Trade Union
Advisory Committee
to the OECD

TUAC

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Comments on the OECD Economic Outlook – May 2024

The basic message from the OECD May 2024 economic forecasts is that the global economy has been resilient and that the outlook for growth is starting to brighten. Key policy priorities are to ensure a durable reduction in inflation, establish a budgetary path to address rising fiscal pressures and conduct reforms to strengthen sustainable and inclusive growth in the medium term.

These policy priorities come as little surprise, as they are part of the standard approach to macroeconomic policy. An approach whereby the power of fiscal policy and monetary policy to achieve real economy objectives, such as reaching full employment and investing in a new and green economy, are strictly conditioned on arbitrarily chosen financial criteria (2% inflation targets, 60% of GDP public debt ratios as in the Euro Area). By constraining both monetary and fiscal policy to pursue these financial objectives, policy makers often have little choice but to undertake questionable structural reforms that risk social cohesion while having no, or even damaging, long-term effects on the economy.

At the same time, a closer reading of the Outlook raises doubts about the wisdom of some of these conventional recommendations.

Restrictive monetary policy as a "key downside risk".

To ensure a durable reduction in inflation, the OECD insists on the need for monetary policy to remain "prudent". While the Outlook does admit that there is "scope" to reduce interest rates, the key message is that rates should still be kept at a level that restricts activity "for some time to come".

In practice, the OECD expects central banks to reduce interest rates by 50-basis points this year and another 100-basis points next year, bringing interest rates down from 5% currently to 3.5% (roughly speaking). However, a 50 or even a 150-basis point reduction pales compared to rates recently being hiked by 500 basis points. Spending and investment by economic agents facing maturing debt will still get squeezed significantly over the next years(s) as debt that dates from earlier years when interest rates were close to zero is replaced at much higher interest rates.

Hence, if growth remains "modest" in 2024 and 2025 (especially so in the Euro Area with just 0.5 - 0.7% expected growth), much is due to the enduring monetary restriction that is endorsed by the OECD.

At this point the Economic Outlook takes an interesting step by identifying the risk of a stronger than anticipated delayed impact of higher real interest rates as a "key downside" risk. The OECD - analysis describes in detail the different dangers in keeping monetary policy restrictive:

Up until now, economic actors were shielded from the effects of monetary tightening because of loans dating back to years when interest rates were exceptionally low. As debt

matures and is replaced by new borrowing, spending and investment of households, businesses and governments will be squeezed further by rising interest expenditure.

Quality of corporate debt has recently deteriorated significantly, implying weaker business sector resilience from higher interest rates. The OECD signals that bankruptcies continue to rise and exceed pre-pandemic levels in Canada, France, and the UK.

In this respect, this quote from the OECD in 2020 needs to be stressed : “Supported by a low-interest-rate environment, the mechanics of the credit rating system have allowed companies to increase their leverage ratios and still maintain a BBB rating, which has come to dominate the investment grade category. Over the last three years [2017-2019], BBB-rated bonds have made up 52% of all new investment grade bond issuance. As BBB is also the lowest rating in the investment grade category, the significance of the demarcation line between investment and non-investment grade bonds has become increasingly important. Absent the support of low interest rates or in the case of a business downturn, the same rating mechanics that allowed increased leverage will lead to downgrades that increase the borrowing costs for companies and limit their scope for investments.”

Rising bankruptcies and corporates missing debt payments could in turn result in severe credit losses for banks and other financial institutions. Combined with ongoing stress in real estate finance and duration risks on banks’ balance sheets (interest rates banks pay on short-term funding, exceeding the interest rate they receive on their existing investment portfolio), this would lead to banks tightening lending conditions to households and companies.

More broadly, financial market stability may become jeopardized by sharp corrections in bond and equity markets if market expectations of forthcoming policy rate cuts prove misplaced.

Interest rates in advanced economies remaining higher for longer than expected could trigger capital flows moving out of emerging markets, thereby causing currency depreciation and unsettling financial markets globally. Sixty percent of low-income countries are at risk of debt distress or already in it, with several facing interest rates more than 300 basis points above US interest rates.

