Executive Summary

ECONOMIC POLICY FOR THE NEXT DECADE: A CHANGED ROLE OF GOVERNMENTS?

Will the role of governments in the economy change after the Covid crisis, and if so how? During the crisis, government activism to protect the economy, supporting households, job matches, and firms has been massive. While the pandemic crisis is unusual, these developments have revived discussions on the role of government. Some people argue that governments should also take a more active role after the pandemic, at least for a longer phase during the economic recovery. Some argue that the situation is so special and different that it does not have any implications for the future of government. Others object that weaknesses and deficiencies of government responses to the pandemic reflect limited effectiveness of the public sector in general, suggesting that devoting more resources to it may be counterproductive unless accompanied by significant reforms.

The future role of governments depends on other consequences of and lessons drawn from the crisis. First, public debt has increased considerably, limiting the financial resources available to governments in the future. Second, the disruption of international trade and supply chains and the lack of critical medical supplies like masks and ventilators in certain countries in the early phase of the pandemic is sometimes presented as a reason to foster autarky and roll back globalization and international trade. Third, the idea that many companies and even entire sectors need support to restart their activity has given rise to the idea of "building back better," suggesting public support for the recovery should steer the economy towards more sustainability, in particular decarbonization. The European Green Deal reflects this view. But it is also a concern that exaggerated views on what governments can accomplish can lead to inefficient policies and stifle adjustment and growth.

No crisis passes without causing structural changes, and it is therefore natural to reflect on the role of government and economic policies in the perspective of a long list of policy challenges including the climate, technological change, aging, and inequality, but also a possible de-globalization. At the same time, it is important to see the developments in a broader perspective, not forgetting the experience and lessons of the recent past. This report takes such a broader perspective to relate the current situation to the economic and political developments that have occurred since the 1970s, highlighting specific aspects particularly relevant to the contemporary discussion and also pointing out some of the current challenges, including high debt levels and looming inflationary pressures, that have been experienced in the past.

CHAPTER 1
Macroeconomic Conditions and Outlook

Since the beginning of 2020, the world has been under the shadow of the Corona pandemic. Despite increasing immunization of the population, the more infectious new variant called Omicron has triggered a new wave in large parts of the world this winter. The associated uncertainty, consumer reticence, labor shortages, and existing problems in international supply chains will determine the development of the global economy this year and imply that economic activity will be noticeably subdued this winter. Thereafter, a strong recovery is likely, as experiences from previous pandemic waves have shown. Industrial order books are full, and with a renewed and further normalization of everyday life, services will also largely recover. The current inflationary dynamics in the world will ease once the demand overhang has been reduced. The underlying supply chain problems, the shift away from just-in-time production in industry, and the substitution of services for goods by consumers are only temporary. In addition, central banks have begun tapering and the first interest rate hikes have already occurred or are expected. Nevertheless, inflation rates in many countries around the world will remain well above implied or communicated inflation targets for some months to come.

In Europe, too, inflation has risen sharply over the course of 2021. It peaked at 5 percent in the euro area at the end of last year. The gradually easing supply constraints will not only ensure an easing of inflationary pressures, but also strong value-added growth in the manufacturing sector during the year. The construction sector will continue to be supported by the low interest rate environment and public financing of transport infrastructure investments. The retail sector, which has benefited from consumers substituting goods for unavailable services since the start of the pandemic, will return to normal this year. The UK economy continues to be also weighed down by the impact of Brexit. The economic recovery is less advanced in the United Kingdom than in the euro area. In addition to the problems also faced in Europe, a severe shortage of certain skilled workers has made itself felt.

Forecast risks are once again on the downside. While advances in vaccination may accelerate and the Omicron wave may support overall immunization, increasing the likelihood of the virus becoming endemic, emerging viral variants may pose new challenges to society. Further recovery will also depend on how quickly supply-side shortages can be addressed. On the political front, risks relate to the negotiations between the European Union and the United Kingdom on the Northern Ireland Protocol and the foreign trade agreement between the United States and China in 2022. Another risk is that the economic slowdown in China could be more severe than expected. The impending exit from loose monetary policy, especially in the United States, also poses the risk of negative spillover effects for emerging markets, as in previous tapering episodes.

