Trade Union
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Reflections on the state of the economy

TUAC - input for the May 2023 EPC-session

2023 has had a worrying start. Not only did annualised growth in the US nosedive from 2.6% to 1.1% in the space of a quarter, but the European economy reported a miserly 0.1% growth over the same period. Q1 has also seen a substantial drop in demand for credit from households and businesses in the eurozone; German factory orders fell in March by 11% month on month; and the fact that shipping company Maersk has seen overseas freight volume decline by 9.4% does not bode well for global trade dynamics.

In light of these disturbing downward trends, there are a number of key concerns that need to be addressed with regard to current economic policy.

The full cost of monetary policy tightening is yet to be seen

It takes time for the effects of monetary policy to work their way through the economy. Estimates indicate that raising policy interest rates by one percentage point reaches its maximum impact only after 8 quarters or more (see Table 1 below), while the negative effect on real activity far outweighs the reduction to inflation. Given the ambitious rate at which interest rates have risen in recent quarters , we can expect a significant drag on 2023-2024 growth. For example, the ECB calculates that the 350 base point interest rate increase from past quarters will translate into a 2 percentage point lower output in 2023 dropping even further to 3pp lower in 2024, accompanied by a 1 percentage point decrease in inflation in 2023.

Table 1: Peak impact and time lags of a 1 pp increase in policy interest rates

	Recent interest rate increase	Peak impact on GDP	Number of quarters to reach peak impact on GDP	Peak impact on inflation	Number of quarters to reach peak impact
US	5	-1	11	-0,6	7
Euro Area	3,75	-1	9 to 11	-0,3	7 - 9
UK	4,2	-1,4	4	-0,4	2,5
Canada	4,2	-1,3	6	-1	12

Sources: Champagne, Sekkel (2021), Changes in monetary policy regimes and the identification of monetary shocks: Narrative evidence from Canada, see here ; Cesa-Bianchi A.ea (2020), Monetary Policy Transmission in the UK, see here ; ECB (2022), The Euro Area hiking cycle: an interim assessment see here; Fair (2021),'What do price equations say about future inflation?' Cowles Foundation. New Haven: Yale University; see here.

Financial sector stress implies risks are firmly balanced to the downside

Since it interacts with the banking and broader finance sector, the impact of monetary policy on economic activity risks being significantly amplified. Higher interest rates are exposing the vulnerabilities on financial institutions' balance sheets, in particular the mismatch between short term funding and longer-term investment. The result is a much more restrictive lending environment. If yet more financial market turmoil materialises, bank lending - which has already started to slow down - will decelerate further , potentially echoing what happened in the Great Recession. At that time, the provision of new lending to finance investment, durable household purchases and trade took a serious hit. The latter, together with an overall loss of consumer and business confidence, inflicted serious damage to the economy.

Monetary policy tightening has other negative effects beyond shaking financial market stability. Interest rate increases directly push up mortgage costs, shifting demand from buying to renting. This higher demand for renting, especially in large cities, then drives up rental prices. Therefore, monetary policy tightening ultimately adds to inflationary pressure, since housing is one of the primary components of households' consumption baskets.

Are economies overheating or re-allocating and adjusting?

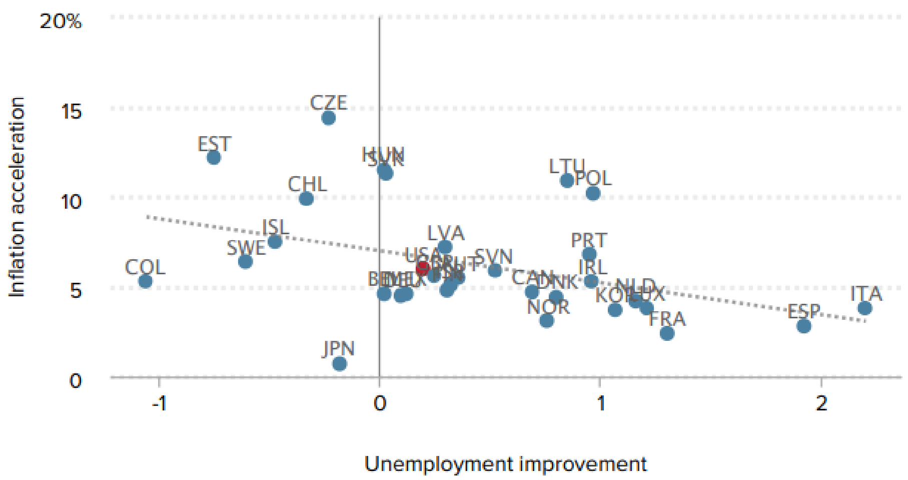
Tighter monetary policy is a reaction to the idea that high inflation is caused by excessive aggregate demand overheating the economy and labour markets. However, comparing the acceleration of inflation in the 2021-2022 period to 2018-2019, given the change in unemployment before and after the COVID-19 pandemic, casts doubt that this is what is happening today. Those economies where unemployment improved the most (i.e. where the labour market is warming up), experience a more modest acceleration in inflation compared to economies where unemployment increases (see Graph 1 below, where a fall in unemployment is shown as a positive change).

