RIS Policy Brief

COVID-19: Economic Collapse and Recovery

Introduction

COVID-19 has resulted in a severe reduction in economic activity in almost all countries including India. Economic activity contracted in India in the April-June quarter of 2020 by almost 24 per cent compared to the same quarter the previous year, and many analysts argue that the actual decline was even greater as the extent of decline in the informal sector has not been fully captured. Governments in several countries have sought to counter the effects of Covid on the economy. There has been uniformity in the response of central banks. Given their experience of the 2008 financial crisis, central banks quickly reduced interest rates to near zero and many central banks expanded their balance sheets by buying what would be considered non-usual assets.[1] In India, the Reserve Bank had been cutting interest rates even before the crisis as the economy had been weakening and it had continued to cut interest rates after the onset of the crisis. But it has more recently halted the interest rates cuts as the rate of inflation has increased. There has been greater variety in the fiscal response of countries to the covid crisis. The fiscal response has had two objectives that of strengthening social security safety nets by increasing unemployment assistance and paying part of workers' wages, and undertaking measures to revive the economy.

Response by Other Countries

As noted above the central banks of other countries have acted to reduce interest rates and to widen the class of assets they would purchase. In addition, the governments have acted to safeguard companies from bankruptcy and to protect workers' incomes. The packages have varied from more than a fifth of GDP in Japan to almost zero in Mexico. The packages usually consist of a combination of expenditures to pay workers' incomes or to increase unemployment compensation to guarantees for company loans. Of course, in the latter case it is not always immediately obvious what the net outlay of the government would be or what the expansionary effect of the guarantee would be.[2]

For instance, Germany provided more than 1.2 trillion euros package that is almost 35 per cent of GDP.[3] While much of this was in the form of loan guarantees to companies, the programme included payment of 70 and 77 per cent of a worker's net salary from the fourth month

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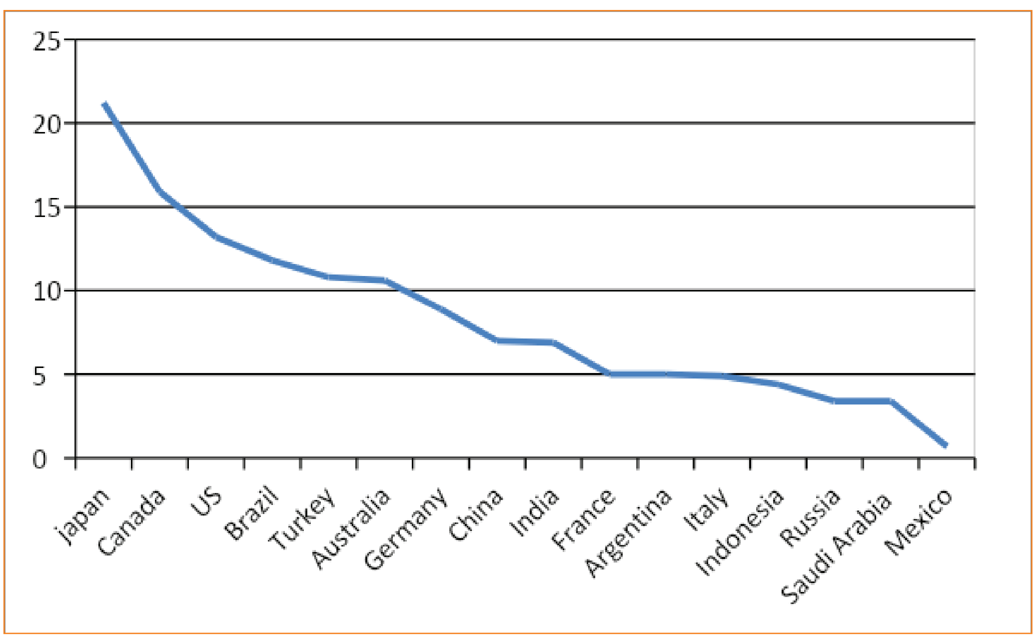
of unemployment, and 80 to 87 per cent from the seventh month. Unemployment benefits were also increased. Many other European governments also provided support to maintain workers' incomes. The US government first unveiled in March 2020 a 2.2 trillion dollar relief package or about 10 per cent of GDP. It was later increased. About 550 billion was for direct payments to people, and additional unemployment benefits and support for welfare programmes such as food stamps. Over 900 billion was to support businesses on condition they maintained their work force.

