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CORONAVIRUS PANDEMIC SHOCK; Contrasting Classical and Keynes Theories

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ABSTRACT:- Theories inform policy decisions in meeting managerial objectives, testing practices as well as forecasting short and long term socio-economic goals. The classical school of thought economists were disapproved by the Great Depression of **1930s** with their invisible hand of the self-adjustment of internal market mechanisms in an event of external shocks. Keynes' macro-economy view point of instability which calls for policy levers has been widely applied in terms of fiscal and monetary policies as well as adaptive measures on mitigating the impact of pandemics such as coronavirus pandemic. Therefore, the central thesis of this paper was to analyze the practicability of the classical theory in light of the Great Depression as well as evaluating the applications of Keynes intervention measures in the emergence of 2019-nCoV pandemic. The desk review data was employed in giving different viewpoints of the two theories as well as the researcher's personal observations. The paper found out that Keynes principles are widely used with relatively significant results from economic viewpoint of economists and tax experts. Being an explanatory study on the Keynes' application of tools, the paper recommends carefully chosen interventions in consideration to the nature of pandemic shocks. Kenya became the main country where the monetary and fiscal tools were being examined as the government grapples with the impact of the fast spreading virus to cushion her economy.

Key words:- Coronavirus, Pandemic **shock**, Classical and Keynes theories.

I. INTRODUCTION

Pandemic shocks are among the external shock determinants of macro-performance of an economy. Coronavirus pandemic will determine macro-economic outcomes across the globe in terms of output of total goods produced and services offered which is the real Gross Domestic Product (GDP) and jobs factor in the context of levels of unemployment. In addition, average prices of goods and services have started responding to 2019-nCoV effect as growth which is year to year expansion in production capacity of countries increasingly becoming uncertain day by day as the infections continue to shore up. Not even spared either by the pandemic is the international balances which is the international value of the dollar against other currencies, trade and payments of balances with other countries.

In a nut shell, Ahuja (2004) notes that these macro-economic outcomes define a nation's economic welfare as determined by external shocks, internal market forces as well as policy levers. External shocks include pandemics or disasters, wars and trade disputes while internal forces entail inventions and innovations, population growth, or spending behavior with policy lever encompassing regulations, tax policies, changes in the availability of money and government spending (Gothell, 2005).

It is vital to note that external shocks do occur once in a while and at times government policies may be absent under such circumstances and an economy will basically depend on the internal market forces to produce goods and offer services, economy can even grow and create employment opportunities as well as develop prices, (Hansin, 2005).

However, under such circumstance begs the questions; is the economy stable or unstable? Can the internal market forces alone guarantee average price stability of goods and services? What of ensuring full employment of the people? Is the market mechanisms a score bet for desirable output? The answers to these questions are the central thesis of contrasting theoretical view points of the classical theory and Keynes theory. While the classical economists believed that the economy was stable under the internal forces of the market place, Keynes thought otherwise insisting that the economy was unstable and there is nothing like self-adjustment but policy levers intervention are necessary. In order to analyses the view points of the two theories, the study will use the Great Depression of the 1930s and the coronavirus pandemic of 2020 to demonstrate the stability of economy under market mechanisms alone and if it cannot hold the necessary, intervention measures to prop the economy. Remember these two events had are having massive impact on economies across the world.

1.1 The classical theory

The classical economists were of the opinion that irrespective of the existence of the external shocks and absence of government policy levers, the internal market forces were sufficient to self-adjust economy to deviations from its long-term growth trends. The theory therefore held that the economy was inherently stable under the internal market forces and any attempt to intervene the impact of external shocks like pandemics or other phenomenon was unnecessary because water will always find its own level.

To drive the view point of this theory, the classical economists argued that producers might occasionally reduce their output and people may be thrown **out** of work. However, to them, these dissolutions were insignificant and would only cause immaterial damages to the economy. These impacts were viewed as temporary and not permanent because the internal forces of the market place would reorganize itself "magically" to restore economic prosperity.

