Are ECB policies leading the Eurozone's economy towards a 'Japanisation'?

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Abstract

This paper examines how Quantitative Easing and the ultra-lax Monetary Policy implemented by the ECB in 2015 affected the Eurozone's economic recovery. Additionally, the paper analyses the ECB's response to the Covid-19 crisis and how it worsened the economic stagnation of the Euro Area, leading to a "Japanisation" that seems inevitable. This analysis explores the structural conditions that led the European economy to stagnation that are comparable to Japan's experience. The Secular Stagnation Theory posed by Hansen, and later Summers, explains the Eurozone's economic stagnation. The ECB's response to the Covid-19 crisis includes the defence of a supply-side approach to undergo a structural adjustment that prevents the "Japanisation" trend from aggravating.

Keywords: Quantitative Easing; ECB; Covid-19 crisis; "Japanisation"; Secular Stagnation Theory; Structural Adjustment; Pandemic Emergency Purchase Program (PEPP), Coronabonds

1. Introduction

In 2015, the ECB introduced an ultra-lax expansionary monetary policy, lowering interest rates to zero and introducing an aggressive QE to prevent sub-zero inflation to recover from the eurozone debt crisis. These policies have prevented necessary adjustments in many countries after the crisis; which, combined with low growth, low inflation, an ageing population, and rising levels of public debt, have led to a stagnation that 'mirrors Japan's experience'[1]. Moreover, the answer to the Covid-19 crisis might aggravate the stagnation that was already affecting the Eurozone's economy. Is there a way out? Can the Euro Area avoid the "Japanisation" of its economy and at the same time mitigate the effects of the Covid-19 crisis?

The paper will start by exposing the signs of "japanisation" that the Eurozone has shown during the last years by looking at macroeconomic indicators. Secondly, the essay will explore Summer's thesis on secular stagnation and how the ECB's policies have led to a 'zombification' of the economy. Finally, I analyse how the Covid-19 crisis forced the ECB and the Eurogroup to take extraordinary actions that, while helpful in the short run, might magnify stagnation and hinder the recovery after the recession.

2. What does "Japanisation" mean?

After the asset price bubble burst in 1992, Japan suffered from stagnation and deflation. This situation was unprecedented for an advanced economy. The Bank of Japan answered by dropping the nominal interest rates, that reached zero in 1999, and with a program of QE from 2001 until 2006. Nevertheless, the global financial crisis of 2008 forced the Bank of Japan to lower rates again, which was coupled with a large QE program among other stimuli, as part of the so called 'Abenomics'. Despite these measures, Japan's economy has not abandoned stagnation, turning these short-term solutions into a long-term condition.

In order to analyse the extent of "japanisation" in the Eurozone, although there is no consensus on its exact definition, there are some facts listed by professor Takashi Ito that characterise this phenomenon: stagnant growth, nominal zero bound, deflation and secular stagnation[2], to which it is necessary to add the impact of demographics and the rising levels of public debt.

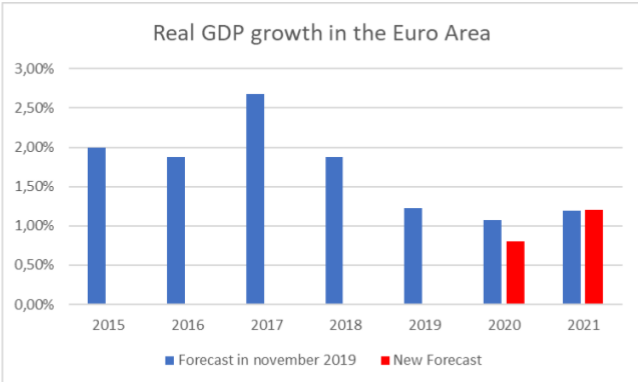

Figure 1: 'Real GDP Growth in the Euro Area including predictions for 2020 and 2021 pre- and post-Covid19 crisis', OECD.