CHAPTER 2
The Rise of Market Liberalism

To understand what might happen post the pandemic it is useful to review how policy and circumstances interacted in the stagflation episode of the 1970s and in the disinflation, international integration, and market liberalization developments of the 1980s and 1990s. We examine three principal areas of policy change or reorientation: the search for an answer to inflation, including institutional changes and the move to central bank independence; the deregulation of labor markets, as an answer to persistently high levels of unemployment; and attempts to limit the growth of government expenditure and of government debt. In each case we attempt to answer the question about whether the move was driven by international exposure, global competition, and a pressure for institutional emulation. Did market liberalism follow from globalization (and conversely might a retreat from globalization necessarily imply a cutting back of market liberalism)?

Bad economic performance and ideological shifts often trigger sharp policy changes. What is now frequently if perhaps inaccurately termed “neoliberalism” emerged as a response to the economic and political crises of the 1970s. Reduced growth, high inflation, and the challenge of the oil price shocks seemed to offer a fundamental challenge to democracy. The malaise of the 1970s, a combination of a threat to growth, concern with limited resources, higher inflation, and challenges to democracy, all look quite contemporary again. It is consequently worth revisiting the experience of the 1970s, at a moment when the world seems to be denouncing, reviling, and moving away from neoliberalism.

In a longer-term perspective, the 1970s started the most intense phase of globalization – as measured by the share of trade in output – that the world ever experienced. The elements of a new liberalism included combating inflation, deregulation, and a reduction of trade union power. The movement was most dramatic in the United States and the United Kingdom, and the outcome was often associated in consequence with Anglo-American society – but continental Europe adopted some of its precepts. Though the turning point is often associated with the highly ideological figures of Ronald Reagan and Margaret Thatcher, in reality the fundamental shift already began much earlier.

The practical outcomes of new approaches to a new challenge of globalization, however, were not dissimilar, although there were time lags. A substantial convergence took place and constituted one of the major phenomena of late twentieth century globalization. In all countries, inflation fell, with a broad convergence that by the 2000s included many non-Western countries as well. Countries increasingly embraced trade liberalization. They deregulated many markets, and those countries that hesitated were chastised as laggards. Trade union membership and labor conflicts both fell away.

CHAPTER 3
From the Global Financial Crisis to the Covid-19 Pandemic: The Rise of Populism

Economic policy in the period between the outbreak of the Global Financial Crisis in 2008 and the outbreak of the Covid-19 pandemic in late 2019 was characterized by a number of developments which distinguish it from the policies which dominated before the crisis. The most remarkable policy shift is the rise of populism. The most striking example is the election of Donald Trump to the US Presidency in 2016. Earlier in the same year, the Brexit referendum surprised the world and ended six decades of deepening political and economic integration in Europe. In the debate before the referendum, arguments frequently used by populist politicians played a key role. In other European countries, populist movements also gained influence – in many cases boosted by the migration wave in 2015 – including countries as Italy, France, Hungary, and Poland

Chapter 3 outlines what was perceived as the dark side of market liberalization’s economic implications –higher inequality and instability – and how they have been linked to the rise of populism. The distributional consequences of globalization and liberalization, which had already appeared in several countries in the 1980s, came to the forefront during the Global Financial Crises and engendered a feeling of fracture with countries.

A climate of mistrust in elites and policy makers developed in the wake of the Crisis and created a challenge to economic policy that has been accentuated by the Covid-19 health crisis. Citizens in many EU countries seem to share a widespread perception of government failures, and what makes these perceptions unique is that they are shared across the political spectrum even if the reasons for the mistrust differ.

The dissatisfaction with policy has also stemmed from the looming environmental crisis. Both markets and policies are perceived as having failed the general population and tensions have emerged along a variety of dimensions. Younger generations feel their parents and grandparents are responsible for a crisis whose costs only the younger generations will need to bear; poorer countries blame richer nations; and within countries the income divide has also become a divide between those who generate high emissions and those who do not. Moreover, the increase in public debt that occurred during the Great Recession has been accentuated by the Covid-19 crisis, leaving governments in a tight spot. In this context, a complete rejection of the liberal paradigm of the past few decades is being advocated by many. Yet the very special economic climate over the past two years has created unusual circumstances and novel challenges.

CHAPTER 4
Will the Role of Governments in the Economy Change after the Crisis?

