I. THE RISK OF STAGNATION

The COVID-19 virus has caused a negative supply shock to the world economy: global supply chains have been seriously disrupted, factories have been shut down, retail shops have also been closed. Social distancing measures adopted to contain contagion have also caused a severe reduction in demand.

Unfortunately, the supply disruption caused by the virus is likely to be persistent, since firms may not be able to restart production for a while and, even when finally allowed to do so, they may not be able to ramp up quickly. Workers will not return all at once, social distancing measures will likely disrupt production lines, global supply chains may have to be reconfigured and, in general, the costs of production and distribution are bound to go up. Furthermore, some companies will be forced into bankruptcy and their assets may not be recycled productively for some time.

As explained by Fornaro and Wolf, absent aggressive monetary and fiscal policy interventions such a persistent disruption of supply may ‘cause a demand-driven slump, give rise to a supply-demand doom loop, and open the door to stagnation traps induced by pessimistic animal spirits’.  

In their simple model of the economy, the virus reduces productivity growth and, therefore, causes an initial reduction in employment and aggregate demand. This in turn causes a new reduction in supply since firms’ investment is positively linked to aggregate demand. Firms invest more when they expect to obtain a greater return on investment and such a return is greater when expected demand is larger. The reduction in investment further depresses productivity growth and in turn aggregate demand, and so on and so forth. Thus, the virus gives rise to a perverse ‘supply-demand doom loop’. The loop may be even more troublesome if firms and households are pessimistic about future productivity growth, as such ‘pessimistic animal spirits can push the economy into a stagnation trap’.

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1 Luca Fornaro and Martin Wolf, Coronavirus and Macroeconomic Policy, 2020 <https://voxeu.org/article/coronavirus-and-macroeconomic-policy> accessed 18 April 2020.
The only way to escape from this vicious circle is to boost demand. Central banks may help to slow down the supply–demand doom loop by lowering interest rates and thus propping aggregate demand. However, conventional monetary policy alone may be insufficient, or even unable, to reverse the loop when interest rates are close to zero, as arguably it is now the case. Dealing with the loop will thus require helicopter money or an expansionary fiscal policy or both.

II. THE FISCAL MULTIPLIER

The new Keynesian economics explains that, in an economy where firms have some market power but not all rents are appropriated by firms, the fiscal policy multiplier is greater than 1, as Keynes had argued. This is because, provided prices are above marginal costs, firms will always be eager to expand investment. An expansionary fiscal policy increases aggregate expenditure, which increases profits, which in turn increases investment and employment, which then further increases expenditure, and so on.

More importantly, the fiscal multiplier—ie the change in aggregate demand resulting from an increase in government expenditure—depends on the profit margin. Under some reasonable regularity assumptions and perfect competition, the fiscal multiplier is $1/(1 - \alpha)$, where $\alpha$ denotes the marginal propensity to consume in response to a change in income. In the limiting case in which all rents are appropriated by firms, that multiplier equals 1. In general, with imperfect competition, the multiplier is equal to $1/(1 - \alpha \mu)$, where $\mu$ is the price-cost markup. As the markup goes up, the fiscal multiplier goes down.

In short, fiscal policy becomes more effective as a tool to boost aggregate demand when product markets are more competitive. This is true whether fiscal policy is instrumented via increases in government spending or reduction in taxes, or even when the increase in government spending is matched by an increase in taxes so that the government budget remains balanced. In all cases, the output expansion effect of fiscal policy is greater when the economy’s markup is lower.

III. KEYNESIAN ANTITRUST

Hitherto, we have explained that (i) the COVID-19 virus may cause a supply–demand doom loop in the absence of a strong macroeconomic response; (ii) conventional monetary policy on its own is unlikely to reverse the loop; (iii) our governments will have to adopt expansionary fiscal policies; and (iv) the success of those fiscal stimulus will depend, among other things, on the competitiveness of their economies—ie the degree of market power in product and services markets.

The problem is that several indicators point to a significant increase in markups across most Western economies. Some attribute that increase to technological factors, but others, including De Loecker, Eeckhout, and Unger, argue that the cause is the increase in market power. Some sustain that the deeper cause of the increase in

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2 N Gregory Mankiw, ‘Imperfect Competition and The Keynesian Cross’ (1988) 26 Economics Letters 7.
3 Jan De Loecker, Jan Eeckhout and Gabriel Unger, ‘The Rise of Market Power and the Macroeconomic Implications’ (2020) 135 (2) Quarterly Journal of Economics 561.
markups (and inequality), especially in the USA, lies in the lenient nature of antitrust policy.4 Whatever the cause, the implication is that the fiscal policy initiatives adopted in response to the current crisis might be less effective than they could have been if our economies were more competitive. This has several implications:

• First, it is not a good time to relax antitrust policy, especially in highly concentrated sectors. We should also step up our efforts to detect and deter price-fixing.
• Secondly, we need to be very careful with mergers aimed at increasing market power (as opposed to those that may serve to address the problems of failing or flailing firms).
• Thirdly, we should also be wary of requests to facilitate the development of national champions either by relaxing merger control or easing the conditions under which these companies may receive public funding.
• Fourthly, some European Union Member States may receive financial support in order to be able to prop up their economies out of the crises. Conditioning those funds on austerity measures like those imposed after 2008 makes no sense this time (maybe did not make sense in the past either), but requiring those countries to adopt liberalization policies that increase the competitiveness of their economies is a win-win and thus constitutes an appropriate policy.

IV. SUMMING UP

John Maynard Keynes, the most influential economist of the 20th century, once said ‘The political problem of mankind is to combine three things: economic efficiency, social justice and individual liberty.’ Contrary to what the reader may infer from that statement, he was an optimist. In 1930 he said, ‘assuming no important wars and no important increase in population, the economic problem may be solved, or be at least within sight of solution, within a hundred years. This means that the economic problem is not – if we look into the future – the permanent problem of the human race’.5

Unfortunately, today, 10 years before the 2030 deadline he set out, we cannot be so confident about our economic prospects. More worryingly perhaps, social justice and individual liberty are also under threat and not only because of the COVID-19 virus.

4 Thomas Philippon, The Great Reversal: How America Gave Up on Free Markets (Harvard UP 2019).
5 John Maynard Keynes, ‘Economic Possibilities for our Grandchildren (1930)’ in Essays in Persuasion (Harcourt Brace 1932)