The theory relied on the concept of flexible prices and wages hence the producers would manipulate the two to meet their objectives. Therefore, if the procedures faced challenges in selling their entire produce at the prevailing prices, they had two options; one, is to reduce the rate of output which has the consequence of lay-off from employment while the second alternative would be to reduce the prices of their output. This second choice would stimulate an increase in the quantity demanded and with the spike in the quantity demanded more produce would follow and as such more people would be needed to work in order to meet the increased demand.

Price manipulation would spike demand of goods and services at the same time flexible wages when rates paid are lowered, the unemployed would scramble for engagement at the low prevailing wages. The low cost of production will not eat into the profit margins of the producers as such and they will be encouraged to produce more. The flexible wages would then have those who are able and willing to work get jobs. The self-adjusting internal market forces as premised on flexible prices and wages will enable the economy to be stable.

Jean-Baptiste Say one of the classical theorists contended that even the emergence of any external shocks such as wars, pandemics, droughts or trade disputes would not threaten the economy because of itself adjusting mechanism. It was therefore absolutely unwarranted to institute policy levers to sustain output, guarantee employment, stabilize prices and international balances as well as ensure growth in production capacity.

The classical economists were highly contended by the internal market forces and strongly dismissed the Great Depression ever occurring. There assumptions were taken as the gospel truth and people felt safe and went about their businesses as usual. However, this was short-lived as the Great Depression shocker of 1930 threw everything in disarray. There was a huge set-back in production and in spite of the falling wages, unemployment conditions worsen. The demand for goods produced could not hold even with the low prices and the classical self-adjustment of the economy simply did not work.

1.2 What then happened?

With the collapse of the self-adjustment of the economy at the emergence of the Great Depression, there was economic instability. Unemployment grew and persisted, the purchasing power of the people became very low in spite of the falling prices and this could not stimulate demand. The market mechanisms could not meet the desired output to spur economic growth and stabilize international balances. It subjected the people to recurring bouts of unemployment, inflation and declining output. The Great Depression became the turning point of the classical view of the economy, thus Keynes theory which was a complete contrast emerged.

1.2.1 Key inference to the classical theory

The key inference of the classical theory is the leissez-faire theory.

i) The leissez-faire theory

The classical theory was a laissez-faire theory of market intervention. The leissez-faire theory of public policy maintains that any market based equilibrium, however imperfect, still provides a more equilibrium allocation of resources within the economy than does an equilibrium involving government intervention. The theory further posits that in the absence of distortions inducing government intervention, the outcome of decentralized private sector activity will remain more efficient, even in the second-best sense than market equilibrium with government intervention.

Therefore from this view point, government intervention in markets result primary in rent-seeking behavior of special interest groups seeking to bolster their allocation of social wealth (Stigler 1971: Peltzman 1989). It therefore means that to the Laissez-faire theory, calls for government assistance in providing pandemic insurance or catastrophe may be viewed as opportunistic attempts to secure an ex-ante/post disaster/or catastrophe wealth transfer from taxpayers and programmes to provide liquidity to governments for disaster relief would be viewed as rent-seeking behavior by government officials. However, the Keynes approved the laissez-faire classical view otherwise as the Great Depression of 1930 took toll on the economy.

1.3 Keynes theory

In 1935, John Maynard (Keynes) noted that "classical economists were apparently unmoved by the lack of correspondence between the results of the theory and facts of observation; a discrepancy which the ordinary man has not failed to observe……..…". In simple facts, the Great Depression destroyed the credibility of classical economists' theory. To Keynes, there is nothing like self-adjustment and as such he argued that the private economy was inherently unstable. Therefore with any disturbance in output, prices or unemployment however small, it was likely to be magnified, not muted by the invisible hand of the market place.

Keynes further observed that macro-failure would be the rule not the exception because the Great Depression was not a unique event but a calamity that would recur if governments relied on the market mechanism to self-adjust. The central thesis of his theory was that the inherent instability of the market place required government interventions. When the economy falters in any external shocks such as 2019-nCoV pandemic or otherwise it is imprudent to wait for some assumed self-adjustment mechanism. But instead, there should be interventions to protect jobs and income of the people. Keynes therefore concluded that policy levers were both effective and necessary thus without such the economy was doomed to bouts of repeated macro-failure.

