TIF - Knowns and Unknowns in the Covid-triggered Global Economic Crisis

C.P. CHANDRASEKHAR

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A container ship on the high seas in normal times: Trade by air and sea has now been severely disrupted by national lockdowns affecting, in turn, global production value chains | Wikimedia

The traditional toolbox of fiscal and monetary measures will not help deal with the exogenous shock given by Covid-19 to the global economy. In these unknown waters for now the state can at best ramp up medical services and devise proper relief for the poor.

The coronavirus or Covid-19 pandemic has put the world's economic decision-makers and their advisors in no man's land. The challenge they must address is visible and obvious, but the means to do so effectively are almost an unknown.

It is clear that in the first quarter of 2020 the economies of most of the world's nations would have contracted, some to a significant degree. Whether that contraction will continue and, if it does, for how long, is anybody's guess. Speculative forays into estimating the degree of contraction in the gross domestic product (GDP) and where collapsing stock markets would settle are mere games that can yield the right numbers only by accident.

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These conjectures only serve to divert attention from the more crucial questions that must be confronted.

The fundamental problem today is that while the policy establishment must act to mitigate and overcome an inevitable crisis, the known instruments of economic policy hold out no promise of being effective, at least in the near future.

This situation is the result of the nature of the crisis at hand. The virus, which quickly moved across frontiers from the first epicentre of infection in China, the world's manufacturing hub, to new epicentres in developed country locations in Europe and the United States (US), has overwhelmed underfunded and/or unprepared health systems. This has made national isolation through closures of borders and aggressive intra-border physical distancing, culminating in lockdowns, the main means of trying to control the spread of the pandemic.

As expected, this has meant a sudden stop to economic activity. Even before the lockdowns, the disruptions in trade and global value chains had adversely affected production because of a loss of market access and/or shortage of raw materials. With flights banned and even domestic transportation restricted, the travel and tourism businesses were crippled. Full-scale lockdowns then shut down production and closed a host of businesses. Masses of workers lost their jobs, especially since across the world there has been a rise in the share of casual and precarious employment in recent decades.

These developments have affected both supply and demand. With production chains broken, factories shut down, and businesses forced to close, the supply of a range of goods and services—barring those considered essential—was suddenly blocked. This has had its spin-off effects on upstream and downstream sectors. Even suppliers of essential goods, facing problems in transportation and distribution, have had to curtail production.

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The supply shocks soon translated into demand compression for most goods. With incomes and earnings curtailed or wiped out, demand has fallen for consumption goods. The halt in production cut demand for intermediates as well. And with capacity idle and economic activity disrupted, investment froze.

Since supply was independently disrupted, the magnitude of the demand compression (driven in part by the supply shock) cannot be easily estimated. But the collapse in energy demand that led to the unwinding of the production-limiting agreement between the Organisation for Petroleum Exporting Countries (OPEC) and non-OPEC oil-exporting countries like Russia, which, in turn, resulted in a collapse of oil prices to less than $20 a barrel, reflects the grim situation.

In the past, exogenous supply-side shocks that reduced production and availability, such as the effects of adverse weather conditions on monsoon-dependent agriculture, were limited to a few sectors and one or a few countries. Where national reserves could not address such shocks, trade came to the rescue. National availability was enhanced by imports from abroad. In this crisis there is much less flexibility with Covid-19 infections reported from more than 100 countries and cases of disease approaching a million worldwide.

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With stringent lockdowns in place and almost half the world's population confined to their homes, production shortfalls are now globally widespread. These shortages have been amplified by their transmission through global value chains. Moreover, trade is limited as transportation links have been cut or weakened. This has led to a synchronised reduction in production and supply of most goods and services other than of essentials. Essential commodities too are flying off the shelves in many locations.

Given the virus-induced and exogenous nature of this shock, throwing money into the system to ramp up production cannot immediately help. Capacity shortages are not the problem in most areas. The difficulty in keeping economic activity running is the problem. Where there is a shortage of capacity, the problem is that fresh investment cannot be made immediately.

Production can be sustained only where the state steps in and ringfences production on grounds of the activity concerned being crucial, for example, to address the medical emergency or to produce essentials. In other areas, a slow return to normal production levels must await an environment- or immunity-induced reduction in the intensity of the pandemic. Physical distancing and lockdowns are interim means of reducing the number of cases or "flattening the curve" of rising infections and mitigating damage till factors that help the pandemic subside become operative. That increases the uncertainty about the period for which the supply shock is likely to be in play.

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Given this supply shock, addressing the other aspect of the crisis, which is demand compression, becomes difficult too. Wages, earnings, and profits have shrunk or have been wiped out. However, a Keynesian-style fiscal stimulus or monetary measures to fuel credit-financed spending are both likely to run up against exogenously generated supply bottlenecks, triggering inflation. They would create a new problem without resolving the old one.

These features of the Covid-19 induced economic seizure make this an unusual conjuncture, which is what leaves policymakers without any sense of direction.

