INDIA VERSUS COVID-19: A CASE IN FAVOR OF SUPPLY-SIDE POLICY SOLUTIONS

Vrinda Saxena
Ramjas College, University of Delhi

1. INTRODUCTION

Come March 2020 and the global public health outbreak, Covid-19, had made its presence felt big time in India. The virus, declared a global pandemic by the World Health Organization, not just overwhelmed India's public health infrastructure but also brought into limelight fundamental loopholes in the organisation of India's economic emergency response mechanism.

When Prime Minister Narendra Modi announced a nation-wide lockdown on March 24th, 2020 in order to enforce social distancing measures and stop the spread of the virus, a country like India with a massive population of self-employed and daily wage earners, was left to ponder the solutions to questions of sustaining livelihoods.

Addressing these concerns, the Central government of India (GoI) provided a fiscal stimulus in two stages. In the first fiscal injection in April 2020, a package of Rupees 1.7 lakh crore was announced, comprising of insurance cover for wage workers, food provisions and cash transfers. Wages under the MGNREGA scheme were increased from Rs 182 per day to Rs 202 per day and the Rs 2000/- payouts (of the annual Rs 6000) to 8.7 crore farmers of India under the PM Kisan Yojana, amounting to Rs 17,400 crore for the government, were ordered to be disbursed earlier in April. The next leg of the fiscal package announced relief operations worth Rupees 20 lakh crore to be delivered in tranches in May 2020. Dubbed as the PM Atmnirbhar Bharat Abhiyan (self-reliance campaign), it offers schemes of the provision of collateral-free loans amounting to Rs 3 lakh crore for MSMEs, Rs 45,000 crore partial credit guarantee schemes for NBFCs for which the first 20% would have GoI as the guarantor, liquidity injection of Rs 90,000 crore in Indian DISCOM sector, and liquidity relief of Rs 2,500 crore for EPF establishments, among others.

While the measures seem to have gone down well with a few economists and the electorate at large to douse momentary anxieties, the following article is an attempt to understand how cash transfers are not the policy solution India needs to prevent another crisis after one the ongoing coronavirus-led immediate economic crisis.

2. WHY SUPPLY?

It has often been observed that failed policy measures stem from the minds of those who do not understand the nature of the problem in entirety. Thus, the following points explaining the characteristics of the crisis at hand are necessary to build the argument further:

1. The Covid-19 outbreak in India, as in the world, can be described as an exogenous shock rather than an endogenous one (Danielsson and Shin, 2002). In that sense, while the associated crisis is similar to the global financial crisis of 2007-08 with respect to shortages caused and liquidity crunch, the nature of the two crises are starkly different. Additionally, there is also a distinction in the nature and origin of the crisis- it may have originated like an exogenous crisis, but derives its damage from the endogenous risk amplification process which has made all financial crises as bad as they turned out to be.

2. The Coronavirus outbreak is more of a supply-side problem than a demand one. Studies show that the demand effect of the situation can be understood as dampening consumer spending and tilt of aggregate preferences towards essential and sustainable goods and services (Criteo, 2020). However, the bulk of other recession is stemming from the 'containment' measures adopted for social distancing that have brought manufacturing and production activities to a grinding halt (Baldwin, 2020).

3. POLICY MEASURES

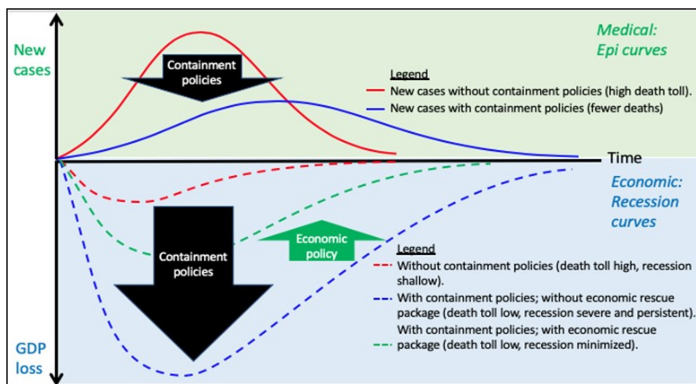
The Indian government needs to be lauded for its promptness of action in ordering a large scale lockdown, even at the risk of appearing panicky. In hindsight, the initiative seems to have paid off in terms of preventing a steep acceleration in numbers of Covid-19 positive pa-

Author's email address: vrindasaxena06@gmail.com

tients. However, while the move worked in favour of keeping a public health disaster at bay, it also had a significant and not-so-pleasant impact on production.