The Eurozone economy has slowed over the last three years. According to the new projections of the OECD, the forecasted growth of 1.1% will contract at least 0.3 points in 2020 due to the Covid-19 crisis[3] (Figure

[1] Summers, L. H. 'Secular Stagnation and Macroeconomic Policy', IMF Economic Review, 2018, p.231

[2] Ito, T. 'Japanization: Is it endemic or epidemic?', National Bureau of Economic Research, 2016, pp. 5-6.

[3] OECD, 'Real GDP Forecast', 2020.

1). Moreover, the ECB has been unable to reach the inflation target of 2% in the last six years[4] and to raise nominal interest rates, which dropped to zero in 2015 (Figures 2, 3). In terms of public debt levels, although there has been a steady drop in the entire Eurozone since 2014, there are big asymmetries among members. For instance, while Germany's debt-to-GDP ratio has decreased since 2013, countries in the south have not managed to reduce their debt levels despite the slow but persistent growth of recent years (Figure 4).

Furthermore, the economies most affected by the Covid-19 crisis will have much higher debt-to-GDP levels than forecasted. According to the European Commission, Spanish debt-to-GDP level will reach 115% by the end of the year, which implies an increase of 20 points when compared to the levels prior to the outburst of the crisis. In the case of Italy, according to Fitch, the debt-to-GDP ratio will also suffer an increase of 20 points, reaching a level of 156% by the end of 2020.

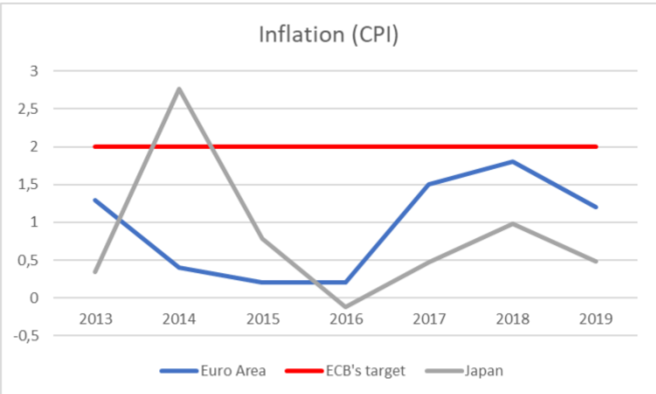

Figure 2: 'Inflation (CPI) levels for the Euro Area and Japan', OECD.

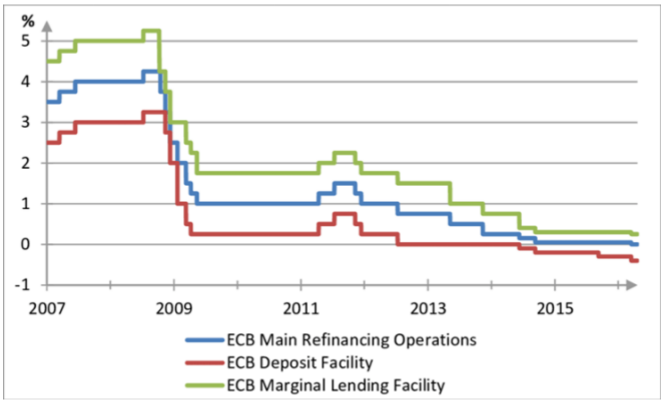

Figure 3: 'Key ECB Interest Rates', ECB.

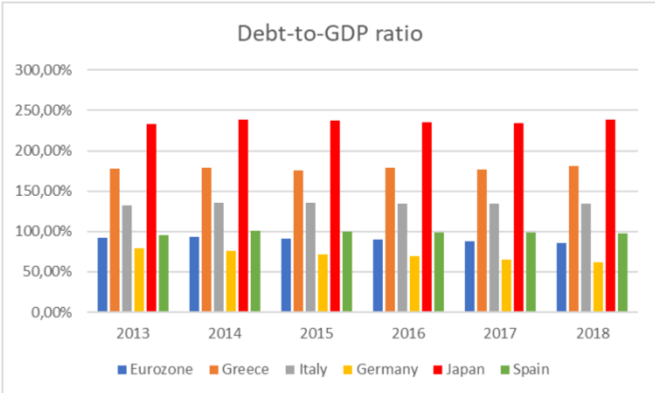

Figure 4: 'Debt-to-GDP ratios of the Eurozone, Greece, Italy, Germany, Spain and Japan', OECD.

