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RECOVERY? WHAT RECOVERY?

TUAC analysis of the OECD Interim Economic Outlook

On the 17th of March, the OECD[1] published its interim report on the economic outlook. This note critically analyses the OECD's view on the state of the economy and on the policy recommendations made in the report.

Key points

- The OECD expects economic growth to gradually recover from the negative shocks suffered over the last year. Even as the OECD underlines the fragility of the recovery, it continues to call for raising interest rates further.
- A closer analysis of the interim report reveals that the OECD's economic recovery projections are unconvincing. Two years after the COVID-19 crisis, OECD economies have failed to get activity back to the level where it would have been had economic expansion continued on its pre-pandemic trend. With growth only marginally recovering in the next two years, this gap between trend and effective GDP will increase further.
- Central banks are on a quest to fight inflation by hiking interest rates, whatever the cost and risk which may be inflicted on the real economy and labour markets. Such monetary policy tightening is unprecedented. It explains why the recovery is so weak, and casts doubt on the recovery itself, as hiking interest rates is clearly causing damage within the financial sector. This in turn risks triggering a credit crunch that amplifies monetary restriction and serves to bring the economy to a stop. It is regrettable that the OECD report, instead of making a stronger emphasis on these risks to the recovery, supports central banks in their drive to squeeze more demand and jobs out of the economy by calling for interest rate increases to continue.
- The OECD report expresses concern about current wage dynamics not being in line with central banks' price stability targets, without considering that

[1] OECD Economic Outlook, Interim Report March 2023: A fragile recovery

corporations have used increases in energy and commodity prices as an opportunity to pass on expanded profit margins besides higher input costs in their price setting. This has significant implications for inequality; with the OECD taking the view that workers should now abstain from bargaining to recover lost real wages, the distribution from wages to business profits that has taken place will be cemented. The OECD report fails to take the opportunity to launch a discussion on how to better distribute the burden of the cost-of-living crisis, a weight that is now being carried by labour only.

The OECD's narrative

The OECD's interim report on the economic outlook, published on 17th March, expects the economy to stage a gradual improvement in growth performance over 2023- 2024 after the series of negative shocks over the last year (cost-of-living crisis, war in Ukraine and the slowdown in China).

According to the OECD's narrative, this recovery of growth would be driven by incomes being less squeezed as high inflation gradually recedes; by tight and resilient labour markets supporting private consumption; and by the positive impact of China's reopening to global activity.

The OECD does recognise that the predicted economic improvement is fragile and that downside risks "predominate"[2]. There is a warning that the full impact of monetary tightening could be even higher than expected, in the face of underlying vulnerabilities in financial markets and risks in the business models of financial institutions such as Silicon Valley Bank.

Regrettably, this does not keep the OECD from calling for further monetary policy tightening. More interest rate increases are still seen as necessary, as core inflation would recede slowly and in 2024 still amount to 2.5% (US), 3% (euro area) and 3.2% (UK). In an implicit reference to "wage-price spirals", the OECD targets wages by arguing that wage growth in most countries is at rates that are not compatible with inflation returning to target.

[2] It could be argued that this is different and somewhat stronger language than the usual formulation of risks being "tilted" to the downside.

A different view

A deeper analysis of ongoing trends and policies currently being implemented raises three key observations regarding the OECD's narrative.

Recovery? What recovery?

By simply looking at the numbers put forward by the OECD itself, the growth dynamics expected over 2023-2024 are unconvincing. Whereas advanced economies have been expanding in 2022 at rates between 2% (US) and 3.5% (euro area), and even as much as 4% (UK), the rate of growth for 2023 is expected to collapse to figures ranging between a mere 0.8 and 1.5%. The UK economy is even thought to be shrinking by 0.2%.

No resurgence of growth is expected for 2024 in many economies either. In fact, the pace of growth in the US will weaken further from 1.5% in 2023 to just 0.9% next year.

