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OECD Economic Outlook

Back to Supply-Side Economics?

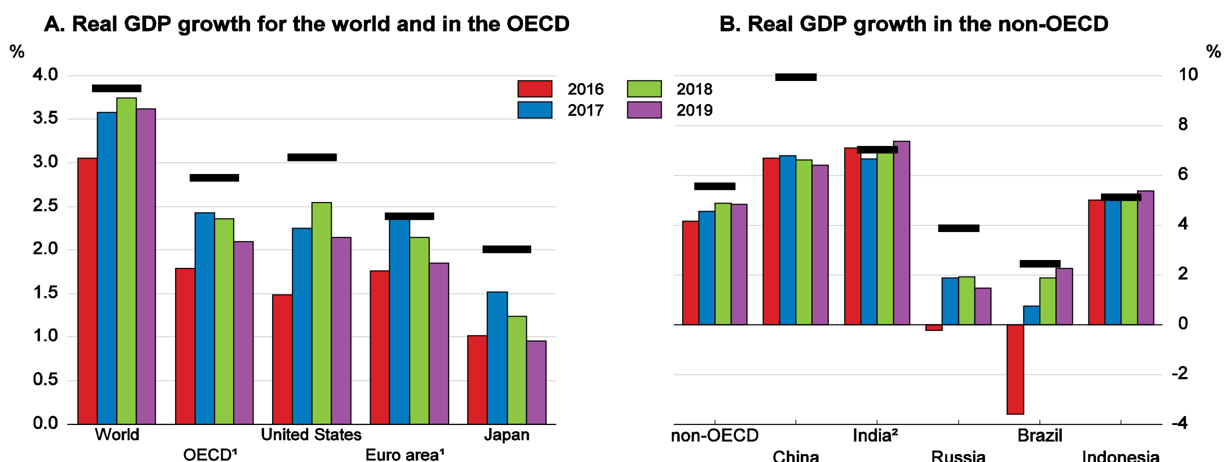
Paris, 28 November 2017

The key message from the OECD Economic Outlook published today, is for governments to engage "renewed" and "deeper" structural reforms – trade liberalisation and de-regulation, to raise business profitability over so-called "hurdle rates", which is estimated at no less 14%, and thereby help redress the investment gap since the 2008 crisis.

In doing so, the Economic Outlook suggests an unwelcome shift in the OECD recommendations from demand side policy to a business friendly supply side policy agenda close to a classic "trickle down" strategy. This is not warranted.

- With cyclical slack in labour markets still in place and with wage dynamics that continue to be sluggish, an incidental improvement in short term momentum does not provide for a robust basis for a supply side policy agenda.
- Channelling productivity increases into profits is a continuation of the decade long trend of decoupling of wages from productivity, of falling labour shares and rising inequalities.

One key message of the OECD Economic Outlook released on 28 November, is that economic growth is firming up to. After a meagre performance in 2016 (1.8%), OECD-wide GDP growth should reach 2.3% in 2017 and in 2018. Yet, growth is projected to level down again in 2019 to 2.1%. For the OECD, a too moderate upturn in business investments is making the economic expansion hit capacity constraints. To remove structural impediments to stronger medium term growth, the OECD therefore recommends to "creating the environment in which business investment will strengthen", inter alia: product market reforms, liberalisation of trade and regulation, a better public spending mix and labour market measures. Supply-side economics.



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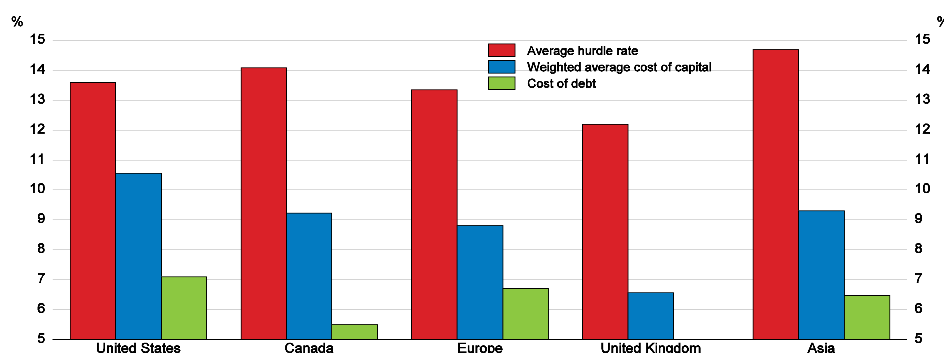
Why is corporate investment lagging behind?

Investment spending in 2018-19 is projected to be around 15% below the level required to ensure that the productive investment rises at the same pace as over 1990-2007. The persistence of this investment gap comes as a surprise considering the more favourable economic conditions and importantly, the equally favourable interest rate environment. For this OECD, this gap points to the existence of "longer-term structural impediments to investment". The Economic Outlook pays special attention to the "hurdle rate": the return on investment threshold above which decision to invest is taken. According to the OECD hurdle rates appear to be as high as 14% compared to an average cost of capital closer to 9% estimated at weighted average. They are also "sticky' and haven't come down from these high levels despite the fact that policy has driven down interest rates to almost zero.



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For the OECD, the lessons and the policy recommendations are clear: to facilitate the business decision to invest, the internal rate of return on investment needs to be pushed above current hurdle rates (14%). For that to happen, businesses need an even more favourable regulatory environment and government should engaged in "renewed structural policy efforts": further liberalisation of trade, further de-regulation and cutting red tape for businesses, etc. This would boost total factor productivity, thus pushing up rates of return on investment above current profitability thresholds and encourage firms to expand and upgrade their capital stock.