This stagnation is reinforced by demographics too: there is a clear downwards trend of the working age population since 2009, which, according to Eurostat, will keep declining by 0.4% every year at least until 2040[5] (Figure 5). Apart from the direct effects on productivity and growth, wage growth will be subdued even if low levels of unemployment are reached, as it has already happened in Japan[6] (Figure 6).

[4] OECD, 'Inflation (CPI)', 2020.
[5] Eurostat, 'Employment Statistics', 2019.
[6] Arsov, I. & Evans, R. 'Wage Growth in Advanced Economies', Reserve Bank of Australia, 2018, pp.9-10.

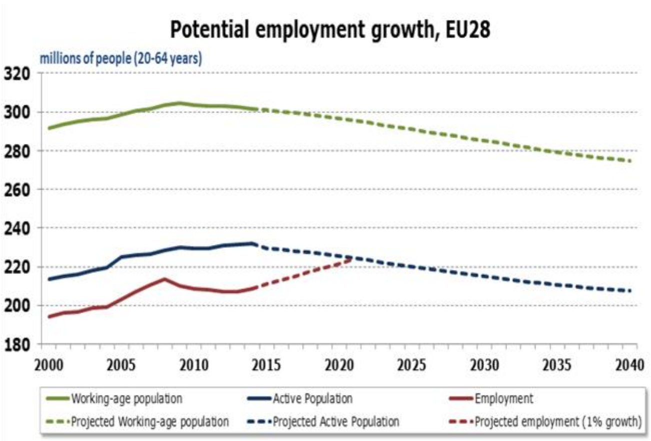

Figure 5: 'Potential employment Growth in the EU' (including the UK), European Commission.

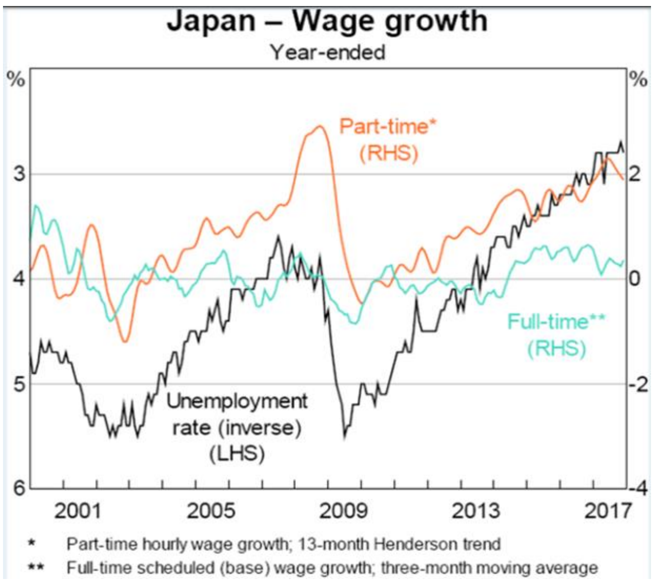

Figure 6: 'Japanese Wage Growth', Arsov, I. & Evans, R. '*Wage Growth in Advanced Economies*', Reserve Bank of Australia, 2018.

3. The Secular Stagnation Theory

These economic conditions reinforce the presence of secular stagnation, characterised according to Summers by persisting low levels of aggregate demand compared to aggregate supply, which brings the natural interest rates consistent with full employment to the negative while real interest rates always stay above[7]. The primary cause of secular stagnation is insufficient private investments at the normal interest rate to absorb private savings[8]. (Figure 7). This circumstance explains the consistent trend of low interest rates in the Eurozone, in which an appearing short-term solution turns into a long-term condition. Like Japan, the Eurozone's condition remains at a low equilibrium rate of interest semi-permanently.