The policy options advocated for by Keynes were basically three; first, shift the aggregate demand curve by an increase in government spending on goods and services as well as a cut in taxes to stimulate greater consumer and investor spending. In the budgetary toolkit, government spending and taxes are commonly used instruments to influence the macro-outcomes such as growth, prices, output, jobs and international balances.

Besides the fiscal policy of government expenditure and taxes manipulation, the aggregate demand curve shift may be instigated by monetary policy. It is basically the use of money and interest rates to alter economic outcomes. The macro-equilibrium may be affected by amount of money in circulation thus policy arsenal must include some levers to control the money supply.

The second policy option would be to shift the aggregate supply curve by reducing the costs of production or otherwise stimulate more output at every price level. This would need tax cuts on wages and profits to increase the disposable income of the consumers thus enhancing their purchasing power.

In addition, the investors will be incentisized with the cut on after-tax income to supply goods at any given price level. Besides the tax cuts, government regulations is another staple of supply-side policy. Thus regulations that slow innovations or raise the cost of doing business reduces aggregate supply. Therefore, removal; of unnecessary red-tape can facilitate more output and reduce inflationary pressures.

The third policy lever is do nothing in a situation where identification or control of the aggregate demand and supply is not possible. In this case, the economy should be left in the hands of self-adjustment of the internal mechanisms of the market place which is a kin to throwing economy to the dogs.

The Keynes theory of government intervention through the policy levers have been applied by different governments to meet specific macro-economic outcomes. The coronavirus pandemic has seen Keynes concepts applied because the phenomenon is both demand and supply oriented requiring careful application of relevant policy levers to revive economic growth, stabilize prices, secure jobs, guarantee output and sustain favourable international balances.

1.3.1 Key inferences to the Keynes theory

The key inferences to the theory are the public interest theory and market enhancement theory.

i) The public-interest theory

The public-interest theory was originated by Musgrave and Musgrave (1984). The theory suggests that existence of market failures associated with moral hazards, adverse selection or other externalities can lead to sub-optimal allocation of resources and that government intervention targeted at addressing these market failures to improve welfare.

The social safety net programme by the Kenyan government to cushion the vulnerable elderly citizen and the disable is a social insurance-model like government intervention financing. Also, the on-going pilot programme of indexed based insurance solution for livestock herders in the Arid and Semi-arid regions as well as crop-index insurance in some parts of agricultural productive regions like Vihiga County exemplify government's interventions as informed by the public interest theory. The herders and crop farmers transfer weather risks such as rainfall deficit and excess rainfall impacts to be compensated by the government in a structured subsidized financing social insurance model. The economic stimulus packages instituted by different countries are on the basis of public interest theory.

Annual budgetary allocations or contingency fund utilizations are the immediate financing options that facilitate public interest theory intervention measures in rescuing flood hazard victims, the covid-19 public intervention strategies of awareness, advocacy and education as well as screening, testing and caseload management of the victims. Monetary and fiscal policies applied by the government in stabilizing the economy are some of the economic lever weapons the public-interest theory parameters encompass. A number of county governments in Kenya have suspended taxes, waived mortuary expenses for the relatives of the deceased as well as supporting burial expenses to enhance preparedness measures the national government is executing against covid-19, all these are in line with the principle of public interest theory.

ii) The market-enhancing theory

The Market-Enhancing Theory was developed by Lewis & Murdock 1996, 1999 respectively. The theory too recognizes that market failures can create sub-optimal allocation of resources and that private sector coordination is not always effective. The theory here holds that, public policy should facilitate the development of private market but not replace the private players for instance by improving information flows, and ensuring fair play in the market. As an example, the market enhancing view would suggest that a government funded catastrophe risk mapping programme would provide valuable information to the market on catastrophe risk zones, but that the provision of catastrophe insurance should be left to private institutions.

The theory also recognizes that government intervention can help facilitate the creation or enhancement of private institutions for solving market failures. Therefore, government policies on micro-insurance products, establishment of Disaster co-operative societies among others are enhancing mechanisms in the disaster levers intervention in the dynamic environment.

