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**SYNTHESIS REPORT ON THE STRATEGIC RESPONSE**

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### Where are we in the response to the crisis?

1. The ongoing global policy response will hopefully shorten the duration of the recession and alleviate its social costs. Measures taken at the national and international level provide impressive policy stimulus, resources for IFIs, and guidance for a reform of financial markets worldwide. Governments have made calls for keeping markets open and taking action to put the world economy on a more sustainable and greener growth path.

2. We face two scenarios. Growth consolidates and moves beyond policy driven recovery into a new stronger self-sustained path. Or, after initial green shoots have waned, the world economy teeters on the edge of a “double dip”. In this latter case sharp and prolonged falls in production, trade, employment and risk-taking lead to a lower potential growth path and unstable imbalances. The difference lies in well-designed and properly implemented global economic policy responses grounded in international cooperation, between governments, international organisations, business, labour and civil society.

3. The response to the crisis has been impressive for its magnitude, intensity and degree of global coordination. It has also confirmed the need to ***involve all major players in global economic governance***. However, these are only the first steps of a process towards a more sustainable global economy. ***More needs to be done*** and the emphasis must shift to a medium- to long-term perspective. The global economy must move from a policy driven recovery to self sustained growth. Just as important is the need to tackle the consequences of rising unemployment which could turn the economic crisis into a major social crisis.

4. Once the recession is over, ***the global economy should not go back to business as usual***, as past practices have proven to be unsustainable. Governments must already begin to address the issue of how to exit from the exceptional measures they have taken, on several fronts, to face the crisis. To do so, they will have to ***ask not only how or when to exit, but also towards what to exit***.

### What should the next growth model look like?

5. Growth should be ***stronger***: Better regulation of financial markets, a healthy balance between markets and government, and policies to promote more innovative long-term growth in a more balanced global economy. Global imbalances should not be allowed to widen as in the past. Addressing them requires looking at both a macroeconomic and a structural dimension. Excess investment over savings in some countries also reflects excessive debt issuance. And, excessive savings in others reflect a high degree of risk aversion due to the lack of adequate social protection. A sustainable growth environment requires addressing these underlying factors in the global distribution of saving and investment. This in turn requires structural and medium term policy action in addition to macroeconomic adjustment to be undertaken in a coordinated framework.

6. Growth should be ***cleaner***. The crisis offers the opportunity to put the global economy onto a low carbon growth path, in line with ongoing efforts to mitigate climate change. Investments which are harmful to the environment should not be made for the sake of supporting the economy, especially when other alternatives are available. Growth going forward should also be smart and more knowledge-intensive. To be sustainable and equitable, it must also be supported by a transparent environment with strong coordinated initiatives to fight corruption, tax evasion, bank secrecy, and promote more transparency and a level playing field in investment.

7. Growth should be ***fairer***. More effective trade, investment, and development policies, strong social frameworks and a common global governance structure based on cooperation between developed emerging and developing countries with more opportunity and less inequality. Open markets remain a fundamental principle of well-functioning economies. The dramatic, generalised and very rapid fall in

trade, if not reversed, undermines the activity of dynamic firms that operate in the tradable sectors, where productivity growth is higher, with potentially disruptive consequences on the global value chains. Open markets remain a key driver of growth as well as of innovation diffusion. Protectionism would be a very serious mistake. The poor and the most exposed to the risk of exclusion should not be left out. Growth must be socially sustainable and based on increasing employment. Unemployment breeds poverty and curtails long term growth. Social pressure caused by rising unemployment could exacerbate protectionist pressures.

### What does all this mean in practice?

8. Since launching the *Strategic Response to the Financial and Economic Crisis* in 2008, the OECD has intensified its efforts to support governments, covering the key areas that need to be addressed to tackle the crisis, both in the financial sector and in the real economy. It has undertaken new analysis and released special reports on the crisis. The OECD has also 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). Building on its deep and longstanding co-operation with non-OECD partners, the OECD is also monitoring the crisis' impact on emerging and developing economies.

9. This document contains the latest deliverables from the *Strategic Response*, and others are under development. These reports are included as Annexes to this synthesis report [C/MIN(2009)9/ANN1-5]. The main findings and policy recommendations can be summarised as follows.

