regulation. With hindsight, we understand that, in part, the imbalances that built up over the recent years were driven by excessive financial leverage. Reforms are now being put in place that should make financial systems stronger, sounder and better regulated and supervised. The momentum toward such reforms needs to be maintained.

In this regard, the recent agreements on capital and liquidity standards should be seen as a first building block. But progress is needed in other areas. These include, for example, the introduction of a common maximum leverage ratio, because leverage is a key driver of risk. Countries will also need to deal with too-big-to-fail problems associated with systemically important financial institutions, whose failures have exposed significant vulnerabilities in many countries during the crisis.

Furthermore, reforms have to address the volatility of capital flows. This is the very crucial issue of enhancing the capacity of countries to orient the inflows toward the longer term. Investors became increasingly focused on short-term returns. In the 1980s the average holding period of an investment in stocks was as long as 5 years. By the end of 2009 it was 5 months. This situation needs correction. By helping governments strengthen the quality of their financial infrastructures, refining legal frameworks, along with fostering the financial education of citizens, the OECD helps countries to accommodate sustainable inflows of long term capital.

In addition, through its standards and principles the OECD plays an essential role in addressing core issues of corporate governance, transparency, and anti-corruption. We also contribute to improving the regulation and supervision of institutional investors, through pointing out accounting, solvency and investment solutions that facilitate long-term investments. For example, we work to strengthen the governance of pension and sovereign funds. Taken together, by raising the knowledge and capability of economic agents to address opportunities for long-term investment, these activities are essential in enabling strategic decisions and facilitating the creation of less volatile financial instruments.

Prime Minister, Ladies and Gentlemen,

We face numerous challenges.

At the country level, policy makers need to grapple with the consequences of the recession, including addressing the long-run sustainability of public finances. In the international sphere, countries need to reach a common understanding of the challenges and how to address them. Here, multilateral cooperation is the key tool. It is the only way forward in today's increasingly global economy.

The OECD has worked to achieve better policies for better lives for 50 years now. We offer advice and expertise to individual national governments, as well as through our participation in international fora on the most relevant public policy issues.

Count on us! We are here to work with you and for you!

Thank you!

