Trade Union
Advisory Committee
to the OECD
*Commission
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auprès de l'OCDE*

OECD Economic Outlook:
Taming Inflation or Playing with Fire?

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TUAC's reaction to the latest Economic Outlook

The latest Economic Outlook, *Confronting the Crisis*, provides a comprehensive and layered picture of the main macroeconomic risks that world economies are facing. The report is objective in characterising the difficult balancing act that governments and central banks need to perform so to contain inflation on the one hand, while avoiding that too restrictive policies provoke an even starker and unintended recession, in the process of containing prices, on the other.

Yet, despite the sober take on the risks that overly restrictive and internationally uncoordinated monetary and fiscal responses might entail, the OECD is quick to call on additional monetary and fiscal tightening.

On monetary policy, the OECD does not seem to consider the supply roots of current inflation, given the political consequences of the Russian invasion of Ukraine, which prompted most advanced economies to introduce sanctions on Russian oil and gas, driving energy market prices up and prompting countries, particularly in Europe, to search for alternative and yet currently insufficient energy suppliers. In such a context, central banks' tools are inadequate to cope with price pressures, because they cannot address the supply side factors while only weakening aggregate demand in the process of trying, further jeopardising the economy.

While the OECD acknowledges that monetary policy has a lagged impact on inflation and that central banks should stand ready to change course in their policy action, it does not reflect its own considerations into practice. It points out instead that policy rate hikes remain thus far below inflation levels and that further increases are warranted to contain it further. Yet, most recent consumption and industrial production indicators point to a deceleration of economic activity already underway, which will most probably translate into a slowdown of inflation rates, even absent further monetary tightening. To this end, it is also worth noting that medium-term inflation expectations in major economies like the US are in line with historical trends pre-dating the current inflationary spike, therefore they should not represent a cause of worry.

Another point of concern revolves around wages. On several occasions the OECD has confirmed that there is no evidence of a wage-price spiral, and that nominal wage growth has not been keeping up with inflation. At the same time, the cautionary language used by the OECD indicates that the fear of a potential wage-price spiral, even if not supported by facts, is enough to call for containment of wages as a justifiable preventive policy measure to contain inflation. To back up this position, the OECD claims that unemployment will not rise considerably next year, despite the deceleration in economic growth, and that wage pressures will be mounting over 2023-24. The idea that unemployment will not substantially increase hints implicitly to the Phillips curve argument that inflation and unemployment have an inverse relationship, i.e. that if unemployment remains low inflation will keep rising. While the stability of such relationship has been seriously put to question over time, many economic projection models, including OECD ones, still rely on the basic assumption that a traditional Phillips curve holds in the long run.

Further to this, the OECD does not substantiate why wage pressures are expected to mount in the coming two years. It should be noted that whether higher wage demands will be met by employers does not only depend upon labour market tightness but also on the workers' bargaining power. Decades of labour market flexibilisation and reduction in collective bargaining coverage have considerably weakened workers' ability to demand better wages and working conditions. This is well explained in the 2022 Employment Outlook, where the drop in collective bargaining coverage is among the factors that explain the increased imbalance in labour bargaining power in favour of employers and the rising negative impact of labour market monopsony on wages and employment levels. None of this is adequately reflected in the Economic Outlook.

Trade unions in OECD economies have thus far shown great restrain in wage hike demands, bearing more than their fair share of the "cost-of-living" crisis. For example, wage growth in the US has been assessing at around 4-5% even if inflation is closer to 8% this year, despite a tight labour market. Meanwhile, in the Euro area collective bargaining agreements are either continuing to set wage growth at a moderate pace (Nordic countries, Italy) or are trying to avoid inflationary spirals, by sharing the cost of high inflation between businesses, governments, and workers. They also combine structural wage increases that align to price stability targets with lump-sum bonuses to temporarily protect workers' purchasing power (IG- Metal and IGBCE agreements in Germany). Yet, the role of collective bargaining, which has been recognised in the latest Employment Outlook as important for both securing an equitable distribution of the cost-of-living burden and for better labour market outcomes, is completely ignored.

Regarding fiscal policy, the Economic Outlook clarified one year ago that the fiscal impact of structural reforms had to be expansionary, whereas the OECD is now moving back to a simplistic approach of deregulation and flexibilisation, including most likely, albeit not expressly stated, the labour market. As repeatedly proven, any such kind of reform performed in a period of weak economic growth and high uncertainty risks producing more damage and scarring effect than boosting a country's economic performance, a lesson that the OECD should be remindful of.