Monetary policy measures, the policymaker's favoured instrument for a few decades now, cannot work at this point of time. These measures have been pursued with limited effect since the 2008 global financial crisis and during the global recession that followed. Once the banks were bailed out and the financial system was stabilised, central banks in the rich countries went on a bond-buying spree with the express purpose of infusing liquidity into the system. The motivation was to trigger credit-financed consumption and investment, thereby spurring demand and a recovery.

To encourage the clients of banks and non-bank financial companies to borrow, policy rates were reduced to near zero or even allowed to go negative in the hope that the benefit would be passed on to private borrowers. This worked only partially as the 'new normal' of low growth that has characterised much of the world for over a decade makes clear.

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Banks were not too keen to lend to clients burdened with past debt and many borrowers were reluctant to take on more debt. Credit did grow significantly in this period. But this was used in substantial measure for investment in asset markets that experienced unwarranted price inflation driven by speculation. Even overleveraged corporates that managed to access credit used a lot of it for financial investments.

Despite the ineffectiveness of the currently favoured monetary tools for macroeconomic management, confused policymakers have returned to the same toolbox in the current crisis. In Europe, Christine Lagarde, the president of the European Central Bank (ECB), while recognising that the virus attack was “a major shock to the growth prospects of the global and euro area economies,” initially argued that saving the Eurozone was not the sole responsibility of the ECB, but also that of member governments. In response to demands that the ECB should cut interest rates to reduce borrowing costs for highly indebted eurozone countries that are faced with interest rates much higher than German bonds, for example, Lagarde declared: “We are not here to close [bond] spreads, there are other tools and other actors to deal with these issues.” She, in fact, felt that a region-wide fiscal stimulus coordinate by governments was the need of the hour.

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The reaction to these views was aggressively negative, forcing Lagarde to backtrack. Within a week the ECB announced a huge and additional Euro 750 billion bond buying programme, covering sovereign and corporate debt, to be completed within the year. Lagarde also said that: “There are no limits to our (ECB’s) commitment to the euro. We are determined to use the full potential of our tools, within our mandate.”

In the US too, the Federal Reserve decided to opt for another dose of the same medicine that had been used in 2008 to save the banks. It decided to reduce interest rates to near zero and buy $700 billion worth of Treasuries and mortgage-backed securities, and in the process feed liquidity to the banking system. Ben Bernanke and Janet Yellen, two former chairpersons of the Federal Reserve, noted in the *Financial Times* that this is unlikely to work because while in 2008 a financial collapse had frozen credit and spending, currently financial markets are “only reflecting underlying concerns about the potential damage caused by the coronavirus pandemic, which of course monetary policy cannot influence.”

Essentially, any attempt to pour cheap liquidity into the system and force cash into the hands of anyone who can spend it cannot help, because the money will not move from the financial system to needy borrowers. If yet governments and central banks are returning to discredited monetary instruments, it is for two reasons. One, to provide banks, financial institutions and big corporates the liquidity needed to meet commitments when business is slack or stalled. Small firms and vulnerable citizens are unlikely to directly benefit much. Two, to facilitate borrowing by the government because at the least, as Bernanke and Yellen admit, fiscal policymakers must “fund the public health response while providing critical aid to people whose lives and livelihoods have been shattered by the virus and its effects,” and “do more as the size of the hit to economic activity becomes apparent.”

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On the surface, the pandemic seems to have increased the acceptance of proactive fiscal policy measures, though references to remaining within the "available fiscal headroom" persist. In Europe, the European Commission appears willing to relax its unjustifiable fiscal rules, and governments in France, Germany, Italy, and Spain, have announced higher than conventionally supported fiscal packages. In the US, President Donald Trump and the Congress have negotiated a $2 trillion stimulus package, which is touted as the "largest of its kind in modern American history".

This appears surprising since unprecedented spending may not yield expected results when there are, as noted earlier, supply constraints. But these packages, large and small, merely fund what governments think they can do. Besides working hard (and competently) to contain the spread of the pandemic and mitigate its effects, there are only a few things they can immediately do such as ramping up spending on protection of medical staff, testing and treatment.

Not all the things that have to be done can be anticipated straight away. There are some required actions that are obvious. One, for example, is to reach relief to those devastated by the sudden stop in economic activity. This would include covering those who are vulnerable for the simple reason that their jobs are not regular or are precarious and they therefore now find themselves without a job or income. Relief should also cover those who cannot help themselves and are severely affected when the people or systems on whom they depend are themselves helpless. Massive transfers in cash and kind to these sections are imperative, combined with an emergency drive to ensure that the essentials of daily living are produced and distributed.

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Putting cash in the hands of people when what they need is not available would only trigger price increases, benefit hoarders and speculators, and erode the real value of the relief provided. In many areas, public provisioning of essential goods and services may be the better solution.

A second obvious action is to ensure that the huge informal sector and small business entities that do not have the reserves and the wherewithal to restart business as and when normalcy returns must be provided the support needed to survive. This would involve not just provision of credit, but subsidies and transfers as well, so that whenever the time comes individuals and businesses would be in a position to return to managing their economic lives.