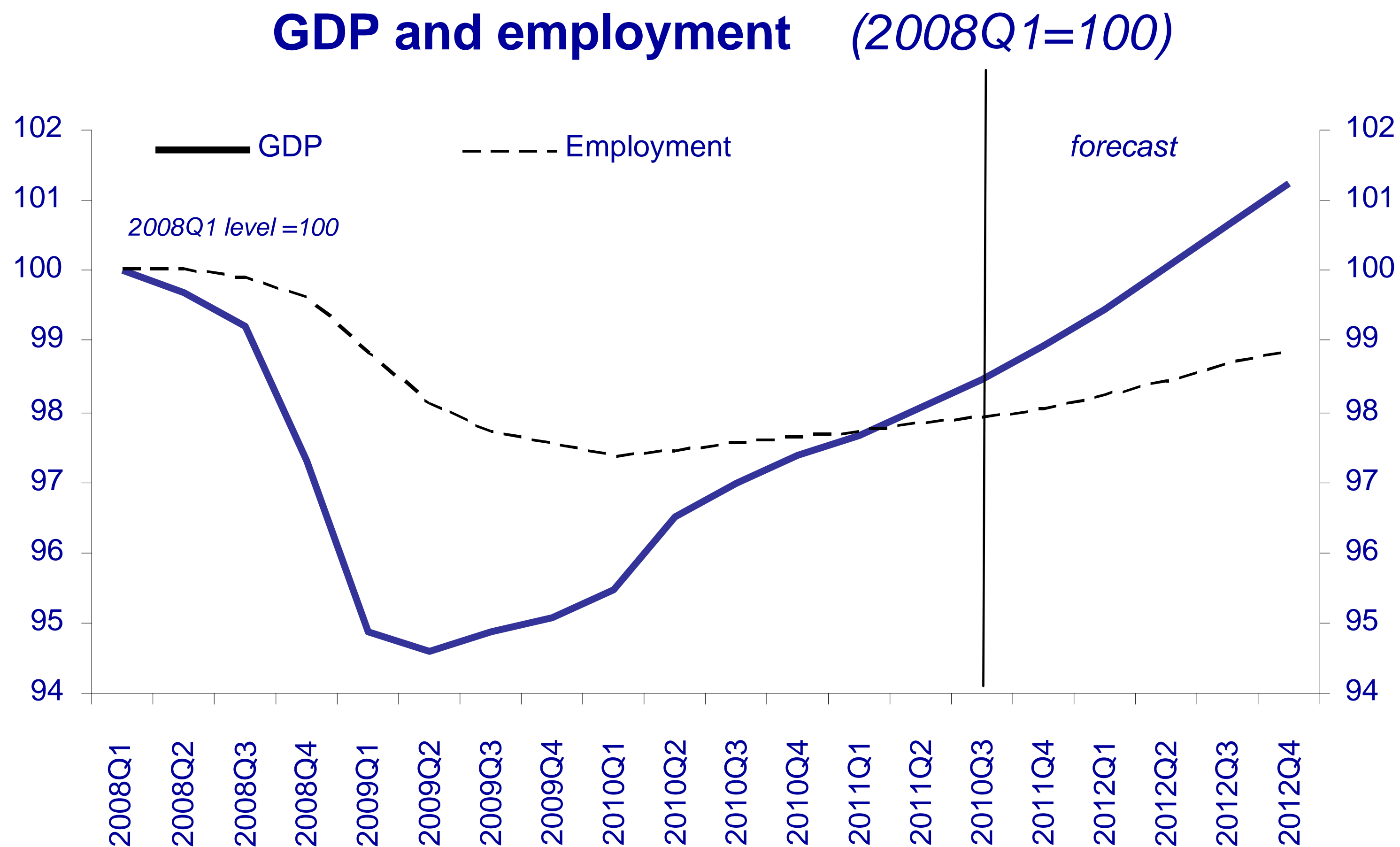
Economic challenges of Europe and a comprehensive response to them

Commissioner Olli Rehn

Economic Council of Finland
Helsinki, 10 February 2011

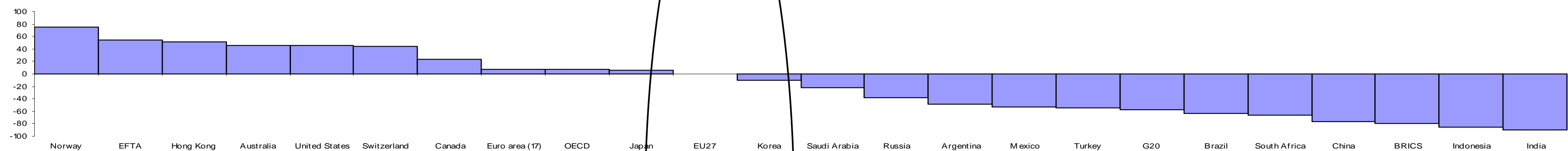
The impact of the crisis is severe

The deep contraction in GDP wiped out on average four years of growth.

