Evolving Paradigms in Economic Policy Making

An analysis of OECD’s Economic Outlook

What is OECD?

- OECD is the Organization for Economic Co-operation and Development
- Founded in 1961
- 36 member countries
- Annual budget of 374 million euros
- 2500 employees worldwide
- 250 publications per year

Methods used for investigation

Conduct economic surveys

What paradigm is adopted?

What relation does this paradigm have with the macroeconomic responses of that period?

A brief history

Testing the limits of demand management (1960's and 1970's)

1960’s

- Policy conditioned by Bretton Woods System of fixed exchange rates.
- Three significant results from meeting:
  - World Bank
  - International Monetary Fund (IMF)
  - Stabilising currency exchange rates

1960’s

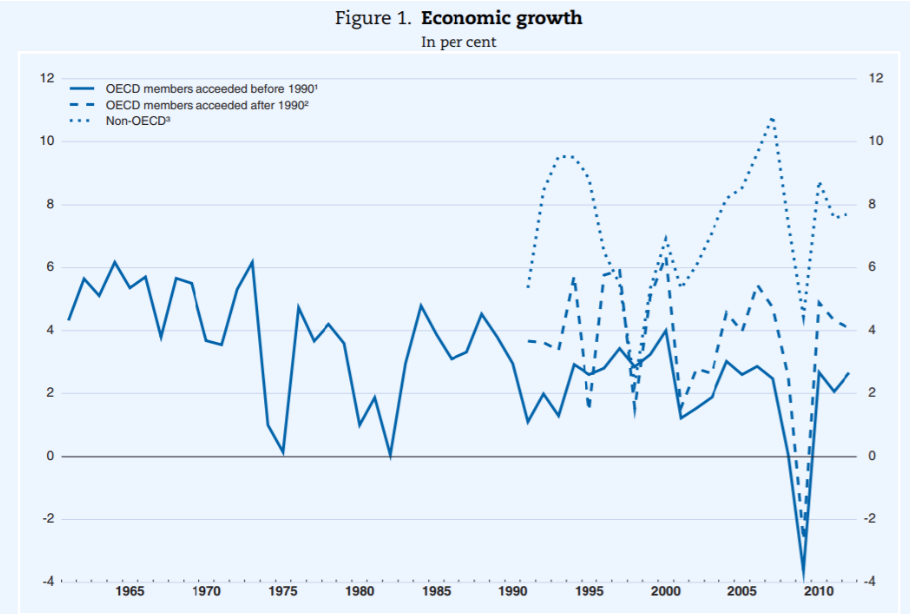
- Dominated by demand management policies
- Fiscal and monetary policy instruments to:

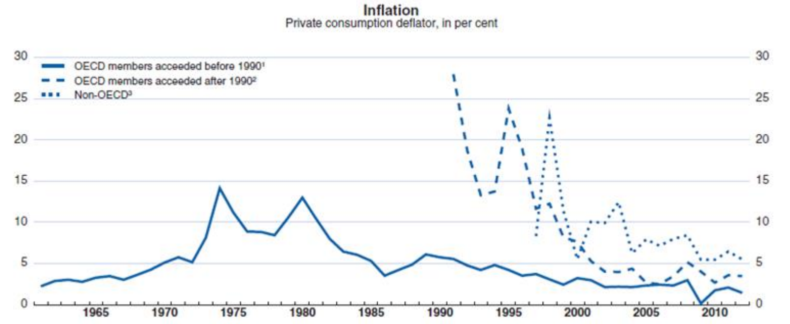
  – keep unemployment low

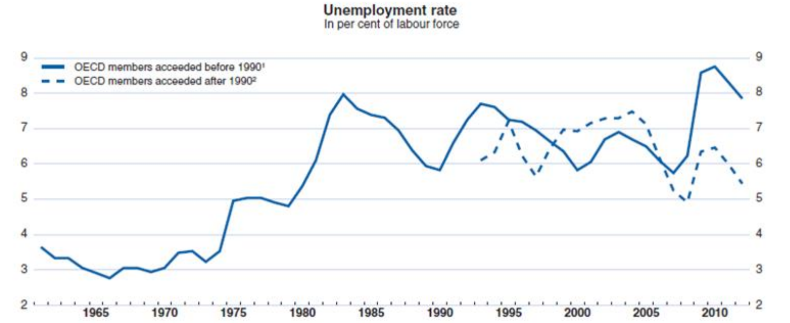
  – keep low inflation

  – prevent unsustainable current account imbalances

- The 1960's was a period of rapid OECD growth, stable inflation and full employment.