Government of India's Policy Response

The government's response in India has also like that of many other government's been twofold, partly humanitarian and partly to revive the economy. To help the poor survive the storm, the government promised in March 2020 to provide an additional 5 kg foodgrain free to 80 crore beneficiaries of the National Food Security Act (NFSA), over and above their monthly entitlement. In addition, the government would provide 1 kg of a pulse. Initially, the scheme was for three months April, May and June only. Later the government extended the scheme for five additional months till November. The scheme would cost almost Rs 150000 crore, or about 1.5 per cent of GDP.

The measures announced on May 13 were to revive the economy. These concentrated on providing more liberal credit to businesses, particularly small and medium enterprises. The policy was aimed at inducing a supply response from businesses. Many analysts have criticised this approach, arguing that the problem was a lack of demand and government should take measures to boost demand.[4] In particular, many such analysts have argued for an expansion of the Rural Employment Scheme, a ready made tool to increase incomes in the hands of the very poor and so increase demand. This expansion could be in terms of more days of employment in the rural areas and extension of an employment scheme to urban areas.[5] Given the leakages in such schemes[6] it may be better to implement a

Figure 1 Fiscal Stimulus (% of GDP)



Source https://www.statista.com/statistics/1107572/covid-19-value-g20-stimulus-packages-share-gdp/

1 For instance, in 2008 the Fed announced it would lend to bail out bond dealers stuck with collateralised debt obligations they couldn't resell on the secondary market. The Fed itself also temporarily bought bad debt.

2 For instance, the amount made available by the German Government for loan guarantees is almost a third of the GDP but the net stimulus is calculated as 8.9 per cent of GDP. Similarly, while the total second package announced by the Government of India is about 10 per cent of GDP, as shown in the figure above, analysts calculate the fiscal stimulus calculated after subtracting the credit guarantees to be considerably less.

3 The first package was introduced in April 2020 and an expanded programme in June.

4 See, for instance, Bhaduri Amit and Deepankar Basu, "An economic disaster foretold," *The Hindu*, 16 September 2020.

5 Dreze has championed such a scheme, Decentralised Urban Employment and Training. https://www.ideasforindia.in/topics/poverty-inequality/duet-a-proposal-for-an-urban-work-programme.html

6 See Debraj Ray on the difficulties of implementing such a scheme https://www.ideasforindia.in/topics/macroeconomics/duet-towards-employment-as-a-universal-right.html

basic income scheme. We argue below that the COVID-19 has created both a demand side and a supply side problem reminiscent of Nurkse's vicious cycle of poverty and there is need for a coordinated approach. Policies that deal only with the supply side or the demand side will not be adequate. What was important in Nurkse's 'big push' was not so much the size of the programme but its coordination.

Problem of Coordination Limits of Credit Expansion

In Nurkse's cycle of poverty since incomes were low demand was low and so businesses had little incentive to invest and since investment was low income would remain low.[7] The solution was to generate a coordinated increase in investment in a number of industries. The output of any particular company would then be bought by workers in other companies whose income had now increased.

A similar issue arises with merely provision of credit in the Covid situation where there are both supply side and demand side problems. The problem has been created as businesses were closed to prevent the spread of infection. As workplaces closed production fell and workers lost their jobs and incomes. Even when businesses could be opened they neither had workers to start production nor any certainty that even if they could produce there would be demand as workers no longer had any income. So producers were reluctant to hire workers to produce and so long as workers were not hired there would not be income and demand.

Provision of cheap or guaranteed credit only acts on the supply side to encourage businesses to restart production. But it does not solve this conundrum caused by the lack of consonance between supply and demand. A business would be reluctant to borrow to sustain production as it would be very uncertain whether demand would exist for its output. Without some surety of demand conservative businesses would be wary of borrowing for production. The problem may be even worse. One might suspect that only those businesses would borrow who are likely to either invest in very speculative projects or who would use the loans to finance their consumption. In either case the NPAs of the banking sector would increase forcing the government to further capitalise the banks. Since this is at the expense of savers, the savers expecting a reduction in their future real wealth might react by reducing consumption thereby worsening the demand recession.