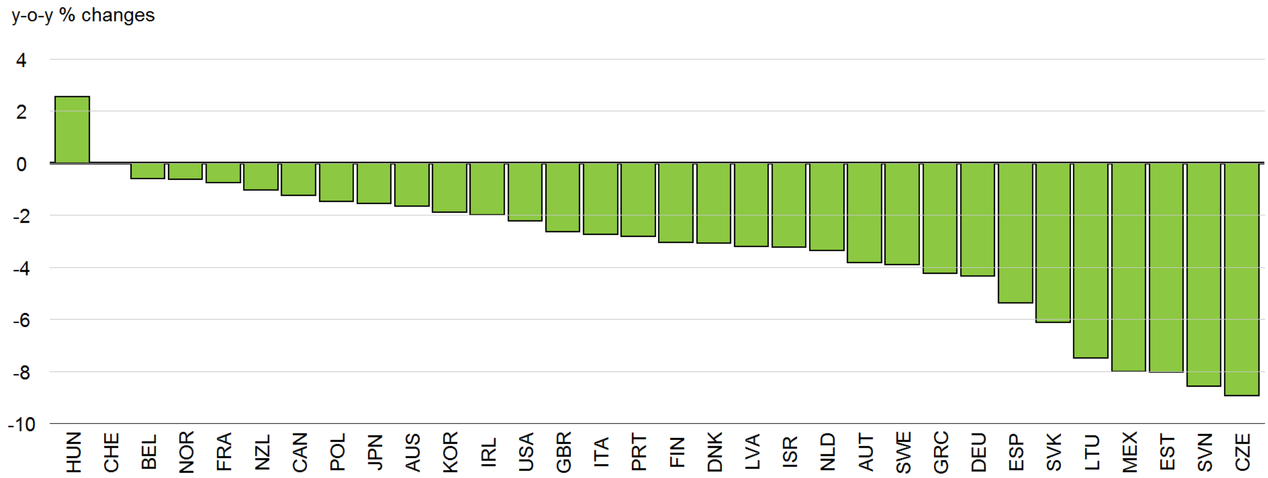
In conclusion, it is TUAC's opinion that the OECD should provide more nuanced policy recommendations at the current time, in line with the complexity of the present macroeconomic situation, avoiding stark monetary and fiscal contraction that is not only ineffective in containing supply-driven inflation, but would push economies over the brink of yet another recession.

Setting the macroeconomic scene

The Economic Outlook warns of the feeble state of the global economy and the downward risks to economic growth in the coming period. While economic projections are slightly revised for 2022, compared to the September [Interim Report](#) (3.1% global GDP growth, from 3%, particularly driven by upward revisions to the United States, the Euro area, but also Japan, Brazil and China), world GDP growth will still be half what it was in 2021 and probable to slow down further in 2023, at 2.2%, down to 0.8% in the OECD and 0.5% in both the United States and the Euro area. Unemployment in the OECD area should see a slight increase, from 5% this year to 5.5% next.

A number of challenges pose severe risks to economic growth: high inflation, low confidence, persisting uncertainty amid the prolonged war in Ukraine, energy supply issues, financial fragilities are all pieces of this grim puzzle. As to the labour market, the OECD confirms that despite sustained tightness across the OECD, i.e., a high number of vacancies compared to the number of unemployed, wages are not keeping up with inflation, with a sizeable drop in real wages in most countries (Figure 1).

Figure 1 – Trend in real compensation per employee, total economy, 2022Q3



Note: Compensation per employee deflated using the personal consumption expenditures deflator.
Source: OECD Economic Outlook 112 database; and OECD calculations.

Current challenges and risks ahead

The third quarter of 2022 saw a bounce in industrial production, retail sales and international trade that softened the economic slowdown in the first half of the year. Still, this has only partially tampered the downward trajectory, as the sharp rise in energy costs and the drop in real disposable income, particularly in Europe, depress aggregate demand. The OECD reminds that low-income household are particularly impacted by high inflation, given that energy and food expenditure account for a larger share of their consumption basket.

