OECD ECONOMIC OUTLOOK No. 55

The attached release contains the introduction and selected tables from the OECD Economic Outlook No. 55. The Outlook appraises current trends and projections for the next 18 months.

A press conference on the OECD Economic Outlook No. 55 will be held at the OECD, 2 rue André Pascal, Paris 16e, at 10.45 a.m. on Thursday 30th June.

The proceedings of the conference will, like the publication itself, be under embargo until Thursday 30th June, 7 p.m. Paris Time.
INTRODUCTION

The outlook

Economic growth in the OECD area as a whole is steadily gathering strength. OECD activity could expand by over 2\(\frac{1}{2}\) per cent in 1994 and close to 3 per cent in 1995. Where recoveries are well established (North America, the United Kingdom, Australia and New Zealand), output continues growing at a healthy pace, and unemployment is falling. Recovery is becoming apparent in an increasing number of continental European countries. For continental Europe as a whole, however, the pick-up of domestic demand is modest; and, despite a significant boost from net exports, GDP growth is unlikely to be sufficient to reduce the unemployment rate until 1995. In Japan, recent indicators are encouraging. Domestic demand should strengthen progressively this year and could expand relatively rapidly next; output growth in Japan will nonetheless probably remain weak because of a continued decline in net exports due to the appreciation of the yen. Inflation is projected to remain low, declining somewhat in Europe and picking up slightly in North America.

Recovery must be sustained; this is not the time for any relaxation of policy effort. Attention should be concentrated on ensuring that the longer-term setting of policy is aimed effectively at achieving fundamental economic and social goals.

A growth-oriented approach to longer-term policy setting

OECD economies must expand more rapidly than over the past two decades if they are again to become high-employment societies with steadily-rising national living standards. The challenge is to raise economies' capacity to grow, i.e. their "supply potential". Individual aspirations for high living standards and agreed social needs are such that there is no basic secular deficiency of demand in OECD countries, even though there may be periods in which effective demand is cyclically weak. However, growth-inhibiting rigidities have increased considerably over the past two decades or so, making the OECD recovery more inflation-prone. The ways in which most OECD countries sought to extend and deepen social protection have played an important role in this respect. Increasing inflexibility has weakened the pace at which output potential and overall living standards could rise, making it increasingly difficult to achieve social goals, and contributing significantly to rising unemployment.

Faster growth of output and productivity economy-wide, as well as high employment, would provide the economic basis for improved social cohesion. Achievement of these goals requires appropriate macroeconomic and structural policies. A common element in both sets of policies is the provision of a framework in which economic agents have the greatest possible scope and incentive -- and also the ability -- to innovate, adapt and work.
Experience over the post-war period shows that macroeconomic policy has an asymmetric influence. While bad macroeconomic policy always results in bad economic performance, good macroeconomic policy does not, by itself, guarantee good overall economic performance. It must be combined with structural policy reforms if fundamental goals of a sustained expansion of living standards with much lower unemployment are to be achieved.

The key elements of "good" macroeconomic policy are:

-- Improving public finances. Budget deficits have weighed increasingly adversely on economic performance by pre-empting national saving, raising interest rates through the build-up of public debt and impeding private-sector investment. Continuing efforts towards fiscal consolidation should set the stage for sound public finances consistent with better overall economic performance over the longer term. The greater scrutiny of public expenditure, aimed at improving its quality, will also support better performance. As economies recover, it is important to take the crucial lesson from recent history and avoid the temptation to relax the commitment to an underlying improvement in public finances as deficits fall in response to strengthening activity.

-- Keeping inflation under control. Most OECD countries have achieved low inflation or effective price stability. It is essential to build on this to establish firmly the credibility of policy geared to maintaining price stability over the longer term. With inflation uncertainty eliminated, investors and consumers can take decisions in a context of clear relative price signals. This will contribute to the efficient allocation of resources.

-- Ensuring coherence of fiscal and monetary policies. It is particularly important to avoid a situation in which monetary policy, aiming at the objective of underpinning price stability, is overburdened because of an inconsistent fiscal-policy setting. Moreover, even with coherent, appropriately set macroeconomic policies, patience is typically required because it takes time to unwind imbalances. Trying to force the pace, via macroeconomic stimulus beyond the adaptive capacity of the economy, would only be counterproductive.

-- Achieving consistency of policies and the exchange-rate regime. Within essentially fixed exchange-rate systems, appropriate macroeconomic policies must be supported by structural policies. These should aim to ensure that wage and price adjustments provide sufficient flexibility in responding to shocks to make commitments to fixed exchange rates credible and viable. Where exchange rates are floating, currency movements resulting from divergent monetary policy actions that are appropriate domestically should be accepted, so long as they remain within reasonable limits.
Supporting macroeconomic policy with a further liberalisation of the multilateral trading system. Governments must be seen to be engaging in co-operative efforts to ensure that the implementation of macroeconomic policies does not lead to tensions, not only in the exchange markets but also in trade matters, to avoid undermining business and consumer confidence. It is particularly important that the Marrakesh agreement, which concluded the Uruguay Round negotiations, be implemented fully and rapidly.

