

Emergency Keynesianism 2.0: The political economy of fiscal policy in Europe during the Corona Crisis

Temanummer: Coronakrisen i samfundsperspektiv

Learning, radical uncertainty, and a state of exception

Fiscal policy is the sum of decisions on taxation and spending that one takes in an economy, particularly in times of crisis. As such, it is of existential importance in the life of a society. Known for its recent waves of spending cuts and tax increases (austerity) during recessions (Blyth, 2013), 2020 Europe has had a more expansionary fiscal policy than ever before. How do we make sense of this shift? To answer this question, let us draw on select insights from three political economy literatures on fiscal crisis management. The first is the literature on learning. For its proponents, changes in fiscal policy are powered by evidence-based, yet politically mediated cognitive updating in the corridors of power. Plainly put, policymakers are keen students of what changes in their environment. This literature has showed that a great deal of learning took place in the EU since 2010 in particular (Schmidt, 2020; Kahkhaji and Radaelli, 2017; Dunlop and Radaelli, 2019). Its main implication for fiscal policy under corona is that between 2010 and 2015 the EU leaders learned about the limits of austerity and the virtues of more spending and tax cuts in a recession. Consequently, one would expect that when a deep recession arrives again (and it did in the spring of 2020), they would not be tempted to do a rerun of the self-defeating policies of the 2010-2012 period. As Keynes put it, “when the facts change, I change my mind.”

The second literature the paper takes inspiration from dwells on the role of economic ideas in policy in moments when radical uncertainty reigns, that is when no one can precisely calculate the risk attached to certain courses of action versus others (Blyth, 2001; Seabrooke and Tsingou, 2020). For these scholars, such moments of uncertainty open up the doors for radically new ideas to enter the specter of policy possibilities. For example, Keynesian ideas shaped policy during the Great Depression in countries as different as the US and Sweden because both the state and capital had quickly run out of conventional choices and were thoroughly uncertain about what to do next (Blyth, 2001). Yet what makes the Covid crisis peculiar is that it was not only a crisis of radical uncertainty. Indeed, unlike in the Great Depression, when orthodox ideas were tried first, this was a particular form of radical uncertainty: one where most policymakers converged on operating with a doomsday scenario of a catastrophic and sudden stop in consumption, trade, finance and investment. The usual politics of scapegoating some countries and lionizing others due to their fiscal policy situation (Matthijs and McNamara, 2015) took a back



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seat everywhere in Europe as long as these fears persisted (March-June 2020). It is into this unique gap and under aura of emergency that radical forms of “emergency Keynesianism” familiar since 2008-2009 (Bremer and McDaniel, 2019) could walk in.

Yet in a complex multi-level polity with unevenly situated national economies such as the EU, not all policy ideas are equal. The third strand of literature I draw on is the EU crisis governance scholarship that emphasizes coordination between the representatives of the EU member states at the expense of the EU’s supranational technocracy. Some called this “intergovernmental domination” (Fabbrini, 2016) and identified it as the main locus of power in the EU since 2010, with the domestic politics of the surplus/creditor countries filtering what ideas and policies could be adopted at the EU level (Matthijs, 2016; Bremer and McDaniel, 2019; Bremer, 2020; Redeker and Walter, 2020; see Schild, (2020) for a skeptical view). The simplified implication of this literature is that the fiscal ideas with which to reduce systemic uncertainty stand to be not any ideas learned from the previous fiscal crisis, but only those that are also aligned with the interests of dominant actors in these strongly positioned countries. This line of thinking invites the following hypothesis: while emergency Keynesianism was deployed at the national level in the EU between 2008 and 2009, the fact that the doomsday scenario associated with Covid gripped the decision-making processes of both the surplus and deficit countries¹ during corona meant that Keynesianism could be scaled up from the national to the EU level.

Learning from the last war

Learning is relatively rare in economic policy (Oliver, 2016; Kahkhaji and Radaelli, 2017; Dunlop and Radaelli, 2019) and it is not unusual for powerful actors such as the German government or the European Central Bank to (rationally) learn the wrong lessons (Matthijs and Blyth, 2018). But between 2011 and 2015 the failure of the strategy to cut one’s way out of the recession induced by the Great Financial Crisis of 2008 had become manifest at the level of the EU (Ban, 2020; Schelkle, 2016; Schmidt, 2020). Far from enjoying some privilege, government bond markets in the Eurozone appeared to be fragile and more susceptible to self-fulfilling liquidity crises than in standalone countries with a national currency. To illustrate, low debt Spain almost went bankrupt (Blyth, 2013) and high debt UK and Hungary did fine in the bond markets (de Grauwe and Ji, 2013; Ban and Bohle, 2020). The main reason for this divergence was the ECB’s reluctance to act as lender to all governments in the Eurozone (“lender of last resort”) in the early years of the crisis (De Grauwe and Ji, 2013), in contrast to the central banks of the UK or Hungary (Ban and Gabor, 2016; Ban, 2020).

