OECD ECONOMIC OUTLOOK No. 56

The attached release contains the introduction and selected tables from the OECD Economic Outlook No. 56. The Outlook appraises current trends and projections for the next two years.

A press conference on the OECD Economic Outlook No. 56 will be held at the OECD, 2 rue André Pascal, Paris 16e, at 10.45 a.m. on Tuesday 20th December.

The proceedings of the conference will, like the publication itself, be under embargo until Tuesday 20th December, 7 p.m. Paris Time.
INTRODUCTION

OECD economies have now come out of recession. A number of them have for some time been growing sufficiently rapidly to bring down unemployment. And, on the assumption of some increase in short-term interest rates over the next year or so, the OECD Secretariat projects steady growth, without a revival of inflation for the OECD area as a whole.

The challenge now facing policy makers is to sustain the current revival of non-inflationary growth and of employment as effectively as possible and to reduce the gap between aspirations for and realisation of economic and social well-being over the longer term. Meeting this challenge has three elements. First, it is crucial to consolidate trends towards price stability through prudent management of monetary policy, and to provide a stable environment for private-sector decision-making. Second, it is necessary to make the best possible use of this recovery phase for fiscal consolidation, going beyond the improvement in public finances resulting from the cyclical recovery and reducing the structural element of budget deficits. One important benefit of fiscal consolidation should be a greater amount of national savings to be made available for private investment at lower costs. Third, governments should take full advantage of the current cyclical improvement in economic conditions to move forward with the structural-reform agenda, in particular to promote efficiency in product and labour markets, while meeting domestic and international social (equity) objectives.

Setting monetary policy

It is difficult to establish firm benchmarks as to the timing and amount of policy tightening required to contain inflation pressures that may arise over the next year or two. Nevertheless, the following broad considerations for the orientation of monetary policy seem relevant:

-- In the United States, where the economy is now running at about capacity, it is not clear whether the degree of monetary tightening which has taken place so far is sufficient to ensure a "soft landing". Preparedness to apply further restraint would appear to be the best policy posture at this point in the business cycle, as the risks from remaining too restrictive for a short period are less than those of allowing inflation to re-ignite.

-- In the United Kingdom, Australia and New Zealand, where recoveries are fairly advanced, a process of monetary policy tightening is also under way. However, it is unclear that policies are yet sufficiently restrictive to ensure that inflation is kept low, even though output remains below capacity, because output is expanding rapidly. For the time being at least, there is a case for continuing with gradual
monetary tightening until clear evidence emerges that any tendency for these economies to overheat is being avoided. In the case of Canada, another country where recovery is fairly advanced, the orientation of monetary policy will be influenced by financial market concern about the process of fiscal consolidation as well as developments in US interest rates and in the exchange rate.

-- In Ireland and most Nordic countries, economies are also expanding strongly. Little inflation pressure is apparent in Ireland, Denmark or Norway. However, in Finland and Sweden, export sectors are experiencing high levels of demand which could have inflationary repercussions throughout the rest of their economies; monetary authorities have already moved to raise interest rates. All of these countries will need to be alert to the risk that any exchange-rate weakness could imply for inflation.

-- In most other continental European countries, the judgement appears to be more finely balanced. Recovery is becoming well established but capacity constraints do not appear likely to emerge in the near future. In Germany, which will have a key influence on European monetary policy more generally, inflation, while on a downward trend, is still somewhat higher than desired. This suggests that the scope for further easing is limited. On balance, this climate suggests no immediate case for a shift in policy, with risks, going into 1995, appearing fairly evenly balanced in both directions.

-- In Japan, the appropriate time for moving rates to an upward path appears to be some way off, given that inflation is virtually non-existent, banks’ balance sheets remain weak, further upward pressure on the yen would be unwelcome, and the economy is not yet growing fast enough to begin absorbing unused capacity.

A complication in the setting of monetary policy is concern about the possible adverse effects of the large increases in long-term interest rates since around the beginning of 1994. However, insofar as unexpected and nearly simultaneous increases in long-term interest rates across OECD countries can be associated with short-term prospects for OECD activity which have improved surprisingly rapidly since the beginning of the year -- particularly in continental Europe -- this is not a matter of disquiet. Furthermore, in many countries the current levels of "real" interest rates (i.e. nominal interest rates adjusted for inflation) do not appear to be significantly higher than the average over the period since 1980.

Nonetheless, the extent to which long-term interest rates have risen does point to underlying tensions. Some of the rise in nominal long-term interest rates is quite possibly due to a reassessment and upward revision of
private-sector inflation expectations. Market participants may not be as convinced as policy makers that present low rates of inflation will be sustained: a "credibility gap" may exist here. This gap can only be reduced or eliminated through a clear commitment of monetary authorities to consolidate the good price performance now evident in many OECD countries. This calls for an institutional framework conducive to sound monetary policy decision-making. In this regard, ensuring the credibility of inflation targets, by helping to make the actions of monetary authorities more transparent, may have an important role to play in many countries.

