ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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Session 1: Europe and the global economy – Challenges, options and policies

Introductory remarks by

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The economic crisis…

- …was caused by a financial crisis which
- …was caused by the bursting of a bubble which
- …had two kinds of background
  - Narrow financial market reasons
  - Broader economic background

The narrow financial reasons for the bubble included

- Moral hazard, including that created by too-big/too-interconnected to fail
- Procyclical effects of financial regulation
- Absence of balance sheet consolidation and lack of transparency
- Securitisation reducing incentives to analyse credit risk
- Securities being intransparent, heterogenous and traded in thin markets with liquidity risk
- Remuneration packages providing skewed incentives
- The role of rating agencies
- Tax incentives in favour of debt

The general economic background to the bubble included

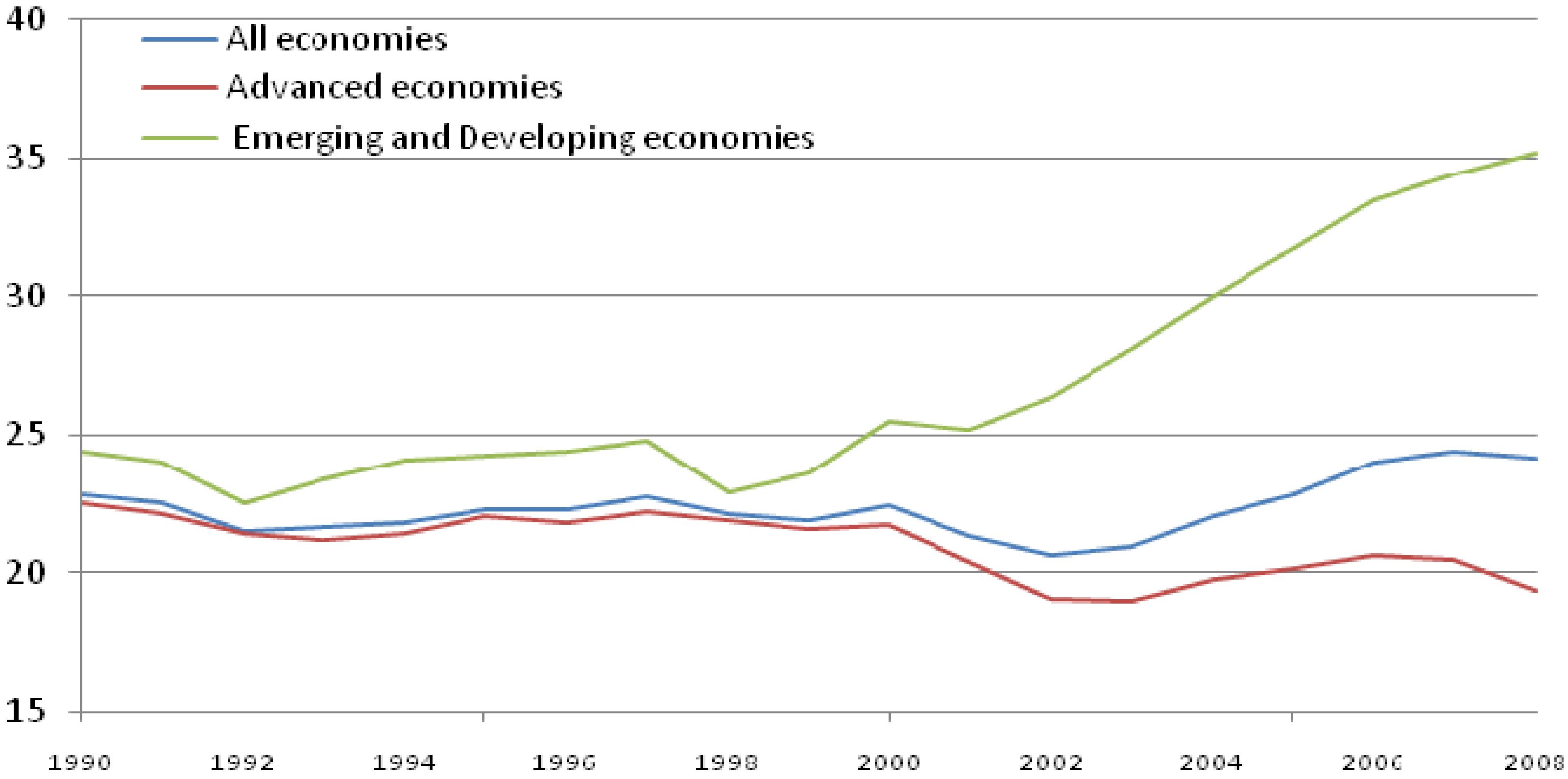
- Greater macroeconomic stability (“the great moderation”)
- Higher saving (“the saving glut”)
- Easy monetary policy

Reasons for greater macroeconomic stability

- Greater weight of services in GDP
- Better inventory management
- Greater openness and diffusion of idiosyncratic shocks;
- Fewer common shocks such as oil price shocks
- Less policy-induced instability as inflation became more stable due to better anchoring of inflation expectations, globalisation
- Greater financial depth reducing the role of liquidity constraints and allowing for more demand smoothing by private agents.