Is Transferring Money to Consumers a Solution?

The effect of maintaining workers' incomes can be seen in the case of Germany where the amounts transferred to workers have been considerable; they received 70 to almost 90 per cent of their incomes and they also have not lost their jobs. So once goods become available they might be willing to spend. Producers knowing this would be willing to resume production once the restrictions due to the Covid have been lifted. The effect of the measures can be seen in the employment picture. The unemployment rate in Germany increased from 5per cent to 5.8 per cent from March to April as a result of the Covid shutdowns and further to 6.4 per cent in June. But since then it has remained steady at that rate. Furthermore, payments for shorter hours which had increased from 2.5 million in March to 6.1 million in April and 6.7 million workers in May dropped to 4.6 million in August. A similar trend can be seen even in the US with its less generous safety nets. In the U.S., unemployment surged from 4.4 per cent to 14.7 per cent. But once the restrictions were lifted many businesses opened up and hiring of workers increased and unemployment fell for four consecutive months to 8.4 per cent in August.

[7] This is discussed in his book Nurkse Ragnar Problems of Capital Formation in Underdeveloped Countries, Basil Blackwell, 1953.

The important question is what the people who receive the money will do with it. This will depend very much on their expectations about the future. In the case of Germany workers expected very little decrease in their future incomes and they were prevented from spending only by the non-availability of goods as shops had shut down. So once shops were opened they were willing to spend. Even in the US once shops were allowed to open consumers gradually came back to consume mainly services, hairdressers, bars, restaurants, etc. But this might not be the case in India. While the very poor may obviously be expected to spend any additional money given to them, whether they actually do so will depend on their expectations about their future incomes. They might restrict their expenditures and save some of the moneys given to them if their expectation is that in the future their incomes would be zero and they would be saving for such an eventuality. Given their recent past experience where they had to face considerable hardship with little or no food and being thrown out of their rented accommodation, and uncertainty as to how long the government would provide them with subsidised food, they will spend only on bare necessities, mainly food items. There is the further problem that they may be eligible for the subsidised food at a different location from their work place or their place of residence as the nationwide one ration card scheme is still to be implemented. While the increased demand for food may be good for farmers it is not clear that farmers would benefit as currently they do not seem to be facing a shortage of demand. The thousands, who have returned to their villages carrying what little they could and whose future place of work and/or residence is uncertain, are unlikely to indulge in purchases of more durable consumer goods. Furthermore, they would try to guard against future uncertain incomes by saving as much as they can. So the size of the expansionary effect in India of income transfers is not clear.

The reluctance of Indians to spend can be seen in the growth of currency in circulation (CIC). This rose sharply to 9.8 per cent in the current 2020-21 fiscal year so far as compared to 2.6 per cent in the same period a year ago. The latest data from the Reserve Bank of India shows that the year-on-year CIC growth was 22.6 per cent as of 4 September whereas in comparison it was only 13 per cent last year. The increased hoarding of money is also evident when the growth is compared with the end-March 2020 figures, when year-on-year CIC growth was 14 per cent. Given the various shocks that the Indian consumer has faced in recent times, it can be expected that his liquidity preference has increased. Furthermore, while the middle and upper classes may resort to e-shopping and may maintain their demand, lower income people may be more constrained in the use of e-shopping systems and thus may see a drop in their consumption.

The Indian Measures

The Indian measures announced by the Finance Minister amounted to Rs598,450 crores or 5984.5 trillion. Of this amount almost 60 per cent was in the form of 100 per cent credit guarantee for loans from banks which would become collateral free and to infuse funds by the government into MSMEs. The government also infused liquidity as it promised to pay dues by government and public sector undertakings to MSMEs within 45 days, and to disallow global tenders in procurement of goods and services of value below Rs 200 crore. Most of the rest of the programme was for the government to provide additional liquidity to NBFCs, housing financiers and micro lenders, and to Power Finance

Corp. Ltd. and Rural Electrification Corp. Ltd and by paying part of the employers and employees contribution to employee provident fund and cutting PF contribution of both employer and employee.