Actions to reduce unemployment significantly have been reviewed extensively by the OECD Secretariat in carrying out the mandate received from Ministers in 1992 to examine the reasons for and the remedies to the disappointing progress in dealing with unemployment. A synthesis of this work, presented to Ministers and published under the title "The OECD Jobs Study", is presented immediately following this introduction. Although the structural-reform recommendations focus on unemployment, many of them would help to improve economic performance more generally.

Macroeconomic policy requirements in the current situation

During the recent downturn, general government budget positions weakened by the equivalent of 3 per cent of GDP on average in the OECD area. While the deterioration was partly due to the recession, a third to a half appears to have been structural. OECD governments recognise the need for action to restore balance to public finances, and most countries have embarked on medium-term programmes to reduce deficits. There has been a steady tightening of fiscal stance throughout the OECD area since last year, the notable exception being Japan, and budget positions should improve as recoveries become established in more countries.

There are no grounds for complacency. If the recovery is sustained at an average annual growth rate of 2½ to 3 per cent over the remainder of the decade, implementation of present plans is likely to narrow general government deficits significantly, perhaps to between 1 and 2 per cent of GDP in 2000. However, this would be sufficient only to stabilise gross public debt relative to GDP during the period to the end of the century, and in most countries at very high levels: some 70 to 75 per cent for the OECD as a whole, compared with below 60 per cent in the late 1980s. Furthermore, were there significant slippage in implementing consolidation programmes, or were growth not sustained, the situation could be substantially worse. Only slightly lower growth -- by half a percentage point per year -- could lead to debt levels in 2000 averaging close to 85 per cent of GDP.

With the room for manoeuvre on fiscal policy severely circumscribed, monetary easing has been the motor of OECD economic recovery -- although a series of fiscal stimuli have also been adopted by Japan. Short-term interest rates fell significantly from the peaks in the late 1980s or early 1990s to more recent troughs (or most recent observations): by 6 to 7 percentage points in the United States and Japan; by around 5 to 10 percentage points in most
continental European countries; and by around 10 percentage points or more in the United Kingdom, Canada, Australia, Finland and New Zealand. Peak-to-trough falls in long-term interest rates, although smaller, have also been substantial.

More recently, however, long-term interest rates have risen across countries. This started in the United States in October last year, in Japan in early January, and followed in most other countries from the end of January. Policy implications depend on the relative importance attached to different causes of these developments:

-- Insofar as the rise in long-term interest rates reflects an improvement in long-run growth expectations and higher expected returns on business investment over time, it may have no special implications for policy.

-- Insofar as it reflects an increase in inflation expectations or a slippage in the pace of fiscal consolidation and the prospect of higher public debt relative to national and global saving, a firmer hand on the relevant policy lever -- monetary or fiscal -- is called for.

-- Insofar as it reflects the perception of higher risks involved in long-term financial investments associated with greater uncertainty about the future course of domestic or external policies, there may be a need to articulate policy intentions more effectively in order to stabilise the expectations of domestic and international investors in bond markets.

-- Insofar as the earlier declines and recent increases in bond yields reflect short-run erratic and reversible factors and have been taken by corporate and other borrowers as such, this would not affect economic activity, and hence would not require policy response. To the extent that the earlier decline in long-term interest rates had begun to be built into real economic decisions by prospective borrowers, the reversal could inhibit recovery and thus could call for a relatively easier stance of monetary policy (i.e. less rapid tightening or greater easing than earlier envisaged), if this could be achieved without additional upward pressure on long-term rates.

These considerations, together with the implications of different cyclical positions among major countries, point to differing policy requirements.

-- The United States, where recovery is relatively strong and the margin of spare capacity is possibly the least of all OECD countries, has already begun to move to the more "neutral" monetary policy stance necessary to guard against inflation pressures that would otherwise threaten sustained recovery. Continuing efforts to convince the markets of the monetary authorities’ readiness to adjust the monetary
policy stance as necessary to keep inflation under control could contribute to the stability of market conditions and help to sustain non-inflationary growth.

-- In other countries where recoveries are under way, margins of spare capacity are larger than in the United States, but the forces which have led to tighter monetary conditions there are likely to come increasingly into play.

-- In countries where activity is still weak, easy monetary conditions should be maintained. Further cuts in short-term interest rates could be envisaged, depending on how weak recovery is likely to be, how inflation prospects are viewed and whether it is judged that action on short-term interest rates can be taken without increasing the pressure on long-term interest rates.

In all countries, insofar as real long-term interest rates are considered to be too high, the solution is more likely to be found in more ambitious reduction of budget deficits.

13 June 1994

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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"OECD Economic Outlook No. 55"
OECD, Paris, June 1994
France only: FF125 All other countries: FF160; US$27; DM49
ISBN 92-64-14103-0 (12 94 55 1)
Available from the OECD Publications Distributors - see attached list.