Back in 2010-2012, important European politicians and technocrats proclaimed that fiscal austerity was needed to cut public debt and make the economy grow again (Blyth, 2013; Helgadottir, 2016). Indeed, it was not until the

ECB stepped in to “do whatever it takes” to defend government debt throughout the Eurozone and the heads of the member states established the European Stability Mechanism (a kind of bailout fund) that the Eurozone got something close to a lender of last resort function (Howarth and Spendzharova, 2019; Gabor and Ban, 2016; Gabor, 2016). European elites also became concerned with the fall in credit to the “real economy” despite bank bailouts and deeper public spending cuts. As a result, they asked the bank of the EU (the European Investment Bank) to ramp up credit and even created a new European public lender (the so-called Juncker Plan) in order to lend to projects too risky for the EIB and more tailored for small and medium firms in Europe (Quaglia, 2017; Schmidt, 2020).

This backdrop of the 2008-2012 crisis in Europe is important for an analysis of fiscal policy during Covid in the European Union (EU). Thus, for all their differences, both the technocrats in Brussels or Frankfurt and the national heads of state had been primed for reading another major recession (such as the Covid recession) with different lenses than the ones of 2010-2012, when austerity had been the norm. However, as the next section shows, to the extent that the EU-level management of the 2010-2012 crisis was deeply anchored into the national politics of the surplus countries (Germany, Holland, etc.) (Puetter, 2016; Schimmelfennig, 2018; Smeets and Beech, 2020; Carstensen and Schmidt, 2020), the Covid crisis and the emerging “emergency Keynesian” policy response made a Keynesian fiscal stimulus and supporting monetary stimulus unavoidable because this time around the surplus countries started at economic catastrophe as well.

A crisis like no other and the importance of having supportive central bankers

In March 2020, both the European Commission and the International Monetary Fund expected most advanced economies to enter the most severe recession since the Great Depression. At the time of writing this study, that fear seems to have been exaggerated, yet the fear of coordinated financial and fiscal collapses in the EU had been widespread in the spring of 2020. This “end of times” atmosphere, complete with the harshest lockdowns in modern memory, precipitated European economies, almost overnight, into war economy conditions. That “war economy” was not a journalistic hyperbole was demonstrated by its use by elite names as different as UN head Antonio Guterres,² French President Emmanuel Macron,³ Spanish prime minister Pedro Sanchez⁴ or former ECB chairman Mario Draghi.⁵ And war it felt like. The collapse of aggregate demand and international trade, as well as a sharp drop in the GDP of OECD countries, created panic across Europe. According to a recent estimate, the global economy shrank 7.8% in the second quarter of 2020. In the Euro area, the corresponding figure was 12 percent,⁶ an unprecedented drop in peace time (OECD 2020). It was at this juncture in the spring of 2020 that Eurogroup President Mario Centeno junked “peacetime” moral hazard considerations and stated that,

“The challenge our economies are facing today is in no way similar to the previous crisis. This is a symmetric external shock. Moral hazard considerations are not warranted here. We must bear this in mind when we consider coronavirus dedicated instruments.”

From a strictly fiscal policy standpoint, it was a crisis like no other because of anticipated disruptions affecting both supply and demand across Europe’s national economies (Guerrieri et al., 2020). This sense of extreme disruption led to the fast adoption of unprecedented containment policies based on the unorthodox coordination of monetary and fiscal responses. If conventional policy assigns virtues to monetary policy alone and is skeptical of fiscal stimulus as self-defeating (Ban, 2015), the lessons of the 2008-2012 crisis had softened this approach. Indeed, the ECB and other European central banks adopted bold and unprecedented forms of financial stabilization and support for government debt in the bond markets.