The problem is that when designing emergency programmes to address an exogenously triggered crisis, governments may go wrong or even misuse the opportunity. This is partly reflected in the US's mammoth Coronavirus Aid, Relief and Economic Security (CARES) Act that provides for a $2 trillion package. It was essential that transfers be provided to those whose incomes are under threat. So, around $300 billion of the $2 trillion package is likely to be devoted to such transfers. Direct payments of $1,200 would be made to tax paying individuals earning up to $75,000 a year.

There is much that is problematic in this design. With the average hourly minimum wage in the US at around $8 an hour, the minimum wage for a 40-hour working week would stand at $320. This would mean that the maximum transfer per person would not cover even four weeks' earnings at the minimum wage. The effects of the crisis, on the other hand, are likely to be felt for much more than a four-week period.

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The transfer scheme is, however, combined with enhanced unemployment benefits. A sum of $250 billion has been allocated to an extended unemployment insurance programme, which widens eligibility and provides workers an additional $600 per week for four months, in addition to what states provide. This programme applies to the self-employed, independent contractors and gig economy workers.

But compare these outlays with the support big business gets. A sum of $500 billion is to be devoted to providing loans and loan guarantees, at near-zero interest of course, for a period not exceeding five years to the big players. Passenger airlines are to receive $50 billion of that money and air cargo carriers $8 billion. One-fourth of the US package is devoted to salvaging that section of corporate America that in the past was in a position to build reserves to face a crisis of this kind. Add to this the Federal Reserve's contribution to save the banks and financial institutions, and it is clear that much money would flow to the narrow top of an unequal structure.

On paper, the motivation underlying the large fiscal spend in response to the crisis is not to directly spur demand, but to provide relief and support to selected sections and sectors. But as is inevitable, power relations determine allocations in ways that do spell inequality. Since the impact of the underlying virus-induced economic crisis is more severe on the poor and the vulnerable, an intensification of inequality will be the outcome.

Such inadequacies in relief packages are to be found elsewhere as well. In India the Pradhan Mantri Garib Kalyan Yojana is woefully inadequate in the current circumstances. The Yojana has two main components. One is a set of measures aimed at reaching essential food to those who cannot access it or would find it difficult to access it through the open market. The second is to quickly put money into the pockets of chosen sets among the poor, so that they can meet essential expenditures.

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On the first component, the government has declared that it would provide, free of cost, to the 800 million beneficiaries of the National Food Security Scheme (NFSS), 5 kg of rice or wheat per person per month and one kilogram of pulses for a household for the next three months. This would be in addition to the 5 kg they are already provided against payment. However, restricting access to only those covered by the NFSS would not only deprive those groups such as migrant workers who are known to be excluded from the scheme, but also those who may not be eligible usually but have now been pushed into a dire situation. Some way of including such sections, or universalising access should have been found.

The second main component of the package includes an ex-gratia payment of Rs 1,000 per individual to poor senior citizens, widows and the disabled, and transferring an even smaller sum of Rs 500 to 200 million Jan Dhan accounts held by women. This is indeed niggardly. When a crisis of unprecedented proportions throws a large

number out of work and leaves them without an income, the obvious solution is a direct income transfer that protects them as best as they can. In a city like Delhi, where even the official minimum wage for unskilled workers is close to Rs 15,000, a transfer should aim to cover at least half that sum. What we have instead is little more than tokenism.

Globally, the crisis would accentuate existing inequalities. In fact, the global crisis is likely to hit developing countries particularly adversely, with their own internal Covid-19 crisis aggravated: one, by steep declines in commodity prices and, two, by an outflow of capital. Given the uncertainties generated by the crisis, the footloose capital that had been accumulated during the many years when accommodative monetary policies had injected large volumes of cheap liquidity into these countries, has already begun to exit in large volumes.

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UNCTAD reports that portfolio capital outflows (both debt and equity) from nine emerging markets (Brazil, India, Indonesia, Philippines, Republic of Korea, South Africa, Thailand, and Turkey) in the month after the Covid-19 crisis went global (21 February to 20 March) was $59 million—more than double the outflow over a similar period starting 19 September 2008 during the global financial crisis. One consequence has been a sharp depreciation in the value of the currencies in these countries. This will naturally have an impact on the cost of servicing external commercial borrowing by the corporate and financial sectors, borrowing that had risen steeply during the years of access to cheap dollar credit.

With the local currency cost of servicing hard currency debt rising, defaults, and bankruptcies are unavoidable. The poor in the developing countries, devastated by lockdowns and the sudden stop, would also experience the adverse effects of this larger crisis and the harsh ways in which governments respond to the situation.

Altogether, a crisis of huge proportions is overwhelming the world economy and its most vulnerable regions and populations. The problem is that given the exogenous nature of the prime driver of this crisis and the inability of most governments to restrain the force of that influence with means other than isolation and harsh lockdowns, it is not clear when the crisis would abate.

Till the Covid-19 pandemic loses much of its momentum, to pull economies out of the economic crisis they are experiencing seems difficult. The only certainty now is that how and when the crisis will bottom out remains unclear.

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