In some countries, there may also have been a market reassessment of the seriousness of the medium and longer-term outlook for public finances. It is notable that some of the largest rises in long-term rates in the course of 1994 have been in countries where public debt is high and there has been concern about the ability of governments to achieve a sustained reduction of budget deficits. Market reaction here may also be linked to the assessment of inflation expectations: concern may linger that policy makers could yield to the ever-present temptation to attempt debt reduction through inflation, thereby adding to risk premia embodied in long-term interest rates. Hence, a faster pace of fiscal consolidation, which would contribute to a higher level of national saving and tend to put downward pressure on interest rates, appears to be a crucial element in durably higher OECD growth.

Improving public finances

The average OECD general government deficit may narrow from a peak of 4 1/4 per cent of GDP in 1993 to below 3 per cent by 1996. Although much of this improvement will be "structural", reflecting progress in fiscal consolidation, the public-finance position will remain unsatisfactory in nearly all OECD countries. It is especially noteworthy that gross public debt as a percentage of GDP is likely to rise in virtually all OECD countries between 1993 and 1996. For the OECD as a whole, gross debt could increase from 68 per cent of GDP in 1993 to close to 75 per cent by 1996, and could be well above that average in Japan (nearly 90 per cent), Italy (over 120 per cent), Canada (over 95 per cent), Belgium (around 135 per cent), Greece (around 120 per cent) and Sweden (around 110 per cent). And, by the year 2000 public debt for the OECD as a whole should still be around current levels.

This medium-term outlook for public-sector financial positions strongly suggests that many countries need to review and strengthen their plans for fiscal consolidation. Furthermore, this outlook embodies sustained recovery and some falls in nominal long-term interest rates from their present levels. If these developments do not occur, average OECD public debt in the year 2000 would be significantly above current levels. In considering the appropriate degree of ambition to bring to fiscal consolidation, it should be noted that the Maastricht targets for EC countries are fairly modest: they should be seen as only a medium-term step on the longer-term road to sound public finances.
The specific measures to be taken to speed the pace of fiscal consolidation will need to be tailored to situations in individual countries, but governments in all countries will be concerned to take account of considerations of equity and the impact on living standards for low-income groups. In most cases, if not all, governments have recognised that the main effort will have to be made on the expenditure side. Increasing the overall level of taxation, which already creates significant distortions in most Member countries, could generally have strong negative side effects. As well, in making any changes on the tax side, care should be taken not to reverse the thrust of tax reforms that have been implemented in many OECD countries over the past decade or so -- given that these reforms were designed to put in place a tax structure more conducive to improved economic performance. Tax revenues will rise as economies recover, but it is important not to interpret this cyclical development as a permanent (structural) improvement in public finances. By the same token, it is also important to recognise that proceeds from privatisation, although helpful in reducing financing requirements in the short run or redeeming debts, are capital receipts, i.e. one-off financing items, that do not significantly improve the structural position.

On the expenditure side, however, reform confronts entrenched expectations and perceptions of acquired rights and implicit social contracts. Recent experience and OECD Secretariat work provide some pointers to the specific forms corrective action could take.

-- Whether or not it is possible -- or desirable -- to reduce the "output" that many government programmes and services deliver to the public, it may well be feasible to reduce the cost of such output, i.e. to improve "micro efficiency" in some areas. A good example of where such scope exists is health expenditure, an area in which major questions about the cost of services have been raised in many countries. More generally, the development of competitive environments in the public sector through recourse to market-type instruments such as user charging, market testing, contracting out and the creation of internal markets, has allowed for more cost effective provision of certain public services in a number of countries.

-- Pension liabilities are increasingly being recognised as a long-term problem. Many countries are now attempting to assess which of a range of policy choices might most effectively and most acceptably reduce the burden of future liabilities on public finances. Countries are considering policy responses including increasing the retirement age or the length of service required for full benefits, increasing contributions, reducing benefits and achieving (better) capitalisation.
Many analysts (including the OECD Secretariat in the recently published Jobs Study) have reached the conclusion that a range of social transfers are achieving their fundamental and legitimate objectives but only very inefficiently. In some cases policies are close to being counter-productive, such as when they create dependency traps. There would appear to be scope for re-examining how basic social objectives could be achieved while reducing overall budget costs.