The lower panel in Figure 1 demonstrates how the impact of crisis with containment measures had a deeper impact on slowing down production than the crisis alone would have had. Work-from-home setup and information technology in India have made the service sector able to stay partially functional still. However, commodity manufacturing and a few backend ones like enabling IT infrastructure providers, which require physical proximity of workers and machines, have been deeply affected.

Figure 1*: Impact of lockdown on production*



Source: Richard Baldwin: Gourinchas (2020)

The cash transfer scheme adopted by the government, which can be described as 'helicopter money' in the words of economist Milton Friedman, is good to achieve only so much as an appeased electorate. Shrunken demand can also be traced back to falling income and saving levels. The ideal approach, hence, in this scenario should be for the government to pursue a slightly modified version of the fiscal stimulus package, replete with food and wage subsidies, provision of social safety nets like insurance covers and a stream of money redirected towards producers rather than consumers. In his book, Poverty and Famine (1981), Nobel Laureate Amartya Sen provides support for the above rationale by stating, "Manipulating total demand, such as by printing money, will cause inflation and could make things much worse. Ensuring the supply of basic essentials, especially food, should be a priority". As in May 2020, even while the government maintains that most schemes of its latest fiscal packages are largely self-financing, the exchequer's strain is visible and economists like C Rangarajan are predicting debt monetisation as the next step, despite the 1997 norm against it. Production processes have been hit, value chains are near shut and firms have already started running down their inventories. In this scenario of limited supply, if the government provides more idle cash to consumers it is only going to stimulate demand further and inevitably create inflationary pressures.

My case to push for stimulus for producers in the economy hinges on three main considerations:

3.1. A blow to the manufacturing sector could imply its ruin in a service dominated economy

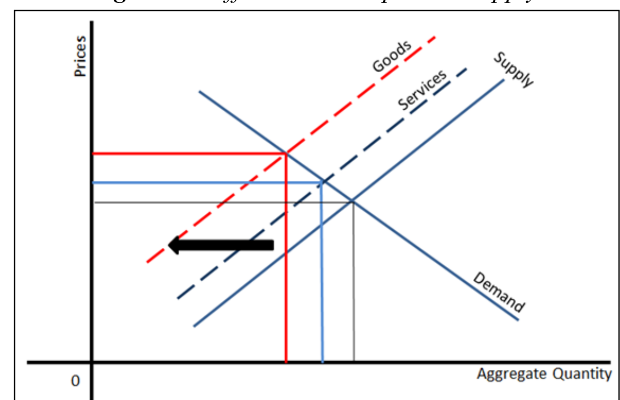
The International Monetary Fund (IMF) predicted a 3 per cent slowdown in global economic growth in 2019, and amidst this, India's predicted growth forecasts also received double cuts- from 6% to 5.8% and then to 4.9%. The automobile, FMCG, telecom and other sectors faced major blows and the ongoing crisis seems to have hit like a meteor.

Further, India's transition to a developing country from an under-developed one was different from that of others. We moved from being a majorly agrarian economy straight to a service-led growth pattern, skipping the phase of manufacturing activity booming. Given both these realities, it doubly becomes the government's priority to provide cushion to production activities. In an already slowing economy, hit so deeply by another crisis, if we are not careful today a number of manufacturing units might end up hitting the rock bottom with no hands to pull them back. Small and medium enterprises (SMEs) of India could be among the worst hit.

