ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

OECD

For a stronger, cleaner, fairer world economy

The Road to Recovery

Update on the OECD's Strategic Response to the Financial and Economic Crisis

27 March 2009

FOREWORD

At the end of 2008, the OECD launched its *Strategic Response to the Financial and Economic Crisis* to offer governments evidence-based choices to address the crisis and move towards building the foundations for a stronger, cleaner and fairer world economy. The deterioration of economic performance in countries around the world since then underlines the urgent need for policy action.

Since launching the *Strategic Response*, the OECD has intensified its efforts to support governments. We are releasing special reports on the crisis, and have been called upon to participate in global discussions in the G8 and the G20 and others, and to address regional issues (in Europe, Africa and Latin America, for example). Our contributions to the G20 Action Plan cover a number of key areas, including tax transparency, financial sector crisis resolution strategies, corporate governance, pensions, financial education and maintaining open markets for trade, investment and competition. We are also contributing to strategies to address the employment crisis and achieve a "green" recovery.

The need to strengthen the underlying rules by which market economies operate and enhance international policy co-ordination is essential. Within the G8 and G20, initiatives are emerging aiming at developing common principles and standards on integrity, transparency and propriety of the financial and economic activity and at ensuring a sustainable development of the global economy. The OECD is prepared to support these initiatives. Indeed, we have valuable policy and legal instruments developed over decades which could form the basis for this new framework. Together with the ILO, IMF, World Bank and WTO, an inventory has been prepared to facilitate stock-taking and identify strengths and gaps to be filled. We will continue to enhance this collaboration to maximise the collective impact of international organisations' contributions.

Building on our deep and longstanding co-operation with non-OECD partners, we are monitoring the crisis' impact on emerging and developing economies closely, including on donor performance against ODA commitments and aid for trade, aid effectiveness and the achievement of the Millennium Development Goals (MDGs).

The G20 Finance Ministers and Central Bank Governors on 14 March 2009 wisely emphasised the need for coordinated action to fix the financial system, boost demand and jobs and keep trade and investment open. The OECD will continue to respond to these and other emerging policy challenges the crisis and the road to recovery will inevitably raise, to serve its member and partner countries, and the international community more broadly.

THE ROAD TO RECOVERY: UPDATE ON THE OECD'S STRATEGIC RESPONSE TO THE FINANCIAL AND ECONOMIC CRISIS[1]

The global recession has gotten broader and deeper.

The global economy is in the midst of its deepest and most wide-spread recession for more than 50 years. The collapse of industrial production over the past six months is continuing in almost all OECD countries, and with non-OECD countries slowing sharply, world growth has turned negative. In recent weeks, it has become evident that the financial dimension of the crisis is far from over. Furthermore, what began as a financial, then economic crisis is increasingly becoming a social crisis. According to OECD forecasts, unemployment rates are set to reach more than 10% in the OECD area by the end of 2010. At the same time, trade and FDI flows are contracting sharply. Over the last quarter of 2008 and first quarter of 2009 world trade fell at an average annual rate of more than 20%, a rate of decline not previously experienced in the last four decades, and the WTO is predicting a drop of 9% or more in 2009.

What is more, the crisis is now sweeping across countries and regions which earlier had not felt the full brunt of the downturn. Double-digit depreciations have hit emerging market currencies in countries such as Brazil, Indonesia, and Russia and several European countries outside the euro zone since mid-2008. Developing countries are increasingly being affected, suffering important reductions in trade, investment and access to finance. Plummeting prices of natural resources and falling remittances from abroad are further constraining their access to finance – and impacting growth and employment. While promising, the scaling up of OECD Development Assistance Committee (DAC) flows of official development assistance (ODA) witnessed in 2008 and projected for 2009-2010 is still below what is needed to mitigate the impact of the downturn on these countries and to meet the Millennium Development Goals.

The OECD is implementing a two-pronged strategy to build a stronger world economy.

