



# A new political economy for Europe post-COVID-19

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## Abstract

The COVID-19 pandemic has led to unprecedented economic support measures from governments across Europe. With this, the crisis has provided an occasion for a significant demonstration of the ability of states to implement policies and deliver services. This could create expectations among electorates of permanent changes to the macroeconomic regime, towards one characterised by a more protective state and a rebalancing between the state and the market. Significant political barriers to such a shift remain. The article argues that, in contrast to the aftermath of the two previous economic crises in Europe, many new ideas are floating around and support for a more protective state is emerging across the political spectrum. The current crisis might thus represent a turning point.

## Keywords

COVID-19, Europe, Political economy, Industrial policy, Fiscal policy

## Introduction

The COVID-19 pandemic has shocked European health systems and economies. So far it has not led to any political shocks. A crisis of this magnitude is unlikely to pass by without significant political consequences, though, particularly as it comes at the tail end of a decade of economic crisis in Europe that has not led to a fundamental shift in either the political or the economic regime.

The global financial crisis of 2008–9 and the subsequent crisis in the eurozone had already led to demands for changes to the economic settlement. This backlash came in the form of a number of ultimately largely unsuccessful protest movements, including

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Occupy Wall Street in the US and the Indignados in Spain, but also through a shift in views on economic issues. The theme of inequality was put on the agenda through widely publicised research by the French economist Thomas Piketty (2014). However, economic policy in response to the crisis largely followed existing prescriptions, with the aim of getting back to a more stable and robust version of the pre-crisis situation. As a result, one of the main political implications of that crisis was the strengthening of populist forces across developed democracies which were already disenchanted with the impact of globalisation (Manow 2018, 16–18).

In contrast, the effects of the economic crises of the 1970s, particularly the combination of high unemployment and high inflation, contributed to a change in the macroeconomic regime. The retreat of the state in economic life and the increased primacy given to the market following this shift in the late 1970s and early 1980s is unlikely to be directly undone. However, this article argues that the COVID-19 crisis could provide the trigger for a fundamental rethink, the ideas for which have recently been floating around more prominently than they were in the wake of the previous crisis. It first looks at the economic impact of the crisis, followed by an exploration of what this shift would look like. It then discusses what its impact would be for individual economies and for the organisation of the European economy as a whole, and what that would mean for European integration.

## **The economic impact of COVID-19**

To control the spread of the coronavirus, European governments put large parts of their economies into something like an induced coma. In order to enforce social distancing, workers were told to work from home, and businesses where this was not possible were temporarily closed, with wages in most cases paid at least in part by the state and businesses receiving support through subsidised loans. The support for specific sectors subsequently moved to stimulus measures to support the recovery once economies started to open up in the summer. Meanwhile, central banks provided ample liquidity to financial systems and governments. In all, in response to the economic impact of the health crisis, state support has been unprecedented. This has differed somewhat in size between countries: whereas by early August the German government had adopted direct fiscal stimulus measures worth 8.3% of 2019 gross domestic product, the measures announced in Italy only amounted to 3.4% of its gross domestic product. But almost everywhere governments have provided a significant fiscal stimulus (Anderson et al. 2019). Possibly reflecting a shift in attitudes, the stimuli have also been accompanied by announcements that, in contrast to the experience following the global financial crisis, they will not be followed by a rapid return to fiscal consolidation. To this end, the EU has suspended its fiscal rules until at least the end of 2021, meaning that until then there will be no pressure from Brussels on member states to limit their budget deficits (Brunsden and Fleming 2020). The large-scale fiscal response also sets the current experience apart from the previous crises, when it fell mainly on the monetary authorities to support the economic recovery.

Nevertheless, despite these measures, the economic damage of the crisis is likely to turn out to be significant. The International Monetary Fund expects the world economy

to shrink by 4.9% in 2020, compared with a contraction of just 0.1% in 2009, the high-point of the global financial crisis (IMF 2020). Last time around the economic impact was limited for some by increased demand from around the world; with the developing world now also being hit and China limited in its stimulus options due to the debt overhang from previous efforts to stimulate its economy, this way out is no longer available. For Europe this means a forecast contraction of 10% for the eurozone economy. A rapid return to normal looks unlikely, even if a vaccine is available soon. A long period of demand shortfall and disruption to a large number of sectors is likely to have lasting economic consequences due to high unemployment and large fiscal deficits, which would contribute to existing dissatisfaction with the macroeconomic regime in Europe.