Need for Coordination

For successful production to take place a producer has to purchase inputs, hire workers to transform these into outputs which are then sold to buyers. Suppose A has bought inputs from B, he normally promises to pay within three months. This piece of commercial paper is guaranteed by A's bank so that if A fails to pay the bank has to pay. B, on his side, sells this paper to his bank. So at this stage the financial part of the transaction is a promise by A's bank to pay B's bank. In a recession A is not able to sell his good so his bank has to make the payment. This is not a problem as there will be only a few such cases and A's bank will have made provision for the normal rate of failure to pay. In a financial crisis such as that in 2008 B's bank doesn't know whether A's bank is creditworthy and so may not buy that commercial paper from B. In this case the central bank stepped in and bought the paper. In other words, it guaranteed that B's bank would not be hurt if A's bank failed to pay and this enabled the unblocking of the credit market.[8]

Now in the case of COVID-19, both sides of the market have collapsed. A may not be able to produce as he cannot get inputs, input producers are locked out, transport system has collapsed, or his workers have to leave the workplace. He also cannot sell. For production to restart not only must A be able to get his inputs he must also get his workers and get buyers. For A to get his inputs B must produce and B will only produce if he knows A will buy and A will only buy if he knows that he can sell. To get the entire chain working requires coordination.

In Germany, say, people have incomes and so the capacity to buy, producers have their workers and the government is helping with credit. So as soon as the lockdowns are eliminated economic activity can resume. In India the case is different. With its formal economy Germany could run its social security nets. But how to deal with India's informal economy? We do have experience of dealing with informal sectors. The "Green Revolution" was an exercise in the government energising an informal sector. It had to organise a new technology, get it to farmers through an extension service, organise delivery of inputs including fertiliser and water, and make arrangements for farmers to sell the output where the MSP played a crucial role.

Can something of this nature be done with the manufacturing sector? We used to have super bazaars to sell goods in urban areas. But these and Kendriya Bhandars have been run down. They could be re-energised. Government enterprises do have their uses. Government could promise to buy certain amounts at certain fixed prices unlike in the case of agriculture where it promises to buy all that is offered at the MSP. Together with the provisions for liberal credit that it has put in place this should get the economic engine working.

But while attention has been focused on the informal sector the plight of the formal sector should not be ignored. The number of salaried people losing their jobs amid the Corona virus pandemic has surged to 1.89 crore since April, with around 50 lakh jobs lost last month, (Centre for Monitoring Indian Economy). In comparison, according to CMIE, around 68 lakh daily wage earners lost their jobs during this period. The above suggestion for government procurement of goods would help the formal sector also. It may actually help the formal sector more as they may be better able to deliver their goods

[8] Keeping such credit is considered to be the primary responsibility of the central bank. See Bagehot Lombard Street: A Description of the Money Market (1873), Henry S. King & Co. available online. In the 2008 crisis central banks increased the range of financial assets they were willing to buy.

at designated spots. For the informal sectors something akin to mandis would have to be organised.

An aspect of demand that has been ignored is export demand. Actually some analysts are recommending an appreciation of the rupee in order to slow the inflation. Such an appreciation would reduce exports and worsen the demand situation and the balance of trade. Furthermore, attempts to control inflation through pegging the exchange rate have generally failed. For instance, the Argentine peso was pegged to the U.S. dollar between 1991 and December 2001 in an attempt to eliminate hyperinflation and stimulate economic growth. But the current account deficit ballooned and the attempt ended in a collapse of the Argentine currency.

Conclusion

The Covid crisis has thrown the entire supply chain of goods production into turmoil. Governments have responded with a mixture of humanitarian measures to sustain consumption and measures to encourage production. Actions merely to encourage a supply response or to boost demand only would not be enough as there would be a coordination problem. Such a coordination problem can be avoided in the developed economies where the informal sector is relatively small. Measures to maintain income have meant that people particularly have hoarded purchasing power which people are ready to be use when shops open again. But the problem is graver in less developed economies. Actions such as providing more liberal credit will not evoke a supply response unless producers believe there will be demand for their goods. People will hoard incomes as they are not sure where their next rupee will come from and so not increase demand. The government needs to act to resolve this coordination problem. It may act as a demander of last resort as it has done for a long time for the agricultural sector and which helped in ushering in the "Green Revolution". The government could look to encourage exports to increase demand. In this context, attempts to appreciate the rupee to control inflation would be unwise. The fall in exports following the appreciation would worsen the demand situation and exchange rate based schemes to reduce inflation have generally failed.

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