Through its *Strategic Response to the Financial and Economic Crisis,* the OECD is working to support governments in the key areas that need to be addressed to tackle the crisis, both in the financial sector and in the real economy. In particular, it has undertaken comprehensive new analysis on crisis management and resolution in the

[1] This document is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of the OECD member countries.

financial sector, and an initial comparative assessment of the stimulus packages which are being rolled out in many countries. This includes identifying "double dividend" actions which can spur demand in the short term, and enhance potential output growth. Importantly, the OECD is monitoring the growing unemployment crisis and providing guidance on government responses.

It is critical to take action simultaneously in the financial sector and in the real economy. The recent massive policy actions have been essential steps for stabilisation and recovery. Restoring banks' capacity to lend is essential to put economies back on the path to strong employment and growth. A convincing and comprehensive policy response to problems in financial markets will help confidence rebound faster, and fiscal stimulus take hold more quickly and effectively. Likewise, addressing the slump calls for a continued strong response of monetary policy to restore the functioning of financial markets and limit deflationary risks. The impact of injections of fiscal and monetary stimulus will become clearer as they begin to work their way through the economy. Governments should stand ready to do more if needed, in line with each country's room for manoeuvre.

To be credible and effective, crisis measures must be temporary and keep sight of longer-term goals.

As set out in the *Strategic Response,* ongoing government action in this time of crisis is rightly focused on stopping the downturn and initiating the recovery. Yet, many of the emergency measures taken today could pose a threat to long-term growth and sustainability if not properly unwound – for example, prolonged government presence in the financial sector, or the risk of excessive debt accumulation. For this reason, measures should be designed and implemented in the least distortive manner, with a clear and credible plan and timeline for phasing them out as recovery takes hold. It is critical to consider these so-called "exit strategies" now, together with emergency measures, in order to prevent new risks down the road.

The post-crisis policy framework will need to be built around better risk management and an improved regulatory and governance framework, as well as monetary stability and fiscal sustainability. Implementing necessary reforms and restoring sound public finances in a way that does not hamper the recovery in the medium term will be a major challenge. Credible fiscal consolidation plans may require tax reforms, including the broadening of tax bases to ensure sustainable revenues. The OECD will continue to contribute to ongoing efforts to address these unprecedented challenges through its analysis of the impacts of fiscal stimulus, guidance for developing coherent and effective incentive structures, and strategies to help governments phase out temporary crisis measures.

A number of key steps must be taken to resolve the crisis in the financial sector.

Despite large infusions of public funds into financial sectors in affected countries, market confidence has yet to be restored. Efforts to remove or isolate "toxic" assets are being stepped up in order to enable a sustainable recapitalisation of banks and a timely end to the credit crunch. The recent measures in the United States are an important and innovative step forward. Regulation, supervision and tax policy also need to be reviewed, and upgraded where necessary, to avoid a return to the unhealthy incentives and excessive leveraging that precipitated the crisis.

Strategies need to improve transparency, risk control and incentive structures.

Reinforcing credibility and instilling confidence in the financial sector require actions that keep sight of long-term goals, including an effective balance between prudential risk control and competition; competitive level playing fields; open investment markets; transparency; and reduced agency problems through better governance. These objectives will need to be pursued in a manner that does not exacerbate deleveraging or inhibit lending. The appropriate sequencing of actions and choice of positive adjustment measures over alternative policies will be key ingredients in a successful strategy. Some key considerations, for financial markets, competition, corporate governance, pensions, and investment issues are set out below. The OECD is preparing an integrated and comprehensive review of the incentive structures needed to underpin a well-functioning and sustainable financial system. This report will be discussed at the OECD's annual Ministerial Council Meeting in June 2009.

The first priority is to deal with toxic assets, as a pre-requisite for recapitalisation…

In the financial markets, the clear near-term priorities include a resolution mechanism for toxic assets, with a broad – and preferably global – approach that is not overly dependent on private money in the first instance. The open market auction approach now under development in the United States would be less distortive than dealing with individual firms, since it would lead to widespread ownership. This approach would address directly the immediate need to separate and remove these assets from banks' balance sheets (and the conduits to which they are linked) as a pre-requisite for bank recapitalisation. It also provides a longer-run mechanism to manage assets and recoup costs for taxpayers.

