Interview with Dr. Stefan Kooths, Director of the Business Cycles & Growth Research Center at the Kiel Institute, Germany

Free & Open Competition Would Play a Key Role in Maintaining Sustainable Growth in Europe

By *Japan SPOTLIGHT*

On the outlook for the economy in the European Union, we interviewed Dr. Stefan Kooths at the Kiel Institute, a distinguished German think tank. He is an expert on macroeconomic forecasting.
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Optimism for Global Economic Growth with the Pandemic in 2022

JS: Most economists seem to be optimistic about the economic growth of developed nations in 2021-2022, but do you share this optimism?

Dr. Stefan Kooths

Kooths: It very much depends on what you mean by optimism. If optimism means the crisis that was provoked by the Covid-19 shock can be overcome much quicker than that in the aftermath of the financial crisis in 2007-8, then I fully agree, yes. This time, the crisis is of a different nature; it was more an interruption of all-in-all workable production structures, and from a purely economic point of view, those kinds of production interruptions are much easier to overcome than to solve the problems that become apparent during a financial crisis. Why is this so? Well, a financial crisis is typically just the symptom of hardcore distortions within the economy, with a history of many years before they finally manifest in such a crisis. Whereas the Covid-19 crisis was more of an exogenous shock, and economic agents can cope much easier with those exogenous shocks, rather than with endogenous shocks which are much harder to cure.

In terms of overcoming the crisis, the optimism is well-founded, but we should also pour some water in the wine because we have tremendous stimulus programs in particular in the United States at work, and we currently believe that they are overdosing to a large extent. It is not only to compensate or to get the economy running again – that would not need such a tremendous stimulus program; therefore the question of overheating is on the table, in particular for the US economy. In the medium-term, the world economy faces more and more tensions, in particular in the face of already extraordinarily high public debt-to-GDP levels.

We have seen these debt positions typically only after war periods, and it is for the first time in history that we see these pronounced debt levels in peacetime. They are so far only manageable because central banks keep interest rates at extremely low levels, and the big question for the years to come is, what happens if market pressures would push for higher interest rates because capital becomes scarcer, such that central banks should increase interest rates in order to prevent an overheating of the economy; but, given the high debt positions, the fiscal and financial situation might turn out to be too fragile to swallow rising interest rates. And the problem is not limited to a couple of small countries – and we are also talking about large countries. Then the situation for the world economy in the 2020s can become quite difficult in light of the starting point that we currently have achieved.

JS: The IMF recently issued a forecast that there will be a serious divide between developed and developing nations in light of vaccine distribution. Do you think that overcoming the pandemic and achieving robust global economic recovery is dependent upon the extent to which developed nations could aid the developing nations?

Kooths: It would seem that vaccination is the key factor in overcoming the economic consequences of the pandemic. The no-Covid strategies seem to be extremely fragile because they are vulnerable. We have just seen an example where a whole port was closed due to a single Covid-19 case, and so the world must learn to live with this virus. As far as I can understand, the medical experts tell us that this virus will not disappear whatever we do and however long we close down our economies.

The shut-down strategy is clearly not the way to go for and therefore we must protect people from getting seriously ill from the virus, so the key factor here is vaccination. However, we should not make the mistake of giving up all property rights for vaccination production to have a short-term procurement for the developing world for two reasons. First, the property rights themselves are not the key bottleneck, rather the production possibilities. We are talking about high-tech here, nothing that can be produced without sophisticated production infrastructures. Second, we must think about the incentives that we would set if we now told those who ran serious risks in investing in vaccine development if we just absorbed their results for free. It is important to distribute vaccinations all over the world, but this can work fully hand-in-hand with market forces. Market forces mean that of course they will first serve those economies where the willingness to pay is the highest and these are the advanced economies where you can sell your product for the highest price.

Once the developed world is vaccinated, the next group of customers comes on the stage and there is no reason why we should believe that the producers of vaccines would not be willing to provide them with their product. The development costs are already earned by the sales in advanced economies, so we will see prices going down because prices are connected to the willingness and the ability to pay and therefore yes, we do need global vaccination programs, but we do not need a severe government intervention in property rights to achieve this goal.

Euro Economy in 2022

JS: How do you envision economic growth in 2022? The IMF and other economists have predicted around 4.5% for economic growth in the euro area in 2022.

Kooths: This is more or less in line with our numbers; we have 4.4% for the euro area next year. We had a slump of 6.7% in 2020 and our current estimate for 2021 is 5.3% so we still have a way to go. Plus, we must not forget that in a counterfactual scenario without the Covid-19 crisis, the economies would have grown so we are only catching up at best to the growth path that we had seen prior to the crisis.

