

Rolf Strauch interviewed by Jornal de Negócios (Portugal)



Interview with Rolf Strauch, ESM Chief Economist

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Jornal de Negócios: The euro area practically stagnated in the second quarter. Are we really getting to that point, especially the larger economies like Germany?

Rolf Strauch: When we look at the euro area, we see that there is a recovery, and that growth will accelerate somewhat. Growth will be slow, and we also see that inflation will be under control. The main factors driving these slightly higher levels of

growth are real wage gains, and a relatively strong labour market. In the short term we also see that global trade will help and support external demand. But obviously in the medium to long term, the picture is less promising.

The main reason is that, in some respects, the Eurozone is falling behind other major economies in terms of economic growth. The main point is that, considering the megatrends that will shape our future, we need to adjust and boost innovation and productivity growth. This is where Europe has been lagging and this factors into our growth prospects. The main megatrends for the coming decades are ageing, climate change and geo-economic fragmentation, which will affect our prospects.

You're talking about the long term, but in the short term we have to solve a series of problems. Let's look at the Portuguese economy. Do you see these problems sometime in the future or in the present?

As far as the region's overall performance, once again, in the short term, economic activity should recover based on domestic demand, labour and the resilience that our labour markets have shown over the last few years, which helps a lot. And - without anticipating what the ECB will do - generally the markets expect central banks to lower rates, which will obviously help support demand and credit expansion. So, these are the driving factors. Then we see that external demand is also strengthening a little this year. So, exports could perform better.

And what is your assessment of the Portuguese economy now?

As far as the Portuguese economy is concerned, we can see that, in fact, in recent years during the recovery, it has outperformed the euro area economy and has grown relatively strongly, which is also due to domestic demand. Employment growth has been strong and there have actually been increases in real wages. This has really helped the Portuguese economy to achieve its performance and, as in other economies, the services sector has been relatively strong. Tourism, among other sectors, has been a driving force behind this growth.

What can we do about the pressure of ageing that will increase over the next 10 to 20 years?

Ageing is a general trend, but the way countries face it is different. If we look at the euro area, for example, we see that in some countries, including Germany and Italy, the working-age population is shrinking. In other countries, such as France or Spain,

this trend would only materialise in a decade.

We see differences in dependency ratios, which play a key role, and there are also big differences in the structure and nature of national pension systems. While for the EU, the European Commission has calculated that by 2050, the overall increase in gross pension expenditure will be 0.7 per cent of GDP, nine countries will actually have an increase of more than 2 per cent in part due to differences in the pension system.

The Portuguese situation in this area is also quite precarious. That is what we must consider when we address this issue. There is a general trend, but the way countries position themselves in this regard can vary depending on demographics and the pension system.

How precarious is Portugal's situation?

The Portuguese population is relatively old. The median age in Portugal is 47, while the median age in the EU is 45 and it is only expected to rise to 48 by 2050.

This difference may seem small for the EU, but it means that the ratio of workers to pensioners could fall from three to one to two to one. In the next ten years, according to the European Commission, ageing costs, (including pensions, but also healthcare, education and long-term care) will increase by more than 2 percentage points of GDP in Portugal. And by 2050, ageing costs will be 4 percentage points of GDP higher than today if nothing is done.

Now, 2 percentage points of GDP amounts to the interest rate burden Portugal is paying, 4 is double that figure. If you think about the pressures on spending and everything else that comes on top, i.e. climate change, defence, technological change, it is really necessary to plan ahead and have a very cautious budgetary path that has enough buffers for future shocks and creates space to finance future needs.

Could the reduction in interest rates by the ECB jeopardise the recovery of the Eurozone economy that you were referring to? Is now the right time to cut rates?

It is not for me to say whether it is the right time or not. The ECB will decide, based on the data it has, whether it wants to do it now and what the exact moment is or

how far it wants to go. The key question in the medium term is actually what is the natural real rate, the long-term rate of the economy that you want to have, and how you can or want to address that, given the inflationary risks that exist.

Given the megatrends you've identified, do you think we can expect a series of cuts and interest rates similar to those we had before the pandemic?