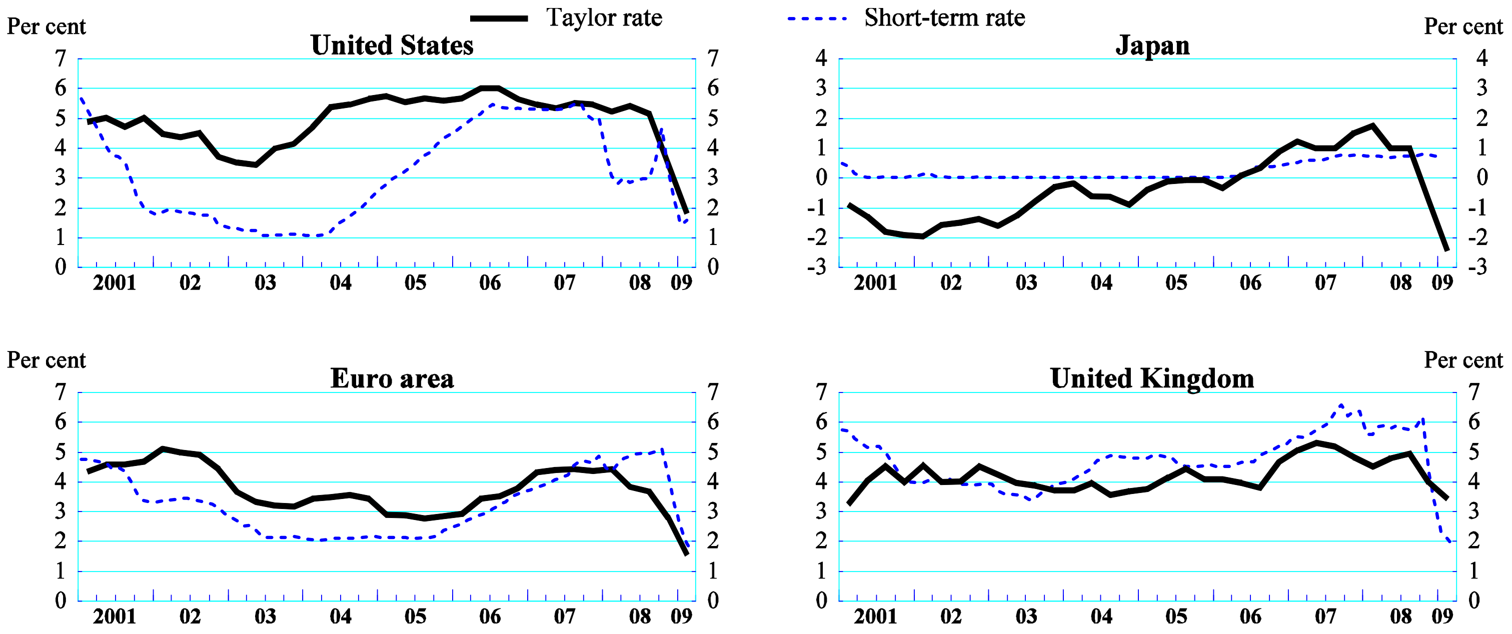
Saving rose, boosting asset prices and risk

(Total economy, % of GDP)



Source: IMF, World Economic Outlook

Easy monetary policy helped fuel credit, asset prices



Note: The Taylor rule rate is a function of the equilibrium real interest rate (short term), the (implicit) inflation target, the average output gap and the gap between actual core inflation and the implicit inflation target. Equal weight is given to the inflation gap and the output gap. For the United States, the assumed price stability target is for inflation of 1.9% and the assumed equilibrium real interest rate is 2.85%. For Japan, the assumed price stability target is for inflation of 1.9% and the assumed equilibrium real interest rate is 2.1%. For the euro area, the assumed price stability target is for inflation of 1.9% and the assumed equilibrium real interest rate is 2.1%. For the United Kingdom, the assumed price stability target is for inflation of 2.0% and the assumed equilibrium real interest rate is 3.0%.

Source: OECD

When the bubble burst…

- …asset prices fell, lending attitudes hardened and securities markets froze…
- …which depressed demand, with the economic crisis feeding back into financial markets
- Falling demand and credit constraints led to a collapse in world trade…
- …hitting "innocent bystanders", who were also affected by capital movements

So where are we now?

- Financial conditions have begun to improve
- “Green shoots” are emerging
- But need to keep things in perspective
  - Outside China, it is too early to talk about recovery
  - In the OECD, only the second derivative has become positive
- In the world of economic forecasters
  - Convergence on the outlook
  - Perpetual downward revisions may be over
  - Risks around projections have narrowed and become more symmetric
- Still need for determined policy effort

Where are we heading?

- Issues to focus on going forward
  - How much, if any, further fiscal stimulus?
  - Need to clean up bank balance sheets?
  - How to get regulations and supervision right in financial sector?
  - How to exit from current interventions in financial sector?
  - How to eventually fix government budgets?
  - What structural reform to reverse the likely increase in structural unemployment?
  - Is there a need to reconsider parts of the macro-economic policy framework?