Recapitalisation also requires information about the appropriate average level of capital, and how it might vary over the business cycle in a countercyclical manner. In this regard, the work of the Basel Committee and the Financial Stability Forum (FSF) is of great importance. Investors, financial firm management and regulators/supervisors need clarity on how the cost of capital will be related to different risk activities, and whether an overall balance sheet constraint will apply. A very clear "phasing in" arrangement will be needed over the duration of the exit strategy to ensure that the building up of capital does not work against the near-term goal of increased financial intermediation.

Liquidity issues have been an important part of the crisis, and the buyers' strike for wide classes of financial instruments has led to a spate of emergency measures. The removal of these measures requires reducing uncertainty in two ways: first, through an improved and globally coordinated central bank liquidity support function that works in crisis situations (perhaps in tandem with countercyclical capital rules). Open investment principles would argue against rules that ring-fence domestic domiciled firms from subsidiaries and/or branches abroad. Second, current work on improving transparency of the collateral underlying securities, global infrastructure, reporting and clearing mechanisms for OTC derivatives needs to be completed.

… followed by the dismantling of emergency liquidity and official lending support.

With these mechanisms in place, and as signs of stress in markets decline, the dismantling of emergency liquidity and official lending support would become a higher priority. This is especially the case when support has focused on individual institutions, in order to remove subsidy elements and to restore a competitive level playing field. This dismantling should not be rushed and should be voluntary in order to avoid exacerbating the crisis. Over time, authorities could consider tightening conditions for such support in order to encourage greater recourse to markets.

A similar process should be applied to the unwinding of guarantees, which distort risk assessment and competition. These should not be withdrawn precipitously. As the secondary market to price guarantees develops efficiently, and to the extent that extensions can be avoided, terms and conditions prevailing in the broader market should facilitate adjustment. Where financial institutions are concerned, the ultimate goal of the exit from guarantees is to move towards a redesigned comprehensive deposit insurance scheme.

Improved corporate and regulatory governance structures should foster stability and competition.

As the crisis has unfolded, authorities have sometimes been obliged to foster mergers of financial institutions and to increase public ownership. Minimising the creation of additional institutions of systemic importance through mergers, especially when these do not add new net capital, is desirable, as it will facilitate the ultimate goals of reduced prudential risk and a sound competitive environment. Where mergers are necessary, competition can be safeguarded by identifying foreign partners rather than a large domestic firm, or selling businesses in parts.

On the side of positive adjustment, mergers between smaller strong regional banks, which are well placed to lend now and to compete later with large, previously underperforming banks, could help to promote both current lending and long-run goals. Other positive competition policies, such as reducing regulatory barriers to entry in banking and credit rating agencies; encouraging the widespread availability of more fine-grained credit rating information on SMEs and consumers; and reducing the cost of switching between financial institutions may also help to meet the current needs of business, while promoting long-run competition goals. In a new report, the OECD has issued guidance on safeguarding competition in the financial sector, including exit strategies for rescue and recovery.

A major lesson of the crisis has been the danger of contagion risk, particularly where investment banking is mixed with commercial banking. While holding company structures offer many synergies for affiliates (e.g. shared technology platforms), other structures exist which can help to reduce contagion risk and protect the balance sheets of banks without losing advantages of scale. In this respect, authorities might consider non-operating holding company (NOHC) structures, particularly in the exit phase. NOHCs involve legal separation of the parent from its affiliates and offer a number of benefits, facilitating internal terms and conditions for affiliates more akin to those that would apply to dealing with outside entities; balance sheet protection of the banking group; and easier regulatory intervention.

