Intelligence MEMOS

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To: Fiscal Policymakers

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Re: **Coronavirus and Supply-side Shocks**

The news on coronavirus seems to be getting worse each day. Policymakers have rightly been focused on the health of Canadians.

Meanwhile, fear has reached financial markets, which have been shedding points at alarming rates the last few days. It is natural to wonder what this entails for the Canadian economy, especially when the epicentre of the virus (China) plays a massive role in global supply chains, on which Canada heavily depends. If the effects of the virus are long-lasting, the question becomes whether policymakers are equipped to handle an economic downturn that originates from disruptions to supply. Here, the answer is unclear.

Let's begin with the markets. The S&P/TSX fell for a fourth consecutive day on Thursday closing more than 1,000 points – or 6.5 percent – below its Friday levels, and wiping away all the gains since the new year (4.3 percent). The fall in markets has many concerned our decade-plus run without a recession may be nearing an end.

Markets tend to overreact, however, and this might just be a correction from the record highs over much of last year. And it is always possible that effects on global and Canadian economic growth will be temporary, and once the virus is contained, things might get back to normal.

But let's assume for a moment the disruption to global supply chains is severe enough that it has a longer-lasting effect on output. What might that look like, and are policymakers ready?

The IMF's conservative scenario for the economic effects of coronavirus lowers China's expected growth for 2020 by 0.4 percentage points to 5.6 percent. What might seem like a small decline, on an economy of $15.27 trillion, is still $61 billion. With China's imports and exports totaling $4.5 trillion in 2019, one can imagine how this drop might disrupt the global economy, including Canada with its integration in global markets.

In terms of policymaker preparedness, monetary policy is typically seen as the economy's first line of defence. Economics 101 tells us that the intersection of demand and supply will lead to an equilibrium of price and quantity (price times quantity equals nominal GDP). Since demand is downward sloping (i.e. quantity demanded falls as price increases,) when it falls, prices and quantities fall simultaneously. Central banks typically react by lowering interest rates, making borrowing cheaper, thus increasing aggregate demand and bringing prices back up. Demand-side shocks, thus, are a natural fit for the Bank of Canada's toolkit.

On the other hand, a negative shock to supply, which is upward sloping, will cause quantities to fall, but prices to increase. This is a bad scenario for central banks, especially those that target inflation. The bank might lower interest rates to mitigate knock-on effects to demand, but this will increase prices even further. If the bank instead increases rates, it might lower prices, but it will simultaneously lower demand, further slowing output.

Most of the unconventional monetary policy we saw in the 2008/09 crisis, like emergency lending and liquidity facilities, and quantitative easing (though not in Canada), are similarly demand-side policies.

What this means is we will be forced to turn to fiscal policy even sooner. There are, of course, fiscal tools already in place for economic downturns. Automatic stabilizers, such as employment insurance, are designed to increase when economic activity slows down. Since these tools are both limited and not focused on the economy's supply side, we are likely to have to turn to discretionary fiscal policy.

Of course, this demonstrates why during economic expansions, governments should be cautious about running deficits. Shocks can emerge in unexpected ways. When they do, it is important that governments have retained the fiscal capacity to respond.

That said, if governments are forced to act, what types of fiscal policy are supply-side in nature? Infrastructure spending, which has not fulfilled its promise, comes to mind. As does the removal of barriers and the reforming of regulation that **inhibits business investment.**

From an economic perspective, the coronavirus might end up being a blip. However, if it does cause a longer-lasting economic downturn, governments must be ready to act. Unlike last time, monetary policy is unlikely to be the first line of defence.

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