Will eurozone policymakers take the long view?

The 2010s were an exceptional decade that called for unprecedented economic policies. Now, however, the eurozone's fiscal and monetary policymakers must think more long-term and accept that continued stimulus measures are unlikely to offset the effects of Europe's demographic decline, **writes Daniel Gros**

Daniel Gros

A different question

The beginning of a new year, and the start of a new decade, is a good time for longer-term reflection on economic policy. In the 2010s, a decade dominated by the aftermath of a once-in-a-lifetime financial crisis, a strong monetary and fiscal stimulus was clearly justified. In fact, there is now general agreement that large fiscal expansions by governments almost everywhere, followed by unconventional monetary policies, were instrumental in preventing the Great Recession from turning into a repeat of the Great Depression of the 1930s.

But now that the crisis has been overcome, the question for eurozone policymakers in particular is whether to continue with emergency measures into the 2020s, and, if so, what long-run effects one should expect. And that is where we quickly bump up against the limits of economic knowledge.

Could fiscal stimulus be the answer?

Both economic theory and much evidence suggest that a fiscal stimulus will lead to more demand and employment in the short run, especially when financial markets are in disarray.

But economists fundamentally disagree as to the longer-term effects of fiscal policy when markets are working normally. Although theory suggests that expansionary fiscal policy can induce a forward shift in household expenditure, in the long run, consumers will spend only what they earn. Moreover, the long-term empirical evidence is thin, because few countries have run persistently large fiscal deficits or surpluses over decades.

> *Some argue that without this fiscal expansion, Japan's growth would have been much weaker still*

Japan provides the most obvious example of using fiscal policy to combat a protracted economic slowdown, which started after the country's real-estate bubble burst almost exactly 30 years ago. But although successive Japanese governments have run large budget deficits since then, headline GDP growth has remained lackluster. And while Japan's per capita growth has held up much better, it has merely been in line with that of other developed economies running much smaller fiscal deficits.

Some argue that without this fiscal expansion, Japan's growth would have been much weaker still. But this proposition can be neither proven nor disproven, because we cannot rerun the last 30 years under a different policy.

The difference between Japan's headline and per capita growth rates underscores the importance of demographic trends for longer-term economic policymaking. Whereas the country's working-age population increased by about 1% annually during the boom years, it now is declining at a similar rate. This implies that, holding productivity constant, Japan's potential growth rate must have declined by about 2%.

Or should we focus on infrastructure?

The eurozone is now experiencing a similar trend, with the working-age population of its 19 member countries projected to fall by about 0.4% per year over the next decades. Although this decline is less pronounced than in Japan, it is set to continue, implying that the eurozone is also likely to face a decade of low headline growth (although income per capita in the bloc will continue to grow because productivity is increasing, albeit slowly).

Accepting the economic implications of demographic decline is difficult, especially when political systems revolve around distributing ever more economic gains to voters. One logical way to ease the growth constraints imposed by a shrinking working-age population would of course be to raise the retirement age. In principle, this should be possible, given the increase in healthy life expectancy. But the current wave of strikes in France in response to President Emmanuel Macron's planned pension reforms once again highlights the tenacity of public opposition to such measures.

Increasing infrastructure investment would seem to be a more politically palatable way of boosting sluggish eurozone growth

Increasing infrastructure investment would seem to be a more politically palatable way of boosting sluggish eurozone growth, and would be fiscally painless if financed by issuing more debt. But Japan's experience is a warning to eurozone policymakers not to regard infrastructure investment a miracle cure. When Japan's growth rates began to decline in the early 1990s, governments massively increased public infrastructure spending to as much as 6% of GDP, about twice the level of other developed economies with a similar GDP per capita. Yet Japan's growth rates continued to decline, with subsequent reports pointing out that much of the additional spending had financed the construction of "bridges to nowhere."

Of course, any government embarking today on an infrastructure spending spree will claim that its investments will be much more focused and productive. But this is likely to be an empty promise, because there are simply not that many economically viable infrastructure projects remaining in advanced economies.

Even public investment in "green" infrastructure is useful only as a backup option, needed only if it proves impossible to raise carbon prices sufficiently high to induce the private sector to reduce emissions fast enough to achieve Europe's ambitious new climate targets. In any case, the returns from such green investment would not be higher GDP growth, but lower emissions – good for the planet, not for raising wages and incomes in Europe.

More broadly, the returns from infrastructure investment decline rather quickly. Although a moderate increase in infrastructure spending might be useful after a period of underinvestment, one should not expect more than a temporary impact on growth.