Regarding interest rates and the interaction between monetary and fiscal policies, there is a risk that long-term future interest rates could be higher than those seen before the pandemic. This risk stems precisely from the megatrends and the pressures on spending that they entail. It will be difficult to finance all of this. If in the future there is more public debt to finance these needs, there is clearly also the risk of having to face higher interest rates, which could have negative repercussions on available budgetary space.

Do you see the need for a strategy for pension schemes that is closer to the financial markets, as is the case in countries like the United States, for example?

The idea of a savings and investment union, which was presented by Commission President Ursula von der Leyen, is based on the idea of bringing more Europeans into the capital market. Normally, people save for old age. If we do not want to leave the whole burden of financing old age to workers or governments, we have to encourage people to invest in the capital markets.

As a European initiative, it would also help to invest on larger markets in Europe, and allow people to diversify their portfolios across countries. This will contribute to our growth and, for me, is a crucial step for the future.

Will we need hyper-integration?

Not hyper-integration, I would call it the necessary integration of capital markets. We need to think carefully about how to do this to guarantee financial stability and efficiency. There may be elements in the regulation of financial markets that can still be adequately regulated and supervised at national level, and then perhaps elements that can be dealt with at European level. That is not for me to discuss here. But these are issues that need to be addressed and considered based on common rules.

What is the impact of an ageing population on the stock market?

If we think about the consequences of ageing, it has an impact not only on growth through the supply of labour, but also through savings, the size of existing savings in the economy and perhaps also through the preferences people have in how they want to use their savings. And what we see is that, in general, this is one of the reasons why, due to the amount of savings and risk preferences, ageing populations tend to be less innovative and therefore less orientated towards productivity growth than other economies.

What does this mean for the creation of other pension systems?

Obviously there must always be adequate consumer protection and protection that guarantees an adequate flow of information. Markets need to offer the right products. In some European countries, we have funded pension systems that work. In the Netherlands, for example, or in Denmark. There is room to move in that direction, obviously always with the right safeguards in place. Financial literacy plays a significant role in this regard. People must be informed about what they are doing and there must be good supervision and responsible behaviour.

The pressure on public finances has been a major concern for Portugal. Do you think it is out of the woods now, even with an ageing population and low productivity?

There is one point, not just for Portugal, but for all euro area countries, that we should be concerned about, and that is productivity growth. In fact, improving productivity growth also improves competitiveness. If we look at Portugal, we see a very dramatic decline in the level of debt, which was brought below 100 per cent of GDP last year and is now significantly closer to the euro area average of 89 per cent. This was obviously due to inflation, but also to relatively solid growth and prudent fiscal policy. Portugal is one of the few countries in the euro area with a budget surplus. But there are challenges.

What challenges?

The level of debt is still relatively high. That is why we are looking forward to Portugal presenting its medium-term strategy, in the draft budgetary plans and also as part of the structural fiscal plan, which has to be presented to the European Commission. Portugal will have to spell out how it intends to adjust public finances

to meet the challenges. The presentation of budgetary plans and compliance with the new budgetary framework is crucial, not only for Portugal, but more generally for the credibility of the new framework. We want governments, in Portugal, but also other countries to present credible fiscal plans.

Between the pressure on public finances and rising interest rates, is there a new challenge for debt dynamics?

The only way to deal with this situation is through great budgetary caution, budgetary priorities that maintain a balanced budget over time, and mobilising all possible sources of growth. Deepening the single market can increase Europe's GDP by about 7 percentage points in the long term. We need these growth dividends to meet the challenges of the future. And we need an efficient distribution of labour at European and national level if we are to make progress.

Are you worried about a new debt crisis?

At this stage, there is no reason to be worried about an immediate debt crisis. If you look at the financial markets, it is not in the cards.

The Draghi report [*published on the day of the interview*] suggests a strategy of continuous joint financing. Do you think the EU should have a joint financing mechanism?

I have not had time to read the full documents yet, which overall is 400 pages long. From the point of view of the ESM, as a permanent crisis resolution mechanism, we are very keen for Europe to have sufficiently strong financial support. For us, it is also related to the ESM's Treaty change and our role as a common backstop. We want the ESM to be effective to address future challenges.

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