### Finance, competition and governance: priorities for reform and strategies to phase out emergency measures<sup>1</sup>

10. ***Reforms are needed in a number of areas to create incentives in financial markets that encourage a better balance between the search for return and prudence with regard to risk.*** Where possible, it is important to design crisis measures so they are consistent with this agenda (in order to avoid policy reversals later on). Equally important to consider is that markets will look critically at the 'sustainability' of crisis measures. ***If the policies are perceived as 'inappropriate', in the sense of not being sustainable, the market will reject them*** and the crisis will deepen. As policy makers choose emergency measures, they should seek (where possible) actions that are consistent with long-term goals in order to reinforce credibility.

11. ***Strategies to phase out emergency measures – "exit strategies" – need to be broadly consistent with longer-run economic goals.*** These goals include: better and more symmetric information flows (transparency) to reduce the risk of liquidity crises; non-distorting regulation; corporate governance and tax regimes that promote incentive structures for better risk control; corporate structures that address contamination risk from affiliates; competitive markets with level playing fields within and between countries; and macroeconomic and social policies that are sustainable and do not 'crowd out' private activity or worsen longer-run employment and welfare prospects.

### Reform Principles

- Many issues must be addressed to restore public confidence in financial markets and to put incentives in place to encourage ***a prudent balance between risk and the search for return*** in (broadly-defined) banking. Action from the G20 and the European Council has begun to address

<sup>1</sup> See Finance, competition and governance: priorities for reform and strategies to phase out emergency measures [C/MIN(2009)9/ANN1].

such issues. While there is considerable scope for flexibility at the level of specifics, a few strategic priorities for policy reform stand out:

- Streamline the regulatory framework, emphasise prudential and business conduct rules and strengthen incentives for their enforcement.
- Stress integrity and transparency of markets; priorities should include disclosure and protection against fraud.
- Reform capital regulations to ensure much more capital at risk (and less leverage) in the system than has been customary. They should have a countercyclical bias and encourage better liquidity management in financial institutions.
- Avoiding impediments to international investment flows will be instrumental to attracting sufficient amounts of new capital.
- Strengthen governance of financial institutions and ensure accountability to owners and creditors with capital at risk. Non-Operating Holding Company structures should be encouraged for complex financial firms.
- Once the crisis has passed, allow people with capital at risk, including large creditors, to lose money when they make mistakes.
- Strengthen understanding of how tax policies affect the soundness of financial markets”
- Respond to the increased complexity of financial products and the transfer of risk (including longevity risk) to households with improved education and consumer protection programs.

### ***Exit Strategy Principles***

12. Reforms along these lines should be put in place as quickly as is feasible. Stabilizing the economic and financial situation will take time. But once this happens, governments will need to begin the process of ***exit from the unusual support measures*** that have accumulated in the course of containing the crisis. As the situation will be fragile, recovery should not be jeopardised by a precipitous withdrawal of the various support measures. Getting the exit process right will be more important than speed. While there is great scope for pragmatism, ***clear principles guiding the process*** should be established early on. These should be:

- The time-line for exit (including a full sell down in government voting shares) will be conditional in part on progress with regulatory and other reforms consistent with the above principles.
- Level competitive playing fields will eventually be re-established and support will be withdrawn.
- Viable firms will be restored to health and expected to operate on a commercial basis in the market place.
- Support will not be withdrawn precipitously but will be priced on an increasingly realistic basis.
- If beneficiaries do not find ways to wean themselves off support, then such pricing will increasingly contain a penalty element.

- As adequate pools of equity capital become available, state-owned or controlled financial firms will be privatised and expected to operate without recourse to any implicit guarantees that state-ownership usually implies.
- The bad assets and associated collateral that remains in governments' hands should be managed with a view toward recovering as much for the taxpayer as is feasible over the medium term.
- Reinforce public confidence in, and the financial soundness of, private pension systems and promote hybrid arrangements to reduce risk.

### Keeping markets open<sup>2</sup>

13. Although trade and investment protectionism remains a threat and there is a need for continued vigilance, governments have largely resisted protectionist pressures so far. At the same time, many governments have adopted measures to channel public investment and sectoral subsidies and they often have considerable discretion in their application.