Although the numbers look remarkable, it is a long time since we have had 5 or 4 before the decimal point when talking about GDP growth numbers, but, again, this is a catching-up process, and it is a different story when it comes to the potential growth rates that we can expect for the years ahead. In many parts of the world, demographics will show up in the potential growth numbers in a substantial way.

To give an example for Germany: we come from a 1.5% growth rate of potential output over the most recent three or four decades. So this was the normal number – German GDP grew year by year on average by 1.5%. We are expecting this number to shrink to something like 0.5% until the end of the 2020s.

The trend here is similar in all aging economies, so we are facing a situation with much slower potential growth, and at the same time – and this *per se* is good news – populations are aging, so people live longer but they also must be supported by social security systems for longer or they must run down their savings. Either way, while they are no longer contributing to production they continue to live as consumers.

This will put a lot of tension on the social redistribution schemes, and I can currently not see that the economies and in particular the governments have prepared themselves in an adequate way to face this challenge. Plus, we must not forget again that we enter this period with very high debt-to-GDP ratios; we are used to extremely low interest rates that make the high debt positions appear sustainable but every extra percentage point in terms of interest which may well go hand in hand with the aging of populations will make the whole situation more difficult. The medium-term outlook in terms of macro-economic stability is rather gloomy, I am sorry to say.

JS: The pandemic caused deflation in 2020, and there was huge negative economic growth in European economies. Even though the growth potential is getting lower, is there a huge deflationary gap?

Kooths: No longer in 2022. We expect that the output gap next year will be practically closed. Obviously in the US it will already be in positive territory, which could mean overheating of the economy, but even in the EU context we are talking about a more or less closed output gap then. This is also the assessment of others such as the European Commission and the OECD. The recovery is rather strong – we have seen a by-and-large V-shaped development – so yes, the slump was heavy, but the recovery was also very strong. We are back at normal capacity utilization rates rather quickly, again compared to other types of crises like the financial crisis.

JS: Are you concerned about inflation in the euro area economies?

Kooths: Indeed – we still see an ultra-loose monetary policy stance. Last year, the euro system absorbed all extra net debt that was issued by governments in the euro area. This was a 100% monetization of public debt. Liquidity is vast – we have unused liquidity positions in the banking system that are at an absolute historic high.

During the crisis, a couple of extra spending programs were adopted, and these will only work once the crisis is over. We would be back at normal capacity utilization levels anyway, but then there comes an extra stimulus from fiscal policy makers. Even in 2022, the fiscal rules have been switched off so we will see remarkable fiscal deficits, even in a situation that is no longer shaped by the crisis. There are a couple of ingredients that should make macro economists look very closely at what is happening with inflation. What might be misleading is that there are very good reasons that the current inflation numbers are heavily influenced by temporary factors like reemergence of energy prices, and a couple of other reasons which work only temporarily. The current inflation numbers are 4% in Germany, and this is driven by temporary factors.

But, this does not mean that other factors might not have a medium-term impact on inflation – just because we have some very prominent temporary factors does not mean to say that there are no other factors that we should be concerned about.

Fiscal Debt a Key Structural Issue

JS: Turning to the issue of cumulative fiscal debt, this is a very pressing structural issue not only for Europe but other developed nations too. What should be done in particular for EU members to reduce such cumulative debt stemming from the pandemic?

Kooths: Well, the extra debt that was produced by the pandemic is not really the key factor here. This was only another element that came on top of an existing high debt position. So we should not narrow down the problem to saying that the pandemic caused a lot of extra debts. The debt positions were already at an alarmingly high level, and this crisis has only aggravated the problem.

The root cause of the problem is that policy makers all over the world think that they should not consolidate because it is almost free to take on extra debt. Policy makers are very much short-term oriented, and it is unpopular to consolidate and much more popular to distribute money or reduce taxes and therefore they are just relying on these very easy financing conditions, and they do not consolidate enough to give monetary authorities more leeway in their primary mandate which is that of price stability.

This had already been the problem prior to Covid-19, so we must not mistakenly assume that all our problems are due to the pandemic. The root causes of our macro-economic problems are more of a hardcore type. The extra debt that comes from the crisis can be swallowed; this is not really something that would be a macro-economic game-changer. The mechanisms behind fiscal policymaking in general are causing the accumulation of more and more debt.

JS: What do you think of the new 15% corporate tax rate adopted by the G7 in Cornwall?

Kooths: I don't think it will be a game-changer for the world economy. There are still a lot of loopholes, plus the overall story that is told that we have a problem with tax evasion in the corporate sector is not really convincing on a broad basis; yes, there are some very prominent examples. We all know about Google and Apple, but if you look at the corporate tax-to-income ratios in OECD countries, we do not see something like a race to the bottom. What we see is that they are becoming already more similar, so the dispersion within corporate tax rates has already declined prior to this agreement and therefore I really do not see that this will fundamentally change the global tax landscape. This is more of a success for communication towards national voters, in my interpretation.