1.4 Conceptualizing the external shocks

We have already seen that the macro-economic outcomes are determined by internal market forces, external stocks and policy levers. These could be conceptualized as shown in figure 1;

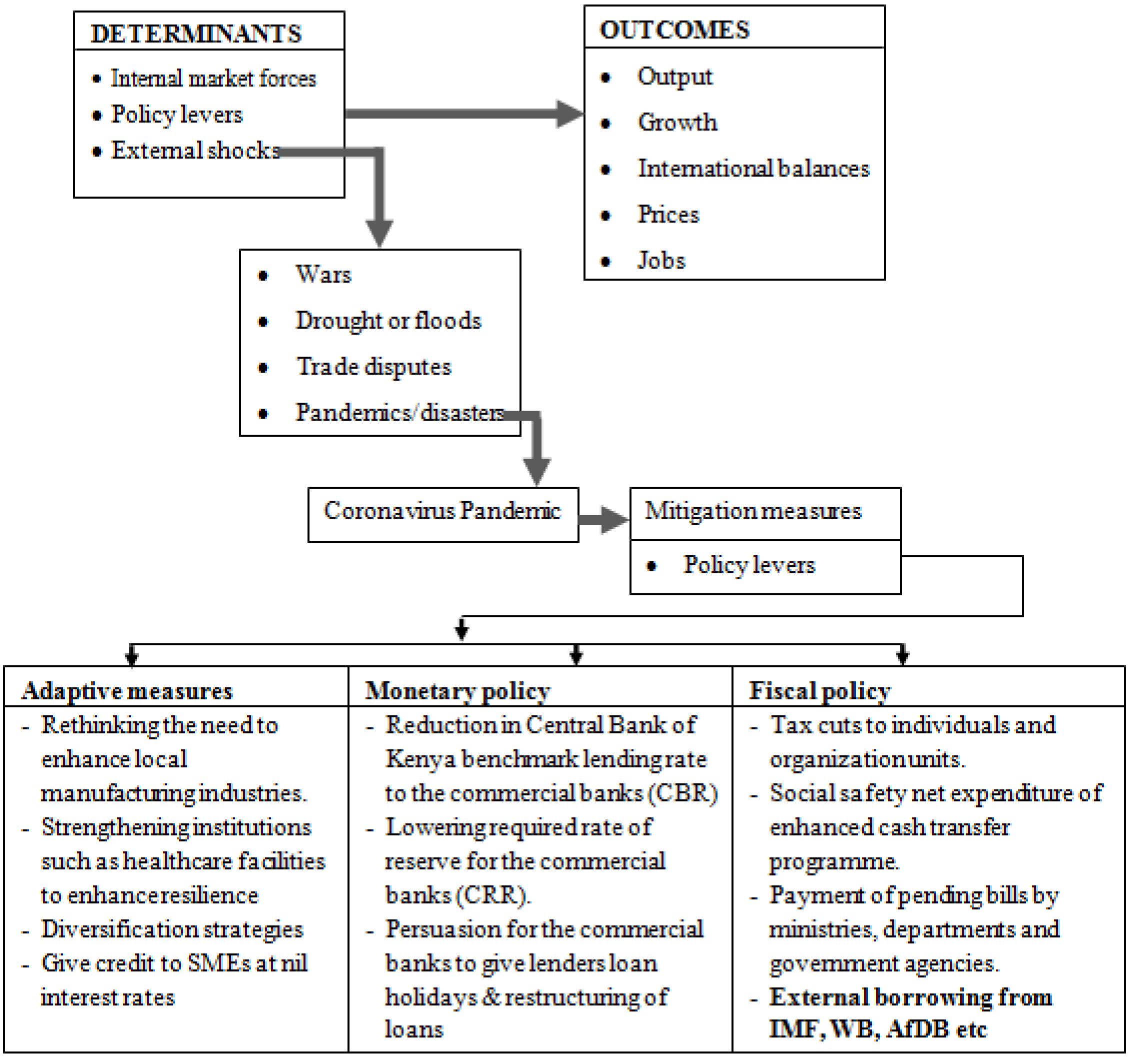

Figure 1: Conceptualizing the relationship between external shocks and mitigation measures
Source: Self-conceptualization (2020)

As has already been evidenced that the Great Depression needed mitigation measures and not the laissez-faire sort of self-adjustment of the internal market forces as is the 2019-nCoV pandemic impact. The policy levers of mitigating its impacts are fiscal and monetary policies as well as adaptive measures. It is vital to note that coronavirus pandemic should not be wished away because looking at what happened in China where it first originated before quickly spreading to Europe, the African continent should prepare for the worst as the World Health Organisation (WHO) Director General warned. The need to enhance health intervention measures as well as economic interventions is necessary.