Time to think long-term

Barring higher inflows of working-age immigrants – a political nonstarter – Europe, and the eurozone in particular, therefore has little choice but to settle for an "age of diminished expectations." Although national governments will be strongly tempted to maintain for too long the expansionary policies that seemingly proved effective during the crisis, they will run up against the eurozone's fiscal rules. True, the 3%-of-GDP upper limit on national fiscal deficits enshrined in the Maastricht Treaty was much criticized (and effectively ignored) during the crisis. But this limit can now prove useful in forestalling excessive accumulation of debt by governments vainly attempting to offset the inevitable consequences of demographic decline.

The European Central Bank also will need to lower its sights. At the peak of the crisis, the ECB needed to vow to do "whatever it takes" to preserve the euro. But today, it makes little sense for monetary policymakers to insist on additional bond purchases to achieve an elusive inflation target.

The 2010s were an exceptional decade that called for unprecedented economic policies in the eurozone. Now, however, the ECB and fiscal policymakers must think more long-term and accept that continued economic stimulus is unlikely to offset the effects of a shrinking population.

This article first appeared in Project Syndicate on 7 January, 2020

Author

Amrita Naik Nimbalkar
Junior Economist, Global Macro
amrita.naik.nimbalkar@ing.com

Mateusz Sutowicz
Senior Economist, Poland
mateusz.sutowicz@ing.pl

Alissa Lefebre
Economist
alissa.lefebre@ing.com

Deepali Bhargava
Regional Head of Research, Asia-Pacific
Deepali.Bhargava@ing.com

Ruben Dewitte
Economist
+32495364780
ruben.dewitte@ing.com

Kinga Havasi
Economic research trainee
kinga.havasi@ing.com

Marten van Garderen
Consumer Economist, Netherlands
marten.van.garderen@ing.com

David Havrlant
Chief Economist, Czech Republic
420 770 321 486
david.havrlant@ing.com

Sander Burgers
Senior Economist, Dutch Housing
sander.burgers@ing.com

Lynn Song
Chief Economist, Greater China
lynn.song@asia.ing.com

Michiel Tukker
Senior European Rates Strategist

michiel.tukker@ing.com

Michal Rubaszek
Senior Economist, Poland
michal.rubaszek@ing.pl

This is a test author

Stefan Posea
Economist, Romania
tiberiu-stefan.posea@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Jesse Norcross
Senior Sector Strategist, Real Estate
jesse.norcross@ing.com

Teise Stellema
Research Assistant, Energy Transition
teise.stellema@ing.com

Diederik Stadig
Sector Economist, TMT & Healthcare
diederik.stadig@ing.com

Diogo Gouveia
Sector Economist
diogo.duarte.vieira.de.gouveia@ing.com

Marine Leleux
Sector Strategist, Financials
marine.leleux2@ing.com

Ewa Manthey
Commodities Strategist
ewa.manthey@ing.com

ING Analysts

James Wilson
EM Sovereign Strategist
James.wilson@ing.com

Sophie Smith
Digital Editor
sophie.smith@ing.com

Frantisek Taborsky
EMEA FX & FI Strategist
frantisek.taborsky@ing.com

Adam Antoniak
Senior Economist, Poland
adam.antoniak@ing.pl

Min Joo Kang
Senior Economist, South Korea and Japan
min.joo.kang@asia.ing.com

Coco Zhang
ESG Research
coco.zhang@ing.com

Jan Frederik Slijkerman
Senior Sector Strategist, TMT
jan.frederik.slijkerman@ing.com

Katinka Jongkind
Senior Economist, Services and Leisure
Katinka.Jongkind@ing.com

Marina Le Blanc
Sector Strategist, Financials
Marina.Le.Blanc@ing.com

Samuel Abettan
Junior Economist
samuel.abettan@ing.com

Franziska Biehl
Senior Economist, Germany
Franziska.Marie.Biehl@ing.de

Rebecca Byrne
Senior Editor and Supervisory Analyst
rebecca.byrne@ing.com

Mirjam Bani
Sector Economist, Commercial Real Estate & Public Sector (Netherlands)
mirjam.bani@ing.com

Timothy Rahill
Credit Strategist
timothy.rahill@ing.com

Leszek Kasek
Senior Economist, Poland
leszek.kasek@ing.pl

Oleksiy Soroka, CFA
Senior High Yield Credit Strategist
oleksiy.soroka@ing.com

Antoine Bouvet
Head of European Rates Strategy
antoine.bouvet@ing.com

Jeroen van den Broek
Global Head of Sector Research
jeroen.van.den.broek@ing.com

Edse Dantuma
Senior Sector Economist, Industry and Healthcare
edse.dantuma@ing.com

