

Interview with Álvaro Santos Pereira, Director of the Country Studies Branch at the Economics Department of the OECD

Long-Term Prospects for the OECD Economy Under the Risk of the Delta Variant

By Japan SPOTLIGHT

The OECD is one of the major think tanks providing a mid- to long-term outlook for developed nations in that it represents an objective, neutral and comprehensive perspective on their economies. With the current threat of the Delta variant of Covid-19, how does the OECD view the economic outlook? *Japan SPOTLIGHT* interviewed Álvaro Santos Pereira, director of the Country Studies Branch at the Economics Department of the OECD who oversees the peer review process for its economic surveys and is thus well placed to assess member nations' long-term economic performance.

(Interviewed on Sept. 3, 2021)

How the OECD Could Help Developing Nations Emerge from the Worst of the Pandemic

JS: The availability of vaccines seems to be key to restoring public health but also the economy. Some countries have enough vaccines, while some developing countries do not, which could create a gap in economic growth. Do you think it will be important to promote cooperation between these two groups of countries to help the global economy get out of this difficult situation?

Pereira: Many countries with high vaccination rates are starting to rebound quite strongly. Strong vaccination efforts are leading to the resumption of activity because there are now fewer restrictions. This is not exactly the case in many other countries – parts of Africa and Latin America and even Asia have vaccination rates lower than 1-2%, although in many countries this is up to about 10-20%. What this means for these countries is that very often, especially with variants like Delta which are highly contagious, restrictions will most likely remain in place in many sectors, and this leads to different economic outcomes. So we see a strong correlation between vaccination and economic activity.

We are projecting world GDP growth of around 6% and around 5.3% for OECD economies, but since we got the data for the second quarter we think that growth is going to be even stronger for the OECD economies. For many other economies, however, this is not happening because of vaccinations, so there will be a widening gap at least in the short term. The priority should be for us to try to vaccinate as many people as possible around the world so that we don't have bad surprises down the line. There are new variants against which



Álvaro Santos Pereira

vaccinations are not quite so effective and if this remains the case, we are going to have some situations that are highly unwelcome to everybody. It's very important to have cooperation between developed and developing countries so that we can vaccinate the entire world and get out of this pandemic, including its strong negative impact on the economy.

JS: Overall, the economic landscape of developed nations is very positive. Do you see any disparity between OECD economies or are they all in good health?

Pereira: While many economies are recovering strongly, the upturn has been quicker in countries like Australia, Canada, South Korea, and the United States compared to Europe or Japan, partly because of the restrictions that remain in place. Australia was fast but now with the Delta variant new restrictions are likely, and the outcome may not be as positive as we first thought. Certainly, we saw some OECD economies recovering faster and this is strongly linked very often either to how successful they were in limiting the pandemic through restrictions, or how fast the vaccination efforts have occurred. So the US and Canada are recovering much faster than many parts of the OECD. But remember, the OECD is a very heterogenous set of economies in which we have countries like Colombia and Chile where I think the recovery is a little slower than other parts of the OECD. Chile has been extremely successful with its vaccination efforts. Even within the OECD we see some divergent outcomes, even though in most countries recovery is underway and it is a matter of months before they are fully recovered, there is still a lot of uncertainty especially related to the Delta variant – many countries have 60-70% of their population vaccinated but that means that 30% are not and the Delta variant is so contagious that this

is putting pressure on ICU units, hospital beds and health centers. There are still restrictions in some sectors due to the Delta variant. Countries like Spain and Italy which rely on tourism are more affected and are not recovering as fast as we thought. There are some issues with global supply chains and labor shortages that are also adding to the uncertainty and affecting the speed of the recovery.

Impact of Structural Problems on the Recovery Process

JS: Many countries will have structural problems with their economies – Japan has an aging population, for example, and due to this factor the recovery process may not be as stable as other countries. Could factors other than policy affect the recovery track?