Impact of Low Interest Rates

JS: Low interest rates could have some impact on the economy. Some economists would claim that this low-interest policy could increase inefficiency in the economy because it could provide a stimulus to so-called "zombie companies".

Kooths: I share these concerns on "zombification". Of course, from an individual point of view, every insolvency looks like a failure, like a disaster even from a personal point of view. But from a systemic economic point of view, it is important that those companies that have lost a viable business model leave the market. Easy credit conditions make it easy for them to survive. By staying in the marketplace, they are still absorbing scarce resources that could be used much more productively elsewhere in the economy.

The most important scarce resources that we have are our employees. Typically, the turnover in the labor market has a lot to do with corporations that must close down, and the longer we keep people in occupations where they are not really productive or not as productive as they could be elsewhere, the longer they weigh on overall productivity growth. Given the aging of our populations, we should make sure that those people of working age are at least working in the most productive way. Therefore, this negative side effect of ultra-low interest rates should be taken seriously.

Open Economy – Key to Raising Productivity

JS: How do you see the role of innovation in encouraging high productivity in the EU?

Kooths: Innovation is very popular in the political debate – people say they want to make the EU the most innovative place to be – but innovation does not come from government interventions, it comes from the players and entrepreneurs in the marketplace. To support this innovation process, policy makers must keep markets open to keep the competitive pressure as high as possible, which in turn stimulates new ideas, products, and processes. Unfortunately, the answer to all these problems that we can currently see on the EU policy level is rather that we want to become more protectionist.

They call it "economic sovereignty" and what they mean is to bring back supply chains within the EU borders. Giving up the high degree of global division of labor would mean that we cut into already existing productivity. In order to give productivity growth a chance, we should not become more protectionist but more open to the rest of the world. This is where a substantial part of our overall wealth comes from – the open market and the global division of labor. This is not a new economic insight but is still true.

An extra concern that I have is that we have now started a period with very challenging climate policies. Given that the decarbonization is already a huge task, we should make sure that we are as open as possible for any technological way to achieve the emission goals; but here again, we see a rather interventionist approach which tries to promote some technologies at the cost of others, and this brings the risk that the overall decarbonization project becomes much more costly than it needs to be, because we are too interventionist and instead of just setting the framework we intervene very specifically in decisions about technologies that should be taken by entrepreneurs and not by bureaucrats.

JS: Turning to the labor market situation in the EU, you have stressed the importance of open market policy as well as promoting efficiency. There could be some concerns about the unemployment rate in Greece – for example, due to the policies aiming to enhance efficiency with an aging population.

Kooths: I'm not concerned about rising unemployment; on the contrary, the labor market will be quite differently shaped in the new decade in the EU rather than in the most recent decade. Labor will become more and more scarce, and therefore we need an increase in productivity to at least mitigate some of the problems caused by the aging process. We have never seen anything in any country that could be described as technology-induced unemployment. First, the empirical results are clear; this has never been observed as a massive problem.

It can hit a particular branch, yes, but never the total economy and for good reasons. Because innovation takes place, because labor is so scarce – so the scarcity of labor triggers innovation, and the perception in some parts of the public debate is that labor-saving innovations might cause unemployment. I can reassure you that technology-induced unemployment will not be a major problem in the coming years. We should rather think about how to be competitive in the global labor market in terms of attracting net immigration of well-educated people.

This is more or less the global labor market already, so we must make the European economies competitive such that people immigrate into the European countries on a net basis. We should not take it for granted that the EU is such an attractive place to be, and that all the talents of the world would want to go there; they will not want to come here for the sake of helping us cope with our aging problems and for financing our social security systems. If they come, then they want to build their future here.

They might want to establish their own companies and be productive, they will not come to help us with our legacy problems. They want to see an attractive place for their personal future, or they will go to the United Kingdom or parts of Asia or to the US and they will start their lives there. Instead of being concerned about technology stealing jobs we should focus on attracting people from all over the world. Thus we must make the EU economies attractive as a place to be and as a place to work and to do business.

Of course, the emphasis must be on attracting well-educated and high-skilled people rather than people who will need to be supported by the social security systems. The need is to attract medium- and high-skilled people, not pure numbers of immigrants. If we opened the border to everyone who wants to come here, many would of course come but these are not the people who would be able to help us economically.

Income Inequality Is Not Necessarily High in the EU

JS: There would seem to be high income inequality in the EU, which some critics say is causing increasing political populism. Will income inequality continue to rise after the pandemic?