14. Under some programmes, they attach conditions that may discourage either trade, particularly imports, or investment flows. If such measures are not carefully designed, there is a risk of a drift toward discriminatory policies that could prejudice a return to sustainable growth.

15. Trade agreements and OECD investment instruments provide for flexibility when governments respond to crises. However, they also ask governments to ensure that such measures do not unduly damage other countries' interests e.g. by impeding international investment flows or distorting competition.

16. At the same time, multilateral trade negotiations remain stalled. Countries should strengthen their efforts to conclude the DDA in 2009, to benefit development, and for the systemic health of the global economy

17. The current challenge in preserving "freedom of investment" is for governments to use their new crisis response powers to effectively address economic and social problems, while minimising impediments to inward and outward foreign investment.

18. Governments need to continue to work together to address the current global economic crisis. *How best can OECD and non-OECD governments co-operate, on an on-going basis, to achieve their shared interest in encouraging increased trade and investment, thereby contributing more to restore global economic growth?*

### Aligning stimulus measures with long term growth

19. Going forward, macroeconomic and structural policies should be consistent with three broad objectives: *support high potential growth, avoid unsustainable payment imbalances, ensure fiscal sustainability*<sup>3</sup>. The timing and composition of fiscal stimulus measures should increasingly be aligned with these objectives. A number of specific policy recommendations to this effect are discussed in the report summarised below.<sup>4</sup>

<sup>2</sup> See Keeping markets open for trade and investment: issues for discussion [C/MIN(2009)4].

<sup>3</sup> This latter aspect is developed in paper on fiscal sustainability (ECO).

<sup>4</sup> See Aligning stimulus measures with long-term growth [C/MIN(2009)9/ANN2].

20. The need for additional discretionary fiscal stimulus varies across countries because automatic stabilizers operate more powerfully in some economies. In this differentiated context, the biggest constraint on introducing additional fiscal stimulus is the reaction of financial markets to greater government borrowing needs.

- Crisis measures should not be allowed to undermine competition.
- Coordinated action can create positive spillover effects as it results in a larger overall output effect than if any country acted alone.
- Looking ahead, many of the emergency measures taken today could pose a threat to long-term growth and sustainability if not properly unwound. Measures should be designed and implemented as temporary and in the least distortive manner, with a clear and credible plan and timeline for phasing out as recovery takes hold. It is critical to consider exit strategies now, together with emergency measures, in order to prevent new risks down the road.
- The credibility of the medium term fiscal framework needs to be strengthened through the announcement upfront of a clear commitment to long term fiscal sustainability.
- Credible fiscal consolidation plans may require tax reforms, including the broadening of tax bases and better tax compliance to ensure sustainable revenues.
- As economies emerge from recession, it is likely to be necessary to raise additional revenues. Unless permanent cuts in expenditure are implemented, it will not be sufficient to restore them to pre-crisis levels.

#### ***Tax measures***

21. ***Growth-oriented tax reforms*** would generally involve shifting revenue from corporate and personal income taxation or social security contributions onto consumption and property taxes, including housing taxation.

22. At the same time, any tax policy proposal needs to take account of its effects on income distribution, and it is particularly important to consider the poor during an economic recession, as they tend to be badly affected by crisis.

23. Tax cuts that are targeted at workers with modest incomes can improve living standards, both by directly increasing their disposable income and by giving them a greater incentive to work.

#### ***Labour, social and education measures***

24. ***Subsidy schemes to expand labour demand should be temporary and well targeted. Introduction of early retirement options should be avoided.***

25. 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.

26. Expanding effective active labour market programmes would be important to maintain the activation stance. But it may be difficult to match the rise in job seekers with greater resources for public employment services, not least because it takes time to recruit and train good case managers. Under the

circumstances, there may be opportunities for effective co-operation between public and private employment agencies to provide a range of contracted-out activation services.

27. Support for education and training that enables the transition to new jobs and emerging opportunities should also remain prominent in the policy agenda, as well as policies to help youth in their transition from school to work.

28. Concerns in terms of the integration of immigrants should be fully integrated into the labour market components of stimulus packages.

### ***Pensions***

29. Both private and public pensions systems are undergoing a rude stress test and, in many cases, need to be shored up.

30. Pensions could be part of economic stimulus package. Governments should strengthen safety nets to prevent increased old-age poverty. There could be different investment portfolios and shift to riskier assets near retirement in private (defined-contribution) plans. Longer periods for employer (defined-benefit) pension funds to recover could be allowed.

