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OECD ECONOMIC OUTLOOK No. 48

• The attached release contains a summary and tables from the OECD Economic Outlook No. 48. The Outlook appraises current trends and projections for the next two years.

A press conference on the OECD Economic Outlook No. 48
will be held at the OECD, Room 2, 19 rue de Franqueville, Paris 16e,
at 10.45 a.m. on Thursday 20th December.
The proceedings of the conference will, like the publication itself,
be under embargo until Thursday 20th December, 20.00 hrs Paris time.

SUMMARY

Staying the Course

The economic situation has changed substantially in the course of 1990. Despite the boost to activity from German unification, growth in the OECD area was slowing by mid-year, notably in several of the major economies where inflationary pressures have nonetheless remained strong. More recently, the sharp rise in the price of oil has worsened the short-term prospects both for growth and for inflation. This does not, however, call for any fundamental change in the agreed policy orientations: setting monetary policy firmly against inflation, moving ahead with reduction of budget deficits and stepping up the pace of structural reform, especially in the context of the Uruguay Round.

The current economic situation and outlook

While OECD activity remained strong on average during 1990, differences have become more accentuated between the buoyancy of activity in some countries, notably Japan and western Germany, and its weakness in a number of others, including the United States. At the same time, inflation remains under control in western Germany and Japan but is relatively high in the United States. The weakness of the dollar is contributing to inflationary pressures in the United States, though it will support exports and activity and help sustain external adjustment. Financial-market developments in the OECD area have been disquieting: equity prices have plunged and market-determined interest rates have risen in many countries, only in part because of concerns about the Gulf situation; fragility persists in some sectors of U.S. financial markets where banks are limiting credit to certain classes of borrowers; and questions have arisen about banks' balance sheets in Japan, in particular against the background of the sharp falls in equity prices. Budget deficits in both the United States and Germany will be greater than had earlier seemed likely.

These developments, together with the effects of higher oil prices, have led to a less favourable view of the short-term economic outlook than before the summer: inflation is likely to be higher and output weaker. The projections presented here are based on the assumption of no change in the real price of imported oil from the $27 per barrel estimated for the second half of 1990 (equivalent to a spot price of Brent crude of $29 to $30 per barrel). Two important judgements underlying the projections are that policy reacts firmly to the rise in oil prices, so as to contain inflation, and that private-sector confidence is broadly sustained, notwithstanding the unwelcome developments in oil and financial markets.

To the extent that these assumptions are met, difficulties associated with the oil-price increase should prove to be only temporary. OECD activity could expand by 2 per cent in 1991, picking up to 2 1/2 per cent in 1992; unemployment could increase from 6 1/4 per cent of the labour force in the first half of 1990 to almost 7 per cent in 1992. OECD consumer-price inflation is likely to rise to 6 per cent at an annual rate in the first half of 1991, with the rate of increase in the GNP deflator peaking at just over 5 per cent. But as pressure on productive capacity eases, inflation on both measures could then fall back to 4 to 4 1/2 per cent by the second half of 1992.

Most non-OECD countries will face higher oil import bills; all will be affected by higher interest rates and slower growth of export markets in OECD countries; some will be hurt by the loss of workers' remittances from Kuwait and Iraq. In central and eastern Europe, energy and related problems will further worsen the short-term prospects of countries attempting to transform their economies.

What are the main risks to the outlook?

The main risks in the present situation would appear to lie largely on the downside, quite apart from risks emanating from possible events in the Gulf. The projections embody the judgement that financial-market and oil-market developments have not weakened private-sector confidence to the extent of inducing a sharp fall in business investment or a rise in precautionary saving by households. Confidence has nonetheless become more fragile; policy-makers must play an important role in nurturing it, by responding in a way that prevents the initial boost to prices becoming embedded in a wage/price spiral. If oil prices were to rise further, the task of policy in containing inflation and supporting confidence would be harder. If, on the other hand, the oil price declined towards pre-crisis levels, the risks would be reduced and the outlook could be better than that depicted here.