Failures in corporate governance played a clear role in some of the larger financial firms at the centre of the crisis. Many firms that have received public funds or are owned by governments, and important conflicts of interest may arise. During this period, they should be run in line with the *OECD Guidelines on Corporate Governance of State Owned Enterprises*. Before governments exit from their role as owners, it would be desirable to strengthen the implementation by financial institutions of the *OECD Principles of Corporate Governance*. For example, ensuring the independence and competence of directors may call for strengthening the *fit and proper person test* and extending its coverage. Likewise, the risk officer role could benefit from built-in protections to balance the need for independence from management and access to information. The OECD recently held a global consultation with international organisations, governments, business and stakeholders to discuss the key weaknesses in corporate governance practices and develop a joint plan to improve monitoring and implementation of the *OECD Principles*.

There is a need to restore confidence in private pension systems.

As large owners of equities, pension funds and their agents failed to play an active role in promoting better risk control and governance in their own affairs, as well as in the companies in which they invested. Many pension funds have been extremely hard hit by the crisis, posing serious threats to the funding for public and private schemes. Many individual retirement plans funded by defined contributions have been similarly damaged. There is now a risk of locking in losses which have occurred if there is a switching to low-risk assets at this time. These moves, in some cases reinforced by fund rules, exacerbate pressure to sell in this time of crisis. With respect to resolving the crisis, pension fund investment should, in principle, take up a considerable part of the shares that governments will divest. Governments should therefore move quickly to reinforce near-term confidence in pension schemes and prepare the ground for the exit strategy by:

- Avoiding dipping into funds earmarked for pensions to pay for the financial bail-outs.

- Withdrawing any forbearance permitted on company funding commitments as quickly as possible.

- Emphasising the safety net aspects of mixed public/private schemes and the need to focus on longer-run returns, in order to resist pressure to move back from asset-backed schemes.

- Reforming any rules which increase timing risk when moving between accumulation and retirement stages.
- Strengthening the governance of funds, including better oversight of investment risks and monitoring.
- Reviewing statutory performance targets that may force near-term imprudent behaviour, and any regulations that reinforce selling in periods of increased risk.

Privatising recapitalised banks will need to be carefully timed.

As progress is made on each of the issues above, governments will seek to divest their holdings of bank shares. Banks may also put pressure on governments to exit quickly, but caution must be taken not to act precipitously. Competitive distortions could arise if some banks are in a sound capital position before others, or if the necessary reforms are not in place.

Another consideration is the need for higher levels of capital for banks. Experience suggests that large privatisation programmes can put strains on available sources of equity capital. One aim of the privatisation process is to encourage sources of funds that raise equity net of any leverage. Pension funds and sovereign wealth funds (SWFs), for example, would be less leveraged investors than other banks or hedge funds. Open investment policies will help to unlock SWFs and other international pools of capital from countries that have been net savers rather than borrowers in recent decades.

To end the recession, stimulus measures are focused on boosting short-term demand….

Efforts to end the recession are being pursued in tandem with measures to address the financial sector. In this context, a strong focus has been placed on fiscal stimulus measures intended to boost demand. Many countries have adopted very broad-ranging stimulus programmes, involving both tax adjustments and government spending programmes. Most countries have given priority to tax cuts over spending, with cuts generally focused on personal income tax and, to a lesser extent, taxes paid by business. Indeed, cutting personal income taxes and social contributions for low-income workers now can stimulate demand in the short run and improve the economy's ability to recover after the crisis, by reducing the impediments to labour supply and demand. However, only few countries have room to counter the recession through large-scale tax cuts. Attention has therefore increasingly turned to temporary measures, such as allowing tax payments to be deferred, notably for small businesses squeezed by frozen credit markets.

On the spending side, virtually all OECD countries have launched and/or brought forward public investment programmes. Transfers have often been made more generous, in particular for low-income households. In addition, some countries have increased government subsidies to the business sector.

… but these measures must be reconciled with sustainable, long-term growth.

These measures will produce a positive impact on growth. Evidence from analysis of multipliers shows a positive stimulus effect from fiscal packages during the first two years in OECD countries. However, only in a few countries are such packages likely to add more than 1% to the level of GDP by 2010.