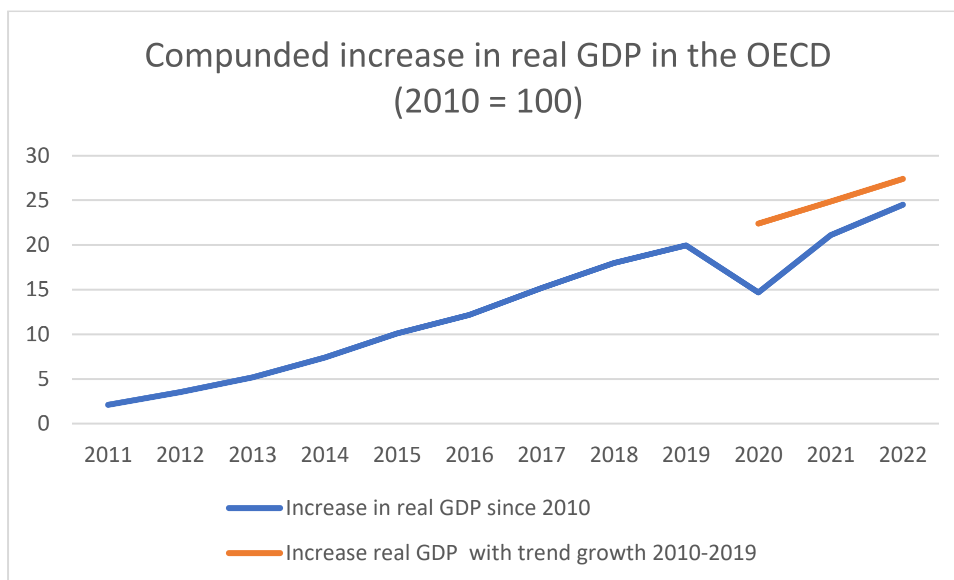
Real GDP growth, year on year, per cent

	2022	2023	2024
World	3.2	2.6	2.9
Australia	3.6	1.8	1.5
Canada	3.4	1.1	1.4
Euro area	3.5	0.8	1.5
Japan	1	1.4	1.1
Korea	2.6	1.6	2.3
UK	4	-0.2	0.9
US	2.1	1.5	0.9

Source data : OECD

The current setback in growth dynamics comes at a time when economies still need to fully recover from the COVID-19 crisis. As the below graph shows, the level of activity of the OECD in 2022 remains 2.3% below the level that would have been expected had the economy continued to expand at its pre-pandemic trend. With growth significantly slowing down in 2023-2024, this gap will only increase further. Hence the question is whether this dismal pattern of growth can really be called a recovery.

Figure 1



Source: OECD data, own calculations

Explaining the non-recovery : Unprecedented monetary policy tightening and the risk of financial market turmoil and a sudden stop in the economy

If inflation is receding and tight labour markets are expected to add new demand to the economy, what then explains the weakness of the projected recovery? Here, the unprecedented cycle of interest rate hikes seen in previous quarters, with the Federal Reserve de facto leading other central banks by increasing the fund interest rate by 450 to 500 base points in less than a year, needs to be highlighted.