31. What governments not do is resort to early retirement/disability schemes to attempt to stem increase in unemployment. Indeed, some countries propose to increase pension age to help pension-scheme finances.

### ***Infrastructure investment***

32. Most OECD and non-OECD economic stimulus packages share a focus on improving the national infrastructure (mostly through public works). The targeted infrastructure includes roads, railroads, public transport, airports, water and sanitation, child-care facilities, schools and universities, hospitals, energy networks and security, and broadband communication infrastructure. Some of these projects are to be run as infrastructure in partnership with provinces and municipalities.

33. Infrastructure spending should consider the following principles:

- Focus on projects which are “shovel ready”, notably those aimed at stated policy goals and advanced enough in planning to be implemented quickly and effectively. A period of crisis does not lend itself to complex investment projects which typically require careful and lengthy planning. To the extent possible, priority should be given to modern projects with a greater potential to raise the efficiency of energy and resource use, and which support long-term environmental sustainability.
- Investment in high speed broadband communication networks that are part of economic stimulus packages must be accompanied by regulatory frameworks which support open access to networks and competition in the market. Such investment should also aim at stimulating the use of ICT to secure economic and social benefits. Linking ICT investment with other large physical infrastructure investment, such as buildings, roads, transportation systems, health and electricity grids, allows them to be “smart” and save energy, assist the aging, improve safety and ad apt to new ideas. Such investment should also be linked to service and organisational networks. These infrastructures can also lower the barriers to entrepreneurial activities and provide means for the efficient and “green” delivery of energy, mobility and important social services – training, job search and networking.

- Target expenses to idle resources, notably vulnerable groups such as low skilled youth, women and older workers, who are at greater risk of falling into unemployment trap.
- Use existing programmes and agencies to distribute the spending but make sure that they are equipped for the task. Regional agencies can be used as a vehicle to reach actors that cannot be reached by national agencies and programmes.

### ***Green growth***

34. ***Economic growth and the green goals can go hand-in-hand.***<sup>5</sup> There are opportunities for win-win policies for both objectives in the long-term: (i) green tax reform (shifting the tax base away from labour and capital towards pollutants or polluting activities) and auctioned pollution permits that generate revenues—they are good for the environment and also contributes towards the goal of fiscal sustainability; (ii) reforming or removing inefficient policies, especially subsidies to fossil fuel production and consumption—with the double/triple dividend of removing inefficiency in resource allocation in the economy, pushing the green agenda and saving governments and tax payers money; and (iii) removing barriers (e.g. market and information failure) to a widespread practice in energy & transport efficiency.

35. In addition, many of the investments in infrastructure in the stimulus packages are directed towards increasing public investments in energy efficiency of buildings, public transport, renewable energy networks, more efficient water treatment supply and sanitation, as well as infrastructure to prevent flooding, and other environmental risks and degradation. These can contribute to increased environmental quality, and seize the opportunity of the crisis to spur public infrastructure investment to contribute a low-carbon economy.

### ***Innovation***

36. The crisis has already begun to affect innovation, through its effects on investment, finance, trade, entrepreneurship and employment<sup>6</sup>. Historically, business R&D expenditure and patent filings have moved in parallel with GDP, slowing markedly during the economic downturns of the early 1990s and of the early 2000s.

37. ***Innovation will be one of the keys to emerging from the downturn and putting countries back on a path to sustainable – and smarter – growth.*** Many governments have incorporated measures to strengthen innovation in their stimulus packages, and can also take action to improve their long-term potential for innovation.

38. Mitigating the negative impact of the crisis on innovation is important as the crisis has magnified widely acknowledged market failures in innovation financing. Investment in innovation is now considered even more risky and some of the longer term investments in new technologies are particularly affected. Moreover, stimulus measures offer an opportunity to put available resources for innovation (notably skilled labour) to good use.

39. In supporting private investment in innovation, care should be taken to ensure that government spending provides good value for money; the less promising innovation projects are typically abandoned first by the private sector and there is no reason to revive these with public money. Policies that can be considered in this context include:

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<sup>5</sup> See Issues paper on “Green Growth: Overcoming the Crisis and Beyond” [C/MIN(2009)3].