It is difficult to say whether a more ambitious fiscal stimulus is appropriate, as this depends on country-specific circumstances. For countries with a very weak initial fiscal position, the room for further fiscal expansion is limited. In other countries, additional support could be appropriate to cushion the projected slump, or if activity were to be even weaker than projected. In all cases, ambitious fiscal stimulus should be accompanied by a credible commitment to steadily withdrawing and reversing the stimulus once the recovery is underway, and to avoid negative feedback from higher long-term interest rates as fiscal positions deteriorate. One strategy to ensure that fiscal sustainability is not undermined by stimulus packages is to announce reforms that will generate fiscal savings in the future.

That being said, the stimulus packages offer an important opportunity to pursue policies that can both boost demand in the short run, as well as strengthen potential output. The challenge is to structure fiscal packages so that they facilitate a redeployment of resources towards activities that offer longer-term economic and social benefits. The OECD's *Going for Growth 2009* outlines a number of broad fiscal measures and structural reforms that could yield this "double dividend":

- Introducing infrastructure projects that can be brought on-stream quickly or improve the quality of existing facilities, particularly transport, schools, hospitals, energy and ICT infrastructure. Selected projects should have undergone careful cost-benefit analysis and environmental impact assessments as appropriate, and should be compatible with longer-term policy goals.

- Boosting spending on active labour market policies, including well-designed education and training programmes to give workers skills that will be needed as the labour market recovers. These investments in human capital will also help increase productivity and employment in the longer term.

- Cutting taxes on labour income, particularly for those with low wages. This will help boost consumption and improve long-term job prospects.

- Reforming anti-competitive regulations in product markets. Obstacles to businesses entering new markets should be reduced to stimulate the creation of new products and businesses, and boost demand. Likewise, state support to ailing activities or firms must be considered with caution. Over the long term, stronger competition will help raise productivity and living standards.

It will be important to achieve synergies – and reduce tradeoffs – between measures to increase demand in the short term; longer-term objectives that can be served by the fiscal stimulus (e.g. compatibility of packages with green and innovation-driven growth – see below); and consequences for fiscal sustainability. At the same time, the choice of public investments must be made with caution, so that they do not crowd out or displace private activity in the long run.

International coordination of expansionary policy stimulus could increase positive spillovers and reduce leakages from national packages. The OECD's analysis in this area offers an important input to understanding the extent to which the packages announced by governments are complementary, in terms of both size and content. The OECD will develop this work further as it continues to monitor the crisis, and it will form the basis of discussions at the OECD's Ministerial Council Meeting in June 2009.

Addressing the employment crisis requires bold policy action.

Most stimulus packages rightly include labour market and social policy measures to cushion the dire effects of the economic downturn on workers and low-income households. However, a preliminary overview of the G7 countries suggests that funds for *additional* labour market programmes are rather limited. This is a missed opportunity. The OECD's analysis in the area of employment will serve as an input to the G8 Labour Ministerial at the end of March, and will be the subject of discussion at an OECD Meeting of Employment, Labour and Social Affairs Committee at Ministerial Level in September.

One key step is to boost labour demand through targeted wage subsidies.

Subsidies that encourage firms to retain or hire workers (e.g. short-time working schemes, hiring subsidies, etc.) have a role to play in supporting labour demand provided they are well-designed and implemented. In order to minimise the negative side-effects, these schemes should be *temporary*, and *well targeted* to firms for whom the demand is only temporarily depressed, and to workers who may find it particularly difficult to regain employment if made redundant.

Another is to maintain an activation stance …

One of the main labour policy reforms in the OECD over the past decade has been the implementation of *activation/mutual obligation* strategies, which combine effective re-employment services with strong job-search incentives, enforced by the threat of moderate benefit sanctions. Expanding the arsenal of effective active labour market programmes would be important to maintain the activation stance in a recession when job vacancies are declining. This expanded arsenal should include well-designed training programmes and public sector job creation schemes targeted to the most disadvantaged job-seekers. The latter should be phased out quickly once labour demand picks up.

…. and effective social safety nets….