1970’s

- Pressure from international capital flows led to a series of policy actions, such as exchange rate re-alignments.
- 1973- generalised floating of exchange rates
- 1979- European Community launched the European Monetary System (EMS) of quasi-fixed exchange rates

1970’s

- Inflation became a widespread problem
- Oil shocks
  - 1st oil shock in 1973
  - 2nd oil shock in 1979

- How can we best deal with a situation in which growth fails to recover to the desired pace, while inflation remains stubbornly high?

Breaking the back of inflation (1980’s)

1980s

A similar question prevails… how to handle a situation in which inflation was rising while output was weak ?

➔ Structural Reforms to make OECD economies more efficient, flexible and competitive.

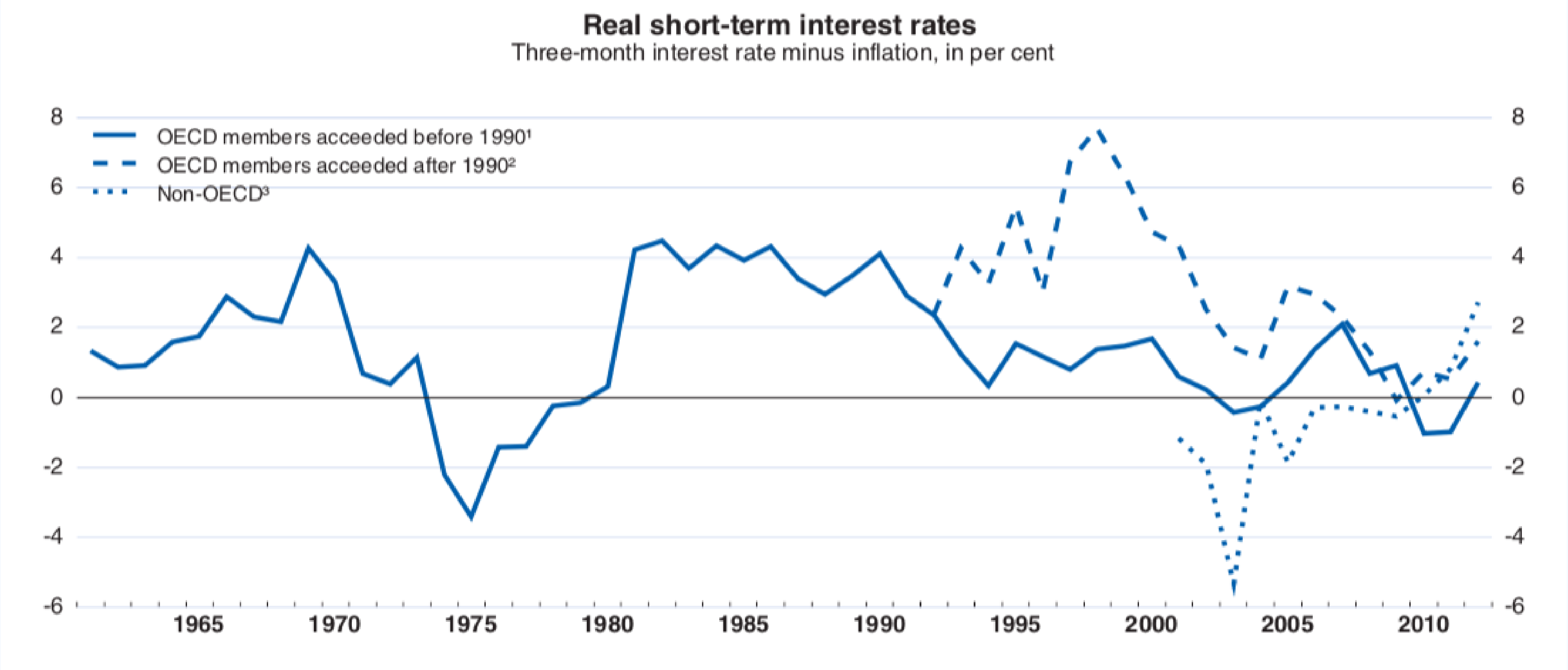
1980s

Monetary policy was geared to inflation control

➔ Limiting the growth of money supply was crucial

As a result, we saw an increase in real interest rates.

Figure 2. **Real short-term interest rates and fiscal positions**



1980s

Fiscal policy on its side, became medium-term oriented, seeking to reduce or eliminate deficits and to stabilise or bring down debt-to-GDP ratios.

