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

Response to the OECD Economic Outlook November 2023: Economic soft-landing or sleepwalking into recession?

Paris, 29 November 2023

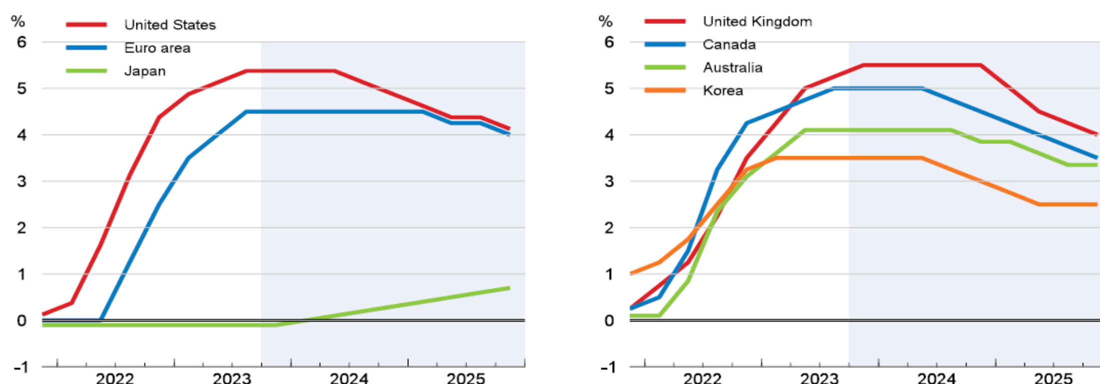
The picture stemming from the OECD Economic Outlook published today is one of cautious optimism: growth has slowed in several advanced economies but has not entered recession and unemployment has not risen significantly, according to latest OECD data, with some easing of labour market tightness. Thus, despite the overall slowdown of the global economy (2.9% GDP growth this year, expected down to 2.7% next year) and the risks to the central OECD projection scenario mostly tilted to the downside, the OECD finds that, with some exceptions, "global growth has been unexpectedly resilient" in the face of geopolitical tensions, from the war in Ukraine to the conflict in Israel and the Palestinian territories, disruptions to supply chains and energy markets, the cost-of-living crisis and tightening of monetary policy. Their impact on GDP has been modest, with consumption underpinning growth (especially in the US), still relying on excess savings from the COVID-19 period and surprisingly resilient labour markets.

Looking at the next couple of years, the OECD anticipates "a moderate slowdown followed by eventual normalisation, with growth returning to near-trend rates, and inflation converging back to central bank targets by 2025". Such path would be smooth but narrow, with "the risks to the projections [...] skewed to the downside": the fast and large-scale monetary tightening, with policy rates around 5% in both the euro area and the US and expected to remain high for most part of next year (see Figure 1), could still trigger unintended consequences on financial markets, as well as among highly-indebted non-financial firms and households. The accruing rather than solving of geopolitical tensions, a further slowdown in a troubled Chinese economy, as well as the negative impact of climate change on economic activity pose considerable threats to the central OECD projections.

1, rue Viala – 75015 Paris
Tél. (33) 01 55 37 37 37 – tuac.org — @tuacoecd

Figure 1 – The sharp increase in monetary policy rates will be only gradually eased in time.

Policy interest rate for selected advanced economies



Source: OECD STEP 114 database; and OECD calculations.

While TUAC shares the concern about potential risks to the global economy, it finds that they are downplayed, leading to excessive -even if cautious- optimism and wrong policy conclusions on the part of the OECD: the Economic Outlook is adamant in calling for monetary policy "to remain restrictive until there are clear signs that underlying inflationary pressures are durably lowered", suggesting that "some additional rate rises could still be needed if underlying inflationary pressures prove very persistent". Yet, the OECD recognises that both headline inflation and core inflation are falling, mostly thanks to the large reversal in energy prices, with core inflation down to an annualised rate of approximately 3% in the US and Canada and 3.6% in the euro area (2023Q3). Disinflation is also quickly spreading throughout the economy, with the share of consumer price items experiencing more than 4% inflation dropping from 60% in January 2023 to 30 to 40% in the US, euro area and Japan.

Still, the Economic Outlook does not connect the dots, persistently ignoring that the sharp increase of policy rates across most countries is not the adequate tool to fight the supply-side roots of inflation. Admittedly, this was clear months ago, when the same set of recommendations were advanced in the September Interim OECD Economic Report. It is now becoming even more evident as core inflation falls.