<sup>6</sup> See Fostering innovation for sustainable growth [C/MIN(2009)9/ANN3].

- Focusing public support on research and innovation most affected by the crisis, *e.g.* long term and risky research, research conducted by start ups, and research addressing societal challenges (environment, ageing etc.). Using existing instruments and vehicles for support can help maximise the short term impact.
- Well-designed existing public-private partnerships can help enhance the resilience of investments in R&D over the business cycle. One way of achieving this could be through adjusting the balance of public and private funding over the business cycle. Such partnerships can also be used at the local or regional level, *e.g.* in innovative clusters, to ensuring that government funds reach new and small players, thus reducing the risk of capture by “strong players”.
- As with other investments in infrastructure, investments in research infrastructure can contribute both to stimulating demand in the short term and supply in the longer term.
- Open and competitive public procurement can also be used to support R&D, especially where it contributes to solving social challenges, *e.g.* mobility, energy or health.

40. Governments also need to focus on medium to long-term actions to strengthen innovation. As discussed in the Interim Report on the Innovation Strategy<sup>7</sup>, a broad range of policy reforms will be needed in OECD countries to respond to the changing nature of the innovation process and strengthen innovation performance to foster sustainable growth and address key global challenges.

### ***Entrepreneurship and industrial renewal***

41. In changing their approaches to innovation, governments also need to consider how to best support risk-taking, such as investments in innovative start-up companies. Regulatory reform of financial markets to address the financial crisis could revisit the role of venture capital markets and the securitisation of innovation-related assets (*e.g.* intellectual property) which are key ways of financing for many innovative start-ups.

42. New business opportunities and the reallocation of resources from declining activities towards emerging opportunities are vital to recovery. Governments will need to avoid locking-in old economic structures and business models. Supporting firms and industries that do not have a viable business model will thwart the restructuring required for more sustainable growth. Facilitating the creation of new firms and ensuring competition can help underpin such restructuring.

43. Governments can prepare for the next phase of innovation-led productivity growth, for example, by encouraging the entry and expansion of new businesses or the exit or re-orientation of existing businesses facing difficulties.

44. Some sectoral policies have potentially protectionist elements (*e.g.* some of the sectoral subsidies, potentially some of the “green” measures) while others have a better appreciation for the borderline between pre-competitive and the market place (R&D) and have put into place pro-competitive policies with the stimulus packages (*e.g.* broadband plans requiring “open access”). Attention should be paid to the various strategies and their deployment looking more in depth at methods and the cost of picking winners versus protecting losers; favouring of incumbents versus encouraging entrepreneurs; compile best practices on mechanisms being developed for evaluation and monitoring.

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<sup>7</sup> Interim Report on the Innovation Strategy [C/MIN(2009)8].

***SME financing***

45. Access to financing continues to be one of the most significant challenges for the creation, survival and growth of SMEs, especially innovative ones<sup>8</sup>. The problem is strongly exacerbated by the financial and economic crisis.

46. The following policy recommendations to tackle the long-standing deficiencies in the SME financial environment may be considered:

- As SMEs often lack face-to-face contact with bank managers due to the structure of the modern banking system, banks could consider using their scoring methods for assessing SME credit-worthiness with appropriate discretion, strengthening “relationship banking”.
- Banks could also enter partnerships with business service providers to help them reduce the risks in SME lending. Automatic systems of credit evaluation do not always function to the effect that viable companies can obtain credit. Systems are needed to evaluate the credit risk of SMEs on a company basis rather than on a sectoral basis, while being consistent with prudential management practices in terms of sectoral allocation of funds.
- The specific financing needs of micro-enterprises could be provided through micro-finance in countries which do not already have such schemes.
- As indicated in the OECD Brasilia Action Statement “...informing SMEs of the range of financing options (e.g., public guarantee programmes, business angels, and bank loans) will ensure greater take-up of schemes”.
- SMEs should be engaged in the design of relevant finance-related policies and programmes from the outset to ensure that their perspectives and needs are well understood and taken into account.

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<sup>8</sup> See The Impact of the Global Crisis on SME and Entrepreneurship Financing and Policy Responses [C/MIN(2009)9/ANN5].