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Pandemics and Economics

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Most universities in the US have shut down their physical offerings over the past few weeks and educators everywhere are scrambling to get their courses online. This is quite an onerous transition for everyone involved in the process because the overnight change has caught teachers, students and administrators off-guard. Nevertheless, with high-speed internet commonplace in the US, the move will be made, albeit with many hiccups.

Not all commodities in the economy are as "online moveable" as education. Movie halls, sports arenas, theme parks, stores, and a host of other venues need physical footfalls to generate revenue. As communities and cities across the world self-quarantine to contain the spread of the novel coronavirus pandemic, the big worry confronting economists is the wide-ranging effects on the economy of such an unprecedented turn.

1. Running an Economy

At the most basic level, an economy is simply a group of humans that decide to work together, because doing so is to the mutual advantage of everyone in the group. Small groups organize themselves into bigger communities, small communities band together to form bigger societies, small firms align with each other to create bigger enterprises, so on and so forth till you reach the stage of giant corporations with supply chains and consumers spread all over the world. The apple on your breakfast table might have been harvested on a farm in Costa Rica owned by a Spanish farming company, transported on a ship that docked in Amsterdam or Doha or Singapore, before it reached the shore of your country.

The real ingredients of any economic system are the expectations of the agents that volunteer to be a part of it. Modern economics provide a unifying template for the coordination of disparate enterprises spread across diverse regions of the planet – say, manufacturing in China, production in Vietnam, marketing in the US, consumption in

India, and a host of other activities in different parts of the world – through the coordination of expectations. A manufacturer tries to figure out the how much to make by using the economic marketplace that allows him to gauge the strength of the demand; the consumer tries to determine the best price to pay by using the economic marketplace that allows her to gauge how much other rival sellers might charge; and so on at every step of the value chain. No individual economic agent knows for sure what the actual outcomes will be tomorrow, but by gauging the expectations of others in the system, all agents have a much better sense of what the tomorrow holds for them collectively. The crucial function of the economy is then the synchronization, and the objects that are being synchronized are expectations of agents in the economy.

2. Hermit Kingdoms

The adage of the hermit kingdom is often used to emphasize the importance of trade and exchange. A hermit kingdom has no contact with the outside world and lives and dies by its own means. Humans soured on the idea of hermit kingdoms way back in the antiquities when they discovered trade: tablets and scrolls from Indus valley and China have been found in Mesopotamia and Egypt dating back thousands of years. The fathers of modern economics like Adam Smith or David Ricardo built entire theories extolling the advantages of trade, the basic idea being that trade allowed communities to specialize – you focused on what you did best and bought from the rest of the world for your other needs. This led to more efficient resource allocation all through the value chain, improving the productivity of all stakeholders.

A pandemic like Covid-19 turns the clock back to the era of hermit kingdoms — at least in the short run. As communities start to quarantine and isolate, they are largely confined to their own resources. Of course, the presence of worldwide internet and communications means that there is still ample flow of information. However, the physical flow of goods and services — the lifeblood of modern economies — is grinding to a standstill. Equally important, there is a pervading sense of gloom and panic among economic agents because they expect the system to fall apart. In a sense, the actual failure of the economic system is becoming a quid pro quo consequence of the expectation of failure among the agents in the economy.

3. Economic Expectations

Managing a modern market economy well is really an exercise in managing the expectations of its agents. While the functioning of the actual economic machinery is an important component, what is equally crucial—but often overlooked—is the careful calibration of expectations of the participating agents in the economic system. In the language of policymaking, economic expectations are self-fulfilling. If agents believe that the economy is on a downward trend, they cut back on their investments, and this in turn pushes the economy further down south. On the other hand, if agents believe that the economy is doing well, they spend and consume more, and this in turn boosts the economy.

Navigating one's way out of a crisis thus often comes down to adroitly playing the expectations of the agents in the system, and all important schools of macroeconomic thought concede the centrality of economic expectations — though the precise strategy for revival differs from one school to another. Such macroeconomic strategies and tools, however, were created for more conventional economic crises — problems with debt, or price rise, or banking, or housing, etc. — and the real unknown for economists is whether they work for crises arising out of unknown phenomena such as the Covid-19 pandemic.

4. Curing Economic Infections

The economic policy response to the pandemic across most of the developed world has been to unleash the tools of macroeconomic support. The Federal Reserve has slashed interest rates close to zero this weekend and announced a massive program of bond purchase, dubbed QE4. Europe's central bank, too, has been considering asset repurchases, while China has been preparing its own stimulus program. Despite all these measures, there is a great deal of uncertainty among policy makers, because we have little experience with crises of this variety.

In a conventional crisis, the fundamental reason for the problem is economic in character —things like excessive debt, or lax oversight, or some other inherently economic failure. In the case of a pandemic induced crisis the core reason is biological in nature, so economic policy makers have little control or understanding of the root issues. Further, for politicians across the world the first order concern is to prevent a massive outbreak of disease, and the effects on the economy are, at present, a second order worry at best.

Yet, with time, the economic strain will start to show as massive cutbacks in travel and meeting inevitably soften economy-wide production and spending. In fact, as a precursor, financial markets everywhere have already started to tank. It is not clear, however, if flooding the system with cash will revive spending and growth as it did earlier. Unlike the crisis in 2008, there is not just a deficit of trust in the system, but a very real physical reason why individuals are choosing to keep away from each other. Would it help more if businesses were encouraged to move their offerings online? For example, Disney has begun to offer online streaming of all its movies running in the halls at present. However, such a strategy involves dangers of its own — what if people decide to forego going to the movies even after the crisis winds down? Disney earns much more when people physically go to the movies than when they sit at home and stream. Is Disney digging its own grave by moving its releases online?

Questions like these do not have easy answers. At a deeper level, many of the economic questions raised by the sudden spread of a pandemic like Covid-19 are completely new to the profession. Just as the crisis in 2008 led to the growth of new lines of inquiry and research, it is likely that the Covid-19 induced breakdowns will lead to a fresh look at many of the fundamental assumptions underpinning modern economics.

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