In these projections, the oil-price "shock" passes through OECD economies rapidly and does much less damage than the shocks of 1973-74 and 1979. This reflects several factors (which are elaborated in the special chapter, Macroeconomic Effects of Energy-Market Developments):

-- the oil-price increase is substantially smaller this time;

-- the exposure of OECD economies (in terms of energy use, and especially oil use, per unit of GNP) has fallen significantly since 1973;

-- structural reforms undertaken in the 1980s, in particular those which reduced rigidities in labour markets and increased competition in product markets, have strengthened the capacity of OECD economies to adjust to a relative-price shock without adding permanently to inflation; and

-- in setting policy, governments are drawing on the lessons learned from the two earlier oil shocks, including allowing a full pass-through to energy users of the rise in oil prices.

Nonetheless, there is a risk that adjustment will not take place as smoothly or as rapidly as projected.

Exchange-market developments could again become a source of concern if current trends persisted. It is true that the decline in the dollar in recent months will serve to strengthen the competitiveness of U.S. exports, contributing to the continued buoyancy of exports which underpins the recovery foreseen for the U.S. economy in 1991. However, dollar depreciation also puts pressure on U.S. inflation, which remains high. If the dollar were to decline much further, thereby accentuating inflationary pressures in the United States, monetary policy could be faced with a familiar dilemma, which is taken up below.

What response is called for from macroeconomic policies in the present situation?

The question of how policies should respond cannot be reduced to one of the appropriate response to an oil-price increase alone because, as noted above, other important changes have also occurred. In any case, the fundamental imperatives for monetary and fiscal policy have not changed. What is highlighted by the current circumstances of higher inflation and weaker activity is the need for more effective action across the full range of policies.

Monetary policy is clearly in the front line in the fight to contain an increase in underlying inflation rates. Nonetheless, in a number of countries, and in particular the United States, the burden on monetary policy (and the pressure on interest rates) could be reduced by a more rapid and determined reduction of budget deficits. Achieving visible progress here has become more difficult: slower growth will be reflected in lower tax revenue than would otherwise have been the case, while expenditure will be raised by higher interest rates and increased payments associated with higher unemployment. However, while automatic stabilisers should be left to function, greater difficulties should not be translated into less ambition over the improvement of structural budget positions. The example of countries which achieved good balance between monetary and fiscal policy in the 1980s seems compelling. Among the largest, Japan, western Germany and France, which have had the greatest success in the medium-term management of macroeconomic policy, seem best placed to weather a stormier economic climate. For Germany, this includes the need to absorb the major budgetary "shock" of unification: the public sector borrowing requirement is estimated to have run at some 4 per cent of GNP in 1990 and is expected to increase to over 5 per cent in 1991, before declining over the medium term.

In the United States, the recent budget agreement was reached against a background of a reversal of previous progress in deficit reduction: the Federal budget deficit for Fiscal Year 1990 (FY1990), which ended on 30th September, was much larger than projected earlier, and it was estimated that, in FY1991, the deficit could exceed the Gramm-Rudman-Hollings (GRH) targets by at least $100 billion, and perhaps significantly more. The new agreement will substantially strengthen control over public expenditure, and it is also noteworthy in that the Social Security surplus is now excluded in the calculation of the GRH targets. Nonetheless, the Federal government deficit is likely to remain large for several years. The OECD Secretariat estimates that in FY1991 it is likely to run at close to $250 billion on the new GRH definition (equivalent to around $175 billion on the old basis), and that it could well widen in FY1992.