## **A pandemic-induced regime change**

The pandemic and the policy response to it have highlighted the power of the state in directing economic life as governments have let go of previously dominant restraints on fiscal policy and debt sustainability (Bergsen et al. 2020). This demonstration of state capacity and of the state as the ultimate guarantor of the economy could change attitudes towards the role of the state among European electorates, following a long period of generally hostile views of state intervention in the economy. Although the economic impact is almost certain to vary by country, governments from across the political spectrum have taken similar measures and thereby set similar precedents.

Beyond the economic damage, the measures have also had other side-effects, the most striking and potentially politically meaningful being the exacerbation of existing economic inequalities (Bonaccorsi et al. 2020). It has generally been those lower down the income scales whose employment has been hit hardest by the lockdown measures, as these groups tend to work in low-productivity service sectors and have fewer opportunities to work from home.

In broad terms, there will be pressure to create a new economic settlement in which the state plays a more protective role and in which the balance shifts back from the market to the state. Much will depend on the extent to which existing and some new ideas find traction and political representation.

## **A new regime**

It is impossible to predict the exact shape of the political settlement that might arise from these pressures. Blyth and Matthijs (2017) define the current macroeconomic regime as one that prioritises price stability, compared with a post-war regime that emphasised full employment. This suggests a return to the post-war settlement. However, this situation was a result of the specific circumstances and institutions of the time. Rapid economic growth, as Western Europe caught up with the technological leadership of the US, allowed for wage restraint and full employment through a bargain between capital and labour that was facilitated by corporatist institutions (Eichengreen 2007, 90). However, we are unlikely to move back to any regime that suffers from the same tendency towards

inflation as that which had already, prior to its implementation, been prophesied to lead to the downfall of the full-employment regime (Kalecki 1943). Instead, any new regime, or new political economy, would be more likely to be visible in modest changes to fiscal, monetary and economic policy.

A more protective state, particularly of those groups hardest hit by both the current regime in the form of globalisation and now the pandemic, would require at the very least a stronger emphasis on government ensuring full employment through active fiscal policy (Sandbu 2020, 140–2). Concretely, this would be reflected in the decreased importance of EU fiscal rules and the running of larger deficits for longer, enabled by the current low-interest-rate environment, which would keep debt servicing manageable.

During the first half of 2020 the brakes on fiscal policy were released in order to deal with the crisis, and this included Germany letting go of its balanced-budget target. More supportive fiscal policy after the crisis would not just mean continuing with many of the crisis-fighting measures. In practice, beyond income support, it would mean more investment in infrastructure, health care, research and education.

Political obstacles to such a shift remain significant, in part because it would probably require a shift in the burden of taxation, from labour to capital in many cases. However, there is an appetite in Europe for higher corporate taxes and for European cooperation to achieve this. This is evident following frustration regarding some member states' accommodative corporate tax regimes flowing over into the discussion on the EU recovery fund (Khan and Fleming 2020). The difficult class politics of shifting the burden of taxation from income to wealth would, though, require more political support than currently seems to be available.

During the previous crisis calls were also heard for more fiscal activism, but these were largely ignored as most European countries moved towards fiscal consolidation while the crisis was still raging. Attitudes seem to be shifting now, as evidenced by the German rethink on both its own spending limits and on spending in the EU context. Recent years have seen the rise of influential new ideas in this area, such as those put forward by Modern Monetary Theory (MMT), a school of economic thought that posits that inflation is the only real constraint on government spending and thus that in the current low-inflation environment there is space to significantly increase such spending. While mostly prominent in the US, this theory could be seen as a harbinger of shifts in thinking about fiscal policy more widely.