Graph 1

Figure D

Very hard to see global overheating

Unemployment improvement and inflation acceleration across countries



Notes: The acceleration of core inflation is measured as the annualized rate of inflation from May 2021 to September 2022 minus the average rate of inflation that prevailed in 2018–2019. The improvement in unemployment is average unemployment in 2019 minus unemployment rate that prevailed as of September 2022.

Source: Data from the Organisation for Economic Co-operation and Development (OECD 2022).

Economic Policy Institute

Source : Economic Policy Institute (2023), Lessons from the inflation of 2021-202(?), available here.

An alternative narrative indicates that sectoral shocks are closely aligned with the consequences of COVID-19, such as shocks shifting - not lifting – demand across sectors (for example demand turning away from face-to-face services towards durable goods and back), together with specific supply shocks causing bottlenecks in value chains across the globe (as has been seen with the semi-conductor shortage, port shutdowns in Asia and closure of the least productive oil wells during COVID).

The difference in these two possible scenarios is important. While monetary tightening can address excess demand, it cannot tackle specific supply bottlenecks or manage shifts in demand patterns. Nor does it need to; well-functioning markets are sufficiently strong as to shift resources and resolve bottlenecks by themselves. Part of this process is indeed higher inflation, resulting from changes in relative prices, but this inflationary process unwinds itself once resource allocation has run its course and pressure on prices of specific goods and sectors is relieved . [1] [2]

Profit-price spirals and inequality

Wage-price spirals remain yet to be seen. As stated by the IMF, "the cost pressures from wages have so far been contained despite the tightness of labour markets, with no signs of a wage-price dynamic"[3]. At the same time there is strong evidence of businesses using cost pressure in the upstream supply chain as an opportunity to raise prices by more than input costs have increased, thereby boosting profit margins[4]. The results are significant real wage cuts and rising profit shares, a pattern that is again highly unusual for an economy that is supposed to be overheating.

Triggering a serious economic slowdown by monetary overtightening will weaken the bargaining position of trade unions and prevent workers from negotiating real wage increases that would recover that part of wages lost to business profits. This will embed, perhaps even amplify, the redistribution from labour to capital that has taken place.

Fiscal policy should not repeat the mistake of austerity

Fiscal policy has already withdrawn support as the pandemic receded, the recovery gained traction and emergency stimulus was unwound. With significant monetary policy tightening on its way, care must be taken to not add contractionary fiscal policy to the mix and stifle growth completely. Policy discussions in the Euro area, US and UK are already in the process of shifting back to arguments advocating for fiscal space, debt ceilings, ad hoc public debt ratios and stability pacts. However, experience from a decade of austerity testifies that misjudged austerity fails to bring public debt ratios down, while at the same time damaging economic performance and recovery[5]. Reverting to fiscal austerity would be a costly mistake, especially with financial turmoil looming.

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[1] Galbraith J (2023), The quasi-inflation of 2022-2023, INET- working paper

[2] Stiglitz J. and Regni I (2022), The causes of and responses to today's inflation. Roosevelt Institute working paper

[3] IMF (2023) A Rocky Recovery, World Economic Outlook

[4] UNITE (2023) 'Profiteering across the economy – it's systemic'

[5] TUC (2023), From the doom loop to an economy for work not wealth

Conclusion : Implications for OECD analysis and policy recommendations

1. Given substantial demand restrictions from past policy tightening that is still in the pipeline, in tandem with financial sector fragility, the OECD should stress the need for central banks to take a forward approach instead of the current backward-looking one. This should include advocating an immediate moratorium on raising interest rates.

2. To avoid repeating the mistake of austerity and allow the public sector to stabilise the economy, fiscal governance frameworks need to be smart and flexible, not rigid or arbitrary. Targeting and unwinding the public support from the cost-of-living crisis should not imply contractionary fiscal policy coming at the expense of weakening growth prospects even more.

3. The OECD should draw specific attention to price-profit spirals amplifying the cost-of-living crisis and redistributing income from wages to profits by hollowing out the purchasing power of wages. Social dialogue, including tri-partite social dialogue, to negotiate collective bargaining strategies that will restore the purchasing power of real wages, while keeping central banks from weakening the economy, is to be promoted.

4. Build resilience in a world where economies are likely to experience more global shocks including those resulting from geopolitical tensions. To deal with the increased volatility implied by these shocks, industrial policy and selective price control require renewed policy attention. Besides using short and medium-term public investments to increase capacity and a more secure supply, a discussion is required on the role of monetary policy in dealing with these global shocks increasing volatility. Defining flexible price stability targets based on a target range instead of on one numerical point will create more room for central bankers to distinguish between sectoral shocks that induce relative price changes and across-the- board aggregate demand shocks which aggregate inflation.