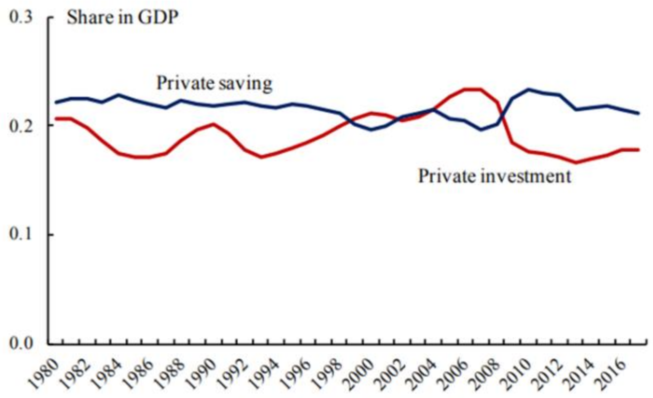

Figure 7: 'Private sector saving-to-GDP and investment-to-GDP ratios in advanced economies', Lukasz, R. Summers, L.H. '*On Falling Neutral Rates, Fiscal Policy, and the Risk of Secular Stagnation*', BPEA Conference Drafts, 2019.

Nevertheless, as long as the net present value is positive and interest rates are kept at zero, there is no apparent reason for investments not to grow. Therefore, it might make more sense to study the economic landscape from a supply perspective rather than as a demand problem. When the ECB introduced its ultra-lax monetary policy in 2015, it managed to prevent the fall of the Eurozone's economy at the expense of a strong and stable recovery. Due to the drop in interest rates and the aggressive QE, a

[7] Summers, L. H. 'Secular Stagnation and Macroeconomic Policy', IMF Economic Review, 2018, p.231.

[8] Lukasz, R. Summers, L.H. 'On Falling Neutral Rates, Fiscal Policy, and the Risk of Secular Stagnation', BPEA Conference Drafts, 2019, p.24.

lot of structural reforms necessary in many member states were paralysed. Spain and Italy are two examples of the relaxation of structural adjustments since 2015, as both member states implemented expansionary fiscal policies against the recommendations of the European Commission and the ECB. In fact, in the fifth 'post-programme' surveillance report after the banking rescue published by both institutions, it is stated that 'after considerable structural adjustment in 2012-2013, the fiscal consolidation effort was relaxed. In 2015 Spain has adopted an expansive fiscal policy that has reversed part of the structural adjustment implemented in previous years'[9]. These ultra-lax monetary policies motivated the delay and even the reversion of these structural adjustments. As a result, governments of Eurozone's Member States started to save companies and industries which should have been restructured or simply substituted. This would have made room to more efficient and profitable corporations that would have attracted the investment that the economy now lacks (Figure 8). In Europe, as in Japan, many 'zombie' companies have survived with no incentive to undertake new investments, causing a secular stagnation much closer to the one initially described by Hansen: 'sick recoveries which die in their infancy and depressions which feed on themselves'[10].

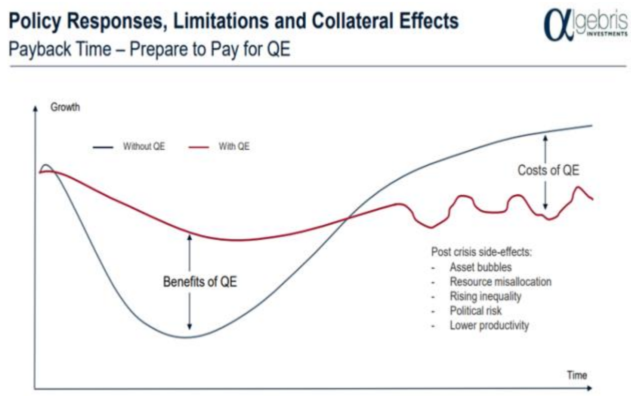

Figure 8: 'QE's collateral effects', Gallo, A. '*Escaping the QE Infinity Trap*', ECMI Annual Conference Algebris Macro Credit Fund, 2016.