3.2. Biased effect on prices

As discussed above, many services such as financial services, communications, etc. are partially functional, thanks to India's IT infrastructure. Goods manufacturing, however, has taken a hit. If we operate with this assumption largely (although there are exceptions, such as enabling services), then we can observe that since labour supply is differently affected so will be the relative supply of the two (Baldwin, 2020). Containment policies that are aimed at avoiding community transmission of the notorious virus are going to reduce the supply of goods relatively more than the reduction of services (Figure 2). Among goods also, the luxury goods

Figure 2*: Differentiated impact on supply*



Source: Author's elaboration

market and FMCG that contribute a large portion of the revenue will be more deeply hit.

In an ideal laissez-faire economy or other types of economic shock, the government is not advised to step in for the producers. However, in the case of an exogenous shock such as this one where supply chains are globally affected, it is almost mandatory for the government to provide support in the form of price subsidies for market shares to recover, or cost subsidies on input procurement to manage the risk of cost-push inflation.

3.3. Credit constraint

The third and final argument stems from the nature of the crisis we are facing today. The good news is that since this crisis is exogenous in nature, there is not much of a culprit investigation to be done, but rather the focus is on damage control. Compared to the time of the global financial crisis of 2007-08, the banking system today is in better shape than what it was then. The crisis also did not originate in the financial system for massive bailouts to be essential. This simply implies that producers will not be facing lending crunches from the banks' end. However, there's also bad news. Compared to 2007-08, the maximum amount of lending today to suppliers and companies comes from the Non-Banking Financial Corporations (NBFCs). These NBFCs are not privy to as much support by the government as the banks, and in the Indian context NBFCs are not particularly in the best of shape today. To add to it, the degree of leverage that defines lending ecosystem today is also the reason why suppliers are at maximum risk. The great degree of indebtedness in the private sector is a major cause of concern (Csullag et al, 2016). It will hence not be long before credit dries up for producers in the country, compounding the adverse supply shock. While the Reserve Bank of India (RBI) is also undertaking monetary policy measures of repo rate cuts, what we seem to be forgetting is that while the ongoing crisis is a massive financial crisis like the 2007 crisis, it is also not a liquidity crisis that developed within the system, unlike the 2007 crisis! Monetary policy measures are only so much effective (Danielsson et al, 2020). The real stimulus to production and investment has to be fiscal in nature.

Former RBI Governor and Chief Economist of IMF, Raghuram Rajan puts it in his book, Fault Lines: How Hidden Fractures Still Threaten the World Economy (2010), governments of the world are often more concerned with jobs than inflation in economic policy responses. Economists who side with the cash transfer scheme have thus often cited the Phillips Curve argument to support the scheme, arguing for accepting more inflation in lieu of decreased unemployment. It is true indeed that the world is looking at massive job cuts, but the Phillips Curve does not have all answers to give this time. As in the 1970s when the relation broke down due to stagflation (reduced output plus higher inflation) in the US economy, the government needs to understand that its scheme of cash transfers will only increase inflation with no corresponding effect on unemployment if nothing is done to boost output today. For economists who argue that inflation is a less than likely scenario, the aspect that needs to be considered is that, depending upon the tenacity of economies, it is quite likely that this recession may end up like a short-lived V-shaped one. It is also likely that pent up demand may shoot up suddenly post the lockdown (Loayaza and Penning, 2020). In that scenario, a sudden volatility led inflation might harm investor sentiment furthermore. Moreover, while supply chains of raw materials and labour have been hugely affected, a slight downward swing is observable in the demand side as well, given the fall in incentives to consume and in investment demand due to negative market sentiment. Monetary transmission is already weak and fiscal multiplier in developing countries especially has been noted to reduce too with the fall in aggregate estimates of consumption proportions and more than usual sluggishness of the goods market. Using a simple C+I+G model it can be observed that no matter how large the change in government expenditure, the magnitude of its final impact rests on the multiplier, hence making a demand-side fiscal stimulus diluted in its impact. In India, size of expenditure multipliers has been found to be greater than central government's and when we put this fact together with the current scenario when state governments spending is very less compared to the central government's (coupled with the minuscule increases in borrowing margins for the former), we understand the magnitude of the situation. Furthermore, the long-run aggregate expenditure impact multiplier was last estimated to be 1.03 (Mishra, 2019) for India, proving that a demand-side boost may not be very heavily impactful. State Bank of India's CEA, Dr. Soumya Kanti Ghosh has declared that the newest leg of fiscal stimulus is expected to create an impact of Rs.2.03 lakh crore, which is minuscule if we consider the 20 lakh crore injected, and similar analysis was made about the earlier Rupees 1.7 lakh crore stimulus.

