

Bodenstein, Martin; Corsetti, Giancarlo; Guerrieri, Luca

**Article**

## Social distancing and supply disruptions in a pandemic

Quantitative Economics

**Provided in Cooperation with:**

The Econometric Society

*Suggested Citation:* Bodenstein, Martin; Corsetti, Giancarlo; Guerrieri, Luca (2022) : Social distancing and supply disruptions in a pandemic, Quantitative Economics, ISSN 1759-7331, The Econometric Society, New Haven, CT, Vol. 13, Iss. 2, pp. 681-721, <https://doi.org/10.3982/QE1618>

This Version is available at:

<https://hdl.handle.net/10419/296285>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

## Supplement to “Social distancing and supply disruptions in a pandemic”

(*Quantitative Economics*, Vol. 13, No. 2, May 2022, 681–721)

MARTIN BODENSTEIN

Division of International Finance, Federal Reserve Board

GIANCARLO CORSETTI

Faculty of Economics, University of Cambridge

LUCA GUERRIERI

Division of Financial Stability, Federal Reserve Board

### APPENDIX A: ADDITIONAL DETAILS FOR THE TWO-SECTOR MODEL

This Appendix derives the equilibrium conditions for the two-sector model and the steady-state condition. Finally, it also shows the derivation of the elasticity of substitution between the two factor inputs in the production function for final output goods.

#### A.1 *Equilibrium conditions*

Households maximize

$$\begin{aligned} \max_{c_t, \lambda_{c,t}, i_t, k_t, \lambda_{k,t}, u_t, \lambda_{i,t}} E_t \sum_{i=0}^{\infty} \beta^i & \left[ \log(c_{t+i} - \kappa c_{t+i-1}) \right. \\ & + \lambda_{c,t+i} \left( -c_{t+i} - i_{t+i} + w_{1,t+i} l_{1,t+i} + w_{2,t+i} l_{2,t+i} + r_{k,t+i} u_t k_{t+i-1} \right. \\ & \left. \left. - v_0 \frac{u_t^{1+\nu}}{1+\nu} - \frac{\zeta}{2} \frac{(i_t - i_{t-1})^2}{i_{t-1}} \right) \right. \\ & \left. + \lambda_{k,t+i} (-k_{t+i} + (1 - \delta)k_{t+i-1} + i_{t+i}) + \lambda_{i,t+i} (i_t - \phi i^{ss}) \right]. \end{aligned}$$

These are the first-order conditions from the households' problem:

$$\frac{1}{c_t - \kappa c_{t-1}} - \beta \kappa E_t \frac{1}{c_{t+1} - \kappa c_t} = \lambda_{c,t}, \quad (\text{A.1})$$

$$c_t + i_t = w_{1,t} l_{1,t} + w_{2,t} l_{2,t} + r_{k,t} k_{t-1} - v_0 \frac{u_t^{1+\nu}}{1+\nu} - \frac{\zeta}{2} \frac{(i_t - i_{t-1})^2}{i_{t-1}}, \quad (\text{A.2})$$

Martin Bodenstein: [martin.r.bodenstein@frb.gov](mailto:martin.r.bodenstein@frb.gov)

Giancarlo Corsetti: [gc422@cam.ac.uk](mailto:gc422@cam.ac.uk)

Luca Guerrieri: [luca.guerrieri@frb.gov](mailto:luca.guerrieri@frb.gov)

$$\begin{aligned} \lambda_{c,t} \left[ 1 + \zeta \frac{(i_t - i_{t-1})}{i_{t-1}} \right] - \beta \lambda_{c,t+1} \left[ \zeta \frac{(i_{t+1} - i_t)}{i_t} + \frac{\zeta}{2} \frac{(i_{t+1} - i_t)^2}{i_t^2} \right] \\ = \lambda_{k,t} + \lambda_{i,t+i}, \end{aligned} \quad (\text{A.3})$$

$$E_t \lambda_{c,t+1} r_{k,t+1} u_{t+1} - \lambda_{k,t} + \beta(1 - \delta) E_t \lambda_{k,t+1} = 0, \quad (\text{A.4})$$