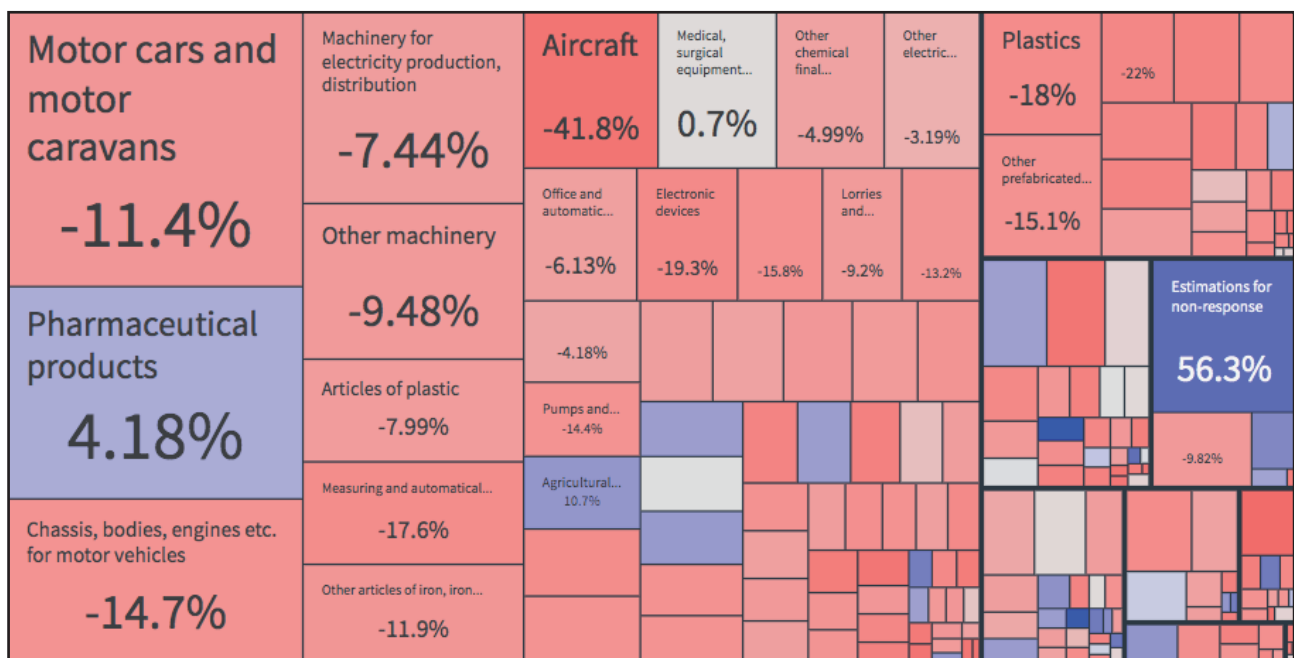
The Covid crisis also introduced coordinated monetary, financial and fiscal stimulus that had been redolent of the golden age of Keynesianism. As “master of the European masters of the universe”, to paraphrase Diessner and Lisi (2019), the ECB unleashed bond buying programs to stabilize markets to an even wider spectrum of activities, with its rates running close to zero. On March 18th, 2020, the ECB launched the 750 billion Euro Pandemic Emergency Purchase Program (PEPP) aimed at national and regional government bonds *as well as* private sector bonds. Contrary to conventional expectations, the main beneficiaries were not predominantly “periphery” countries but an assortment of deficit and surplus economies: Belgium, France, Germany, Italy, Netherlands, and Spain. Less than three months later, on June 4, 2020, the ECB nearly doubled the PEPP (to 1350 billion Euros) and made bond purchases aiming to remove the uncertainty over whether ECB purchases will continue throughout the cycles of the health crisis. In total, PEPP increased the ECB’s balance sheet to half the pre-COVID GDP in the Euro area, making it twice as big as the Fed’s in terms of its GDP ratio. If Adam Tooze (2018) was right that the Fed did better than the more conservative ECB in the previous crisis, the same cannot be said about the COVID crisis.

Arguably, the sudden stop of large volumes of economic activities triggered by the COVID shock led to the emergence of “COVID dominance” – whereby “nations focused monetary and fiscal policies on mitigating and containing the adverse health and economic consequences of the pandemic” (Jinjarak et al., 2020). Simultaneously with PEPP, the EU member states launched large national fiscal stimulus packages to mitigate widespread fears of the worst outcome: collapsing household and corporate income at times of massive medical and policy effort to deal with the new highly contagious pandemic. The COVID-19 Financial Response Tracker mapped out these measures in detail, so it makes little sense to provide a stylized narrative here. Yet it suffices to note that the menu was not entirely part of the typical pre-COVID fiscal policy answer. In addition to conventional tax holidays and credit/grants to

firms familiar before 2020, governments also began owning large parts of the affected sectors and paid in part or in full the wages of the workforce forced to stay at home at the cost of public debt going up 15 percentage point of GDP across the OECD (OECD, 2020).