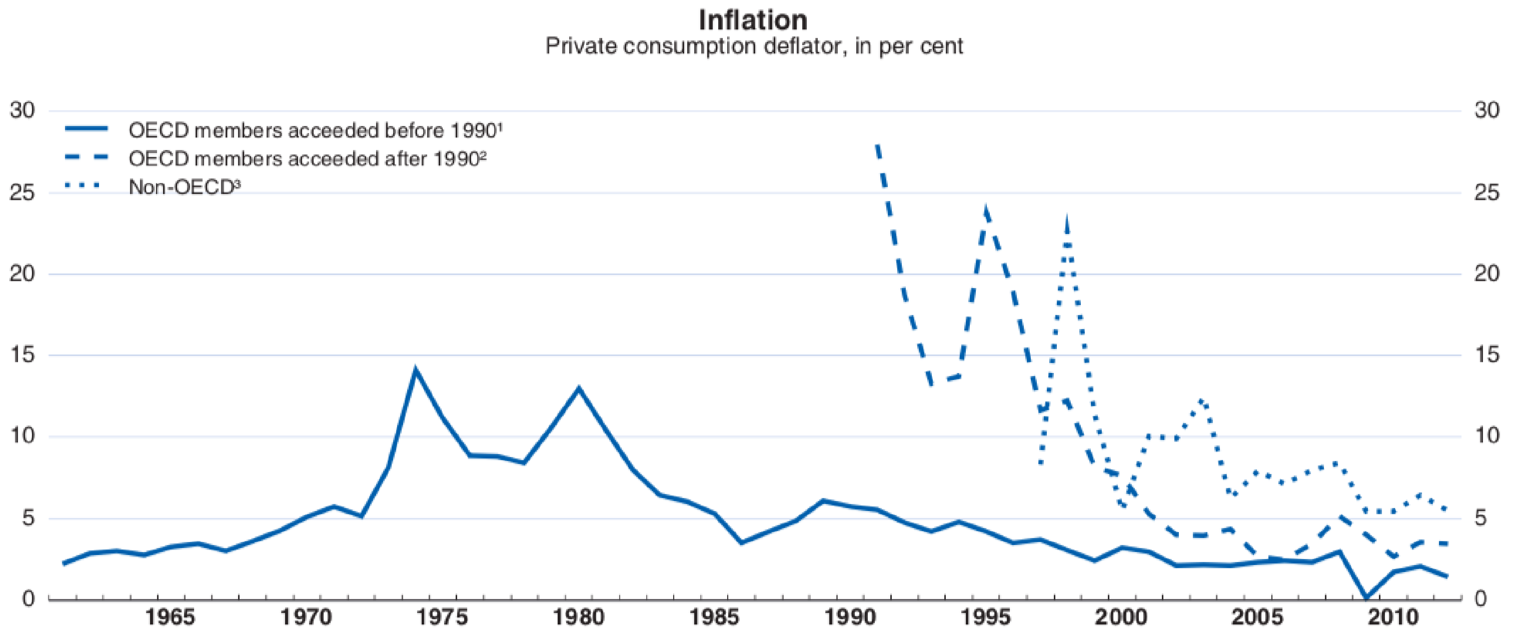
1980s

Policy regained a direction in the 1980s

- Private sectors' confidence;
- Recovery of profits;
- Effects of the financial market liberalisation;
- The prospect of the 1992 Single Market (in Europe).

➔ Supporting a recovery of OECD economies.

Employment increased at a pace not experienced in more than a decade



Although inflation declined, it wasn’t as much as might have been hoped

- Black Monday (1987);
- Monetary policy directed toward exchange rate targets that turned out to be unsustainable.