The coverage and maximum duration of unemployment benefits vary considerably across OECD countries. Given the downturn, countries with weak unemployment benefit systems may wish to consider extending the coverage and, possibly, the maximum duration of their benefit schemes during the downturn. But this should be combined with a reinforced activation stance in order to minimise adverse effects on work incentives which could prove costly once recovery sets in.

The young unemployed and other vulnerable groups need particular attention.

Young workers are particularly vulnerable during cyclical downturns and their unemployment rates are soaring in some countries. This is a major concern; evidence from past downturns show that the most disadvantaged youth are scarred for life. In order to minimise this adverse effect, it is vital to invest in targeting a range of effective education, training and work options to enable the young unemployed, and other vulnerable groups, to get a firm foothold in the labour market.

Reducing the labour supply is not the right way to ease unemployment pressure.

It is also vital to avoid policy mistakes which will have a negative impact on future growth potential. One such error would be to encourage withdrawals from the labour force. In the crisis of the 1970s, many OECD countries introduced early retirement options. Though intended to reduce unemployment by freeing up jobs for young people, this policy proved to be a costly failure since firms laid off older workers but hired few replacements. More recently, there has been a rising trend to park workers with health problems on disability benefits; for many of them, this has led to permanent withdrawal from the labour force. It will be important to resist political pressures to take similar measures now, as labour market conditions worsen.

Nor should labour migrants be neglected.

With rising unemployment, concerns are being raised about migrants taking jobs from native workers despite the fact that there is little evidence to support this. Indeed, migrant workers are at high risk of layoff in a cyclical downturn. For this reason, it is important to ensure that they have adequate access to re-employment services and existing integration programmes are not scaled back. Management of labour migration should be sufficiently responsive to short-term labour market conditions, but bear in mind the future needs for both skilled and unskilled workers in OECD economies dealing with the growth challenge of ageing populations.

The impact of the crisis on developing countries must not be neglected, and priority action is required.

As the crisis spreads increasingly to developing countries, obtaining additional external financing and resources from donors for the most-affected and poorest countries is a priority. The OECD's Development Assistance Committee's (DAC) latest figures show an increase of 10 per cent in total DAC official development assistance (ODA) in 2008, with a projected increase by another 11 per cent over next 2 years to 2010. While these levels will not enable countries to reach the targets set at Gleneagles, these figures represent a positive development, especially given crisis-related spending in other areas.

In October 2008, DAC Members were invited to make an "aid pledge", reaffirming their aid commitments and agreeing to maintain aid flows in line with these commitments. The World Bank and the IMF have reinforced the call for keeping to commitments and have estimated increased concessional aid requirements of at least $25 billion (IMF). The issue facing donors is thus to not only maintain current commitments, but also to organise a special countercyclical aid effort of exceptional proportions. The OECD and the DAC are prepared to support G20 initiatives on aid and other crisis-related measures needed to keep development momentum up and prevent the crisis from further spreading to poor countries.

Keeping markets open to trade and investment is key to speeding the recovery.

A number of other policy areas remain critical. Governments must remain vigilant and actively reject trade and investment protectionism. As unemployment rises and trade and investment contract, political pressure to take actions to "protect" domestic jobs or favour domestic firms is likely to increase. But today's deeper economic integration implies that even small and seemingly innocuous policy changes can have far-reaching consequences. As the crisis unfolds and trade and FDI volumes contract, the risk of a backward slide into trade and investment protectionism is becoming more acute. All nations would be hurt by the introduction of protectionist policies into their crisis packages, which would act to slow the global recovery and be difficult to unravel. Discriminatory state aid to industry, and resistance to mergers and acquisitions as stock prices of listed companies are depressed, are just two examples of potential dangers. Efforts should be made to ensure that financial support and stimulus measures do not impact negatively on competition. A key principle should be the distinction between two different types of aid: support to financial firms for systemic reasons, and aid for non-financial firms with structural problems, but no systemic dimension.

