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

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