The importance of firm fiscal action is underlined by the possibility that tensions may arise in the implementation of monetary policy across the three largest countries. In Japan and western Germany, where activity is strong, a tightening of monetary policy to choke off the extra inflationary impulse arising from higher oil prices poses relatively few problems for the authorities. In addition, the oil-price impact in these countries will be muted by the appreciation in recent months of their exchange rates vis-à-vis the dollar. In the United States, on the other hand, a higher initial rate of inflation will be boosted by the oil-price rise; by the relatively greater exposure of the U.S. economy to such a shock; and by the depreciation of the dollar. Hence, the United States is likely to have the greatest need among the three major countries to set policy firmly against the boost to inflation -- and this situation would be aggravated if the dollar continued to weaken. However, activity is weak in the United States and there are also concerns about financial-market fragility. The experience of the 1980s nevertheless suggests that, if stagflation does emerge as a problem, taking vigorous action against inflation would be the surest way to restore a healthy economic climate and conditions for a revival of growth.

What is the most effective way to cope with financial-market fragility?

Fragility in certain sectors of financial markets has raised the question of how best to maintain the integrity and safety of the financial system while allowing competition and efficiency to develop fully. Prudential problems have emerged in the process of liberalisation of financial markets because of increased incentives to take risks, reinforced to some extent by the specific way in which deposit insurance and investor guarantees have operated. These problems have arisen mostly because regulatory changes have not kept pace with liberalisation, or because incomplete deregulation in some areas has not in fact established a "level playing field" for different categories of financial institutions.

Minimising the risks of financial fragility over the medium term, while sustaining liberalised financial markets, calls for action along the following lines: i) clear indications that monetary conditions would be eased and lender-of-last-resort facilities used only in the face of a systemic threat; ii) greater conditionality in deposit insurance and investor guarantees; iii) clearer accounting standards together with implementation of uniform, well-designed capital-adequacy guidelines; and iv) unified supervisory bodies -- as well as improved co-operation and harmonisation at the international level -- in order to avoid relatively risky financial activities being moved to the point of least supervision.

What are the most pressing priorities of structural reform?

Recent events have underlined the need for economies to be flexible in order to adjust rapidly to disturbances in product, labour and financial markets. It is therefore all the more important to maintain the momentum of structural reform.

This applies particularly to issues of trade policy, both in and beyond the Uruguay Round. Trade policy impinges on virtually every area of structural reform, since freer trade stimulates competition and promotes the efficient functioning of all elements of the economic system: hence the importance of clear progress on the large number of issues covered in the Round. Looking ahead, trade policies must be kept as one of the priorities on the structural reform agenda beyond the conclusion of the negotiations. And further progress should not be confined to the unfinished business of the Round. There is an urgent need to consider how issues addressed in bilateral negotiations and understandings, such as those in the Structural Impediments Initiative talks between the United States and Japan, can be brought into a multilateral context.

The major problems experienced in the Uruguay Round have underlined the difficulties that arise in reaching international agreement on a wide-ranging package of trade liberalisation measures. These difficulties arise not only from vested interests but also from public perceptions that freer trade will not, in all cases, allow domestic and foreign suppliers access to markets on an equal footing. Nevertheless, the broad direction in which OECD trade policies should be moving is clear. Within national economies, and in wider trading areas such as the European Community, it is accepted that market outcomes should be determined by competitive processes, and that free competition among enterprises should be the rule. In most OECD countries, however, there are wide areas of the economy in which competition from foreign enterprises has been blunted or shut out through the use of instruments such as import quotas, so-called voluntary export restraint agreements, safeguard measures, variable import levies, and anti-dumping actions. A systematic review of such instruments is called for, to ensure that internal and external policies are directed towards the same ends.

Progress on trade policy also needs to be flanked by advances in, and greater co-ordination with, competition and mergers policy. With firms competing more intensively across national boundaries, the nature and extent of differences in competition policy across countries has become contentious, as is shown by the discussion of mergers policy within the European Community. Competition policy has to ensure that markets can be contested and that abuse of dominant market positions is prevented.

It is just as important to maintain the momentum of structural reform in labour markets as in product markets in order to ensure satisfactory growth of employment and a reduction in rates of unemployment. The OECD unemployment rate is now rising again after falling for six consecutive years; in many countries unemployment rates are currently above those at the cyclical peak of 1978-79. With little scope for lowering unemployment through expansionary demand policies, the main action must be through structural reform. OECD countries have begun to draw on the lessons of the past two decades by reorienting labour market policies away from "passive" income maintenance to "active" measures, so as to help the jobless find work. This must be reinforced by education and training systems which both provide a high-quality start for entrants into the labour force and facilitate rapid adaptation by the work force to structural change.