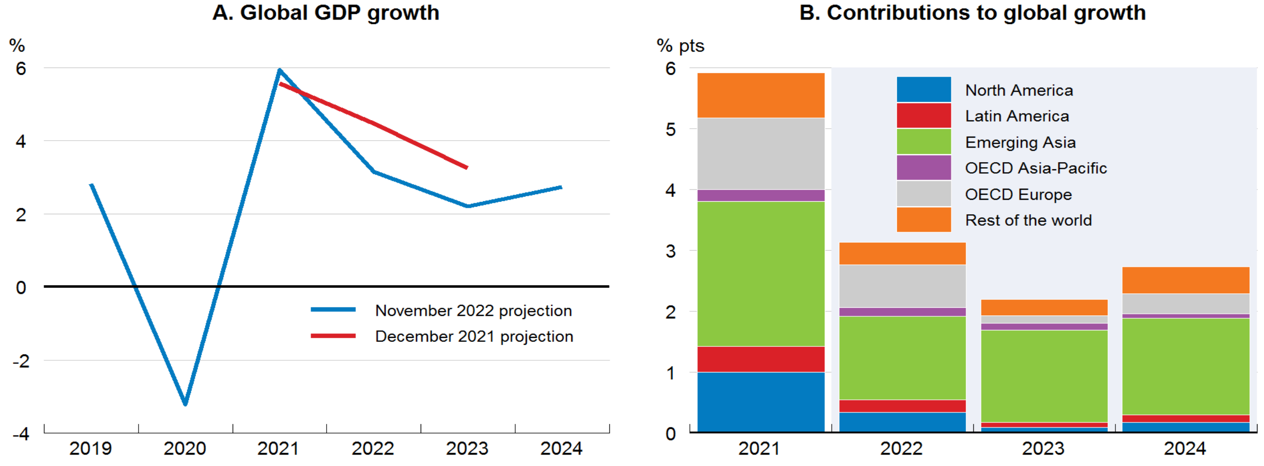
The breakout of the war in Ukraine in February 2022 severely undermined the recovery path upon which most OECD countries had embarked after the spike of the COVID-19 pandemic. Such recovery was made possible by the timely and extensive fiscal and monetary support provided by governments and central banks during the crisis, despite pending challenges such as supply-chain bottlenecks and shipping shortages. The Russian invasion of Ukraine added to supply constraints, particularly through energy and food price spikes. Inflation in the OECD area, at 9.4% in 2022, is expected to drop to 6.5% and 5.1% in 2023 and 2024, respectively. Yet, the Economic Outlook makes two important points: first, inflation pass-through to prices of goods and services has been sustained recently, but in some sectors, profits have been rising as well. While the OECD does not delve into explaining the reason of rising profits, it is clear that companies exploit the current trend to increase their mark-ups beyond concrete inflation pressures, adding to the latter rather than just reacting to cost pushes. The second point is that longer-term inflation expectations remains well anchored within central banks' targets.

At the same time, monetary tightening has increased global financial vulnerability. Volatility in government bond markets is at record high levels, while the raise in US policy rates has strengthened the US dollar, putting exceptional pressure on developing countries whose external debt is denominated in hard currency. Capital outflows from emerging countries are accelerating, given higher interest rates in the United States, while still strict COVID-19 containment policy in China raises uncertainty about the country's economic performance in the coming period.

Private equity markets are also under stress, due to tightened financing conditions and meagre economic growth prospects, which put pressure both on lower-quality investment bonds and leveraged households, as mortgage rates rise.

Altogether, growth is expected to slow down, with further downside risks on the table. North America and Europe will witness the sharpest reduction in growth rates in 2023, as opposed to Asia, which will account for three quarters of expected global GDP growth next year (Figure 2). High inflation, tight monetary policy and high real interest rates, high energy prices, lower household incomes and overall uncertainty are all factors that drag down future growth, particularly in Europe.

Figure 2 – Global growth is projected to slow and be increasingly imbalanced across regions



Note: In Panel B, Emerging Asia comprises China, India, Indonesia and the Dynamic Asian Economies. Latin America comprises Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Peru. Contributions calculated moving PPP shares of global GDP.
Source: OECD Economic Outlook 112 database; OECD Economic Outlook 110 database; and OECD calculation.