Pereira: This is a key issue. We have two or three megatrends going forward. In many countries like Japan, South Korea, Italy, and Spain we have very fast aging. There are not enough migrants in many countries to make up for the labor shortfall. This is one of the major issues that these economies will face going forward. There is also climate change, and we know that while there is a stronger commitment now to get to net zero carbon at the global level by 2050 or earlier, climate change is going to be a huge issue in future. On the other hand, we have the issues of digitalization, which some countries are adjusting to better than others. With all these trends, the speed of recovery is going to be affected. For countries to recover fast, they will need public and private investment and also should undertake structural reform in the next few months to speed up that recovery. Certainly, like Japan, it is very important to have reforms in the labor market, reforms to reskill the repopulation. In many countries such as Switzerland there have been no major pension reforms for decades, and so the current laws are out of date due to people living much longer. The fastest growing demographic in Japan and in many parts of the world is the 100+ group. If we retire at 60 and then live until 100, this becomes unaffordable to the state and there must be some change to our working practices and pension regimes. While it is also an opportunity, we believe that the aging challenge must be front and center in future reform efforts. Using the recovery plans of these countries to tackle issues such as climate change or aging is very important to ensure a strong economic recovery.

JS: You mention growth of 6% next year, but even with such strong growth rates it might be difficult for the global economy to catch up with previous trends before the pandemic. There could be a gap between the case with the pandemic and the case without the pandemic. There could be some deflationary gaps existing even if there is a strong economic growth rate.

Pereira: We do agree and in our last economic outlook we estimated how long it would take for OECD countries to get back to pre-pandemic levels. In many emerging countries that we follow such as Argentina and South Africa and even Saudi Arabia, we believe that it will take between three and four years to return to the pre-pandemic

level. Other countries such as South Korea and the US have already passed the pre-pandemic levels, and countries that rely on tourism such as Spain and Italy will certainly take longer to recover than many other countries. There will be divergent outcomes partly due to vaccination, reliance on supply chains that have been disrupted, and reliance on tourism, and for those countries it is likely to take a bit longer to get to pre-pandemic levels. Some countries have already passed these levels while some will take up to four years, and this is based on everything going according to plan in terms of vaccinations and lifting of restrictions, but of course there may be other variants that could delay the recovery. On the other hand, if we can find an effective treatment other than the vaccine, the recovery could be even faster. Based on these factors, our predictions may be different as we move forward.

Concerns About Inflation & Unemployment

JS: Turning to inflation, loose monetary policy and expansionary fiscal policy has continued for a long time among OECD nations. Could excess pent-up demand appear in the next couple of years and if so, should we be concerned about inflation?

Pereira: In countries that are recovering faster, we are seeing that inflation is a bit stronger than we expected a few months ago, in the US and even some European countries. This is because of higher commodity prices, and some temporary supply-side constraints in sectors such as semiconductors and shipping and, of course, higher consumer demand. Pent-up demand is significant. One of the big consequences of the pandemic was that governments acted very swiftly by introducing strong policies to try to dampen unemployment which could have increased dramatically. It could have increased a lot more if it weren't for job retention schemes and other policy support. An unintended consequence of this was that policy support for households and firms allowed for insolvencies of firms to be much lower than usual, but on the other hand we also saw savings reach almost unprecedented levels in the past few decades. What this means is that when the policy support is removed and the recovery starts gathering steam, it is possible that part of these savings will be used in consumption and will add to demand. A positive risk to growth will possibly be that these savings will be used for consumption, it will lead to stronger consumer demand, and this will lead to stronger growth.

The other side to this higher demand is that inflation will go up and might go up even further than expected. We are facing a world where inflation will be stronger and higher than in the past few years which is not necessarily bad, but the risk is that if inflation goes up higher and stays higher for a bit longer than we expected, then central banks will be forced to react. Do we expect this to be temporary or permanent? Right now, we and many people believe that inflation will spike a bit in some countries but is not likely to get out of control. What matters for central banks is to keep monitoring what is happening in terms of inflation, but right now keeping policy support is crucial to ensure that the recovery gathers steam. We are already seeing interest rate hikes in many developing countries. In emerging markets like Brazil, Mexico, Turkey, and a few others they have already started hiking interest rates, quite dramatically in some cases, and this affects commodity prices

due to exchange rate depreciation. The question is whether this higher inflation will spread to other countries, like Japan and European nations for example, and so central banks need to remain watchful.

JS: The rate of inflation and the unemployment rate are correlated, and with interest rate hikes in the US there is the concern about rising unemployment. Thanks to unprecedentedly large-scale fiscal and monetary stimulus, so far, the unemployment rate does not seem to have been so serious around the world, but from now on interest rate hikes may cause concern.