Critically, COVID did not affect just the fiscally fragile Mediterranean countries. It also affected the fiscally strong Northern and Central European countries. In line with the hypothesis on intergovernmentalism, this situation changed the political economy of crisis management at the EU level. For example, the core industries of the creditor countries (automotive,⁷ aircraft manufacturing, machinery)⁸ saw unprecedented damage,⁹ triggering temporary sudden stops across the supply and value chains. Even in an economy as strong as Germany's, strategic exports shrunk drastically (figure 1).

Figure 1: Germany's product export growth



Source: Observatory of Economic Complexity, <https://oec.world/en/profile/country/deu>

A business survey of German, Spanish and Austrian firms in the industry, service, retail trade, and construction sectors found that the overwhelming majority expect a negative impact of the corona-crisis on annual turnover (to the tune of 20% in Germany and Austria and 25-44% in Spain).¹⁰ These are sectors with political influence via both labor and employer interests (Culpepper, 2010). Their interests could only be served by policies anchored in a bold fiscal stimulus.¹¹ Without supportive measures (including bailouts) from the state, the writing was on the wall for these sectors of systemic importance (Lonegran and Blyth, 2020).¹²

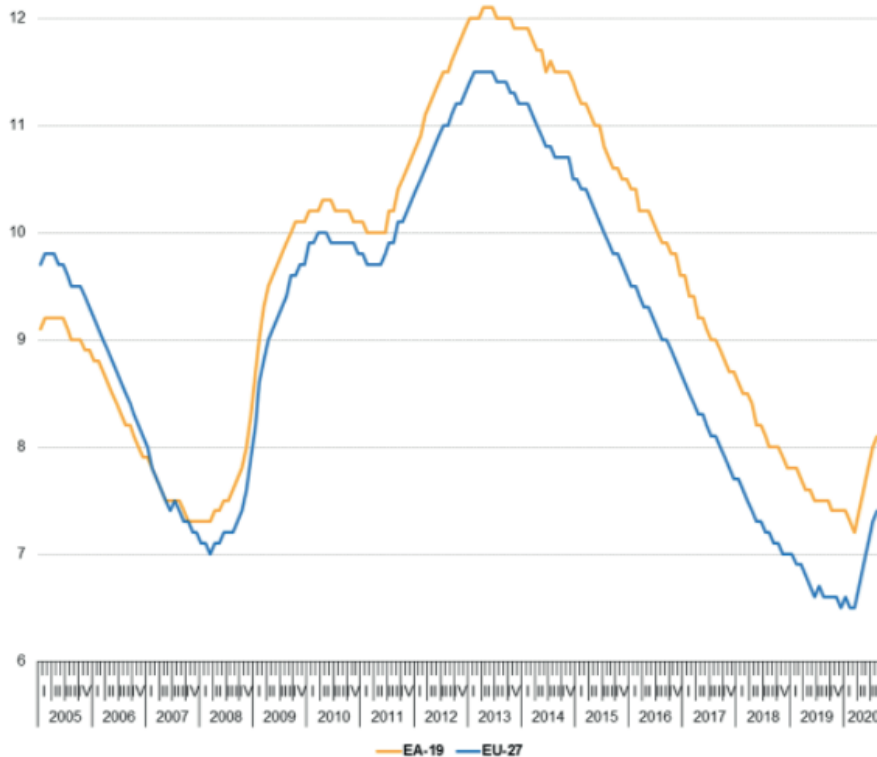
We know from a vast literature that fiscal policy decisions are as good as the trust of the bond markets. Here, EU technocrats and national leaders seem to have remembered how quickly deteriorating market conditions for government debt are followed by deteriorating market conditions for corporate debt (Gabor and Ban, 2016). In this regard, we now have emerging evidence that the implementation of the PEPP prevented runs on sovereign and corporate debt, thereby freeing and funding resources needed to fight the medical and economic consequences of the pandemic (Jinjarak et al., 2020).