4. Covid-19 crisis and EU's response:

Furthermore, the coronavirus crisis which recently hit Eurozone economies threatens to virtually paralyse the activity in many member states, as it has already happened in Italy and Spain. Even though the ECB's President Christine Lagarde assured that it was not the Central Bank's duty to control sovereign yield spread. She recently expressed her 'full commitment' to save the Euro, which alludes to Dragui's famous 'whatever it takes' back in 2012. The ECB's answer has evolved gradually until reaching the "war economy" stage in the face of the severity of the crisis. In its aim to guarantee liquidity, on March 18, the governing council of the ECB approved a €750 billion Pandemic Emergency Purchase Program (PEPP) of both public and private assets to last until the end of 2020. In terms of key ECB rates, they remained unchanged and it is expected that they continue at their present or even lower levels: the MRO rate is currently at zero, the marginal lending facility at 0.25%, and savings are penalised with the

[9] RTVE, 'La CE y el BCE confirman que España relajó en 2015 su consolidación fiscal tras los ajustes de los años previos', Europa Press, 2016.

[10] Hansen, A.H. 'Economic Progress and Declining Population Growth', The American Economic Review, 1939, p.4.

deposit facility rate at -0.5%[11]. However, the price of money does not seem useful as a tool with already abnormally low rates, as proven by the inability of the ECB during the last six years of limited growth to reach the inflation target.

Further measures to stimulate affected economies include the activation by the European Commission of the escape clause of the Stability and Growth Pact, which limited debt levels to 60% of GDP and budget deficit to 3%. In fact, according to estimations, budget deficits this year will reach 10% in Spain and Italy[12].

Moreover, in the Eurogroup meeting of March 24, the ministers of finance approved that governments might benefit from a credit line worth 2% of their GDP from the ESM bailout fund[13]. The so-called Enhanced Condition Credit Line (ECCL) will still involve some conditionality, reflected in a Memorandum of Understanding. Despite being financed at negative real rates and the implementation of the PEPP, the affected southern heads-of-state claim it is necessary to mutualise debt through the issuance of 'coronabonds'. This proposal, backed by the Commission, was rejected by Germany and The Netherlands, both known for their fiscal orthodoxy.

More recently, Spain and Italy seemed to have persuaded Germany to support the development of a reconstruction fund financed through European debt. In an agreement signed by Angela Merkel and Emmanuel Macron, both France and Germany have proposed to provide 500 billion euros exempt of repayment but with conditions based on the implementation of responsible economic policies and reforms, including a big emphasis on investment in digital transformation and the European Green Deal. Despite being far from the 1.5 trillion requested by Italy and Spain, this agreement seems to be a first step towards the mutualisation of debt, something taboo for Germany just one month ago. In order to avoid sovereign debt from piling up in both southern countries which are already experiencing very high levels, the proposal claims that the European Commission should be indebted, instead of the national treasuries, with the guarantee of the EU´s budget.

However, consensus seems far from being reached as the group of northern Member States, including Denmark, Sweden and The Netherlands, have already rejected the mutualisation of debt and instead propose loans to tackle the effects of the crisis.

5. The need for a structural adjustment:

Although these policies, mainly focused on ensuring liquidity, are tackling this as a demand shock, the Covid-19 crisis constitutes a *supply* shock. European economies are not producing less due to a fall in spending levels, but because the dramatic fall in production, like in the case of Italy and Spain. However, this supply shock inevitably leads to a demand shock as consumption and investment shrink due to lower or no income. Market behaviour reflects this preference for liquidity: Investors escape the volatility of stock markets and seek refuge in safer assets such German government bonds, raising yield spreads in Italy and Spain at a disquieting pace (Figures 9, 10). Therefore, the measures implemented are necessary and helpful in the short term. An expansionary monetary policy will make it easier for companies to refinance and rollover debt, and fiscal stimuli will help fight the lower levels of consumption. These expansionary policies stimulate spending. However, if economic activity has

[11] European Central Bank, 'Key ECB interest rates', 2020.
[12] Goldman Sachs, 'Top of Mind: Roaring into Recession', Global Macro Research, 2020, p.2
[13] European Council, 'Remarks by Mário Centeno following the Eurogroup videoconference of 24 March 2020', Press Releases, 2020.

stopped, promoting nominal spending will not tackle this supply shock and therefore will not raise real GDP.