A new OECD report on "Freedom of Investment" calls on countries to remain vigilant and monitor the risk of discriminatory policies and new forms of protectionism which may emerge as a result of the crisis, based on dialogue and peer review. In addition, a new report on *Building Trust and Confidence in International Investment* will be presented to OECD Ministers in June. With its investment instruments, the OECD provides the only multilateral forum for countering investment protectionism. Strong peer monitoring under the OECD's "Freedom of Investment" process – where non-OECD countries, including the G20, participate as equal partners – and the commitments under the OECD investment instruments will be vital to maintaining open markets.

There is little standing in the way of a successful conclusion of the Doha Development Agenda (DDA). Opening markets further for trade in goods and services is another double-dividend action, offering significant benefits with no fiscal cost. For example, a 10% increase in trade is associated with a 4% rise in per capita income; more efficient customs procedures and full tariff liberalisation of agriculture and industrial goods could combine to increase global welfare by 200 billion USD – and much higher gains would be expected if services trade were liberalised. In May, the OECD will launch a new publication entitled *International Trade: Fair, Free and Open?*

which highlights the importance of trade liberalisation. Over the coming year, efforts will also be undertaken to deepen understanding of the economic and trade impact of trade-related policy responses to the crisis.

Innovation must be preserved as an engine for growth and prosperity.

Investment in intangible assets (e.g. R&D, software, worker skills) is at least as important for economic growth as investment in tangible assets, such as infrastructure and equipment. Yet, evidence suggests that the downturn already has begun to undercut innovation in the private sector, threatening long-term economic and social goals. This is in part because investment in innovation is essentially pro-cyclical, financed mainly from cash flows. To counter the risks of a severe loss in long-term innovation capabilities and to facilitate structural change, it will be important to preserve investment in innovation. Recovery packages should include policy measures that seek to mitigate the negative impact of the financial crisis on the level and orientation of innovation activities. Innovation is supported by a combination of private and public investments, and measures should be designed to preserve this balance. Efforts should aim to reinvigorate private sector activities and support entrepreneurship by removing barriers to entry of new firms and to enhance access to credit, particularly for SMEs – which employ the bulk of the labour force in many countries – and innovative firms. An OECD Innovation Strategy is under preparation to provide a forward-looking policy agenda for innovation, to be delivered to OECD Ministers in 2010.

The crisis presents a unique opportunity for green growth.

Stimulus policies can work to serve the objectives of green and innovation-enhancing investment. Investments in energy production, buildings and transport infrastructure last for decades. It is thus important to ensure that economic stimulus packages do not lock in inefficient or polluting energy technologies or dirty modes of production and consumption, but instead shift public and private investments towards "clean" alternatives and green technologies. Public investments to support adaptation to climate change, such as investments in sea level walls or in climate-monitoring technologies and capacity, could also be accelerated. The crisis also provides an opportunity to reform or remove expensive and environmentally-harmful subsidies (e.g. to fossil fuel-based energy, agriculture), reforms which would benefit both the environment and the economy.

In the coming months, the OECD will be assessing the compatibility of the various elements of stimulus packages with these green objectives. Preliminary OECD analysis of synergies between climate change objectives and a green recovery to the economic crisis will provide an input to the G8 Environment Ministers Meeting at the end of April, and to discussions amongst Ministers of economy and finance at the OECD Ministerial Council Meeting in June 2009. These issues will be of critical importance as countries move towards an agreement to address the effects of climate change at the 15th Conference of the Parties (COP-15) to the United Nations Framework Convention on Climate Change (UNFCCC), in Copenhagen in December 2009.

Looking ahead

In the past several months, governments around the world have taken essential actions to address the financial and economic crisis. It is hoped that the innovative approach recently announced by the United States to clean up the financial sector will be effective in stabilising markets, restoring confidence and fostering a return to lending. Time will also be needed to assess the impacts of the massive fiscal and monetary stimulus, and any further measures to be taken. The coming months are sure to see an intensification of the employment crisis, which will require creative, long-term solutions.

Now is the time to prepare the foundations for sustainable growth and a stronger, cleaner and fairer global economy of tomorrow. The OECD will continue to respond to current and emerging policy challenges the crisis and the road to recovery will inevitably raise, to serve its member and partner countries, and the international community more broadly.