Economic lessons of coronavirus

The outbreak of the coronavirus epidemic is neither unprecedented nor intractable. However, its genesis in China, and its transitive impact on global economic activity, portend important lessons for economists.

Globalisation brings structural risks that have to be analytically recognised and addressed: Globalisation represented the triumph of the theory of comparative advantage as technology and innovation lowered the barriers to locating production in the most globally competitive locations. Production costs fell, and global aggregate demand increased, just as predicted by that theory. China was the biggest driver of this structural change due to its sheer size and scale. The outbreak of coronavirus in China has effectively shown that there are serious structural risks that can disrupt the working of the principle of comparative advantage.

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Macroeconomic interventions will not counter these risks: The Federal Reserve acted swiftly to cut interest rates by 50 basis points. But this only assuaged the US stock markets for 15 minutes, as they recognised that such cuts, which essentially cheapen the price of capital and indicate a higher tolerance for inflation, would not address the structural problem of a breakdown in global supply chains. This breakdown could mean, simply, that increased consumer spending would not be matched with a supply response, resulting in inflation without a corresponding counter-recessionary benefit. Domestic investment to create alternative supply chains would take time, and would only respond to cheaper capital costs if businesses perceive the rate cut to be permanent and — importantly— if aggregate demand would not dampen, given that alternative supply chains would be more expensive than the China driven one. A conversation with an Indian manufacturer of transformers confirmed this to me. His profitable company would not relocate production of intermediates currently imported from China. Such a relocation, even if financed by cheap capital, would require the company to sell its product at significantly higher prices, which would not support current demand levels. It would make better business sense to wait and shrink production in the interim.

Decentralised supply chains: Economic activity traditionally involved integrated production clusters because of the high cost of logistics. Competition served to provide alternative suppliers for intermediate goods. Supply chains tended, therefore, to be decentralised and to operate with multiple competing suppliers. Globalisation and supply chain integration meant that only the most efficient location survived: Within that location there is competition, but the location itself becomes an effective monopoly. Decentralised supply chains will become competitive if the risks to such locational monopolies, made apparent by the coronavirus epidemic, are incorporated into investment decisions.

Precautionary inventory management: Before the era of cheap logistics, inventory management was focussed on ensuring that firms did not suffer market share losses due to supply chain disruptions. But the logistics innovation and information technology revolutions have made it attractive to minimise inventory holding. This is likely to reverse as companies learn that risks posed by global supply chain disruptions can increase fragility. When Jaguar Land Rover has to ship car parts in suitcases so as to counter supply chain disruptions, then a rethink on optimal inventories is inevitable.

The demise of multilateralism will need to be reversed: It is a paradox that globalisation was accompanied by the collapse of its potentially biggest safety net — multilateral coordinated action. Notwithstanding the great success of multilateral coordination in abatement of the HIV AIDS crisis, and the demonstrated success in dealing with potential disruptive threats like cartelised oil prices and the ozone hole challenge, multilateral coordination to alleviate real sector global threats declined precipitously over the past 30 years. Multilateral coordination became focused on trade and financial regulation. The coronavirus epidemic highlights the need to start thinking more actively about multilateral coordination, especially when it comes to supply chain management and global human shocks, including, but not confined to, health emergencies and climate uncertainties.

Importance of domestic demand and frugal logistics: This is perhaps the most important lesson for both developed and developing countries. The pharmaceutical supply chain has involved India producing generics and exporting these to Europe while importing intermediates from China. India supplies 26 per cent of Europe's generics and 24 per cent of US generics. But the coronavirus crisis has meant that India's ability to produce these generics has been constrained by a bottleneck on intermediate imports on China. This has led to export restrictions on generics, which has caused a supply crisis in the developed world.

We thus need to rethink the role of logistics in maximising growth, and the costs and benefits of being part of global supply chains. This does not mean we turn inward but rather that we recognise the importance of being frugal with logistics. A frugal logistics chain promotes both decentralised supply and lower risk of disruption.

Going forward, there are two important things that large emerging economies like India need to consider. First, a growth strategy that is based on meeting a broad-based composition of demand is a more resilient strategy than logistics-intensive export-led growth. Second, attention should focus on how to deliver output with less, as opposed to cheaper, or more plentiful, logistics in a quest to better fit in with global supply chains that we now see pose significant risks to economic activity when there are disruptions. Making local with less movement of goods, inputs, and people offers a more resilient growth path.

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