Figure 9: 'Italian vs German 10-year Sovereign bond yields', Investing.com

Figure 10: 'Spanish vs German 10-year Sovereign bond yields', Investing.com

Moreover, precedent of the last recession showed how expansionary monetary policies and the delay of the necessary adjustment in the economy to mitigate the effects of the crisis also meant the constant rescue of unproductive parts of the economy. This crisis and the response given are leading towards higher debt levels, less productivity and as a result, less growth. In other words, the effects of the recession might be mitigated, but the trend of long-term stagnation will be enhanced. Because the entire Eurozone is affected by the crisis, member states will rely on debt to keep fighting the virus and pay for the necessary imports to compensate for production stoppages, making them even more dependent on favourable liquidity conditions, thus enhancing stagnation. Although far from Japanese figures, the rising debt levels in the Eurozone, especially in the cases of Spain and Italy, will hinder its recovery to a bigger extent. While in the case of Japan, 90% of its sovereign debt is held by domestic creditors[14], in the case of Spain, around 50% is owned by international creditors (excluding the ECB's purchases)[15]. This means a bigger exposure to investors' fear of insolvency, which could raise the cost of sovereign debt during the recession as it happened during the last recession when, for instance, 10-year Spanish bond yields reached a maximum of 6.8% in 2012 (Figure 11). This makes it very difficult to maintain the rollovers and the flow of liquidity, both crucial to overcome the crisis.

Figure 11: 'Evolution of Spanish 10-year bond yields', Investing.com

[14] Kobajashi, K. 'The Tenuous Myth of Japan's Fiscal Infallibility', The Tokyo Foundation for Policy Research, 2018.

[15] Secretaría General del Tesoro y Política Financiera, Ministerio de Asuntos Económicos y Transformación Digital, 2020.

Therefore, further economic stimuli, while helpful in the short run, might hinder a strong and consistent economic recovery. As illustrated by the example of Japan and the Eurozone's experience after the Great Recession, these measures do not foster a sustained economic growth, but they hide the real situations of an economy that needs structural adjustment of its production model. In the case of the Euro Area, the reform of its production model was stopped by the ultra-lax monetary policies implemented in 2015. Liquidity injections and expansionary policies aggravated the stagnation conditions that are leading the Eurozone towards a "Japanisation" of its economy. Hence, from a supply-side perspective, the proper answer to the crisis should be to foster economic freedom and reduce the size of the public sector to ensure a proper restructuring of the European economy. This is the only institutional framework that guarantees the flourishing of long-term investment that enables a sustainable and steady economic growth that improves our living standards. Despite the extraordinary situation due to the Coronavirus outburst, the alternative is to keep hindering new entrepreneurship to hide the structural problems of a 'zombified' economy.

6. Conclusion

The perpetuation of economic disequilibria and hiding structural problems under monetary policies have just delayed the necessary adjustment. Ignoring the demographic challenge and low productivity while benefiting from favourable monetary conditions to increase deficit and debt to sustain unproductive sectors has created a bubble during the last years that would eventually burst. The Covid-19 crisis has bounced into this panorama leading to a recession which makes structural adjustments even more unlikely. The ECB's and Eurogroup's answer, while necessary to mitigate the pain of the recession, might turn stagnation into an endemic condition of the economy. In other words, the "japanisation" of the Eurozone may turn from a potential risk into an inexorable fate that will hinder the recovery of the economy, making it unstable and fragile.

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