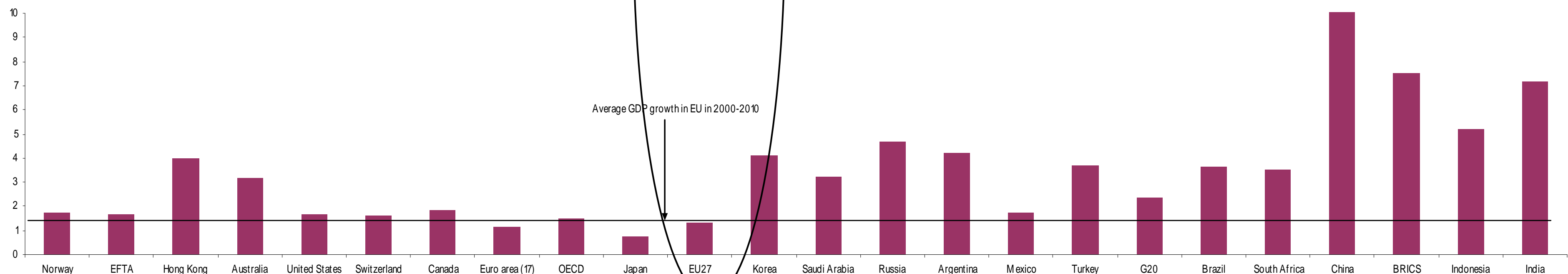


Structural weaknesses existed already before the crisis

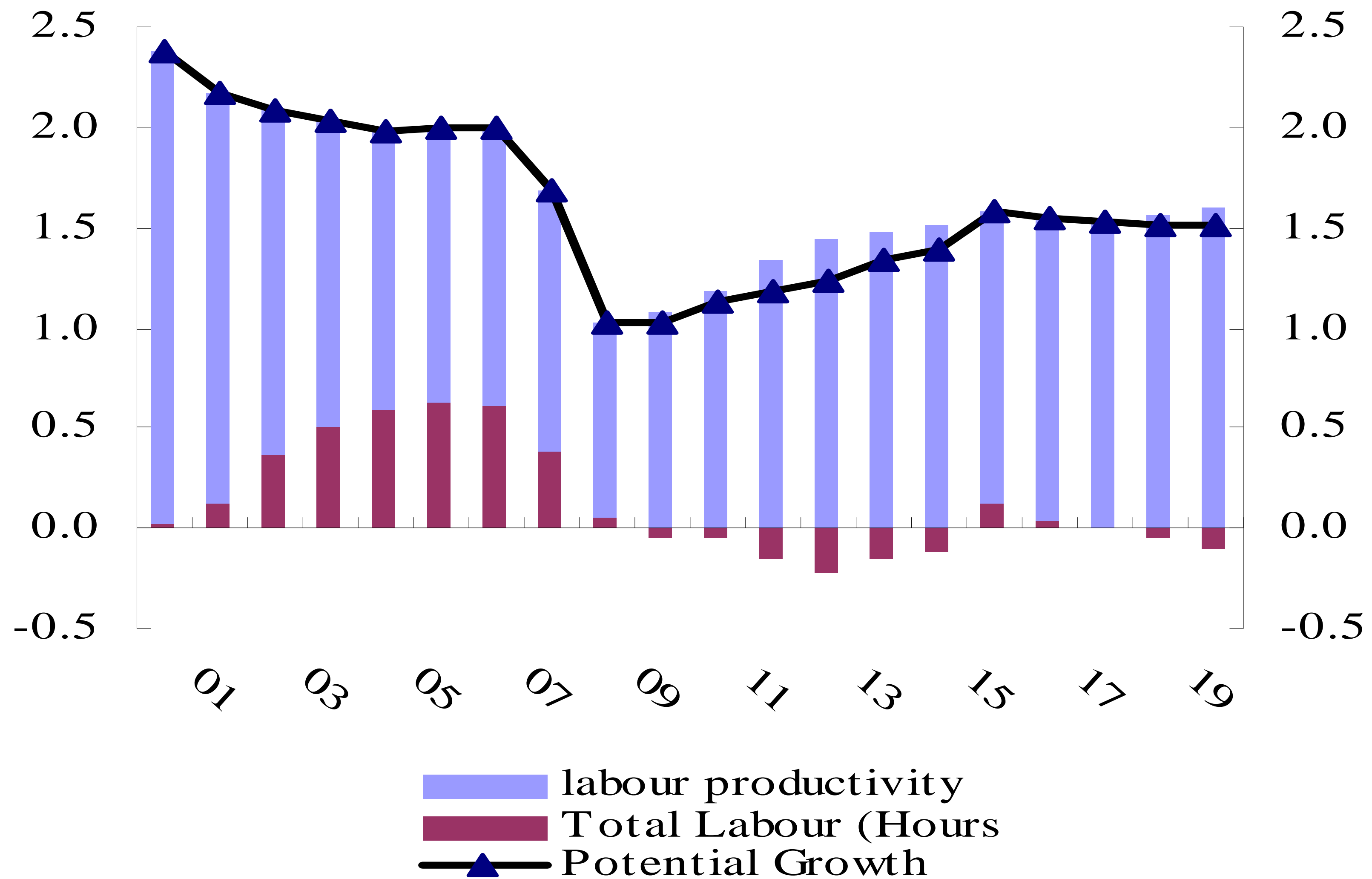
***GDP per capita in 2010** (% differential vis-à-vis EU27 in PPS)*