Pass the fiscal bazooka

It is against this background that the EU institutions embraced emergency Keynesianism at the EU level and in the area of fiscal interventions as well. As early as March 20, the Commission proposed to activate the general escape clause of the Stability and Growth Pact (SGP).¹³ The clause was then embedded into “Six-Pack” reform of the SGP, and granted the Member States the possibility to deal with the fallout from the health crisis by suspending the obligation to adopt austerity for countries failing the fiscal targets agreed at the EU level (no deficit in excess of 3 percent of GDP). The Commission also modified EU State Aid rules to make them more flexible especially for critical sectors such as aviation and tourism. Furthermore, with the Recovery Plan for Europe, the European Commission increased expenditure ceilings, granted additional access to emergency loans and assets for member states, while earmarking funding for the health and agricultural sectors.¹⁴ The EIB (European Investment Bank) was asked to provide support as well by extending loans to companies for up to 200 billion euros, with a focus on financing capital investment of small and medium enterprises (SMEs) especially after the initial phases of the pandemic and a temporary loan-based instrument (SURE, for State Supported Short-time work or reduced work) of up to 100 billion euros to reduce unemployment by protecting workers and jobs. As figure 2 shows, despite a greater contraction of the GDP compared to 2008-2009, the EU experienced a less pronounced increase in unemployment numbers during COVID.

Figure 2: Average unemployment rate in the European Union

Unemployment rates EU-27, EA-19, seasonally adjusted, January 2005 - August 2020



Source: Eurostat

Subsequently, following the collapse of talks over “coronabonds” (collective debt issuance to reduce the interest rate for the fiscally weaker countries), a coordinated EU-wide fiscal package became a reality hard to envisage in February 2020: credit lines provided of the European Stability Mechanism, the EU’s bailout fund established in 2013 in reaction to the failures of the sovereign debt crisis of 2010-2013; a countercyclical ‘recovery fund’ or “European Marshall Plan” (“Next Generation EU” (NGEU)) – worth 750 billion euros readied to jumpstart European economies. The fact that this EU-level stimulus comes in the form of grants makes it doubly special. To top it off, the composition of the NGEU was not vintage Keynesianism, but what can be termed “green and digital Keynesianism”, with climate change and digitalization looming large among the priorities. At the time of writing this article, the member states are expected to submit draft recovery and resilience plans outlining national investment priorities in line with this approach.¹⁵ National objections to this fiscal solidarity reemerged in the later stages of the health crisis, with the “frugal four demanding rebates, stable contributions to the EU budget, climate change budgetary earmarks and conditions attached to the implementation of the stimulus package.”¹⁶ But one should not miss the forest from the trees. These objections merely dented the emerging countercyclical

policy rather than destroy it. At the end of the day, the fact that Germany, the creditor/surplus country with fiscally conservative preferences, supported the EU-wide stimulus package locked in emergency Keynesianism and made a repeat of the 2010-2012 impossible.

Is this a Hamiltonian moment in European fiscal policy?

Recent research on fiscal policy during Corona howed that had the government not provided wage support, local consumption would have declined by 44 percent in advanced economy settings (Casado et al 2020). Since consumption is a large part of GDP, the Corona recession would have been a lot more brutal. Supported by central banks' extraordinary interventions, governments prevented this from happening. Moreover, the EU developed a stronger fiscal arm backed by monetary and financial policy interventions at the EU level, with significant levels of citizen support for them (Beetsma et al., 2020). Yet what exactly should we make of it? Is this a form of emerging fiscal federalism, a United States of Europe in infancy? The scope of this transformation of fiscal policy at the EU level should be interpreted with caution. Three caveats stand out in this regard.

First, as the largest fiscal instrument of these transformations, NextGen is not really the fiscal foundation of a European federalism. Indeed, it is merely a form of fiscal crisis management shaped by the cohabitation of "emergency Keynesianism," "COVID *fiscal dominance*" (a rapid and sharply countercyclical mobilization of fiscal resources to fund the medical system, the sectors disrupted by the health crisis and the workers put on furlough by it) and the advancement of pre-COVID EU reforms, with the third priority in quantitative dominance. Thus,

"Looking at the proposed allocation of the funds, one finds that less than one-tenth of the total (55 bn) should be 'allocated based on the severity of the socio-economic impacts of the crisis' (under REACT-EU), which is presented as a *top-up of current cohesion policy*. The most important part of Next Generation EU is a new Recovery and Resilience Facility of €560 billion, whose purpose is to offer financial support for investments and reforms, including in relation to the green and digital transitions and the resilience of national economies, linking these to the EU priorities – but with no reference to the impact of shocks. The bulk of Next Generation EU should thus not be allocated to help absorb a shock, but to provide financial support for investment linked to EU priorities."¹⁷