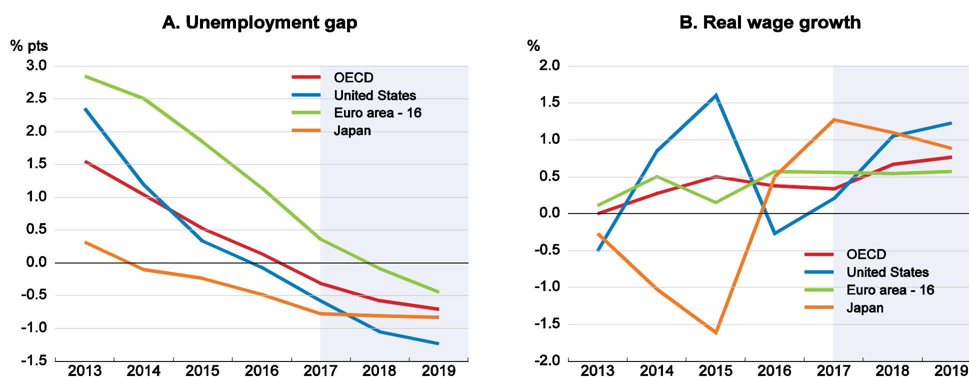
The OECD call for market and labour reform to revive corporate investment is carried further forward in a scenario simulating the effects of reforms that would push up the level of productivity by 1% over the next five years. The conclusion is that GDP and the capital stock would be around 0.9 - 1% higher in 2023. Productivity performance would also be reflected in real wages being 0.5-0.8% higher in 2023 compared to the baseline.

Wage growth unresponsive to falling unemployment rates

As highlighted in previous editions, wage growth remains modest despite falling unemployment rates. It is also evident that meagre real wage growth (0.4% per year on average in 2014-2016) has contributed to popular dissatisfaction.

In doing so, the OECD repeats previous analysis that the conventional measures of unemployment understate the extent of the cyclical slack that is still remaining. Many countries still have high rates of involuntary part-time work and high proportions of people who are only marginally attached to the labour market. Interestingly, it also looks into the possibility that changes in the composition of employment (a higher share of men or women in part time employment) influence aggregate wage growth. The conclusion (except to a certain degree for Japan) is negative as such compositional effects reduce the growth of hourly pay in the euro area and the US by around 0.1% per year, with somewhat larger effects in some individual euro area countries (0.2% per year) reflecting the decline in the share of

male workers in a full time job. In the end, the OECD simply hopes that a continued fall in unemployment will automatically trigger the renewal of wage dynamics which the economy needs in order to sustain the recovery.



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Back to supply-side economics?

While previous editions devoted much attention to demand side policies, this new Economic Outlook shifts much of the focus back to supply-side measures. Past simulations tracking the impact of fiscal expansionary policies are herein replaced by the scenario estimating the economic effects of an increase in productivity. The latter would, supposedly, be brought about by structural reforms.

The OECD call for "renewed structural policy efforts" and "deeper reforms" to strengthen growth prospects is based on the view that the economy's short-term momentum has improved. This stands in contrast with the OECD's own observation that the extent of remaining cyclical slack in labour markets is underestimated – as seen in the weak wage dynamics. This raises the risk of weak aggregate demand dynamics that would be unable to withstand the combination of another wave of structural reforms and a withdrawal of monetary stimulus. If, as a result, aggregate demand dynamics were to slide back again, investment and growth potential would get weaker again, not stronger.

The OECD claim that reforms to improve profitability above hurdle rates of more than 14% (!) will in the end increase real wages is dubious. If increased productivity is necessary to push profitability higher in order to trigger more investment, then such productivity increase cannot flow into real wages. One cannot use the same margin twice. The OECD analysis also turns a blind eye on other factors explaining underinvestment by firms. Part of the OECD findings on hurdle rates indeed stem from a survey from the Bank of England[i]. Unfortunately the OECD report fails to relay the Bank of England's own finding that crowding out of investment is caused by corporate "short-termism" and shareholder pressure (M&As, dividends, share buyback, etc.).

This edition of the Economic Outlook is also incomplete on two other aspects.

The OECD measures the investment gap as 2018-2019 investment spending being 15% below the level required to ensure that the productive net capital stock grows at the same pace as it did over the 1990-2007 period. However, the measure of investment and capital stock being used also includes public investment. Hence, one of the factors explaining the gap is the strategy of austerity and the cuts in public investment budgets that have been made. A recent report of the European Investment Bank precisely shows that the real investment gap that exists is in public investment and is the consequence of the strategy of austerity[ii].

In line with previous editions of the Economic Outlooks, no attention is given to explaining the modesty of wage dynamics in terms of reduced bargaining power of labour. The only small indication in that respect can be found in a footnote: “It may also be the case that the rising number of part-time and temporary workers has reduced the bargaining power of full-time workers, and hence wage growth”.

All in all, the policy recommendations of this edition of the OECD Economic Outlook suggest a return to the same old recipes of the past that have led to decade long downward trends in productivity growth, feeding into profits and shareholders’ remuneration instead of real wages and real investment, and thereby squeezing further the share of labour income.

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[i] The financial system and productive investment: new survey evidence - Quarterly Bulletin 2017 Q1 http://www.bankofengland.co.uk/publications/Pages/quarterlybulletin/2017/q1/prerelease.aspx

[ii] EIB Investment Report 2017/2018: From recovery to sustainable growth http://www.eib.org/infocentre/publications/all/investment-report-2017.htm