The moral hazards of our economic response to COVID-19

Little doubt exists that COVID-19 represents an existential challenge. But could our economic policy responses complicate the return to "normalcy" whatever that may mean?

Governments everywhere are introducing massive subsidies to individuals and business, replicating the standard response in previous recessions. But what if government did much less, or even nothing? What might that look like? And could capitalism ride to the rescue? Has the government created a massive moral hazard for our economy?

To start, many in the economy have not lost personal or business income. Salaried employees able to work from home, groceries, retirees, and on-line retailers all continue to receive income and revenues. Businesses with physical face time with customers and their employees as well as workplaces with high concentrations of workers are taking a direct hit. The point is that, unlike media representations, not everyone works in the "gig" economy or survives paycheque to paycheque.

I am not minimizing hardship or stress felt by many, but trying offer perspective on the extent of the problem, and suggest that blanket subsidies to all, are inefficient and wasteful. They may also undermine long-term economic resilience.

To start, let's do a thought experiment with three scenarios:

First, consider a family with complete income loss, no significant savings, car and other loan payments, and a mortgage of $200o per month… a typical situation. They certainly could use the $2000/month from the Economic Response Benefit; they may also receive employment insurance.

Second, think of a family that rents, also experiencing a complete income loss. The only difference with this situation compared to the homeowners in the first scenario the rental payment to landlord.

Third, there is the nail bar down the street with an owner-operator and three employees, who have all experienced lay-off. Furloughing workers mitigates some of the monthly expenses that economist term "variable costs", but not all, such as rent and utilities, payment of loans, and leases on equipment. It does nothing for "fixed costs" such and payment of leases on equipment.

Imagine governments did nothing to help. In normal times, failure to make mortgage payments would lead to foreclosure; failure to pay rent results in eviction; and finance companies seize equipment upon failure to make lease payments.

These are not normal times. Banks do not want to own homes or apartments. Landlords do not want to enforce mass evictions, especially during a lock down and social distancing, when many prospective replacement tenants cannot view the not yet vacant apartment. Finance companies do not want repossessed foot baths in their front lobbies. We are unlikely to see mass foreclosures, evictions and equipment repossession, although individual instances of business myopia are sure to exist.

The alternative is at hand and the private sector is responding, albeit slowly, Ford, incidentally the only America car manufacturer that did not need a bailout in the 2007/08 financial crisis, now offers 90 days of payment relief to existing customers. It is not forgiving the payments, just adding them to the total owned and sliding the dent six months into the future. The consumer is not getting a free ride and this temporal shift in repayment will increase the total interest payable and raise the ultimate amount paid for the vehicle.

Banks are also starting to respond with mortgage payment deferrals. One could always easily negotiate a one-month deferral and with a good reason a longer deferral. Now the six-month deferral is becoming more common.

Is capitalism becoming more generous? Not really. It is responding to realities of existing and more importantly prospective customers. No way do car companies or banks want media accounts of repos or foreclosures when we are trying to be kind to each other. Consumers have memories and will remember bad behaviour.

It may seem that deferring debt on a large scale will create an unsustainable burden for individuals, firms and government. I think not. Interest rates are at historic lows, a testament to the impotence of monetary policy, but also key to financing the accumulating debt as payment deferrals increase with each day the pandemic persists.

The COVID crisis is also encouraging central banks to adopt modern monetary theory, and anathema for many economists when the economy is at full employment, but now an idea that has transformed from fringe to prescient. The Bank of England has announced a direct lending program to government, bypassing the usual asset purchase processes used in quantitative easing.

A first instance of moral hazard is that the quick response by government to shore up citizen finances likely delayed the response of the private sector in offering payment deferral. A second instance of moral hazard may occur this fall, assuming COVID recedes and the economy bounces back. Consumers may use the payment relief and emergency response, not to quietly ensure they have three months of salary and food to survive a future crisis, but to book a winter holiday to Mexico.

In our world of social safety nets, when we reduce the consequences of individual inaction by allowing the state to take over risk mitigation, we reduce individual resilience. Our ability to withstand crises falls as we become ever reliant on the state.

But if I were Prime Minster, after the daily sombre public health briefings, would I simply turn back into my home and not offer relief to citizens? Not a chance. Moral hazard is insidious … we often sow it through well intentioned and politically expedient policies.

Hubert Humphrey was correct, " A nation's greatness is measured by how it treats its weakest members." But, when we define everyone as weak and needing support, we create a massive moral hazard that ultimately compromises our individual and collective resilience. This can only make future crises more difficult to manage.

Words 966