Francesco Pesole
FX Strategist
francesco.pesole@ing.com

Rico Luman
Senior Sector Economist, Transport and Logistics
Rico.Luman@ing.com

Jurjen Witteveen
Sector Economist
jurjen.witteveen@ing.com

Dmitry Dolgin
Chief Economist, CIS
dmitry.dolgin@ing.de

Nicholas Mapa
Senior Economist, Philippines
nicholas.antonio.mapa@asia.ing.com

Egor Fedorov
Senior Credit Analyst
egor.fedorov@ing.com

Sebastian Franke
Consumer Economist
sebastian.franke@ing.de

Gerben Hieminga
Senior Sector Economist, Energy
gerben.hieminga@ing.com

Nadège Tillier
Head of Corporates Sector Strategy
nadege.tillier@ing.com

Charlotte de Montpellier
Senior Economist, France and Switzerland
charlotte.de.montpellier@ing.com

Laura Straeter
Behavioural Scientist
+31(0)611172684
laura.Straeter@ing.com

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

James Smith
Developed Markets Economist, UK
james.smith@ing.com

Suvi Platerink Kosonen
Senior Sector Strategist, Financials
suvi.platerink-kosonen@ing.com

Thijs Geijer
Senior Sector Economist, Food & Agri
thijs.geijer@ing.com

Maurice van Sante
Senior Economist Construction & Team Lead Sectors
maurice.van.sante@ing.com

Marcel Klok
Senior Economist, Netherlands
marcel.klok@ing.com

Piotr Poplawski
Senior Economist, Poland
piotr.poplawski@ing.pl

Paolo Pizzoli
Senior Economist, Italy, Greece
paolo.pizzoli@ing.com

Marieke Blom
Chief Economist and Global Head of Research
marieke.blom@ing.com

Raoul Leering
Senior Macro Economist
raoul.leering@ing.com

Maarten Leen
Head of Global IFRS9 ME Scenarios
maarten.leen@ing.com

Maureen Schuller
Head of Financials Sector Strategy
Maureen.Schuller@ing.com

Warren Patterson
Head of Commodities Strategy
Warren.Patterson@asia.ing.com

Rafal Benecki
Chief Economist, Poland
rafal.benecki@ing.pl

Philippe Ledent
Senior Economist, Belgium, Luxembourg
philippe.ledent@ing.com

Peter Virovacz
Senior Economist, Hungary
peter.virovacz@ing.com

Inga Fechner
Senior Economist, Germany, Global Trade
inga.fechner@ing.de

Dimitry Fleming
Senior Data Analyst, Netherlands
Dimitry.Fleming@ing.com

Ciprian Dascalu
Chief Economist, Romania
+40 31 406 8990
ciprian.dascalu@ing.com

Muhammet Mercan
Chief Economist, Turkey
muhammet.mercan@ingbank.com.tr

Iris Pang
Chief Economist, Greater China
iris.pang@asia.ing.com

Sophie Freeman
Writer, Group Research
+44 20 7767 6209
Sophie.Freeman@uk.ing.com

Padhraic Garvey, CFA
Regional Head of Research, Americas
padhraic.garvey@ing.com

James Knightley
Chief International Economist, US
james.knightley@ing.com

Tim Condon
Asia Chief Economist
+65 6232-6020

Martin van Vliet
Senior Interest Rate Strategist
+31 20 563 8801
martin.van.vliet@ing.com

Karol Pogorzelski
Senior Economist, Poland
Karol.Pogorzelski@ing.pl

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de

Viraj Patel
Foreign Exchange Strategist
+44 20 7767 6405
viraj.patel@ing.com

Owen Thomas
Global Head of Editorial Content
+44 (0) 207 767 5331
owen.thomas@ing.com

Bert Colijn
Chief Economist, Netherlands
bert.colijn@ing.com

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com

Benjamin Schroeder
Senior Rates Strategist
benjamin.schroder@ing.com

Chris Turner
Global Head of Markets and Regional Head of Research for UK & CEE
chris.turner@ing.com

Gustavo Rangel
Chief Economist, LATAM
+1 646 424 6464
gustavo.rangel@ing.com

Carlo Cocuzzo
Economist, Digital Finance
+44 20 7767 5306
carlo.cocuzzo@ing.com