Average economic growth in 2000-2010



Without new policies Europe stagnates

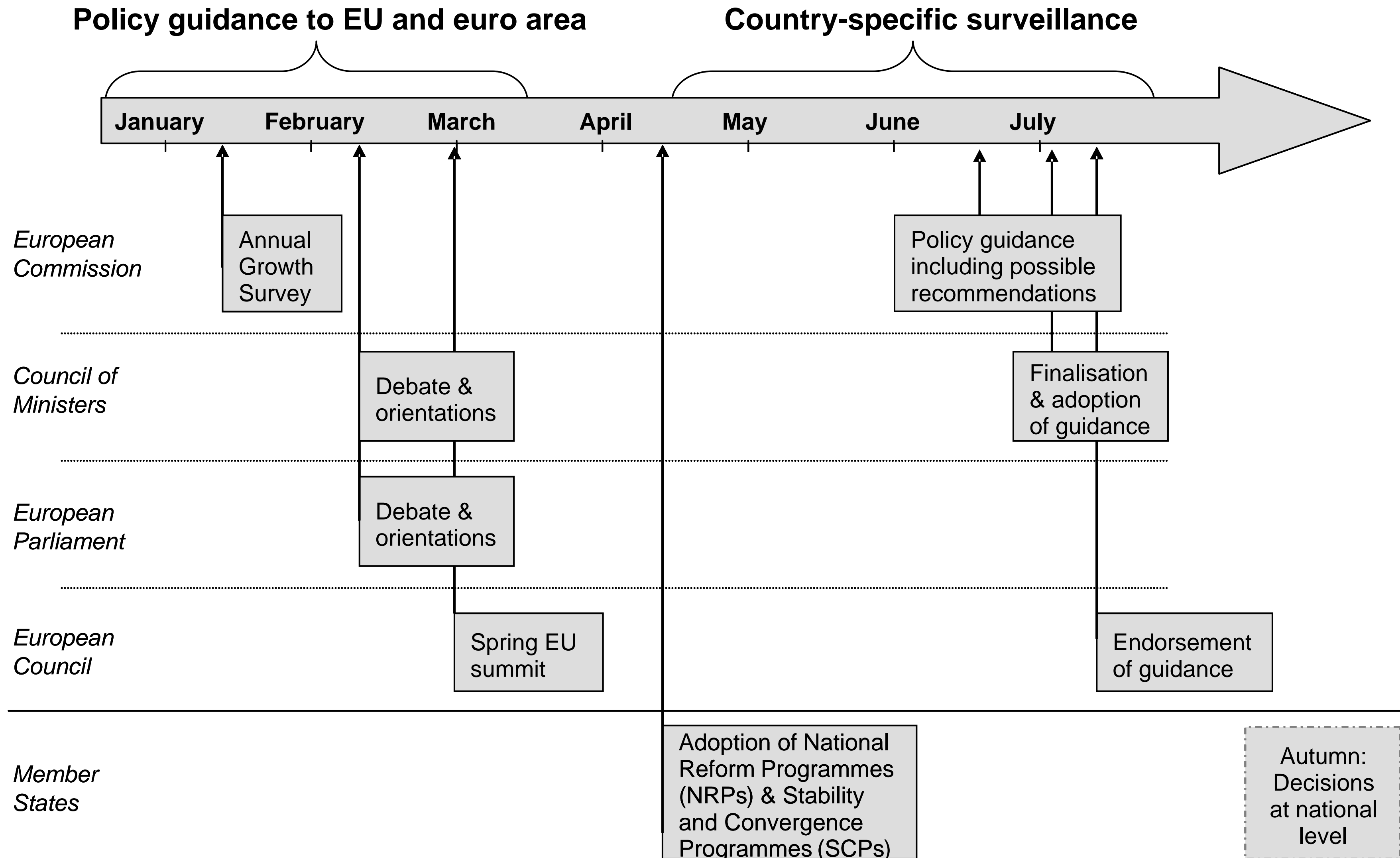


A comprehensive response is needed

- Annual Growth Survey the COM answer
  - Fiscal consolidation
  - Financial repair and beefing up the stability facility
