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## Monetary policy lacks the muscle to boost growth

The answer must be to strengthen our economies' potential to create jobs, writes **Michael Heise**

In Japan, Prime Minister Shinzo Abe announces yet another fiscal stimulus. In Europe, economists nod approvingly when the euro group waives fines on Spain — which, despite years of growth, still runs deficits way higher than the bloc's rules allow. In the US, both presidential candidates promise more government spending.

So it is clear that attempts, however tentative, to cut spending and pay down debt have given way to renewed enthusiasm for policies such as these, that are intended to boost demand instead. This is dangerous. If governments resort to sky-high debt and negative interest rates, despite moderate growth and normalised capacity utilisation, in an upswing, what will they do if and when their economies weaken again?

Especially in Europe and Japan, policymakers have been trying relentlessly to generate growth through bank lending and fiscal borrowing. The Bank of Japan and the European Central Bank have turned interest rates negative to punish banks that fail to convert their cash reserves into loans.

At the same time, these central banks are buying huge amounts of government and corporate bonds. The resulting low, or negative, interest rates help governments to continue running large deficits. Many economists support such policies: if the private sector does not borrow, they argue, then the public sector must do so to generate demand.

Not surprisingly, however, expansionary monetary policies have done little to fuel bank lending and private-sector borrowing. Reviving lending after a financial crisis is like pushing on a string: central banks can smooth out the inevitable debt reduction process by cutting interest rates and pumping liquidity into the banking system; but they cannot totally eliminate the need for companies, banks and households to pay down excessive debt. It usually takes years; this time is no different.

Given that monetary policy lacks muscle, many argue that public deficit spending must compensate for the lack of private demand. Governments should borrow more to invest in infrastructure and innovation. These recommendations are aimed especially at countries such as Germany that have balanced their budgets. But critics of “misguided austerity” are vocal in France and other, southern European nations, too. In their view, the eurozone's caps on public deficits and debt have only made the crisis worse.

This story is simply not supported by facts. Debt levels have continued to rise since the financial crisis in most developed countries. In both the US and the eurozone, total non-financial sector debt (public and private) increased from about 225 per cent of gross domestic product in 2007 to 250 per cent in 2015. Most of this was in the public sector. If growing debt could fuel growth, we would be fine.

We are not. More debt clearly is not the solution to the west's growth problem. The answer must be to strengthen our economies' potential to create more and better jobs. Sure, structural reforms feature among the recommendations of the International Monetary Fund, the OECD and many central banks. Back in the real world, policymakers focus almost exclusively on policies to boost demand.

Many economists who support this view argue that structural reforms work only in the long run. In the short term, they may even be counterproductive because they widen the gap between supply and demand in an economy.

Some look askance at structural reforms, too, claiming they improve the competitiveness and export performance of one economy only at the expense of its trading partners. This is muddled thinking. Policy measures that improve productivity and innovation are good for growth irrespective of how open an economy is.

The lesson we should have learnt from the post-crisis years is that demand-boosting policies on their own cannot return our economies to sustainable growth. Monetary policies are not very effective. Fiscal policies can certainly help — but only if they trigger investment and innovation and enable structural reforms.

But this is not what happened. While total government debt in the eurozone jumped by about €3tn between 2007 and 2015, public investment spending actually fell by about €20bn. Meanwhile, structural reforms came to be considered a nice-to-have rather than the foundation of sustainable growth.

Greater innovation and higher productivity remain the safest routes to restored growth and wealth generation. And this needs open markets, tax incentives for investment and a well-qualified workforce — not ever more fiscal spending and central bank cash injections.

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