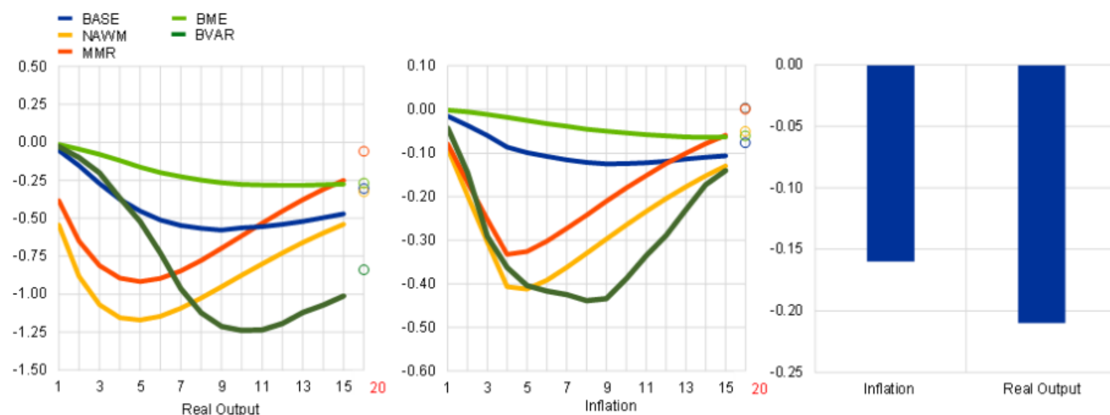
The stated purpose of this monetary tightening is to fight high inflation. However, hiking interest rates is a blunt tool that has significantly more impact on squeezing growth and jobs than it does in bringing inflation down. Estimates from the ECB, for example, indicate that inflation goes down by a maximum of 0.3 percentage points when interest rates are raised by 100 base points. The impact on the level of economic activity, however, is much more important : real GDP will be depressed by a full percentage point.

The following graph illustrates this. It also underlines the fact that monetary policy works with substantial (and non-stable) time-lags, so that the full effect of monetary tightening on inflation and output is only visible one, two or even three years after interest rates have been increased.

Figure 2

Macroeconomic impact of a 100 basis points monetary policy shock (left and middle panel), 12-quarter cumulative impact of a standardised €500 billion balance sheet reduction (right panel).

(deviation of output in per cent; year-on-year percentage points)



Source: ECB, [The euro area hiking cycle: an interim assessment (europa.eu)]

These estimates allow us to understand why OECD economies are facing a non-recovery; the impact of monetary tightening on the real economy is still to come and will be significant. Continuing with the example of the euro area, the ECB calculated the impact of its recent hikes (350 base points) on economic activity would amount to two full percentage points in 2023, with some models even reporting a hit on output of 3 percentage points in 2024. Putting things together, if the OECD interim forecast is just expecting 0.8% growth for the euro area in 2023, this is mainly because of the monetary policy tightening that has been deployed over past quarters. Meanwhile, and again according to the ECB, the benefit of this aggressive tightening in terms of reducing 2023 inflation is limited to a mere one percentage point. With inflation in the two-digits numbers this is hardly noticeable.

Unfortunately, this is not the end of the story. The cost of monetary policy is not limited to its direct impact on the real economy. There is also the risk of inflicting damage on the financial sector, which then feeds back into the real economy by blocking access to credit for business and households.

This risk is especially pronounced now, as more than a decade of low and zero interest rates have led to financial constructions that are profitable when the cost of money is low, but that turn deadly when interest rates go up sharply.

The crisis shaking UK pension funds in September 2022 (triggered by a collapsing government bonds market following the Budget proposed by the Truss government) was the canary in the coalmine. It was followed by the recent US Silicon Bank Valley crisis sparking a flight of deposits from US regional banks into money market funds and large banks, such as Morgan Stanley and Goldman Sachs. As these regional banks are grounded in local communities, and thus essential in providing finance to local businesses and

households, the risk is that the resulting credit squeeze will have major effects on investment and consumer spending, thereby amplifying the already substantial impact of monetary policy tightening on the real economy. Indeed, some have compared the Silicon Valley Bank shock as equalling another 150 base points increase in interest rates with corresponding additional negative impact on the real economy.

Making matters worse, more risks may be lurking in the financial sector that we are currently unaware of. Any carry trade using short-term funding at zero interest rates over the past decade to invest in longer term assets (such as commercial real estate, car loans, private equity, levered or credit card loans) could be at risk because of more expensive financing. In this respect, it is useful to recall past OECD work which calculated that accommodative monetary policy since 2008 has allowed the non-financial corporate sector to borrow at increasing speed, reaching cumulated bonds for USD 13.5 trillion by 2019 (an average of USD 1.8 trillion per year).[3] The share of non-investment grade bonds was 20% of the new issuances since 2010, up to 25% in 2019. Hence why the rapid U-turn in monetary policy that we have seen could have disastrous consequences for a significant share of enterprises.