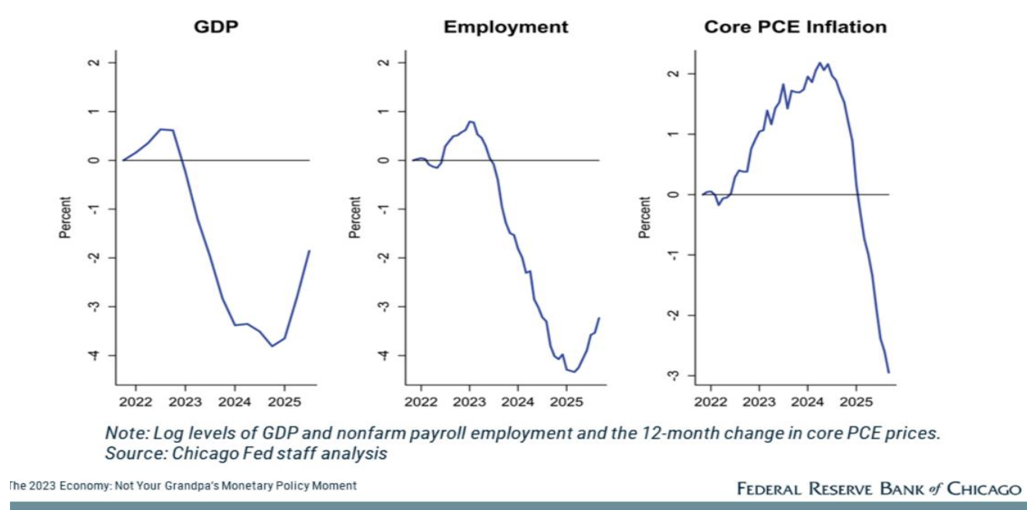
Delving into the cost factors of high inflation, the Economic Outlook treats wages and profits in a conspicuously different way. When it comes to wages, the argument is that higher wage growth, which is only reacting with delay to the substantial cuts purchasing power suffered over past quarters, will prevent inflation from falling more quickly. When it comes to profits, however, the argument is that they may have contributed to inflation in 2021-2022, but this "has started to decline" and that "firm-level studies do not indicate a generalised increase in mark-ups as inflation rose". Hence, "the experience to date does not point to a large structural shift in the distribution of national income toward firms".

Suggesting that wages are inflationary because they "are now catching up, pushing the labour share of income back up", is not consistent. Moreover, the OECD ignores the real counterfactual: if workers did not attempt to catch up some of the purchasing power lost, this would not mean that firms would automatically translate falling labour (and other input) costs into outright price declines. More likely it is that business would use the absence of robust wage demands to hike and expand profits again. The result would not be disinflationary but an even higher profit share.

In discussing potential risks related to monetary policy tightening, the OECD refers mostly to unintended shocks in financial markets and stress in leveraged and interest-sensitive sectors. Such concerns are legitimate, and worrisome. But they also relate to random events difficult to track and point in advance. The overshooting impact of interest rates in an already decelerating inflation scenario is, on the contrary, a widespread and sure feature of the period ahead of us. As TUAC's Ronald Janssen wrote, "by boosting disinflation at the wrong time, central banks will thrust the economy back into the 'lowflation' of the previous decade, when inflation remained too close to zero to be comfortable and central banks were unable to lift the economy out of this trap". Rather than restoring price stability, prolonged monetary tightening, whether at current or higher levels, is going to double down on decreasing inflation trends and consumption and investment levels leading to overshooting the price stability target and thus unnecessarily harming the real economy, beyond the minimal trim in growth rates projected by the OECD for 2024.

This risk is not to be underestimated. Recent work from the Federal Reserve Bank of Chicago confirms that the main impact of interest rate hikes to date (without taking the impact of quantitative tightening into account) on inflation is yet to come and would be as high as 3pp or even more, with corresponding negative effects on GDP and employment (see Figure 2). These results are in line with the overview of research of monetary time lags for the UK, the euro area, Canada, and the US. Most recently, Bundesbank President Joachim Nagel also shared the opinion that most of the contractionary impact from recent monetary tightening is yet to manifest.

Figure 2 – Lags in monetary policy response imply a significant GDP drop in the next two years.



Fiscal policy, again according to the OECD, should also be wound down further to remove pressure on price levels by decreasing aggregate demand in the aftermath of COVID-19, also considering mounting debt levels and the need to anticipate increasing pressures due to aging societies, rising defence expenditure and climate change. By suggesting that "stronger near-term efforts to rebuild fiscal space would enable policy to respond effectively to future shocks", the OECD Economic Outlook has not been so explicit in years in calling for austerity, marking a worrying return of a favourite measure of the early 2010s, one that deepened and prolonged the scars of the Global Financial Crisis.