  - Structural reforms for growth and job creation

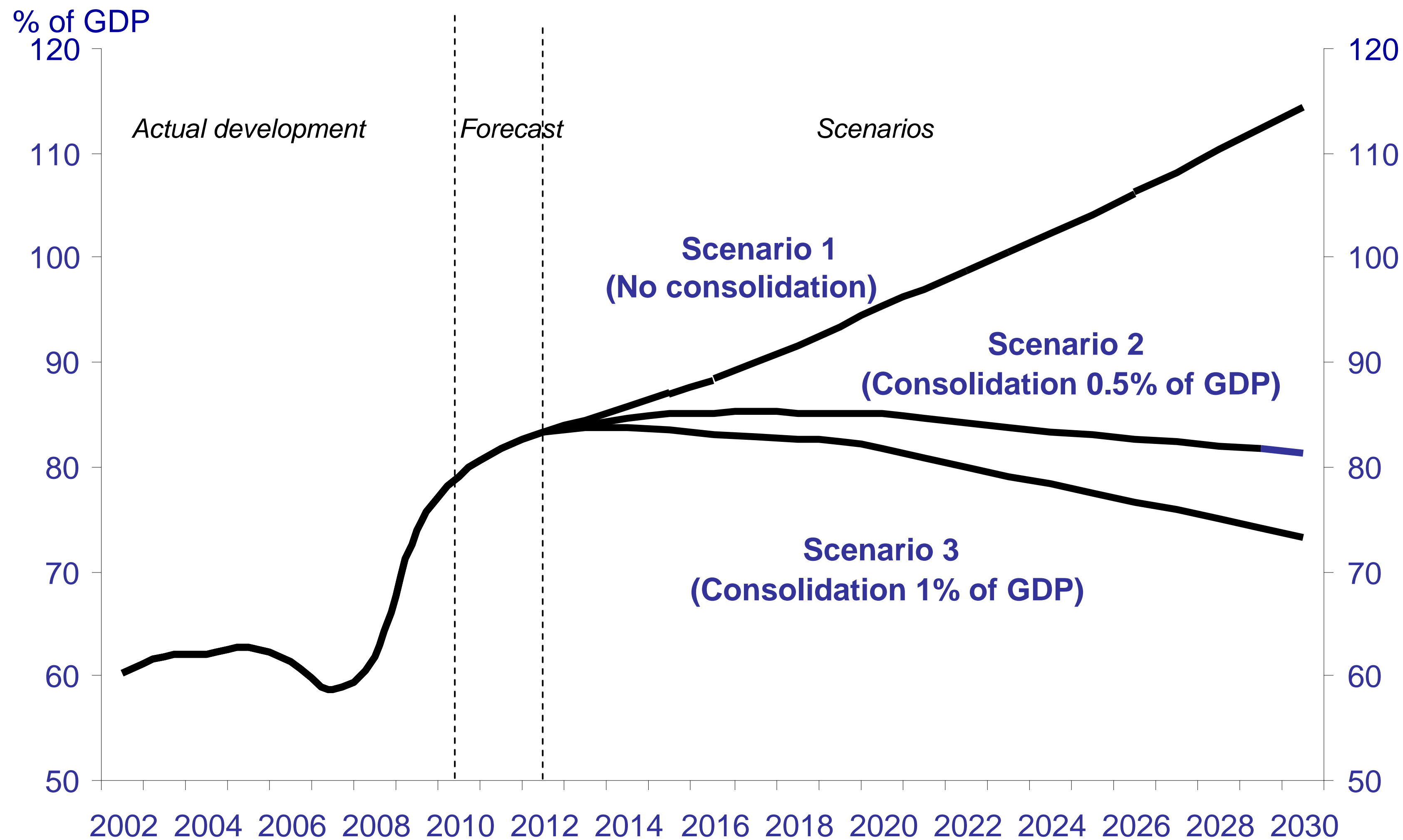
- AGS starts the European Semester
  - Integrated surveillance: fiscal policy, macro-financial stability, growth- and job-enhancing policies
  - Ex-ante coordination
  - EU/euro area dimension in national policies