Despite all this, central banks still appear determined to continue with their policy of pushing interest rates higher. Blinded by their quest for price stability, central banks seem oblivious to the damage being inflicted on the real economy and labour markets, as well as of the risk of inviting substantial and hard-to-control financial market turmoil.

Why the OECD is not making a much stronger case to stress concern about monetary policy tightening and its impact on both the economy and financial stability is an enigma. True, the OECD does recognise that it is difficult to "calibrate" the full impact of monetary policy tightening; but the call to continue increasing interest rates until there are clear signs that underlying inflationary pressures have lowered durably is unambiguous[4] and regrettable.

Monetary policy, inflation, and inequality: Are wages or profits to blame ?

Concerns about wage-price spirals that sustain high inflation is likely behind the OECD's support of monetary policy tightening. As argued by the OECD: "in most countries wage growth remains at rates that, if sustained for some time, would be inconsistent with inflation returning to target".

[3] Çelik, S., G. Demirtaş and M. Isaksson (2020), "Corporate Bond Market Trends, Emerging Risks and Monetary Policy", OECD Capital Market Series, Paris, www.oecd.org/corporate/Corporate-Bond-Market-Trends-Emerging-Risks-and-Monetary-Policy.htm

[4] This call is also dangerous. Given the long and variable-time lags of monetary policy, stopping monetary tightening by the time there are clear signs of a durable lowering of underlying inflationary pressure, it will be too late. Monetary policy will have been overtightened, thrusting the economy into an unnecessary crisis and pushing inflation not to the price stability target of 2%, but back to the zero-interest rate bound.

This argument seems to be supported by a graph showing that the most recent pace of wage dynamics - even if these appear to be stabilising - is as high as 5 to 6% in the Euro area, the US, and the UK (graph reproduced below). Compared to a 2% inflation target plus a trend productivity growth of 1.5%, this pace of wage growth would imply upward and inflationary cost pressures.

Figure 3

Source: OECD, Interim Outlook March

However, the data upon which this graph relies are untested. The Indeed Wage tracker is a very recent wage series using wages that are advertised in job postings. These data only cover a small part of the labour market and not the population of job stayers, hence a tendency to outpace the average trend. Even if this indicator seems to be running a few months ahead of broader wage cost series trends, it is questionable whether it can be used in a literal sense by comparing the current pace of wage growth with the rule of thumb on non-inflationary wage growth, as referred to above. For example, while the Indeed Wage tracker estimates end 2022 US wage growth in advertised vacancies at 6%, the Employment Cost Index reports an annualised quarter-on-quarter increase in wage costs of 4% for the last quarter of last year[5]. The latter number is almost in line with the rate of wage growth compatible with the Federal Reserve's price stability target. Moreover, the most recent statistic published on 8th of April report a slowing of US wage dynamics over the past three months to 3,2 percent annualised growth. With 1,4 percent productivity growth, this number implies wages are roughly in line with 1.8 percent inflation which is actually even slightly below the 2 percent inflation target.

[5] See Employment Cost Index Summary - 2022 Q04 Results (bls.gov)

Figure 4 : **Annualised hourly earnings of all employees, total private**

Source: CEPR blog (2023) It's a Passover Miracle: Fed wins the war on inflation !