$$k_t = (1 - \delta) k_{t-1} + i_t, \quad (\text{A.5})$$

$$\lambda_{c,t} r_{k,t} k_{t-1} = \lambda_{c,t} \nu_0 u_t^{\nu}, \quad (\text{A.6})$$

and the complementary slackness condition

$$\lambda_{i,t+i} (i_t - \phi i^{ss}) = 0. \quad (\text{A.7})$$

Firms in Sector 1 solve this cost-minimization problem

$$\min_{l_{1,t}} w_t l_{1,t} + p_{1,t} [v_{1,t} - \eta(l_{1,t} - \chi)].$$

And from the production function, we also have that

$$v_{1,t} = \max[\eta(l_{1,t} - \chi), 0] \quad (\text{A.8})$$

and that

$$w_t = \eta p_{1,t}. \quad (\text{A.9})$$

Firms in Sector 2 solve this cost-minimization problem

$$\begin{aligned} \min_{u_t k_{t-1}, l_{2,t}, v_{1,t}} r_{k,t} u_t k_{t-1} + w_{2,t} l_{2,t} + p_{1,t} v_{1,t} \\ + [y_t - ((1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{\frac{1}{1+\rho}} + \omega^{\frac{\rho}{1+\rho}} ((u_t k_{t-1})^\alpha (l_{2,t})^{1-\alpha})^{\frac{1}{1+\rho}})^{1+\rho}]. \end{aligned}$$

Notice that firms choose  $u_t k_{t-1}$  as if it were a single input, representing capital services. Note, that the Lagrange multiplier, i.e. the price of the output produced by sector 2, is normalized to 1.

The first-order conditions for this problem are

$$\begin{aligned} r_{k,t} - (1 + \rho) \left( (1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{\frac{1}{1+\rho}} + \omega^{\frac{\rho}{1+\rho}} (k_{t-1}^\alpha l_{2,t}^{1-\alpha})^{\frac{1}{1+\rho}} \right)^\rho \\ \times \frac{1}{1 + \rho} \omega^{\frac{\rho}{1+\rho}} ((u_t k_{t-1})^\alpha l_{2,t}^{1-\alpha})^{\frac{1}{1+\rho} - 1} \alpha (u_t k_{t-1})^{\alpha-1} l_{2,t}^{1-\alpha} = 0. \end{aligned}$$

Notice that  $y_t^x = ((1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{\frac{1}{1+\rho}} + \omega^{\frac{\rho}{1+\rho}} ((u_t k_{t-1})^\alpha (l_{2,t})^{1-\alpha})^{\frac{1}{1+\rho}})^{(1+\rho)x}$ . Find  $x$ , such that  $x(1 + \rho) = \rho$ . That is,  $x = \frac{\rho}{1+\rho}$ . Accordingly,

$$r_{k,t} - y_t^{\frac{\rho}{1+\rho}} \omega^{\frac{\rho}{1+\rho}} (v_{2,t})^{-\frac{\rho}{1+\rho}} \alpha \frac{v_{2,t}}{u_t k_{t-1}} = 0,$$

which can be further simplified as

$$r_{k,t} = \alpha \left( \omega \frac{y_t}{v_{2,t}} \right)^{\frac{\rho}{1+\rho}} \frac{v_{2,t}}{u_t k_{t-1}}, \quad (\text{A.10})$$

$$w_{2,t} = (1 - \alpha) \left( \omega \frac{y_t}{v_{2,t}} \right)^{\frac{\rho}{1+\rho}} \frac{v_{2,t}}{l_{2,t}}, \quad (\text{A.11})$$

$$p_{1,t} - (1 + \rho) \left( (1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{\frac{1}{1+\rho}} + \omega^{\frac{\rho}{1+\rho}} ((u_t k_{t-1})^\alpha (l_{2,t})^{1-\alpha})^{\frac{1}{1+\rho}} \right)^\rho \\ \times \frac{1}{1 + \rho} (1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{\frac{1}{1+\rho} - 1} = 0.$$

Simplifying

$$p_{1,t} - y^{\frac{\rho}{1+\rho}} (1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{-\frac{\rho}{1+\rho}} = 0, \quad (\text{A.12}) \\ p_{1,t} = \left( \frac{(1 - \omega)y}{v_{1,t}} \right)^{\frac{\rho}{1+\rho}}.$$