1.5 Lessons **learnt**

The coronavirus pandemic shock helps us to draw lessons of prevention, preparedness, mitigation mechanisms, response strategies and recovery from the impact of the pandemic. The vulnerability nature of the low and middle income economies such as Kenya teaches us that;

i) The economy is unstable and any small disturbance will affect output.
ii) The policy levers as well as adaptive measures in responding to the pandemic shocks should be informed by the theoretical tenets of Keynes.
iii) The economic impact of a pandemic is the difference between the projected output and the actual outcomes.
iv) It's indeed true that necessity is the mother of innovations thus the adaptive measures to pandemic impacts are driven by necessity.
v) The governments of the day should always strive to use the public resources prudently in strengthening institutions to enhance resilience of nations.
vi) The reactive emergency-aid business model of responding to external shocks should be discouraged but instead a holistic proactive strategies should be applied in both economic and social spheres.

II. METHODOLOGY

This piece of analysis was not based on gathered primary data but it was purely an analysis of the principle tenets of two theories based on two phenomenons of the Great Depression of 1935 and the coronavirus pandemic of 2020. However, it is vital to note that observation approach was adopted in the Kenyan context on how the policy levers applied in mitigating the impact of 2019-nCoV pandemic. Also, besides the general overview of output parameters of the macro-economy, the middle and low income economies such as Kenya were being used in certain justifications to drive study's arguments home in evaluating their monetary and fiscal policies in responding to the covid-19 pandemic. Desk review was mainly used in gathering data.

III. FINDINGS

Based on the analysis of the macro-economy as informed by the Great Depression and 2019-nCoV pandemic, the study observed that; the economy can never be left in the hands of an invisible internal market mechanisms to self-adjust but instead economic levers much be appropriately applied to obtain the desirable outputs of any economy. Also, it was revealed that the external shocks impacts are measured by the difference between the desirable projected economic outputs and the actual results of growth, employment, international balances and prices. In addition, the vulnerability nature of the middle and low-income economies make them highly exposed to the pandemic shock impacts as compared to the developed economies as we draw lessons from 2019-nCoV pandemic response of the developed and under-developed economies. This is associated with the stronger institutions with tested systems and structures of the developed economies unlike the largely untested and poorly structured systems and structures of the under-developed economies.

3.1 Global view interventions to covid-19 pandemic

According to the World Health Organisation (WHO) as at mid May 2020, globally covid-19 infections have reached 4,500,000 people, as deaths near 300,000 casualties and 1,500,000 recoveries. In African all the 54 countries have reported the fast spreading disease with 67,000 people having been infected, 2,400 deaths confirmed and about 25,000 recoveries. Kenya has over 800 infections, about 50 died of the coronavirus and over 300 recoveries. In its regular updates, the global health agency has warned that the coronavirus may never go away and populations will have to learn to live with it just as they have HIV/AID.

In view of the foregoing, coronavirus pandemic shock needs economic and social adaptive measures as well as policy levers to cushion the economies. For example, lessons from developed world show that on March 23, the United States announced measures to provide support for the flow of credit to employers, consumers and businesses by establishing programmes that would provide up to $300 billion (Ksh. 32.19 trillion) in funding.

President Donald Trump also announced a Paycheque Production Programme (PPP) and Healthcare Enhancement Act which would enable loans designed to provide incentives for small businesses to keep their workers on payroll. The UK government made available Ksh. 44.25 trillion (330 billion pounds) of loans and guarantees to businesses as these institutions employ workers.

London also reduced the bank rate to 0.1 percent and introduced a new Term Fund Scheme (TFS) to support the implementation of this new rate cuts with further incentives for lending especially for small and medium enterprises which also provide employment. The UK government will also pay 80 percent of wages of furloughed workers ranging to Ksh. 335,841.40 (2500 pounds) per month. At the same time, self-employed workers can also apply for a grant worth 80 percent of their average monthly profit to help them cope with the financial impact of the disease, according to Rishi Sunak, the Chancellor of the Exchequer.