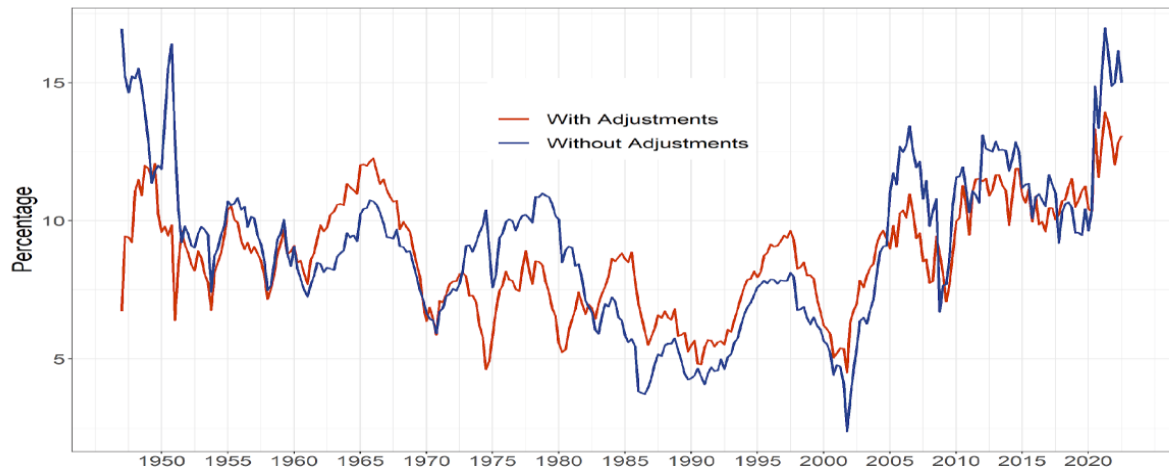
Going beyond numbers alone, the OECD is not addressing the central question of distributional impact. There is now abundant evidence that the cause of high inflation is not limited to external shocks coming from energy prices and disruptions in global supply chains, but also from business corporations passing on higher input costs and higher profit margins into their selling prices. The graph below shows how profits as a share of the US non-financial business sector have been exploding from around 10% to recently more than 15% of added value. Margins have reached a level that has not been seen in the last 70 years. This has been an important contributing factor to inflation. Profits account for two-thirds of the increase in the GDP deflator of US non-financial business since the onset of inflation (third quarter of 2020) to the second quarter of 2022 (9.4% increase of the 14.1% increase of the GDP deflator)[6].

As real wages collapse and profit margins boom, it is workers who are shouldering the burden of inflation[7]. Against this background, the view that wages and collective bargaining strategies should overlook corporate profit taking and respect strict price stability guidelines is far from neutral. By cementing excessive profit margins and the massive distribution from labour to capital, these imply rewards in business price hiking strategies.

[6] Source Weber, I, Wasner, E. (2023) Sellers' Inflation, Profits and Conflict: Why can large firms hike prices in an emergency? Economics Department Working Paper Series. University of Massachusetts Amherst.
[7] This stands in stark contrast to what happened in the hyper-inflation period of the seventies when real wages went up at the expense of profits. It is now the other way around.

Moreover, linking the discipline of wages with the recommendation to continue monetary tightening if workers do not forego trying to extract their lost share adds more oil to the inequality fire. As previously analysed, higher interest rates will trigger an even more pronounced slowdown, perhaps even a sudden stop of the economy. This will undermine the bargaining position of workers and provide business with another opportunity to capture a higher share of value by compressing wages while keeping prices high[8].

Figure 5 :After-tax profit margins of US non-financial corporate business, percentage of GDP



Source: Weber, Wasner (2023) Seller's inflation, Profits and conflicts. Why can large companies hike prices in an emergency ? "Sellers' Inflation, Profits and Conflict: Why can Large Firms Hike Prices" by Isabella M. Weber and Evan Wasner (umass.edu)

Except for one carefully formulated hint – that current wage growth remains at rates inconsistent with inflation returning to target, 'unless corporate profit margins contract' - the OECD's interim report does unfortunately not engage in the discussion on the implications of tighter monetary policy on inequality and for a fair sharing of the burden of inflation, a discussion that should take centre stage in current economic policy making.

[8] Another scenario is that corporations may use the counter energy price shock that is currently unfolding to increase profit margins further by keeping prices high while reaping the decline in input costs. More robust wage demands would neutralise that strategy and restore some of the purchasing power that workers lost without sustaining high inflation because of second-round effects.