There is more. Besides stressing these risks, the OECD argues that keeping monetary restriction in place may not even be necessary. One telling indication is the quote that “on a quarter-on-quarter seasonally adjusted basis G7 headline inflation was running at an annualized rate of 1.9% in the fourth quarter of 2023”. In other words, looking at more recent inflation dynamics (and not yearly rates which also reflect what happened to prices a year ago), main OECD economies have reached the price stability target.

More fundamentally, underlying the forecast is a scenario of nominal wage dynamics moderating but still allowing for real wages to gradually recover from past losses in the cost-of-living crisis, while declining unit costs, lower profit markups and stronger productivity growth push inflation further down. Not only is this different from the language used in previous Outlooks, when the OECD was insisting on a purely mathematical comparison between unit wage costs and the price stability target, but it is also in line with recent and forward-looking data on wage dynamics and profit shares and margins (as analysed here).

In the end, the Economic Outlook explicitly warns against “excessively” weakening growth and inflation undershooting the price stability target, a scenario that TUAC has been warning against for some time now .

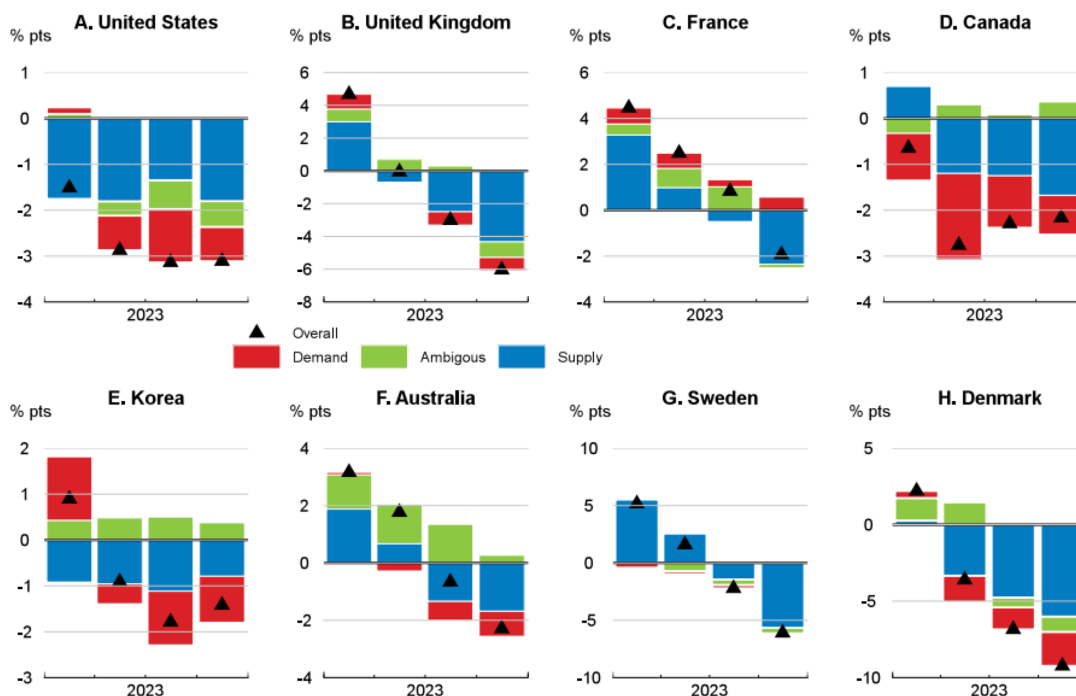
Was it a "supply side" problem after all?

Another striking development is the OECD nuancing the causes of inflation. Just a year ago, the OECD was adhering to the mainstream narrative of high inflation being driven by too much demand overheating the economy. This narrative puts central banks in the driving chair, justifying their policy to hike interest rates in order to get aggregate demand down by increasing unemployment and getting wages down. The current Outlook however acknowledges that the major decline in inflation observed over the past year "corresponds to an easing of supply-driven inflation (see figure below), while quoting research that finds core disinflation in the US (where overheating demand was supposed to be worse) was also primarily supply driven.

Unfortunately, the OECD does not the take the next logical step to raise the question whether it was a good idea after all to go for aggressive monetary restriction squeezing demand now that it turns out that inflation has been mainly driven by the supply side. At the same time, the analysis of inflation driven by supply is in line with the warning quoted above, of unnecessarily weakening growth and risking pushing inflation below the price stability target.