If TUAC's concerns about the lagged impact of monetary restriction on demand and economic activity still that is still to show up are founded, a pro-cyclical fiscal tightening will give the *coup de grâce* to an anaemic economy, worsening debt-to-GDP ratios by widening cyclical deficits at the nominator level and undermining growth in the denominator.

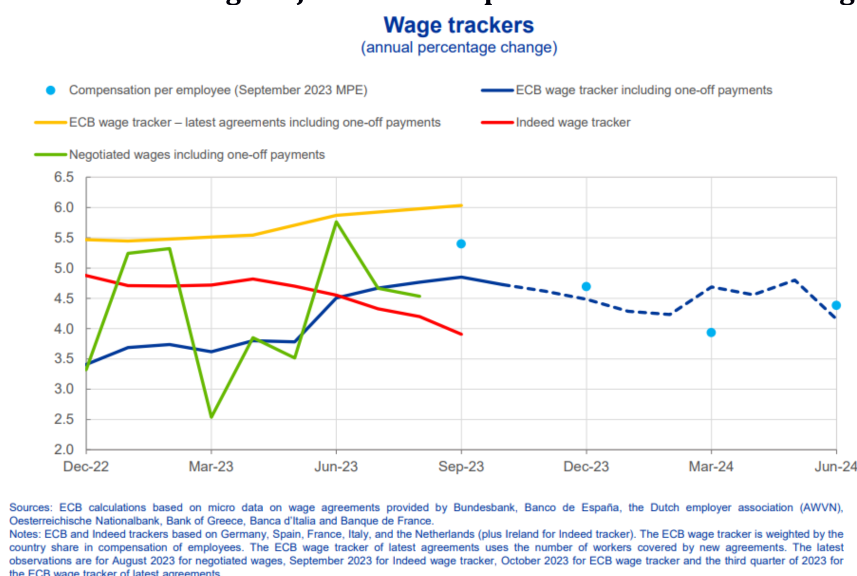
Currently, resilient consumption in the face of eroding real wages is the main engine keeping GDP growth running. Going forward and as inflation recedes, the Economic Outlook highlights that "the resulting increase in labour compensation is expected to sustain real private OECD-wide consumption growth of about 1.5% per annum on average during 2024-25". Yet, the Economic Outlook is on the other hand critical in saying that unit labour costs are contributing to prolonged inflation more than profits, slowing down the fall in prices, whereas the contribution of profits to inflation has started to decline (ignoring the possibility that profits can absorb wage increases without affecting price levels).

Tight labour markets have not prevented the fall in real wages, nor are currently pushing nominal wages to recoup ground beyond what was lost already. In the US, even with unemployment at record lows, nominal wage growth in private industry is decelerating – not accelerating - by a full pp, from 5.5% in June 2022 to 4.3% in September 2023. In particular, wages in the non-housing services (NHS)– where inflation is feared to be sticky - declined from a peak of 8% end 2022 to 4.1% in August – which is close to where pre-pandemic wage growth was.

In the UK nominal pay growth is elevated according to some measures, but the Bank of England is now aiming off the average earnings index. A real time measure shows median pay growth at 5.7 per cent in the year to September, and wage growth is expected "to decline in coming quarters."

In the euro area and in other countries where collective bargaining coverage is high, wages tend to react to a sudden burst of inflation over a prolonged period of time, with wage growth accelerating to allow some catching up with past inflation, decelerating again once real wages have been restored. ECB wage indicators tracking collective bargaining agreements show this process at work, with wage growth slowing down again in coming quarters (Figure 3).

Figure 3 – Upward nominal wage adjustment is expected to smooth in coming months.



Wage catching-up should not be confused with a wage-price spiral. It is not feeding inflation because temporarily stronger wage growth is: (1) absorbed by corporate profit shares falling again and (2) offset by global input prices falling at the same time. Nor it can be credibly argued that the combination of wage growth catching-up when global input prices are falling is slowing down the decline in inflation, as a likely alternative is one where firms maintain profit levels constant despite the decline in input costs, de facto increasing profit margins.

Overall, countries should be buckling up for a rough ride that is of their own making, by insisting on economic theories that are not reflected in the dynamics recorded in the real world, and for which workers will be once again the first to pay the price, facing the labour market consequences of a very much avoidable recession.