MMT also envisages a large role for the monetary authorities, which would effectively enable fiscal authorities to increase spending at will. Monetary policy has already undergone significant changes in the past decade in response to the series of crises hitting the European economy. The idea of the independent central bank as an inflation-busting tool has much to do with the experience of the 1970s, when inflation was high despite high unemployment. In recent years, across much of the developed world the opposite has been the case, with inflation barely picking up despite several economies moving close to full employment. In response to their failure to push inflation to their mandated

targets, central banks have engaged in several forms of unorthodox policy, including large-scale and only moderately effective bond-buying programmes (Andrade et al. 2016). The mechanism of transmission to the real economy of these innovative monetary policy instruments has always been similar to that of traditional monetary policy, that is, the broad interest rate environment, and has attempted to respect the largely imaginary division between monetary and fiscal policy. Instead, under a new macroeconomic regime central bankers could aim to more directly influence the real economy, particularly if political authorities give them the mandate to do so.

The European Central Bank (ECB) has already developed some tools to do so, most notably its bank liquidity support mechanism, the so-called Targeted Long-Term Financing Operations. By creating a system of dual interest rates this mechanism could allow the ECB to support broader policy targets than just price stability, for instance encouraging lending by banks to finance sustainable energy investments (Loneragan 2020). This tool was used to support the financial system during the pandemic but has not yet been targeted to specific policy goals.

The main thrust of a new economic settlement would be delivered through changes to broader economic policy, though. This would affect industrial policy, labour market rules and welfare policy (Bergsen et al. 2020). Following the interventions by states during the COVID-19 pandemic, including in some cases taking stakes in companies, there could be an expectancy and acceptance of a more activist approach to industrial policy. This would follow French and German pressure in recent years to make competition policy in the EU more accommodating to creating European champions in strategic sectors to compete on a global scale (Chazan 2019). A push from policymakers to reshore critical supply chains in the wake of disruption to the supply of medical goods in the early phase of the pandemic did not lead to immediate results but is indicative of an increased willingness to apply industrial policy (Abboud and Peel 2020). Labour market and welfare policy is not just likely to incorporate crisis-time innovations such as the short-time working schemes put in place by most European governments but could look to create more labour protections. Furthermore, experiments with direct payments to citizens and increases in benefits could create a change in the public mindset and expectations, leading to these becoming difficult to remove and possibly even expanded into something resembling a universal basic income. In other words, in all of these policy areas the state would increase its involvement in the economy, in many cases at the expense of market forces.

## European impact

The shift in the macroeconomic regime described above would not just be felt on the national level but would also have implications for the EU. A re-evaluation of the balance between the state and the market runs the risk of clashing with European integration as currently constituted, which has aimed to curb national governments' ability to intervene in market processes (Bergsen et al. 2020). If large gaps open up between different member states over the extent to which this balance should shift, the EU strictures could become problematic as they will be harder to change.

That there is potential for some of the limitations created by the current EU rules to be overcome was demonstrated by the agreement of EU leaders to the creation of a recovery fund to support the countries and sectors hardest hit by the pandemic (European Council 2020). This represents the green shoots of new thinking about fiscal policy in the eurozone economy. The common borrowing the fund represents was often put forward as an idea during the eurozone crisis, but remained unthinkable due to German opposition. This changed in May, when German Chancellor Merkel together with French President Macron established the foundations for the plan as agreed by the European Council. Although it is designed to be a one-off, it could nevertheless form the basis for future common fiscal responses to economic crises (Bergsen 2020a). Nevertheless, the difficulty encountered in agreeing to the plan, in particular the objections from a group of smaller, northern member states, suggests that the same divisions over fiscal risk and burden sharing could hold back any changes in these areas (Bergsen 2020b). A return to fiscal orthodoxy, including strict enforcement of the fiscal rules, thus remains possible and would make the other changes embodied in the regime shift described above difficult to achieve.

## Conclusion

The COVID-19 crisis and its economic implications have the potential to lead to a shift in the political economy or macroeconomic regime in Europe following over a decade of crises. This would not be about a return to the post-war regime but about specific changes and the implementation of new ideas in several policy areas. Many of the ideas are there, and it is possible that the current crisis will provide the trigger, but significant political obstacles remain, not least the lack of political representation of many of these ideas in Europe. Despite this set of ideas largely revolving around the stronger hand of the state in the economy, many of them have found support across the political spectrum. This means that a shift in the macroeconomic regime would not necessarily require a change in political leadership, as it did in the late 1970s. The lack of direct political representation also creates a risk that the political momentum will dissipate following the crisis and, as after the other two recent crises, not much will change.

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## Author biography



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