And from the production function,

$$y_t = \left( (1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{\frac{1}{1+\rho}} + \omega^{\frac{\rho}{1+\rho}} (v_{2,t})^{\frac{1}{1+\rho}} \right)^{1+\rho} \quad (\text{A.13})$$

and where

$$v_{2,t} = (u_t k_{t-1})^\alpha (l_{2,t})^{1-\alpha}. \quad (\text{A.14})$$

And from the budget constraint, we can derive that the goods market must clear

$$y_t = c_t + i_t + \nu_0 \frac{u_t^{1+\nu}}{1 + \nu} + \frac{\zeta}{2} \frac{(i_t - i_{t-1})^2}{i_{t-1}}.$$

The fourteen equations above allow us to determine fourteen variables  $y_t, v_{1,t}, v_{2,t}, c_t, i_t, k_t, u_t, \lambda_{c,t}, \lambda_{i,t}, \lambda_{k,t}, p_{1,t}, w_{1,t}, w_{2,t}, r_{k,t}$ , with  $l_{1,t}$  and  $l_{2,t}$  determined by exogenous processes.

## A.2 Steady-state conditions

Set  $u_t = 1$  and later set  $\nu_0$  to support this choice. Notice that the investment constraint must be slack in the steady state, so

$$\lambda_i = 0. \quad (\text{A.15})$$

Using

$$\lambda_{c,t} = \lambda_{k,t} + \lambda_{i,t},$$

and  $\lambda_{c,t} r_{k,t} - \lambda_{k,t} + \theta(1 - \delta) E_t \lambda_{i,t+1} = 0$ , we can see that

$$r_k = 1 - \theta(1 - \delta). \quad (\text{A.16})$$

Using

$$r_k = \alpha \left( \omega \frac{y}{v_2} \right)^{\frac{\rho}{1+\rho}} \frac{v_2}{k} \quad (\text{A.17})$$

and combining it with  $r_k = 1 - \theta(1 - \delta)$ , we can use a numerical solver to get  $k$ , given  $l_1$  and  $l_2$ .

Knowing  $k$ , and with

$$v_1 = \eta(l_1 - \chi), \quad (\text{A.18})$$

we can solve for  $y$  using the production function

$$y = \left( (1 - \omega)^{\frac{\rho}{1+\rho}} (v_1)^{\frac{1}{1+\rho}} + \omega^{\frac{\rho}{1+\rho}} (k^\alpha (l_2)^{1-\alpha})^{\frac{1}{1+\rho}} \right)^{1+\rho}. \quad (\text{A.19})$$

From  $k_t = (1 - \delta)k_{t-1} + i_t$ , we have that

$$i = \delta k. \quad (\text{A.20})$$

Using  $\lambda_{c,t} r_{k,t} k_{t-1} = \lambda_{c,t} \nu_0 u_t^\nu$ , find the value of  $\nu_0$  that ensures  $u = 1$ . Accordingly,

$$\nu_0 = r_k k. \quad (\text{A.21})$$

And using the resource constraint, we can solve for  $c$ ,

$$c = y - i - \nu_0 \frac{u_t^{1+\nu}}{1+\nu}, \quad (\text{A.22})$$

$$\lambda_c = \frac{1}{(1 - \kappa)c} - \theta \kappa \frac{1}{(1 - \kappa)c}, \quad (\text{A.23})$$

$$\lambda_k = \lambda_c, \quad (\text{A.24})$$

$$p_1 = \left( \frac{(1 - \omega)y}{l_1} \right)^{\frac{\rho}{1+\rho}}, \quad (\text{A.25})$$

$$w_1 = \eta p_1, \quad (\text{A.26})$$

$$v_2 = k^\alpha (l_2)^{1-\alpha}, \quad (\text{A.27})$$

$$w_2 = (1 - \alpha) \left( \omega \frac{y}{v_2} \right)^{\frac{\rho}{1+\rho}} \frac{v_2}{l_2}. \quad (\text{A.28})$$