The European Semester: main steps



Fiscal consolidation

Debt path depends very much on the degree of consolidation



Financial repair

Complete the financial repair, to ensure the provision of credit to the real economy and the path to recovery

- Restructuring of banks to be accelerated
- Implementation the new EU architecture for financial regulation and supervision
- Strengthening of the banks' capital base
- Reinforcement of the EFSF and establishment of a permanent mechanism for sovereign debt crises

Priority policy measures for growth and jobs at the **national** level

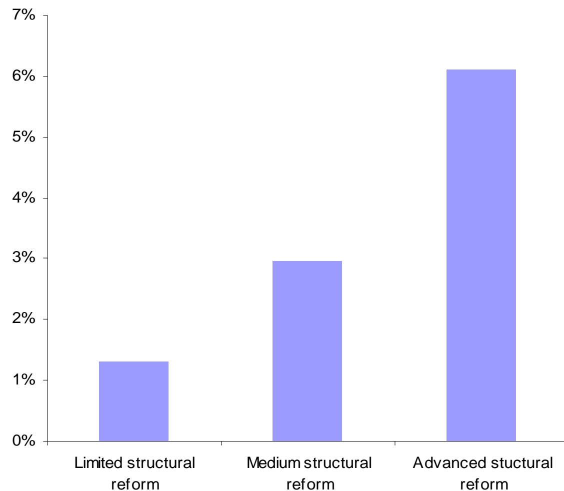
- Help the unemployed getting back to work
- Pension reform to improve sustainability of public finances and to increase labour supply
- Full implementation of the Services Directive
- Ambitious and frontloaded National Reform Programmes

Priority policy measures for growth and jobs at the **EU** level

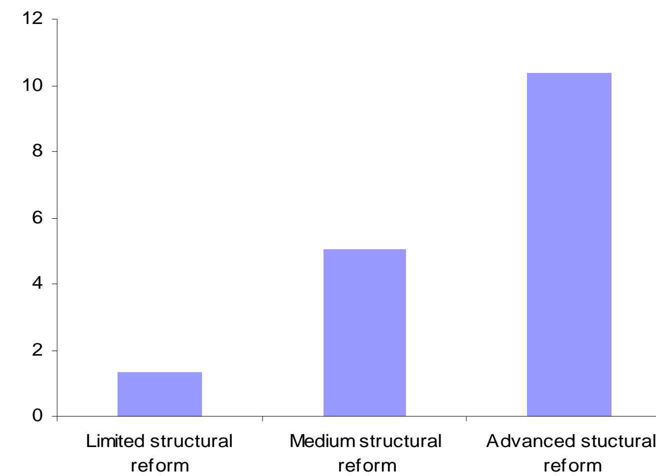
- Tapping the potential of the single market
- Attracting private capital to finance growth
- Initiatives to improve transport, energy and telecommunication infrastructure
- Example: Develop EU-wide standards for energy efficient products – the “next gsm std”

Structural reforms can make a difference, but only if they are ambitious

GDP effect, %



Employment effect, millions



Europe in 2011:
From Crisis to Reform