

# Intelligence MEMOS



From: Ken Boessenkool

To: Federal and Provincial Ministers of Finance

Date: May 29, 2020

Re: **SUPPLY-SIDE SHOCKS AND THE COVID ECONOMIC RECOVERY**

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How should governments help the economy emerge from the COVID recession? Conventional responses are not designed for this – no amount of monetary or broad-based fiscal stimulus will open up middle seats on planes, eliminate childcare constraints on primary caregivers or undo the loss of productivity from ongoing physical distancing rules in our factories.

Or in economic speak, you can't fix a supply-side recession using the demand-side recession playbook.

Until the late 1960s, economists viewed shifts in economic activity through the demand side of the economy. High interest rates, a financial crisis, a general loss of economic confidence causes companies and individuals to spend less and economic activity to slow – sometimes into recession. The playbook for this kind of demand-side recession is to pump more money into the economy through monetary policy – lower interest rates – or replace some of that lost private demand with public demand through government spending.

The oil shocks of the 1970s and early 1980s changed all that. Higher oil prices drove up the cost of living across the economy, most visibly in automobile prices. The gas-guzzler bought in 1972 was worth much less in 1973.

Of course, there are demand-side elements to the COVID-19 recession. There has been a loss of economic confidence, and consumer and business spending has been dramatically reduced. Monetary stimulus has provided liquidity, stabilized core funding markets, and kept interest rates as low as possible. And the plethora of COVID income and wage supports preserved some level of private spending.

But as we move to recovery, it is clear that supply-side shocks will be the dominant force holding back the economy. There is no single playbook for a supply-side shock – if it persists, the economy has to adjust to this new reality over time. During that adjustment [targeted supports](#) can play a role to soften the shock. But a supply-side shock requires a shift from what have become more costly ways of living, producing and driving to cheaper ways of living, producing and driving. The appropriate response to a supply-side shock is micro, not macro.

Ongoing physical distancing rules will devalue capital – a supply-side shock – across the economy, particularly in the service sector. If we ban middle seats on airplanes, the value of a plane will immediately drop. If we limit the number of people due to physical distancing in our stadiums, childcare centres, hotels and barbershops, the value of those businesses will drop. No amount of monetary or fiscal stimulus will fix this destruction of capital.

The proper response is to do whatever we can to improve the investment climate, particularly in the service sector, by improving the return on investment by reducing its tax cost.

We can start by increasing investments in childcare – which could be done by increasing the [money families](#) have [available for childcare](#), and by loosening restrictions on what [kind of care](#) qualifies for that increased money.

Ongoing physical distancing rules will also cause a drop in productivity in the goods-producing side of the economy. Ongoing physical distancing rules and disinfecting will constrain how efficient each employee will be in our production facilities. Meat packing plants will never operate at anywhere near their former levels of efficiency.

Here, we should look to ways to increase productivity through things like accelerating depreciation, lower taxes on investment and eliminating productivity-inhibiting policies like interprovincial trade barriers.

These supply-side shocks will persist until we can return to the way we lived, worked and raised our families before COVID. That will eventually require a vaccine. But supply-side shocks have a way of persisting and changing behaviour long term – when was the last time you saw a genuine gas guzzler? Even today's popular SUVs have twice or three times the gas mileage of those old boats.

The challenge to the COVID economic recovery will be addressing a supply-side shock that will hit industries where workers or customers have traditionally operated in close quarters, and primary care-givers – mostly women – in dual-income families with children.

Writing a playbook to address these supply-side shocks will be the challenge of our day. And that day is today.

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