Figure 6. Supply factors account for the bulk of disinflation over the past year

Estimated contribution to year-on-year change in annual consumer price inflation



The OECD needs to move more.

Despite this critical language on the risks of monetary restriction and the real factors driving (dis)inflation, the Economic Outlook ultimately sticks to a conventional approach:

1) The OECD's ultimate policy recommendation is still to continue monetary restriction "for some time to come": The positive productivity, wages and profit developments that are expected to take place according to the OECD's forecast are not certain. Another scenario, with new supply shocks (shipping of energy through the Strait of Hormuz, extreme weather affecting key food supplies) and higher-than-expected dynamics of wages and profits margins keeping inflation "sticky" and above target, cannot be excluded. The OECD therefore recommends policy to take zero risk and stand firm on maintaining monetary restriction.

What the OECD overlooks is that uncertainty cuts both ways. In case the latter scenario of new inflationary shocks and trends takes hold, maintaining monetary restriction would indeed prevent inflation expectations from drifting upwards. The need to tighten the monetary screws even more and cause a recession to get inflation expectations back down would also be avoided.

But if the former scenario materializes and inflation settles down to target, keeping monetary restriction in place will prove to have been a big mistake as inflation is pushed down even further and below target. This is not a situation policy makers want to end up in either; as was the experience from the previous decade, once inflation slips below 2% and inflation expectations are de-anchored to the downside, moving inflation back up to the price stability target becomes hard as growth is unnecessarily weakened, households and businesses lose confidence to spend and invest, and the economy gets trapped in prolonged economic stagnation.

In other words, balance in policy recommendations when dealing with uncertainty around future inflation is needed. The OECD should acknowledge that the consequences of too restrictive monetary policy could be as bad as those of prematurely loosening the monetary stance. With climate change and geo-political tensions likely to increase the probability of more shocks and supply disruptions, a balanced approach to monetary policy will be required in future as well.

2) Stressing the urgency of fiscal austerity, the OECD focusses on central bank losses resulting from monetary tightening. The policy of hiking interest rates implies soaring interest expenses on the reserves held by commercial banks at the central bank. Losses incurred by central banks then result in halting the usual remittances payments that central banks transfer to governments, thereby adding to the public sector deficit.

The Economic Outlook describes this as a "technical" issue, but it is one with important implications. The reality is that central banks transfer massive amounts away from governments to remunerate banks. The figure below shows these transfers amount between 0.8 to 1% of GDP for the Euro Area and the US and are even close to 1.6% of GDP in the UK. Banks are receiving these funding "for free", that is to say with no conditions attached and are free to disburse these enormous windfall gains to their shareholders and CEOs.

The real and urgent policy problem behind this is not to squeeze public finances even more so that central banks can continue showering commercial banks with huge profits. The real policy issue is to review this measure of central banks remunerating commercial banks for the reserves they are holding, and combining this with imposing an excess-profit tax on banks.

Figure 22. Payments on reserves by central banks have risen substantially

Interest payments on central bank reserves

3) The OECD's overall take on fiscal policy remains problematic.

It is silent on the fact that combining continued monetary restriction with a fiscal policy tightening of 0.9% of potential GDP in 2024 and 2025 for the median OECD economy hampers economic performance and explains weak growth forecast (1.5 – 1.8% across the OECD).

Beyond the short term, the OECD argues in favour of overall spending restraint (with a special focus on pension and social spending!), together with higher indirect/environmental taxes in order "to improve debt sustainability" and "preserve the resources needed to support long-term growth and the climate transition".

However, resorting to austerity to mobilize the trillions of dollars of public investment[1] required to invest in the green economy and in geo-political security, including a rebuilding of more reliable supply chains, is a non-starter, as the challenges faced by OECD-economies are both urgent and huge. A new approach is necessary, in particular rethinking the traditional division of work between fiscal and monetary policy, allowing the latter to create the fiscal space needed to meet the vital investments required for the future of the economy.

[1] The global investment to implement the clean energy transition by 2030 alone is estimated by the IEA to be around 4 trillion dollars, with public investment a major part of that.