

BW BUSINESSWORLD

Economics101 of COVID-19



27 April, 2020
Vidya Mahambare

Economics 101 inevitably starts with the concept of a circular flow of income generation. When one person spends, it becomes the income of the other, and then, the third so on. During the normal course of time, this beautiful machine of the market economy is taken for granted. COVID-19 is playing out as an extreme, unfortunate ‘what-if’ scenario.

What if people can’t spend beyond the very basic necessities? What if the production is hit because the lack of workers? What if the supply cannot be augmented by imports, because every other country is in the same situation? What if we have to stand in queues all the time? What if governments have to intervene and manage the economy for a long time? And the biggest of all, what-if humans can no longer be a social animal? Clearly, none of this is desirable for prosperity or peace.

Naturally the question arises, how long can the lockdown continue, given that the COVID-19 is unlikely to be wiped out by 14th April, last date of the announced lockdown which coincides with the beginning of a new year in many parts of India? And whenever the normalcy resumes what should we expect?

Let us think about this using the key principles of Economics:

Incentives matter – To contain the COVID-19 pandemic, governments world over are relying on the shutting down of the economies and asking people not to venture out. When the state is providing basic income, other cash/in-kind transfers essentially it is essentially creating an incentive for people, especially casual workers, to stay at home, and rightly so. This incentive must work well and reach the neediest for the strategy of a lockdown to work.

Managing Trade-offs- For people who have salaried income or have enough savings and a home, there isn't a big trade off. An opportunity cost of not staying at home – a risk of getting COVID-19 is too high. But what about millions of migrants who don't have homes in the cities where they work? With no work, there is no money to pay for rents. Also, the trade-off they are considering is not only in terms of monetary cost of staying in cities, but also psychological cost of staying away from families at this crucial juncture. And what about urban households which have dismally small houses, now cramped 24 hours with all its family members?

This tragedy brings forth a crisis in terms of the lack of low-cost housing stock in Indian towns/cities that is around for a long time. Embarking on housing for all, and providing subsidy to build homes for poor, as the government has been doing, is not necessarily a good thing if homes are built in villages, far away from where economic opportunities are. It also shows us a dramatic need for a more balanced regional development in India.

Another trade-off playing out at present is clear in the announcement that farming activities and logistics-related to it can go ahead as usual. Even if the government pays farmers cash, they staying at homes means no adequate food supply. Same is the case for cleaning and other essential staff. The opportunity cost they staying at home is far too high.

While the inevitable closing down of the economic activity is turning out to be a much-needed boon for the environment, it also shows us the stark trade-off involved between production and prosperity. Ask in any preliminary economics class about the desirable level of pollution and answers come back swiftly saying zero. The current crisis vividly shows us why zero pollution is not the socially optimal level of pollution and why no government, however efficient, resourceful it is, can replace the markets.

Finally, while it may appear as if many are able to re-coup, enjoy a long break which they haven't taken in years, spend time with family, the net effect of this on aggregate wellbeing of population is unlikely to be positive. Families with young children are under immense stress, so also older people, especially those who live alone. Children and youngsters would become more addicted to electronic gadgets as parents' ability to entertain and engage them fades away after the initial burst. Without much physical activity, apart from those who are really motivated and with over eating, people will become less healthy.

Optimal decisions at the margin - Given numerous trade-offs, how should we decide on the lockdown? The decision about the extension, should be based on the marginal benefit of not extending the lockdown compared to the marginal cost (lowering the risk of spreading the virus). Once the new cases begin to fall, it may be more beneficial to open up the economy while making it mandatory for firms/workplaces to take the temperature of their workers so on.

Institutions matter - Countries with strong and decentralised healthcare institutions are in a better position to face the COVID-19 crisis. Similarly, countries which have good online education/internet access could quickly shift to e-learning. Don't be surprise this turns out to be a big push for e-learning platforms, similar to how demonetisation played out for the payment apps. For healthcare in India though, it is a different story. It is being boosted only temporarily. In contrast, e-learning platforms or PayTM were already around prior to the big shocks.

Government can raise welfare - When there are externalities present such as pollution, the government has a role in correcting it to reach the optimal welfare. Today, pollution is the spread of COVID-19 that can happen if some people do not follow a guidance to stay at home, and create a negative externality for others.

Hence, a need for compulsory lockdown. But, how to do we judge how many people can safely be on roads? This question is similar to what an optimal level of pollution is for any place. The answer of course, is not clear cut, though it is clear that a complete lockdown may not be optimal.

How long will the impact of COVID-19 last? It depends on how long we have to shut down the circular flow of the economy. Economy is not a Ferrari where one can go from the stationary to the speed of 100kms in a few seconds. It will need time to re-adjust and oil all its parts. Millions of informal jobs have been lost already. All of them will not be reemployed. Other firms will lower employment once normalcy returns compared to its pre-COVID 19 level, to cut down on losses and avoid bankruptcy. This would depress wages, especially for new workers.

Finally, pandemics are different from other catastrophic events such as wars because the capital stock and infrastructure remains intact. So a dramatic jump in growth that is seen post-wars as economy-wide capacity building would be missing. Demand pick-up is likely to be slow given job losses and uncertainty. Be prepared for a long haul.

Disclaimer: The views expressed in the article above are those of the authors' and do not necessarily represent or reflect the views of this publishing house. Unless otherwise noted, the author is writing in his/her personal capacity. They are not intended and should not be thought to represent official ideas, attitudes, or policies of any agency or institution.

Link: <http://www.businessworld.in/article/Economics101-of-COVID-19/27-04-2020-190388/>