How can environmental concerns and economic policy best be integrated?

Because of the increasing awareness of the extent of environmental problems and the global scale of some of them, there is now greater recognition that environmental objectives need to be achieved in least-cost ways, in particular by applying economic criteria to environmental problems. The acceptance that economic instruments will often lead to more efficient outcomes than the regulatory approaches typically adopted hitherto needs to be translated into wider application. In this respect, a fuller assessment of the economic costs of regulation, often neglected in the pursuit of tighter environmental standards, is important. Economic instruments, which take advantage of market mechanisms rather than disregarding them, can be particularly effective in dealing with the externalities that lie at the heart of many environmental problems, because they provide the incentives to households and firms that help to ensure a more efficient allocation of resources.

The need to integrate environmental with economic policy is not limited to areas of market failure related to private-sector activity. Often well-identified environmental problems are aggravated by government intervention in the pursuit of sectoral policies: classic examples are to be found in the agriculture, energy and transport sectors, where government involvement has usually been rather extensive. Assistance to agriculture, not only has a high macroeconomic cost, but may also conflict with environmental objectives by, for example, encouraging the use of fertilisers and pesticides which raise the intensity of production but cause environmental damage. Hence the economic arguments for eliminating such assistance are reinforced by environmental considerations. Similarly, in energy and transport, government policies have often encouraged choices by the private sector that are damaging to the environment.

Recent events in the Gulf serve to make more evident the link between environmental, energy and macroeconomic policies. In particular, they underline the point that levies adopted to encourage greater energy efficiency for environmental reasons would also decrease energy dependence, reducing the potential macroeconomic consequences of disturbances to energy supplies.

How are central and eastern European economies coping with the process of transition to market economies?

Recent developments in the world economy have in general served to put even greater pressure on the economies of central and eastern Europe as they attempt the transformation to market economies. The slowdown in the world economy, the rise in interest rates and, in particular, higher oil prices make for a more difficult economic environment in which to pursue the sort of restructuring on which these countries are now embarked.

In several of the central and eastern European economies, a reform process has started. Steps have been taken to reduce macroeconomic imbalances. Budget deficits have been cut and monetary control is being restored. Incentives to greater efficiency have been improved through more realistic prices -- including interest rates and exchange rates. And competition has been enhanced through liberalisation of imports. Nonetheless, it is clear that effective transformation is very much a medium-term process: output declined in all these countries in 1990 and, is likely, at best, to stabilise in 1991, while inflation remains a widespread problem. In the Soviet Union, specific reform measures have not yet been agreed, let alone implemented. At the same time, Soviet output is falling, inflation is accelerating and, despite substantial terms-of-trade gains from the oil-price increase, the trade balance could deteriorate. Oil production is falling, so that a sharp reduction in the volume of oil exports is projected; and while non-oil exports are likely to stagnate, imports seem set to continue to rise rapidly.

Alongside the process of evolution towards a market economy, central and eastern European countries also have to deal with immense environmental problems -- and in doing so, to find ways in which economic factors can be fully brought to bear. As moves are made to a market-oriented system, the opportunity should be taken to use economic instruments wherever relevant to deal with environmental problems. In respect of cleaning up past environmental damage, the efforts of OECD countries to aid these economies should include help and advice on establishing environmental programmes.

A major positive contribution which OECD countries can make to the process of economic reform is to establish more open markets. Restricting market access to exports from central and eastern European countries would serve to blunt the effects of necessary structural reforms in these countries, and could even threaten the reform process itself. Here, as elsewhere, more liberal trade policies would contribute to a more stable as well as a more prosperous world.

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• •••••• 30 November 1990

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 87).

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