The OECD refers to unit labour cost (ULC) to explain why inflation is becoming entrenched, but at the same time ULC growth is only around 4% in the median advanced economy, compared to an average inflation of 9.4% in OECD economies, being not only the result of minimal upward wage adjustments but also of a fall in productivity levels, as employers are not dismissing workers despite current production slowdowns. Given that labour markets remain tight, the OECD considers “probable that many wage demands in 2023-24 will be considerably higher than previously anticipated” (p. 22).

Still, the OECD believes that the loss in jobs might be contained, as employers might prefer to keep workers that proved hard to hire in the recovery from COVID-19, while waiting for markets to recover. Thus, OECD-wide unemployment is expected to move from a low 5% in 2022 to 5.5% in 2023, while the rate of new jobs will be particularly reduced for the next two years. Central and Eastern European economies, Denmark, Finland, Italy and Sweden will see the sharpest rise in unemployment levels, according to the OECD, albeit not at the level of past recessions.

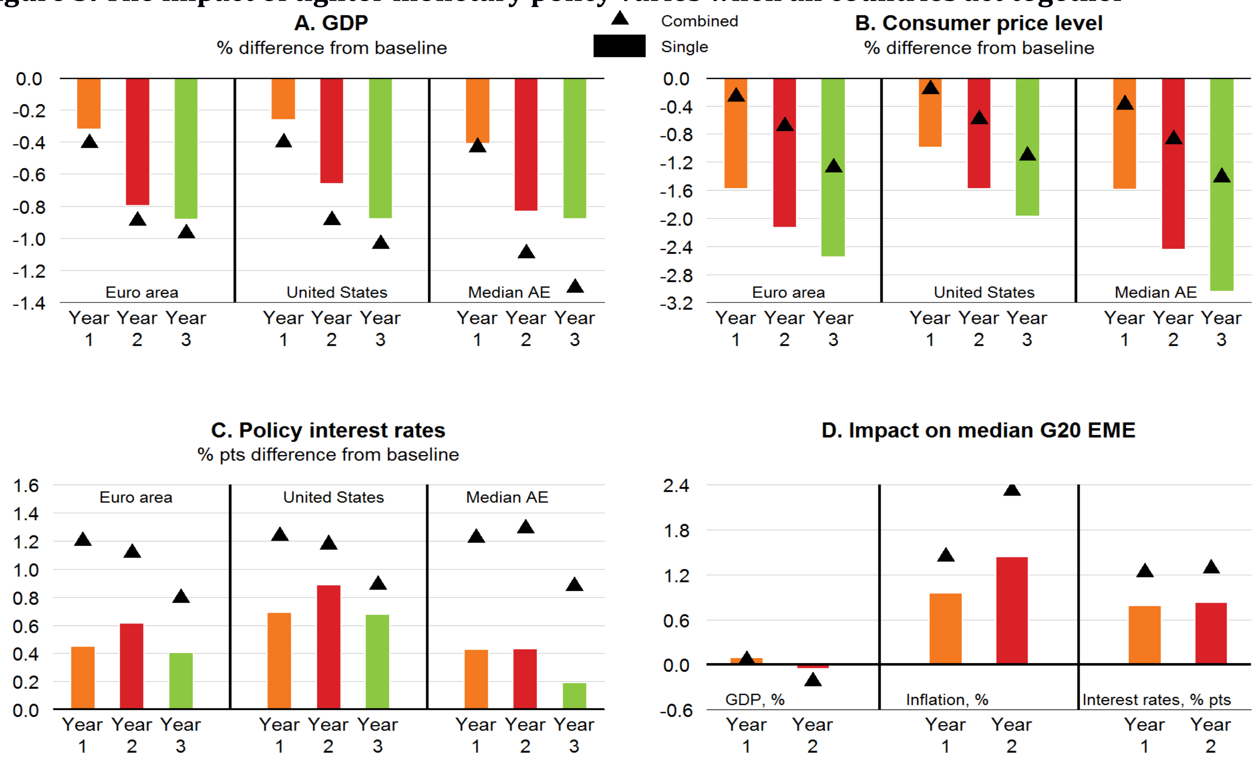
Further energy supply shortages and price hikes are among the major downward risks to the central scenario. Unexpected difficulties in shifting from Russian energy to other suppliers could prevent adequate restocking of European supplies and further price spikes. Even more than the 2022/23 season, the risk lays for next year, when a colder-than-average winter could dry gas stocks up. Of particular concern is the relation between energy expenditure as share of GDP and economic recession: in the past fifty years, all OECD recessions occurred when energy prices pushed energy expenditure in OECD countries above 13% of GDP, with the only exception of the COVID-19 crisis. Today, energy-to-GDP expenditure stands at 17%, with no signs of decrease. A pending question is whether this will necessarily translate into higher prices for consumers.