**Improving employment and productivity performance**

The appropriate setting of macroeconomic policies provides the basis for improved economic performance over the longer term. However, assuring a sustained improvement in employment and productivity requires not only sound macroeconomic conditions, but also a broad range of structural reforms, including the creation of competitive and open markets. It is only when both macroeconomic and structural policies are set appropriately that the synergies between them are fully exploited. These synergies will be necessary if OECD economies are to sustain rising living standards and to be in a position to achieve social objectives more satisfactorily. Among the range of structural actions embodied in this task, the most urgent are arguably those that increase employment and reduce unemployment and those that reinforce the benefits from international trade.

**Employment policies.** A crucial area in which there has been inadequate progress is the implementation of structural reforms aimed at reducing unemployment to acceptable levels. The medium-term scenario presented below suggests that, on the basis of policies now in place and a full return to sustainable medium-term growth patterns, unemployment will still be unacceptably high in the year 2000 in most OECD countries; for OECD Europe as a whole it could still average close to 10 per cent. The structural reforms to address this problem, identified in the OECD Jobs Study, need to cover both product and labour markets in order to strengthen the capacity of economies in OECD countries to adapt to changing conditions, to improve productivity performance and to generate more new jobs. Many measures to improve productivity and product market performance, such as those which would enhance the development and diffusion of technological know-how and remove impediments to the creation and expansion of enterprises, will also contribute to economic conditions which are favourable to job creation. Others, however, such as exposing sheltered industries to greater competition may lead to a labour shake-out and higher unemployment in the short term. This adds to the importance of measures to improve the way labour markets operate in an effort to make early progress in reducing unemployment on a durable basis.

In changing policies so as to improve the functioning of labour markets and thereby boost employment, policy makers will also be concerned that legitimate social objectives are not undermined. In this connection, the focus
may differ depending on the policy being assessed. For the purposes of taxation and means-testing for the payment of unemployment benefits, treating individuals separately from their family circumstances may be necessary to reduce the risks of poverty traps or of discouraging people from entering the labour force. However, for a number of other purposes for which it is thought to be important to assess whether or not social objectives are being achieved, the focus should be on household incomes rather more than on wages of individuals. Situations in which low wages are earned by members of households with adequate income overall are not necessarily inconsistent with the equity objectives. This is especially the case if the low-wage jobs are the first jobs in the working life of the persons involved, allowing them to gain work experience and to obtain a foothold on the job ladder, thereby helping to provide the basis for moving up the ladder to higher-paid employment.

Trade policy. The conclusion of the Uruguay Round and the coming transformation of the General Agreement on Tariffs and Trade into the World Trade Organisation are potentially very positive events for the world economy. However, this potential will be realised only if the agreements are ratified, which a number of key parties to the agreement had not yet done at the time this Introduction was written. Hence, the most important and urgent item on the trade policy agenda is this ratification.

On the assumption that ratification takes place, the progressive implementation of the commitments in the Final Act and the important built-in agenda for further negotiations (inter alia on services and agriculture) should keep up the trade liberalisation momentum. Under this new policy framework and with ongoing structural change in the international economy, some new trade issues have acquired prominence. Broadly speaking these issues can be placed in two groups.

First, international differences in business practices and in policies which affect them (public procurement, competition and other aspects of business policy, openness to foreign investment and technology policy) can impinge on international trade in ways that are perceived to be "unfair". Even though these differences have narrowed, many issues remain to be resolved. International agreements to harmonise the legal and regulatory framework in which businesses operate can address this problem by eliminating divergences which work to the advantage or disadvantage of businesses in particular countries. However, it is important to bear in mind that a framework which minimises the amount of change that is required in many countries is not necessarily the best. The challenge for governments is to achieve a consensus on where harmonisation would be helpful and, in such cases, to identify a set of rules that will increase the contestability of the markets concerned.

Second, pressures are increasing to use trade policy to further other policy objectives, in particular those relating to labour standards and the environment. It would clearly be inappropriate to use restrictive trade
policies to offset the effect of lower wages, as this would deny the benefits of comparative advantage to both the developed and the developing world. On the other hand, there may be a small set of "core" labour standards based on fundamental human and civil rights -- though the International Labour Organisation has been unable to date to agree on which of many conventions would constitute such a set -- which prohibit practices, such as forced labour, that the international community finds unacceptable. Pressures are also increasing to use trade policy to further environmental objectives. It may take time to reach consensus on areas of disagreement, including on free rider problems in the context of global environmental agreements. However, it is important that governments find a multilateral approach which ensures that these issues are not used as a pretext for protectionist practices.

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Journalists may obtain a copy of the report from the OECD Press Division, 2 rue André Pascal, 75775 Paris cedex 16 (tel. 45 24 80 88 or 80 89 - fax. 45 24 80 03).

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