Pereira: To put things into perspective, at the end of 2020 around 22 million jobs had vanished in the OECD compared to 2019. This is quite substantial, and globally at least 140 million jobs disappeared, so we are still talking about a massive impact. Right now, even though there has been a recovery in many countries and lifting of restrictions, there are still more than 8 million more people unemployed compared to before the crisis, and more than 14 million out of the labor force compared to before the crisis. More than 20 million people are unemployed or left the labor force due to the crisis. Not only are we concerned about what happens next, but also unemployment did not go up as much as we expected, due to unprecedented support policy both for firms and for individuals.

However, when this policy support goes away, it is very possible that insolvencies will start going up and this will lead to more unemployment. Many people may also lose their jobs, so it is very possible that when policy support is withdrawn there might be an increase in unemployment. Obviously, going forward, if there is a pickup in inflation and this inflation becomes more entrenched and stronger, central banks will first have to normalize their policy which will involve stopping purchasing assets, which they have been doing in recent years. In other cases, it is very possible that in countries experiencing substantial inflation like Brazil, Turkey and Mexico, interest rates will start going up. This will affect consumption and investment, and there might be an impact on growth and jobs. There are still quite a lot of people unemployed and inactive compared to before the crisis, and in many developing countries there is much higher unemployment than there used to be.

So I am more concerned about getting the recovery underway and getting rid of unemployment. Some countries that have not fully recovered have been forced already to raise rates, and this could delay the jobs recovery. In terms of job security, we believe that the most important thing is jobs, and on the other hand it is very important that governments should ensure that the recovery benefits everyone. In this case, we think that strong income support for poorer households will be important. Also, reforms to improve training in many countries will be key to improving job security and to improving the skills and qualifications of people around the world.

Cumulative Debt as Another Structural Impediment

JS: The cumulative debt question is very serious for all countries because of this unprecedented large-

scale fiscal stimulus. Unfortunately, interest rates are low, so therefore the governments in OECD countries may not be concerned about interest payments rising. To achieve sustainability of fiscal budgets, some sort of macro policy coordination would be necessary. How do you assess the G7 initiative recently adopted in the United Kingdom for a minimum corporate tax of 15%?

Pereira: As you know, we are a multilateral institution, and also the OECD has been front and center of the negotiations for international tax reform. My colleagues at the OECD are already working with more than 130 countries to get a global agreement, so we were very happy with the G7 agreement. We think that this is important for global cooperation but are concerned about what could happen in the next few years regarding fiscal sustainability in many countries because we were seeing unprecedented levels of debt already before the crisis. We already had large public and corporate debt and these countries were already vulnerable either to raising rates or to changes in market expectations.

Obviously with the crisis, governments have rightfully extended strong policy support for both households and firms and have tried to avert a major economic catastrophe. But consequently, debt levels have increased dramatically both in the public and private sectors. We are very concerned that when the pandemic is over, some countries (especially non-OECD, emerging or developing countries) might have problems refinancing their debts and we might see some financial volatility going forward. How can we avoid this potentially huge volatility? Multilateral cooperation could help, to get an arrangement to see if the debts could be financed in the long term, but also to ensure more revenues in the long term. This cooperation on taxes is a way of securing more revenues not only for OECD countries but also for non-OECD countries and this will be key to ensuring fiscal sustainability. In the next few years, we are going to see tax reforms in many countries, as well as pension reforms because fiscal issues will become front and center after the pandemic is over due to the very high levels of debt that we are facing.

Income Inequality Possibly Exacerbated by the Pandemic

JS: The unemployment and inflation issues are inversely correlated, and we need a well-balanced approach to tackle both, avoiding inflation and achieving full employment. We need to employ as many policy instruments as possible, including structural policies for the supply side. In this regard, perhaps income inequality is a very difficult issue to tackle to achieve a strong economy. Do you think inclusive growth would be a key topic for discussion within the OECD, and what would be the key elements in this policy discussion?

Pereira: Inclusive growth has been at the forefront of OECD discussions for many years, partly because we have seen over the past few decades an increase in inequality in different parts of the world,

both inside countries and between countries. We do think it is very important to tackle the issue. Obviously, the pandemic has aggravated these issues because the demand for skilled workers has increased and because these skills are more in demand their incomes have gone up. On the other hand, we know that the demand for low-skilled workers went down, and in many emerging markets not only did it go down but also the losses in jobs happened for the low-skilled, for women, and for young people and informal workers. So there has certainly been an increase in inequality in many countries, but what is the solution?