Monetary policy tightening also comes with considerable downward risks: “A sharp increase in interest rates may jeopardise the ability of households and corporates to service their debts, potentially leading to defaults and bankruptcies, and to corrections in house prices” (p. 38). High household and corporate debt pose a systemic risk, with household debt servicing ratios already higher than in the early 2000s, while debt of non-financial firms in the median OECD economy reached 141% of GDP in 2021 and the share of speculative-rated corporate bonds being downrated is considerably rising. This represents a threat to the financial sector, including banks, pension funds, insurers, etc.

The OECD further points out that the exact calibration of monetary tightening to fight inflation comes with additional challenges: uncertainty about the economic outlook, different channels through which interest rates impact the economy and cross-country spillovers might result in unnecessarily strict or prolonged policy rate hikes, bringing considerable harm to the economy. The lack of international coordination among monetary institutions might lead to ignore the compounded effect of monetary policy tightening across countries: “Concurrent tightening across countries can magnify the effects of domestic policy action, both by reducing foreign demand and by tightening domestic financial conditions, but also potentially change some channels of transmission, such as the exchange rate channel” (p. 43).

Furthermore, coming after two unprecedented decades of monetary easing, particularly since the Global Financial Crisis and the introduction of quantitative easing, the impact of the current change in monetary policy is very hard to predict. Again, according to the OECD, “Higher debt levels, elevated asset prices, changes in the flexibility of product and labour markets, financial innovation and the increased importance of nonbank credit provision, and greater trade and financial openness may all increase the pace at which policy rate changes feed through” (p. 44). OECD simulations show that an uncoordinated, widespread tightening of monetary policy across all economies at once has significantly worse effect on growth, and a more contained one on prices, since the exchange rate effect remains muted (Figure 3).

Figure 3. The impact of tighter monetary policy varies when all countries act together



Note: Based on forward-looking simulations in which advanced economies set monetary policy so as to durably lower the price level by 5% relative to baseline. 'Single' denotes the impact when one central bank acts alone, 'Combined' denotes the impact when all advanced economy central banks implement the shock at the same time. Year 1, Year 2 and Year 3 denote the first, second and third year impact of the policy change.
Source: OECD calculations using the NiGEM macroeconomic model.

OECD policy recommendations

Despite the numerous fragilities and risks to the global economy, the OECD recommends pursing further monetary tightening and fiscal moderation for the coming period, with the primary objective of controlling short-term inflation. A word of caution is still used, when saying "changes in interest rates will need to be carefully calibrated and data dependent, given uncertainty about the outlook and the impact of policy changes, and take account of potential spillovers from concurrent restrictive policy in other countries" (p. 47). However, this caution appears to be soon forgotten, in suggesting that "with 2-3 year ahead household inflation expectations in many major advanced economies currently at 3% or more, policy interest rates may need to be raised quickly above this level where this has not already been done" (p. 49).

With respect to fiscal policy, the OECD takes a hawkish position, in contrast to what we have been used to in recent years, where the role of fiscal policy to guide economic recovery was more prominent. Now, while allowing for some targeted measures to relieve businesses and households from the stark impact of energy costs, the OECD is concerned that overly generous fiscal policy would undermine monetary efforts to contain inflation. It also warns that excessive subsidies or the introduction of price caps risk supressing the signalling role of prices to reduce energy consumption.

In addition to the monetary and fiscal response to the current macroeconomic context, the OECD is returning to the familiar concept of supply-side structural reforms to boost productivity and competitiveness in the longer term. While not delving into details, it calls for enhanced market competition, the removal of barriers to reallocation across sectors and obstacles that prevent firms from becoming more dynamic, greener and innovative, as well as enhanced skills policies. The OECD does not specify what kind of reallocation it envisages, referring probably to both capital and labour, nor it clarifies by which policies such reallocation should be achieved.

The OECD also recommends increased spending on childcare and early childhood education, both to address the cost-of-living crisis and to boost female participation in the labour market.