On the other hand, Japan announced a Ksh. 107 trillion (108 trillion yens) which is equal to 20 percent of the nation's GDP to safeguard lives and livelihoods. The suite includes payment for Small and Medium Enterprises (SMEs) and small businesses. It also has subsidized for business owners who allowed their workers to take off days to take care of their children as well as subventions for freelancers and self-employed parents who cannot work due to childcare.

In Africa, the Zambian government announced waiver of tax penalties and interests to assist companies and businesses manage their cash flows during the coronavirus period with the hope of seeing this transmitted up to the level of these institutions' workers.

3.2 Kenya's state of affairs over covid-19 pandemic

Kenya has started feeling the impact of covid-19 with the pandemic loosening Central Bank of Kenya's (CBK's) grip in shilling with the shilling's exchange rate against the dollar as at the close of trading mid April

2020. Nairobi is in a bad position if not worse due to high public debt which stands at Ksh. 6.3 trillion with 70 percent of Kenya's foreign debt that was in dollars by the end of 2019 up from 31 percent in 2009, no wonder many African countries are appealing for debt waiver and restructuring. Kenya for example, would save Ksh. 71.5 billion if bilateral debt repayments were suspended. According to CBK, Kenya's reserve of foreign currency at the International Monetary Fund (IMF) doubled from Ksh. 37 billion to Ksh. 75 billion.

On March 13, 2020 the day the first coronavirus case was reported in Kenya, Nairobi Security Exchange (NSE) halted trading as share prices collapsed on virus scare. Market capitalization according to the Capital Market Authority (CMA) went to a historic Ksh. 120 billion fall at the bourse as blue chip firms got hit. The value of all stocks closed at Ksh. 2.04 trillion on March 13 compared to Ksh. 2.16 trillion on March 12. Panicky investors made indiscriminate sale of shares on March 13 as of daily trading at the NSE have been net sellers in the wake of covid-19.

President Uhuru Kenyatta while addressing the nation on this year's Labour Day from State House announced that more than 500,000 jobs could be lost in six months if the coronavirus is not contained. Already over 130,000 job losses have been reported according to the Ministry of Labour and Social Protection. All the 133,657 lost jobs so far are in the formal sector and the number excludes employees on unpaid leave and those who have taken pay cuts. The report further details that the most affected sectors are transport, aviation, tourism and hospitality, manufacturing, agriculture and "jua kali".

In addition, about 300,000 workers in the tourism sector are also staring at possible job losses in May and June if the situation does not improve. In the horticulture and floriculture industry 50,000 workers have already been sent on unpaid leave while 900 others from four different firms have given redundancy notices in the transport sector, 90,600 people have been affected following the restriction of movement in and out of Nairobi, Mombasa, Kwale and Kilifi counties.

According to the Kenyan National Bureau of Statistics (KNBS) the cost of living has started going up with the April inflation rate rising to 5.62 percent, despite a significant drop in the cost of fuel. The rise has made lives of consumers harder at a time when the covid-19 pandemic has taken away their purchasing power.

As police-makers grape in the dark on future economic numbers for Kenya in particular, the CBK has revised its economic growth rate projections twice. In April, CBK's economic growth forecast for Kenya this year scaled down to 2.3 percent from 3.4 percent March projection. Originally before the 2019-nCoV pandemic economic forecast was at 6.2 percent of the GDP.

However, the IMF in its latest outlook on Sub-Saharan Africa observed that the pandemic is exacting "a heavy human toll, up ending livelihoods and damaging businesses as well as government balance sheets". The global lender showed that the global economy would contract by as much as 3.0 percent. But with a weak global economy, Kenya's tourists' earnings, diaspora remittances as well as the country's export will be negatively affected.

According to the World Bank, it has got two sets of looking at the Kenyan economy in the wake of covid-19 pandemic; first, the outbreak will leave a major hole in the country's total output this year with the economy expected to register one of the slowest growths in recent times at 1.5 percent. Although to the Bretton Woods institution, this is the best case scenario if the stringent containment measures that have stopped most of the economic activities are lifted by end of May 2020.