### A.3 Deriving the elasticity of substitution for the production function of Sector 2

$$\begin{aligned} y_t &= \left( (1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{\frac{1}{1+\rho}} + \omega^{\frac{\rho}{1+\rho}} (v_{2,t})^{\frac{1}{1+\rho}} \right)^{1+\rho}, \\ \frac{\partial y_t}{\partial v_{1,t}} &= (1 + \rho) \left( (1 - \omega)^{\frac{\rho}{1+\rho}} (\eta(l_{1,t} - \chi))^{\frac{1}{1+\rho}} + \omega^{\frac{\rho}{1+\rho}} (v_{2,t})^{\frac{1}{1+\rho}} \right)^\rho \\ &\quad \times \frac{1}{1 + \rho} (1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{\frac{1}{1+\rho} - 1}. \end{aligned}$$

Notice again that  $y^x = ((1 - \omega)^{\frac{\rho}{1+\rho}} (\eta(l_{1,t} - \chi))^{\frac{1}{1+\rho}} + \omega^{\frac{\rho}{1+\rho}} (v_{2,t})^{\frac{1}{1+\rho}})^{(1+\rho)x}$ . Find  $x$ , such that  $x(1 + \rho) = \rho$ . That is,  $x = \frac{\rho}{1+\rho}$ . Accordingly,

$$\begin{aligned}\frac{\partial y_t}{\partial v_{1,t}} &= y_t^{\frac{\rho}{1+\rho}} (1 - \omega)^{\frac{\rho}{1+\rho}} \eta(v_{1,t})^{-\frac{\rho}{1+\rho}}, \\ \frac{\partial y_t}{\partial v_{2,t}} &= y_t^{\frac{\rho}{1+\rho}} (\omega)^{\frac{\rho}{1+\rho}} (v_{2,t})^{-\frac{\rho}{1+\rho}}, \\ \frac{\frac{\partial y_t}{\partial v_{1,t}}}{\frac{\partial y_t}{\partial v_{2,t}}} &= \frac{(1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{-\frac{\rho}{1+\rho}}}{(\omega)^{\frac{\rho}{1+\rho}} (v_{2,t})^{-\frac{\rho}{1+\rho}}}, \\ \log \frac{\frac{\partial y_t}{\partial v_{1,t}}}{\frac{\partial y_t}{\partial v_{2,t}}} &= \log \left( \frac{(1 - \omega)^{\frac{\rho}{1+\rho}} (v_{1,t})^{-\frac{\rho}{1+\rho}}}{(\omega)^{\frac{\rho}{1+\rho}} (v_{2,t})^{-\frac{\rho}{1+\rho}}} \right) = \log \left( \frac{(1 - \omega)^{\frac{\rho}{1+\rho}}}{(\omega)^{\frac{\rho}{1+\rho}}} \right) + \frac{\rho}{1 + \rho} \log \frac{v_{2,t}}{v_{1,t}}.\end{aligned}$$

The elasticity is given by

$$Elast = \frac{d \log(v_{2,t}/v_{1,t})}{d \log \left( \frac{\partial y_t}{\partial v_{1,t}} / \frac{\partial y_t}{\partial v_{2,t}} \right)} = \frac{1 + \rho}{\rho}.$$

Therefore, to hit a desired elasticity set  $\rho$  as

$$\begin{aligned}\rho Elast - \rho &= 1, \\ \rho &= \frac{1}{Elast - 1}.\end{aligned}$$

#### APPENDIX B: CALIBRATION OF THE MINIMUM-SCALE PARAMETER AND ADDITIONAL SENSITIVITY ANALYSIS

To calibrate the minimum-scale parameter for the production function of Sector 1 in the two-sector model (see equation (12)), we adopt the following strategy. We feed into the model a path of labor supply shocks that meets two restrictions: (1) it balances the decline in value added across sectors and (2) it brings about a reduction in labor inputs in line with the increase in the unemployment rate relative to the 3.5% mark observed in February, 2020. We then set the minimum scale parameter to match a 12% decline in GDP in the the second quarter of 2020. We calculated this decline relative to the consensus level of GDP in the Blue Chip forecasts published in January 2020, before private forecasters entertained the possibility of a pandemic. The resulting calibration choice for the parameter  $\chi$  is  $\frac{6}{10}$  times the steady-state value for the labor input of Sector 1.