Second, some elements of the "emergency Keynesianism" are set to automatically expire with the end of the health crisis. Thus, the (unprecedented) suspension of the escape clause is not a generalized suspension of the deficit rules, which will return in full force after COVID. In this sense, the ministers of finance (Eurogroup) and the EU's fiscal watchdog (European Fiscal Board) stressed that the suspension operates in a "timely, temporary and targeted" manner.

Third, macroeconomic models matter (Heimberger and Kappeller, 2017; Heimberger et al., 2019). The macroeconomic model used by the EU to judge the fiscal policy positions of the member states (the so called “PO model”) remains unaltered. The problem with this model is that it tends to be more pessimistic and critical of those countries that are also forecast to suffer a larger decline in economic activity relative to the pre-COVID-19 levels. It also tends to suggest austerity in the worst of economic times. To avert this twin problem, the Commission needs to calibrate this model used in fiscal surveillance to provide countries with more fiscal leeway as they deal with the long-term effects of the COVID crisis (Heimberger, 2020).

The emergence of a strong set of stimulus instruments at the EU level, the monetary support provided by the ECB and the decisiveness with which the EU uses this crisis to address the climate crisis and Europe’s mediocre performance in digital technologies, suggest that European elites have experienced an intense episode of lesson learning. However, its scope should not be overstated. First, the centerpiece of this new EU-level fiscal activism (NextGen) is a rather sluggish form of emergency Keynesianism, with its implementation still waiting for coordinated domestic action. Second, and perhaps most importantly, shocks of this kind to both supply and demand, shocks that come accompanied by sense of radical uncertainty that bring policymakers and public in “war economy” mode are extremely rare (indeed “black swan”-like) events. As such, their consequences tend to peter out, ushering business as usual once the initial radical uncertainty is replaced by calculable risk about the potential courses of action. If the other “emergency Keynesianism” epitomized by the 2008-2010 crisis serves any lesson, it is that once the emergency is over, the EU may rationally learn the wrong lessons. Rationally learning the good lessons, not the wrong ones (Blyth and Matthijs, 2019), seems to be the contingent blessing of traumatic moments such as the one we are still experiencing.

Noter

1. Northern countries were less affected than the Southern ones (Gräbner et al., 2020) yet the former were also extensively affected, as showed below.
2. <https://www.euronews.com/2020/03/25/coronavirus-antonio-guterres-speaks-to-euronews-about-un-s-covid-19-response>
3. <https://corporate.nordea.com/article/56514/chief-economist-s-corner-war-economy>
4. <https://www.brusselstimes.com/news/eu-affairs/104800/spanish-pm-calls-for-marshall-plan-for-post-virus-europe/>
5. <https://www.ft.com/content/c6d2de3a-6ec5-11ea-89df-41bea055720b>
6. <https://ec.europa.eu/eurostat/documents/2995521/11156775/2-31072020-BP-EN.pdf/cbe7522c-ebfa-ef08-be60-b1c9d1bd385b>
7. <https://www.rfi.fr/en/france/20200526-macron-announce-relief-plan-bailout-covid-hit-car-industry-renault-coronavirus>
8. <https://www.freightwaves.com/news/airbus-orders-in-2020-cut-in-half-by-covid-19>
9. <https://www.dw.com/en/german-auto-vw-bmw-mercedes-coronavirus/a-54443067>
10. https://www.econpol.eu/publications/policy_brief_31
11. <https://www.afr.com/policy/economy/we-are-all-keynesians-again-20200826-p55phs>; <https://voxeu.org/article/economic-policy-under-pandemic-european-perspective>
12. <https://www.ft.com/content/7a739543-a39e-4301-830d-dddc8a0f503b>
13. Articles 5(1) and 9(1) of Regulation No. 1466/97 and Articles 3(5) and 5(2) of Regulation No. 1467/97).
14. EU/EA Measures to Mitigate the Economic, Financial and Social Effects of Coronavirus," 2020.
15. https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1658
16. <https://www.ft.com/content/7faae690-4e65-11ea-95a0-43d18ec715f5>
17. <https://www.ceps.eu/next-generation-eu-2/>

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