Secondly, in the worst scenario where the stringent measures aimed at curbing the spread of the disease spill over the second half of the year then the World Bank expects the country's economy to plunge into a recession for the first time since the early 1990s registering a negative one (-1.0) percent growth. In addition, Mckinsey & Company a financial consultancy firm predicts that the value of Kenya's wealth which is its GDP might drop by 1 trillion as the economy contracts by 5.0 percent.

3.3 Kenya's response to covid-19 pandemic

Coronavirus pandemic being both supply and demand shock driven because it is not only that traders do not have goods to sell after the disease disruption of supply chain, consumers are equally do not have the purchasing power to buy because of the lockdowns and loss of jobs.

Thus, the government of Kenya has responded by establishing a Ksh. 10 billion special food kitty targeting slum dwellers. The amount will be used to register and buy food for people in slums, as the elderly persons and people with disabilities are also earmarked. The number of Kenyans who live in slums is estimated to be about 10 million according to the 2019 census data.

The Tax Laws (Amendments) Act 2020 which is aimed at making like better for the ordinary man in Kenya detailed 100 percent tax waiver to employees earning Ksh. 24,000 in a month. Employees earning over ksh. 24,000 and corporations now pay 25 percent tax on their salaries and profits respectively. Value Added Tax (VAT), or consumption tax has been reduced from 16 to 14 percent.

The Finance Bill 2020 also meant to cushion "Wanjiku" the ordinary citizen also eyes at ensuring that there is fairness in the tax system by correcting maladministration of tax regimes through removal of tax exemptions which targets wealthy individuals and businesses that have continued to pocket billions of shillings in profits at the expense of the public.

The CBK also have undertaken the initiative of reducing the CBR and CRR (the share of deposits banks are legally required to keep with the CBK) which had been already transmitted. This was aimed at injecting liquidity into the economy and of the Ksh. 35.2 billion the CBK freed up after CRR was reduced by 4.25 percent, about Ksh. 15.3 billion had already been sent into the distressed sectors. Half of the cash has gone into the tourism and 14.0 percent to real estate as CBK reveals.

The lowering of CBR will also enable the commercial banks to reduce their interest rate to borrowers to stimulate investment and consumption. Loan holiday and restructuring has been called up by the CBK for the individual borrowers to negotiate with their bankers on a case by case basis. There will be no blanket order on how this would be done according to the CBK governor with approximately Ksh. 9.9 billion debts the stressed borrowers are seeking talks over to be restructured.

3.4 Critiquing the Kenyan policy levers

An advocate of the high court in Kenya Edward Mwachinga thinks otherwise on the new tax relief contained in the Finance Bill 2020 in cushioning the investors. He argues that removing this incentive is counter-productive, especially at this time when investors are grappling with the covid-19 pandemic. He feels that the shift in policy acts as a disincentive to investment during this tough economic times. This has been a subject of intense debate among different economists and tax experts because such incentives tend to increase the returns on investment and they may not always attract more investments.

David Ndii a renowned economist and a fiery critic of the Kenyan government administration does not think the measures that have been in place will have any positive effect on the economy. He posits that people have lost jobs and businesses have closed down thus giving tax-breaks for people who have lost sources of income is counter-productive but instead their plight should be addressed directly. Ndii wonders how this is a rational response policy for a government that was in fiscal crisis before the covid-19 pandemic shock or how tax breaks translates to food on table of ordinary people who have lost incomes and jobs. In addition, he faulted the decision to slash taxes as an intervention by saying that there would be no taxes to be paid anyway as businesses would have closed down.

IV. RECOMMENDATIONS

Following the analysis of the two theories, the study wish to draw the following recommendations; firstly, policy levers are necessary for better economic outcomes. Secondly, because the pandemic shocks are recurring in nature, governments' needs to strengthen their institutions to enhance resilience thus minimize the impacts of pandemics. Finally, it is usually a delicate balancing act among the application of monetary and fiscal polies as well as implementing adaptive measures to pandemic shocks.

V. CONCLUSION

The study concludes by noting that pandemic shocks need relevant interventions depending on their nature. This means that coronavirus being a health hazard will require medical intervention measures as well as economic policy levers and picking on appropriate adaptive strategies to cope with such phenomenon by different economies.

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