The Covid-19 crisis has prompted a debate not only on how to restart economies after the pandemic, but also on the need to rethink economic policies to address policy challenges including the climate, aging, technological developments, inequality, etc. Much of the debate centers on whether more or less government intervention in the economy is needed. Many observers see the Covid-19 crisis as an example of the importance of government intervention, and it is sometimes claimed that governments should also play a larger role after the pandemic. However, since the crisis situation is exceptional, that conclusion may be premature. During the crisis trust in governments has generally declined, potentially suggesting that demand for larger government is limited. But trust in governments usually declines in times of crisis and recovers later.

For this discussion it is important to note that the Covid-19 crisis is different from any other crisis encountered for about a century. The situation is different and unusual and the needed policy intervention therefore also unusual. It is not clear why this experience gained during the pandemic is of much guidance in addressing future policy challenges. It is also worth being reminded of the optimism about the power of fiscal policy (demand management policies) in the 1970s and the rather dismal track record despite substantial policy activism. The brief but important answer is that the policy interventions were not well designed to address the problems arising from supply side changes (oil price hikes) and structural problems in the 1980s, see Chapter 2 and 3. This is not implying that fiscal policy is unimportant or not useful, but a reminder that no policy is omnipotent for all kinds of problems. Later developments and in particular the growth of populism are also a reminder that it is important to take a broad-based perspective on policy making focusing not only on the winners but also how to cope with the losers. A serious policy discussion starts by understanding the problem and why and how policy intervention is needed, and not by defining the solution.

Intergenerational distribution is a common denominator in many contemporary policy themes. The climate and environmental issues have important intergenerational implications. But so have aging and public debt. The agenda of structural reforms to strengthen employment and growth to reduce inequality and improve public budgets and to make pension systems more resilient has not become obsolete as a consequence of the Covid-19 crisis, if anything it has become more urgent. Projections show that aging is driving up public expenditures, causing financial problems, and it is not obvious that such increases should be passively accepted, leading to large governments. Increases in retirement ages – motivated by increasing longevity – and strengthening of private savings are part of the solution.

The degrees of freedom in fiscal policy depend critically on debt. The pandemic has taken public debt to record levels. At present interest rates are low, but so are growth rates, and interest rates may change quickly. It is therefore very risky to base policy making on an expectation that the current low costs of servicing public debt are permanent. The present situation strongly depends on central bank intervention, and a normalization of monetary and fiscal policy will change the situation. The current increase in inflation underlines the fact that central bank support for highly indebted governments may end sooner rather than later. Neglecting the debt issue may thus imply some short-term degrees of freedom at the risk of policies being severely constrained by debt problems in the future. Looking back, there are many examples of countries having lost room for maneuver due to high debt levels.

Prudence in fiscal policy and fiscal rules have not become irrelevant as a result of recent developments. Such rules play an important role as guidepost for ensuring fiscal sustainability and thus addressing the problems arising from aging. However, the current debate about fiscal rules is justified in particular because debt ratios have reached levels far beyond the 60 percent limit foreseen by the treaty of Maastricht. While fiscal rules have their limits and enforcement is difficult, they remain important benchmarks in conversations and negotiations about economic policy at the European level. Just making these rules laxer by increasing, e.g., the maximum debt ratio to 90 or 100 percent of GDP is not solving the problem. There is a need for a better balance between flexibility, incentives, and discipline. One way forward would be to combine higher debt limits with reform requirements like the introduction of equity requirements for banks holding domestic debt portfolios.

Regarding the future role of governments, the consequences of the pandemic are in fact limited. Most importantly, the pandemic is a highly unusual situation, which requires unusual policies. The role of government in this crisis offers little guidance regarding its role when the situation is back to normal, as much as a surgeon may play a key role after an accident, but this does not mean the patient needs him permanently. Rather, there is a significant risk that the exit from the crisis mode, with government support for many individuals and companies, to bring back a situation where market forces are in play, may come too late. It would be highly problematic if the perceived role of government in the economy changed towards the expectation that government support shields companies and employees from any kind of pressure. The reallocation of human and physical capital which is needed to allow for structural change would be inhibited. This is why it is important that crisis related support measures are eventually phased out.

A rather straightforward consequence of the pandemic is that it has led to an increase in government debt, which will constrain government action in the future. The higher debt levels also underline the importance of structural and growth enhancing reforms, so that bearing the higher debt burden is easier. If there is a change in what is expected from governments, there may be a shift towards demand for competence. At the same time, populist politicians have not been very successful in this crisis. Whether this will reduce support for populism in the coming years remains to be seen.