Then there is the aging issue – many countries will have to implement tax reforms, pension reforms and labor reforms to tackle this. Many countries are facing skills shortages, and so they will have to re-skill their populations, providing lifelong learning for many of their workers. Many countries will have to attract more immigrants from other countries, as the US and Canada have done for a while. Also, we do think that it is going to be key to invest in people, skills, and training in the future. If you can work on these, then the gap between skilled and the unskilled workers will be lower, which will lead to more inclusive growth and to lower inequalities. We do think that countries should think about reforms to make growth work for all, and so stronger growth will be vital to propel a strong recovery, which will also help to alleviate the debt problem by tackling the debt/GDP ratio. Supporting the recovery with reforms will be crucial, as will inclusive growth going forward.

JS: In order to achieve structural reform and to reduce income inequality, free trade and free competition policies will be very important to vitalize the economy so that we can reduce inequality and inefficiency and achieve high-growth potential in the post-pandemic period.

Pereira: I totally agree. We certainly believe that in many countries there is not enough competition and because of this, prices are higher than they should be. This is one of the reasons behind the multilateral tax policy, so that we can ensure fairer competition. So we do think that this is going to be extremely important in the future and now that the world is becoming even more digital and companies ever more global, it is important to ensure that there are lower barriers to competition or to entry, and that competition becomes one of the most important elements of a country's policy to create more jobs and ensure stronger and more inclusive growth. Making growth work for all is key and a crucial element of this is more competition rather than less.

New Missions of OECD

JS: Today, the role of emerging economies in the global economy is crucial. In this regard, the OECD may look to strengthen its outreach activities to assess the performance of emerging economies. Could you introduce the direction of the OECD's work for emerging economies?

Pereira: We are already covering the large emerging market

economies, and in the past few years we have had the support of Japan in studying and working with more countries in Southeast Asia and Latin America. We are just starting with Vietnam and have finished reports on Thailand and Malaysia. We are also working with China, India, Brazil, Argentina and so on. We do think it is very important for the OECD and other multilateral institutions to strengthen their cooperation and work with emerging market economies, because part of the growth that will come in the global economy will come from those countries, but also because of the challenges that they face. One of the issues in many emerging market economies is likely to be the fiscal situation and their high debt levels and what will happen to financial markets because of that. So we do think it is very important to give advice to those countries, especially about reforms as the OECD is all about reforms. How can countries implement reforms to improve their performance? I strongly believe that institutions like the OECD can help by giving good advice to countries – emerging markets and non-emerging markets – to try to identify and prioritize reforms toward stronger growth and more job creation. Certainly, this is something that we intend to do, and we work on many emerging market economies and are trying to increase the number of countries that we cover so that we can provide this support.

JS: The OECD has been working very hard on the issue of welfare and happiness. With the pandemic, these issues are more important than ever before. Could you introduce some of these current initiatives?

Pereira: The OECD has for many years been working on well-being and how to measure it, so it is a key priority to pursue what is called the “better life initiative”. We also try to develop and provide a dashboard of indicators on our publications like *How's Life?* and to try to understand what increases or decreases well-being for people. Economists for years have been working on happiness and well-being, but international institutions like the OECD have been devoted to it in the past few years. We are starting to work with individual countries on this issue; for example, with New Zealand we recently prepared a survey focused on how to increase well-being, and in Austria and a few other countries. When we study well-being, we investigate the factors that can improve well-being and do surveys to understand this better. On the other hand, we try to measure the progress of well-being through a dashboard of indicators to precisely understand whether people's well-being and welfare is rising or falling.

Having done this, you can start to think about how to design policies, not only measuring welfare and happiness but how to improve it, and the OECD has been devoting a substantial amount of resources to this. We think that since there is high demand in many countries for this topic, this work will continue after the pandemic is over. People are currently more concerned about their jobs and the legacies of the crisis, but after we start recovering this will be a top priority.

JS

Written with the cooperation of Joel Challender who is a translator, interpreter, researcher and writer specializing in Japanese disaster preparedness.