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COVID-19: When Keynes meets Schumpeter

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To take up the monumental challenge posed by the COVID-19 pandemic, policy-makers are drawing inspiration from both Keynes, an advocate of State intervention in the economy to support aggregate demand and growth, and Schumpeter, who regarded innovation and technological progress as the primary drivers of long-term growth.

The coronavirus pandemic and the measures taken to stem it have generated a shock of an unprecedented nature which has caused a collapse in both supply and demand, with a strongly differentiated impact across sectors.

A simultaneous shock for supply and demand

Lockdown measures made for a violent negative supply shock. The quarantine imposed by the Chinese government on the inhabitants of Wuhan on 23 January, then extended to the entire Hubei province—a major Chinese industrial hub—kept a great many employees from going to their workplaces, forcing Chinese companies (particularly factories) to considerably reduce or cease production.

This resulted in supply disruptions in countries dependent on China given the worldwide organization of value chains, with a heavy impact on certain industries (particularly the automotive industry). Then, following in China's footsteps, many other countries quickly mandated lockdown measures which magnified the supply shock. Entire sectors were forced to stop working overnight (catering, live entertainment, etc.) and their production naturally collapsed.

The shock on demand has several causes: the drop in demand for goods and services from companies with reduced activity; the fall in consumption due to fear of contagion or because of the mandated closure of certain businesses; the rise in precautionary savings. And as one person's spending is another's income, the result has been a drop in income and therefore demand.

The “Keynesian moment”

For now, the demand shock in most developed countries has been considerably cushioned by gargantuan fiscal and monetary support measures. The government and the European Central Bank have provided monumental aid for those most in need of it (salaried workers, self-employed and at-risk workers on lockdown, SMEs and other vulnerable companies). **When the economy is in a recession, Keynes' recommendations to stimulate demand return to the spotlight.**

For **John Maynard Keynes**, there is no self-regulating mechanism that guarantees full employment. In a recession, the government must intervene with counter-cyclical economic policies (both fiscal and monetary) to kickstart growth and return to full employment. **Keynes is**

primarily interested in the short term (“in the long run we are all dead”, he famously noted) **and the countercyclical regulation of the economic fluctuations created by demand.**

Joseph Schumpeter was concerned that government intervention would stymie entrepreneur-driven innovation. He **believed that the free-market economy is constantly adapting to shocks, and that this ongoing adaptation process is the driving force behind long-term growth.** He aimed to foster waves of innovation that lead to what he referred to as “**destructive creation**”, in which outdated or obsolete activities and jobs disappear to make way for new activities, sources of productivity gains.

The “Schumpeterian moment”

The "Schumpeterian moment" is the gale of creative destruction triggered by COVID-19. The collapse of a portion of the production apparatus has tremendously advanced the destructive part of the Schumpeterian equation, making it possible to renew supply. The sectors in which many employees have direct contact with clients and can't work remotely (hospitality, transportation etc.) have been severely affected by the crisis. Companies that were booming yesterday are cutting staff or are going bankrupt. Many of those jobs are lost, probably for quite some time.

The creation part is the tremendous boost given by the pandemic to the digital transformation of our societies. The post-COVID world will be a digital one (artificial intelligence, robotics, telemedicine, remote work, e-commerce, supply chain 4.0, etc.). What impact will digital innovation have on productivity and growth? The debate remains open between the “techno-optimists”, which predict an increase in productivity, growth and overall standard of living, and the “techno-pessimists”, which are alarmed by an unprecedented rise in inequalities.

A nearly Cornelian dilemma for political decision-makers

The reshuffling of cards in the economy represents a major challenge for policymakers: **how to support the companies experiencing hardship that are capable of success in a post-COVID economy without providing subsidies to those that are no longer viable?** The risk is that the authorities will adopt defensive policies to protect jobs or underperforming or obsolete companies, preventing the reallocation of factors of production to the most innovative companies. Creative destruction comes at a high cost in the short term (loss of employment, destruction of value for companies).

How to facilitate the transfer of resources from declining sectors to the sectors more apt to prosper in this new economy, without raising social inequality? As new technologies are disproportionately biased towards highly qualified workers, targeted structural support must be combined with demand-side policies to stimulate growth and stronger redistribution mechanisms. This is undoubtedly a high-risk fine-tuning.

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