Helping supply chains recover

The Indian government has announced a sizeable fiscal stimulus, which some commentators believe can help revive the economy. There are, however, good reasons to doubt this belief. Much of the decline in output is due to supply chain disruptions generated by the lockdown. Government spending can do little to alleviate this. Putting money in the hands of people can increase the demand for goods but cannot increase the supply of goods and services.

In modern economies, the production of goods happens through complex supply chains that traverse geographical boundaries. Upstream sectors like 'mining' produce metals that are in turn used to produce machines. These machines are used to sow seeds, harvest crops, and transport fuel. Finally, the harvested crops are used by downstream sectors to produce flour and bread. At each step, machines and labour combine to produce goods which are the inputs for sectors further downstream.

Reduction in output

Under the lockdown, numerous inputs have not moved from their producers to their users. These disruptions may not at first generate a reduction in consumer goods like bread. However, the availability of consumer goods will begin to decline as bakers run out of flour, and mills exhaust their stocks of wheat. And there is no way to guarantee the flow of essential goods while suspending the production of non-essential goods. Automotive spare parts may be non-essential in the short run, but become essential as food-carrying trucks begin to break down. How far is the long run? This is difficult to say; there may be some variation across goods.

The supply chain disruptions are going to be amplified by labour shortage as workers remain at home. Countries like India are likely to experience a greater reduction in output on this count than, say, Europe or the U.S. because of the higher labour intensity of production (think of the difference in unloading of goods in the port at Rotterdam and the port at Kochi). Poorer countries are less likely to be able to substitute locked down labour with capital because of the dearth of capital in these nations.

As economies emerge out of the lockdown, entrepreneurs, workers, and consumers must adjust to the new reality. The world supply chain must adapt. Firms may, for instance, choose to source inputs from suppliers in their geographical proximity to minimise the risk of future disruptions. This involves building productive capacity at new locations, all of which requires

investments fuelled by savings. Furthermore, the investments must be guided by price signals. Within a market economy, the movement of prices provides the incentive and information needed to adapt and grow. As economist Ronald Coase put it, prices are bundles of information wrapped in an incentive. As the prices of some inputs rise, the buyers of these inputs look for alternate suppliers, and firms which did not hitherto produce the good have an incentive to do so. The key to economic recovery lies in millions of such adjustments through which firms locate new providers of inputs, new buyers of their output, and build factories at new locations.

Why stimulus packages won't help

Unfortunately, market adjustment processes are likely to be disrupted by government stimulus packages. Governments spend by printing money, raising debt, or increasing taxes. Irrespective of the way in which the expenditure in funded, resources are transferred from private entrepreneurs to government bureaucrats. When governments print money, they draw resources through inflation. Bureaucrats tend to be less efficient than profit-motivated firms in allocating scarce resources. Bureaucrats have little incentive or information to bring about the granular supply chain adjustments necessary to revive growth. As the stimulus package kicks in, economic efficiency is likely to decline and so are the chances of a timely recovery of output.

So what can the government do? The experience of West Germany after World War II has a useful lesson. Beginning mid-1944, Allied bombing disrupted the German supply chain by targeting bottleneck sectors like electric power generation. This destruction of the supply chain devastated the German economy. Per person food production fell to about half of its pre-war level. Two years later, this changed after Chancellor Ludwig Erhard lifted price controls and cut taxes. West German entrepreneurs re-established a thriving supply chain through which goods went from upstream sectors to final consumers. By 1950, per capita income in West Germany had reached its pre-war level.

The recent supply chain disruptions are likely to last long. The path to recovery lies in cutting government expenditure, removing price controls, and opening up trade.

Vipin P. Veetil is Assistant Professor at IIT-Madras and Kumar Anand is an economist based in Delhi