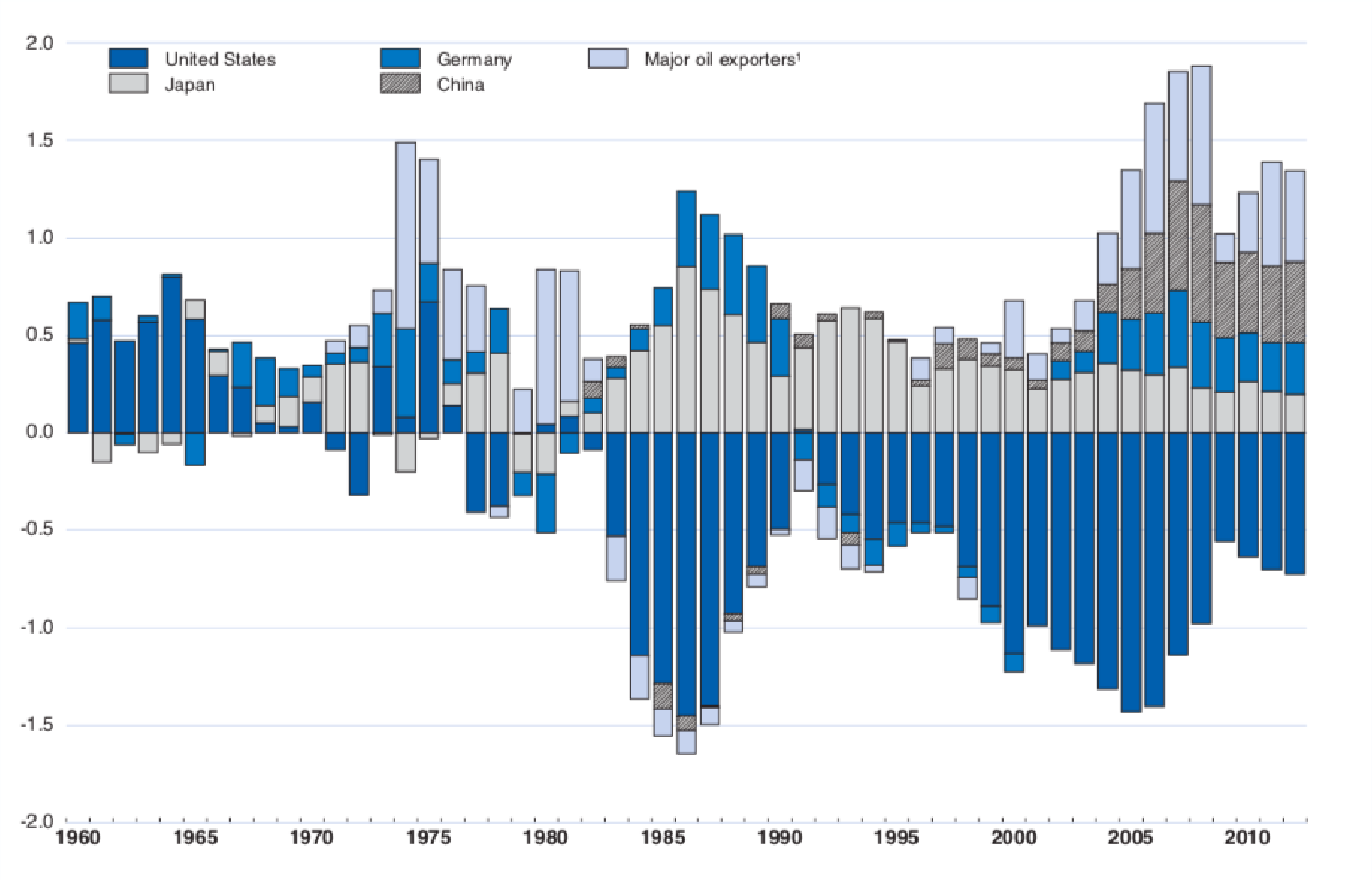
1980s

- International economic co-ordination among OECD countries was limited initially

- Governments pursued a hands-off approach to the IMS where exchange rates are determined in the market.

Figure 4. **Global imbalances**

Current account balance, in per cent of world GDP



1980s

Massive current account imbalances pointed to an overvalued US dollar exchange rate

➔ More active approach to international co-operation:
- Re-aligning of exchange rates;
- Coordination of monetary policies.

1980s

The adjustment burden of global imbalances initially tended to be borne by deficit countries alone.

After monetary policy was eased in response to the stock market crash in 1987, Japan, the US and other Nordic countries fall into Recession.

Structural reform amid rules-based macroeconomic policies (1990s)

1990’s

- OECD Jobs Study:
  -how macroeconomic policy can be used to reduce unemployment
  -structural reforms

1990s

- OECD economies recession
- Japan entered its “lost decade”
- The US recovered, increasing productivity growth
- Growth in Europe met headwinds as countries pursued fiscal and monetary austerity to qualify for monetary union

1990s

- Economic integration:
  –European Monetary Union with the Maastricht Treaty and the Single Market in Europe
  –NAFTA
- OECD began to expand to include more countries in Asia, Latin America and Eastern Europe

1990s

- The impact of the Asian Crisis in 1997 and Russian default in 1998 was limited, and so, OECD economies ended the decade on a strong note

2000s

- World trade escalated and cross-border flows grew from around 5% of world GDP in the mid-1990s to about 20% in 2007
- External assets and liabilities as a share of world GDP more than doubled over this period.