Kooths: First, it is simply not the case that income inequality is particularly high in the EU, actually the opposite is true compared to the US or UK or China. The EU economies with their welfare state model are rather an example of economies where a lot of redistribution is going on and overall inequality numbers are low. It is often repeated in the news that inequality is increasing but this is just not the case.

In a country like Germany, from the early 2000s onwards and till today, income inequality is flat. There is no increase in inequality in income flows. This is the wrong perception of the statistics, and if at all there might be an issue with wealth inequality – but then we must also talk about the impact of monetary policy which of course increases the wealth positions of those who have net wealth dramatically, whereas those who do not have any net wealth do not benefit from these low interest rates.

We should be very cautious with the numbers, and a lot of people are scandalizing the inequality as such, but many of those people do not really work with the numbers or understand them well. There is an ongoing trend over decades in many European countries that the average household size is shrinking. We have many more single households than 40 or 50 years ago. In particular, single parents – from a purely statistical composition effect – are contributing to an increase in inequality.

This is a structural factor that comes from individual decisions that have been taken, and you can even go a step further and say that 50 years ago for a female it was economically unfeasible to leave her husband and live alone with her children. Today, it is possible. You could even interpret this as a side effect of economic growth that people have more possibilities to make a free choice about how they want to live. Statistically, it increases inequality numbers, but it does not mean that the individual circumstances of living have decreased – on the contrary.

Take the inflow of about 1.5 million asylum seekers in 2015 and 2016; these are people with typically very low incomes. Most of them do not have any income when they come here. This increases of course the inequality measure. But it would be completely absurd to assess that German society has become more unfair because inequality numbers are increasing when, in fact, we are giving shelter to asylum seekers. The whole debate is highly politicized and if you look into the root causes and what is really shaping the development you would come to quite different results.

JS: Japan is also concerned about its aging population, particularly over productivity. However, we are also concerned about rising income inequality due to the aging population. Is there a similar concern in the EU?

Kooths: It is rather a redistribution conflict between the already retired people against those who are still economically active, which creates problems. We must adjust our pension system – which means primarily we have to increase the pensionable age – this is more or less a no-brainer.

We have to keep more people in employment, but what we see from a couple of studies is that a society that is aging on average is losing productivity growth just because the age composition is different. This is a problem that should be addressed by lifelong learning and our education systems in general. We should also think about what happens to people who have done a physically challenging job for a couple of years but who cannot work at the age of 65 or 70 in their old occupation, but maybe we can find new occupations for them. Making more flexibility possible is one way to cope with it, but the inequality problem from my personal view is not the key problem but rather the inter-generational conflict around it.

Some Skepticism About Ameliorated EU-US Relations

JS: You mentioned that openness would be key to achieving economic vitality between the US and the EU. Would the current EU-US relationship stimulate growth of trade and investment in Europe and eventually enhance growth?

Kooths: Obviously the atmosphere is more relaxed now. It is easier to communicate over the Atlantic and overall political relations have improved. However, we must not overlook that US President Joe Biden is not a free-trader and is as protectionist as his predecessor. One could even say that his predecessor was quite frank in what he wanted as a protectionist; he just increased tariffs. Whereas the much more difficult problems in the debate on protectionism are the non-tariff barriers to trade, and they have been gaining importance over many years, the WTO is reporting this on a regular basis and year by year the non-tariff barriers to trade are increasing.

There are more new barriers each year than old ones being removed. I would rather warn that we might see an Atlantic coalition of protectionists who try to cut links to the rest of the world by imposing their standards on other regions. This is something that cannot work. We have recently decided upon a supply chain law in Germany, and we will see something similar on the EU level coming very soon which holds corporates responsible for human rights violations in other countries, in their supply chains. This is a tremendous barrier to trade and would rather lead to Western companies withdrawing from countries where it is hard to control whether suppliers play according to Western standards or not.

This will not improve the situation in these countries but make it worse, and we are also opening the door for all kinds of lobbying, for people who want to see competitors from other parts of the world banned because they do not have the same standards in terms of working standards, social security, or environment protection as the Western world. Why do we have these high standards? Because we have already achieved a very high degree of wellbeing; therefore, we can afford these high standards which are the flipside of our high productivity and high per capita income.

Other parts of the world that are less developed just cannot afford these standards, and it would be completely unfair to impose our standards on others. We could also criticize this from a political point of view, because respecting the sovereignty of lawmaking in other countries means we can trade with each other without any approach that imposes our points of view on others.

I am rather skeptical that the new friendship between the US and EU will really make the world a more open place; I am rather concerned about a coalition of protectionists – people who are achieving economic sovereignty, but which will at the end turn out to be the same protectionist policy approach that we have seen many times in history. The names may change, the mercantilist attitudes do not. JS

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