Coronavirus and the economy: what can be done?

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Or, more specifically, what can be done by government? I've spoken previously on this blog about the ways in which government is fundamentally different to a household. However, the current crisis is very different to a normal recession (and Brexit is totally different again).

Economics undergraduates are typically taught to distinguish between the "short run" (i.e. relatively short term changes) and the "long run". It's frustrating to students that we cannot put a neat time period on these two: their definitions change with context.

I actually dislike the dichotomy and find that it can be deeply unhelpful, although it cannot be denied that it's a useful pedagogical device[1]. In a "normal" recession, demand for goods and services falls. The reasons for this might vary, but the outcome is the same. Theoretically, prices could adjust to ensure that this is the end of the matter, but for various reasons in the real world prices appear to be "sticky" – they don't change instantly[2].

As a result, a greater value of goods and services are produced than people are willing to purchase. If prices don't adjust quickly enough then quantities must change instead[3]: people put off that discretionary purchase for another few months until the situation becomes clearer.

If fewer goods and services need to be produced then unemployment typically rises (both from firms laying off workers and from firms going bankrupt). This further reduces demand and so the cycle continues.

Governments and central banks typically react to recessions by seeking to boost demand. In normal times, this is mostly (but not exclusively due to so-called "automatic stabilisers", like unemployment benefits) done via changes in interest rates. When interest rates are near their lower bound (as they currently are), such changes are most effectively wrought through fiscal policy.

What we are currently witnessing looks nothing like that. Yes, economic demand (in the aggregate) almost certainly has fallen, but the primary effect thus far has been a massive (but hopefully temporary!) fall in the quantity of goods and services that the economy can produce (a supply side effect).

The entire hospitality sector has effectively shut down, as have all conferences. International travel has largely evaporated (at least for Europeans) and domestic travel has fallen by over 75%. Sales of consumer durables have evaporated – even if you wanted to the restrictions make it tricky to buy a car at the moment, especially if the vehicle is second-hand.

Huge chunks of the rest of the economy – from education through to various professional services and manufacturing – are operating at reduced capacity. Measures to boost consumer (and business) demand are therefore likely to be largely futile, since the production of goods and services is so limited.

Why, therefore, are people (including yours truly) advocating massive fiscal stimuli, of the sort more normally associated with measures to combat a traditional recession? The answer is redistribution. This might sit uncomfortably with many, but it is incontrovertible.

How are we redistributing? We are redistributing across both time and space. Government borrowing is a transfer over time: it is an attempt to move future consumption into the present. At its most fundamental, people in future will need to pay higher taxes in order that people today are able to eat.

However, there is also significant distribution across space, although this is more subtle. Had the government not stepped in to help those whose livelihoods had (hopefully very temporarily!) disappeared then they would have had to reduce their consumption, sell assets and borrow in order to survive.

Prices would have fallen and those fortunate enough to still have a source of income would have had to buy those assets (cheaply) and lend any income that they couldn’t (or chose not to) spend in the current period. A significant amount would probably also have flowed to the owners of financial intermediaries (mostly shareholders in banks etc.)

It is worth pointing out that the government has stepped in to control both the flow and cost of credit, which amounts to a form of rationing. The upshot is that the consumption off those who had lost their livelihoods would have been permanently lower, whilst those who have retained an income would be permanently better off.

My personal view is that redistributing to ensure that the costs of the Covid-19 outbreak are more evenly spread is the right thing to do. After all, it is nobody's fault that they are laid off, or unable to open their business at the present time. Be under no illusion, however: the current furlough scheme is an extraordinarily generous form of (time limited and conditional) unemployment benefit (and a more modest business support mechanism).

However, the current situation is not unique. This is not the first recession we have experienced, nor will it be the last. A great many people lose their jobs each year – most through no fault of their own. If we can afford to support those who would otherwise struggle to put food on the table in the current climate, we can afford to do the same more generally.

It behoves those of us who are fortunate to help those who are not. I believe that we have a moral obligation to do so. Traditionally, the challenge has been to design a mechanism to do so that still incentivises people to earn their own living where they can. However, there is a method that can do so: an appropriately set basic income (or negative income tax) ensures that nobody need be destitute, whilst giving people a strong incentive to earn a living so that they can improve their standard of living.

[1] *It's also true that the more deeply one thinks about the notion, the less useful the two concepts become. Keynes famously quipped that "in the long-run, we are all dead" and this has a ring of truth to it. After all, the "long run" is made up of myriad "short runs" (I sound like I'm talking about a marathon!) Back in the 1980s, Olivier Blanchard and many others began discussing the concept of hysteresis: my own view is that altering short-run outcomes can induce long-run effects and so the dichotomy is somewhat artificial. Of course, this is not to*

deny the importance of factors contributing to long-run outcomes, but simply to point out the complexity of what are ultimately dynamic systems driven by myriad human decisions and interactions.

[2] *A lot of this appears to be a combination of contractual and temporal factors. Rents typically change annually and there are non-trivial costs to moving for both landlords and tenants. Housing costs make up approximately 23% of the CPIH. Similarly, many transport prices are set annually using a predetermined formula. Temporal issues ("fixed" costs like business rates and business rates) change slowly and hedging (especially currency hedging) can slow the rate at which some prices change as firms are reticent about making a loss on production.*

[3] *The lumpiness of certain purchases – especially consumer durables like cars – might be a factor here. A 5% (or even a 10%) reduction in price is probably not going to be sufficient to induce you to make a purchase now rather than deferring it due to uncertainty.*