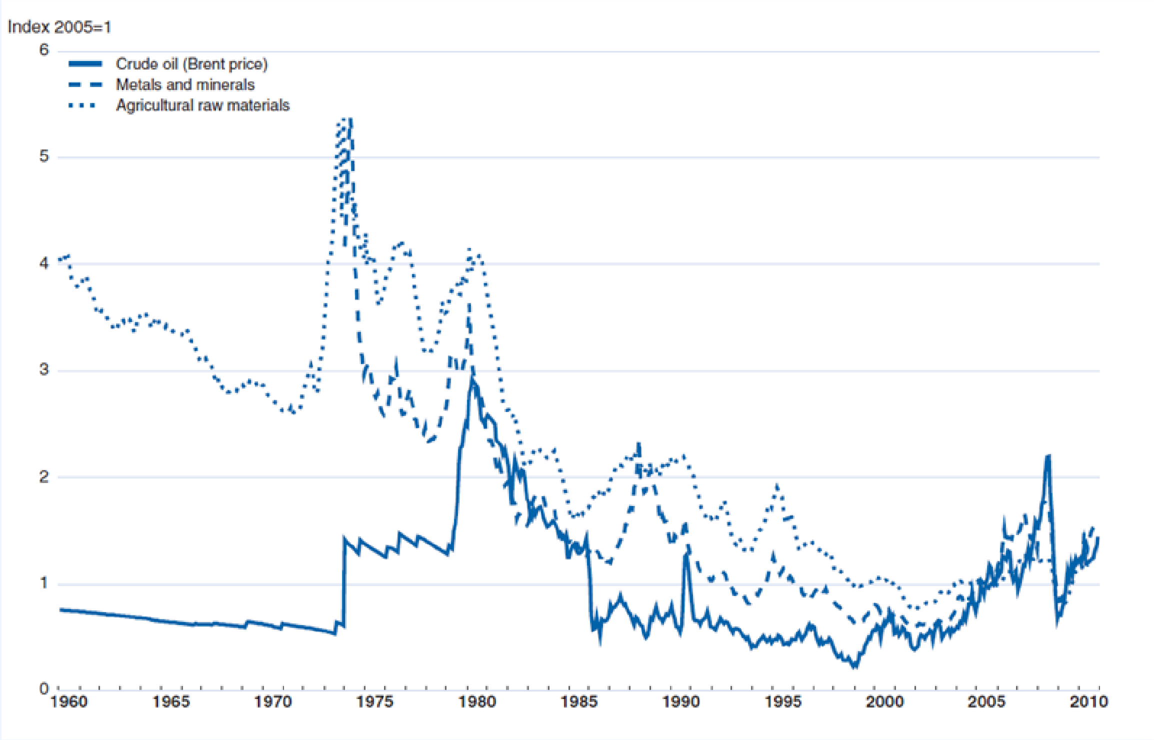
2000s

- China has been running large current account surpluses
- Globalization
  -emerging market economies became a major driver of global growth and kept inflation low in the developed countries

2000s

- Gradually this development was offset by the effect of buoyant demand on oil and commodity prices

Figure 5. **Real commodity prices**[1]



2000s

- Technological progress leads to more complex financial products and systems
- Forward-thinking economic policies increase in prevalence
- Alas, poor supervision and regulation of risks leads to the 2008 crisis

Conclusions

POINTS TO RETAIN

1960's to 1970's

- Problems to tackle
  - stagflation (high unemployment and high prices)

- Policy objectives
  - control inflation
  - increase employment

- Types of instruments used
  - demand management policy (Keynesian approach)
  - Fiscal policy: increase government spending (short-term)

1970's to 1980's

- Problems to tackle
  - stagflation (high unemployment and high prices)

- Policy objectives
  - control inflation
  - increase employment
  - control public finances

- Types of instruments used
  - supply-oriented policy
    - Monetary policy: change in money supply to control prices
    - Fiscal policy: stable public finances (medium-term)
  - structural reforms (liberalisation of markets)

1980’s to 2000’s

- Problems to tackle
  - inflation

- Policy objectives
  - control inflation
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- Types of instruments used
  - supply-oriented policy
    - Monetary policy: change in interest rates to control inflation
    - Fiscal policy: stable public finances (medium-term)
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