4. WHERE DO WE GO FROM HERE?

The pandemic teaches us two things about our economic systems today. First, while immediate policy solutions may be good to deal with the problem at hand, a crisis like this exposes weak spots in the fundamentals that need immediate mending. Second, our perception of risk, the threshold limit of its tolerance, and premiums for it have changed substantially, but not necessarily for the better.

Elaborating on these, foremost, we need to see that the public health infrastructure of almost every country is overwhelmed. That speaks a lot about how much we value essential services and about our resources in case we need to flex in times of emergencies. There is an urgent need for the world at large to upgrade its development services and infrastructure because, in the age of globalism, a crisis anywhere can tense matters. Additionally, while modern technology is developing at an exponential pace, our adaptability to switch to alternate systems or 'backups' is still low. A case in point is that studies show how the sudden crisis has revealed to so many businesses around the world how business chains can be restructured to virtual ones yet they are reluctant from doing it. The ongoing crisis has brought the idea of mortality suddenly closer than what people presumed it to be and exposed the flaws of traditional systems. It is time now that we take lessons from these and work to reduce redundancies. Perhaps, the current exercise can serve as a vaccination to build the world economy's immunity to potential future threats like these.

REFERENCES

1. Baldwin, R., 2009, "The great trade collapse: causes, consequences and prospects," a VoxEU.org, eBook, *CEPR Press*.

2. Baldwin, R. 2020. "The supply side matters: Guns versus butter." COVID-style- voxexu.org

3. Csullag et al (2016), Why it doesn't make sense to hold bonds. VoxEU.org, article. Available at: voxeu.org/article/why-it-doesnt-make-sense-hold-bonds

4. Danielsson, et al. 2020. "Comparing the coronavirus crisis to 2008 is inevitable, but they're quite different." blogs.lse.ac.uk

5. Danielsson, J., Shin, H. 2002. " Endogenous risk. In Modern Risk Management — A History." *Risk Books*

6. Economic Times Online, 2020, "Summing up Modi's Covid Stimulus: Big takeaways from the big Covid package"

7. ETBFSI. 2020. "Coronavirus rescue: Time for helicopter money, universal basic Income, bridge loans?" *The Economic Times*, March 23, 2020. https://bfsi.economictimes.indiatimes.com/news/industry/coronavirus-rescue-time-for-helicopter-money-universal-basic-income-bridge-loans/74767155

8. IMF Blog, 2019, https://blogs.imf.org/2019/10/15/the-world-economy-synchronized-slowdown-precarious-outlook/

9. Loayaza, Pennings, 2020, "Macroeconomic Policy in the Time of COVID-19: A Primer for Developing Countries," *World Bank Group*

10. Mishra, BR. 2019. "The Size of Fiscal Multipliers in India: A State Level Analysis Using Panel Vector Autoregression Model." *Global Business Review*

11. Rubio, M. 2020. "The Case for a Coronavirus Supply Side Stimulus." *National Review*, March 3, 2020 https://www.nationalreview.com/2020/03/coronavirus-case-for-supply-side-stimulus/

12. Silman, R. 2020, "In a pandemic, the wrong economic policy can be fatal." *The Guardian*, March 18, 2020. https://www.theguardian.com/politics/2020/mar/18/in-a-pandemic-the-wrong-economic-policy-can-be-fatal