Figure A.1 compares one- and two-sector models that match the observed increase in unemployment from March through October 2020 relative to the level in February 2020. After October 2020, the labor supply shocks follow an autoregressive process with a coefficient of 0.95. The figure shows sizable differences between the economic collapse

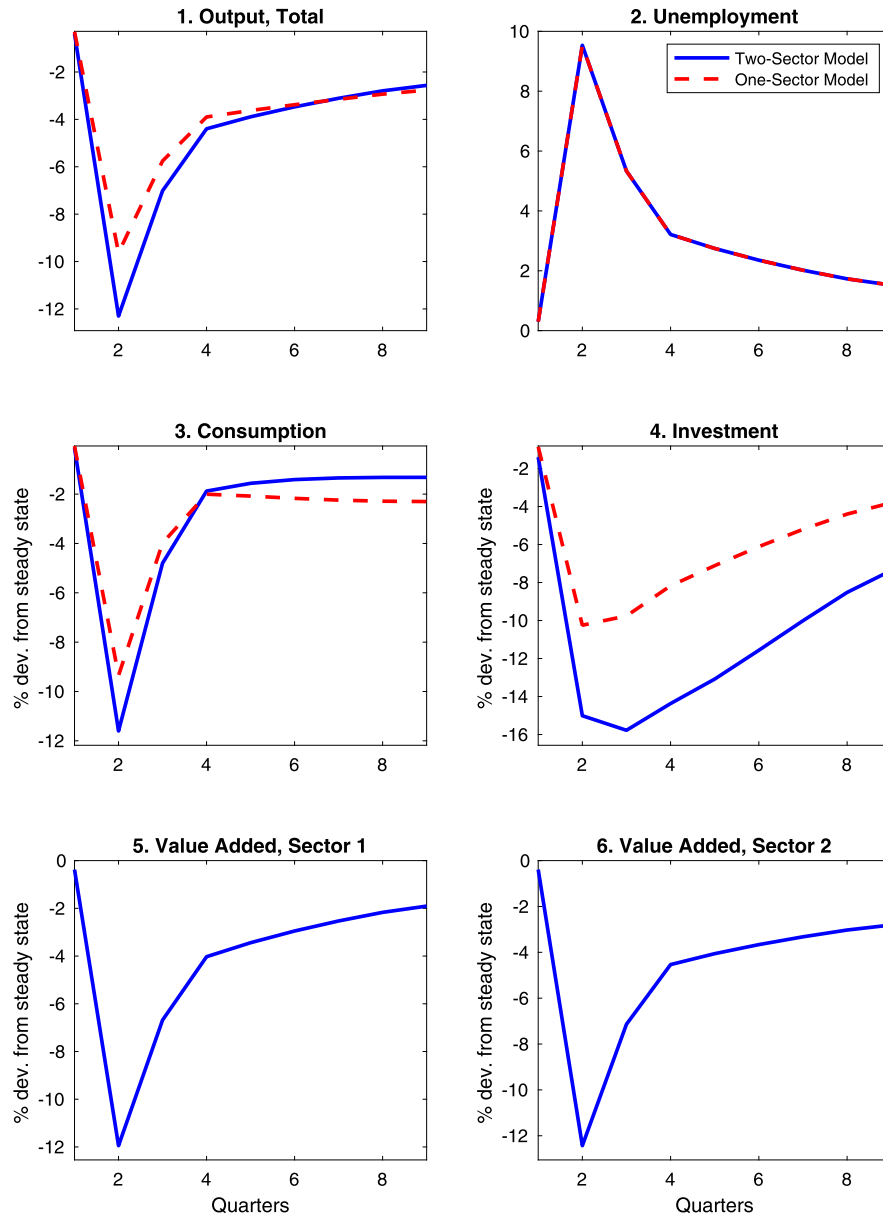


FIGURE A.1. Using the two-sector model to match the observed increase in the unemployment rate relative to February 2020.

that can be matched with our two-sector model and the smaller economic decline implied by the special case of a one-sector model. We conclude that our two-sector model is a more appropriate choice to study the economic consequences of the COVID-19 pandemic.

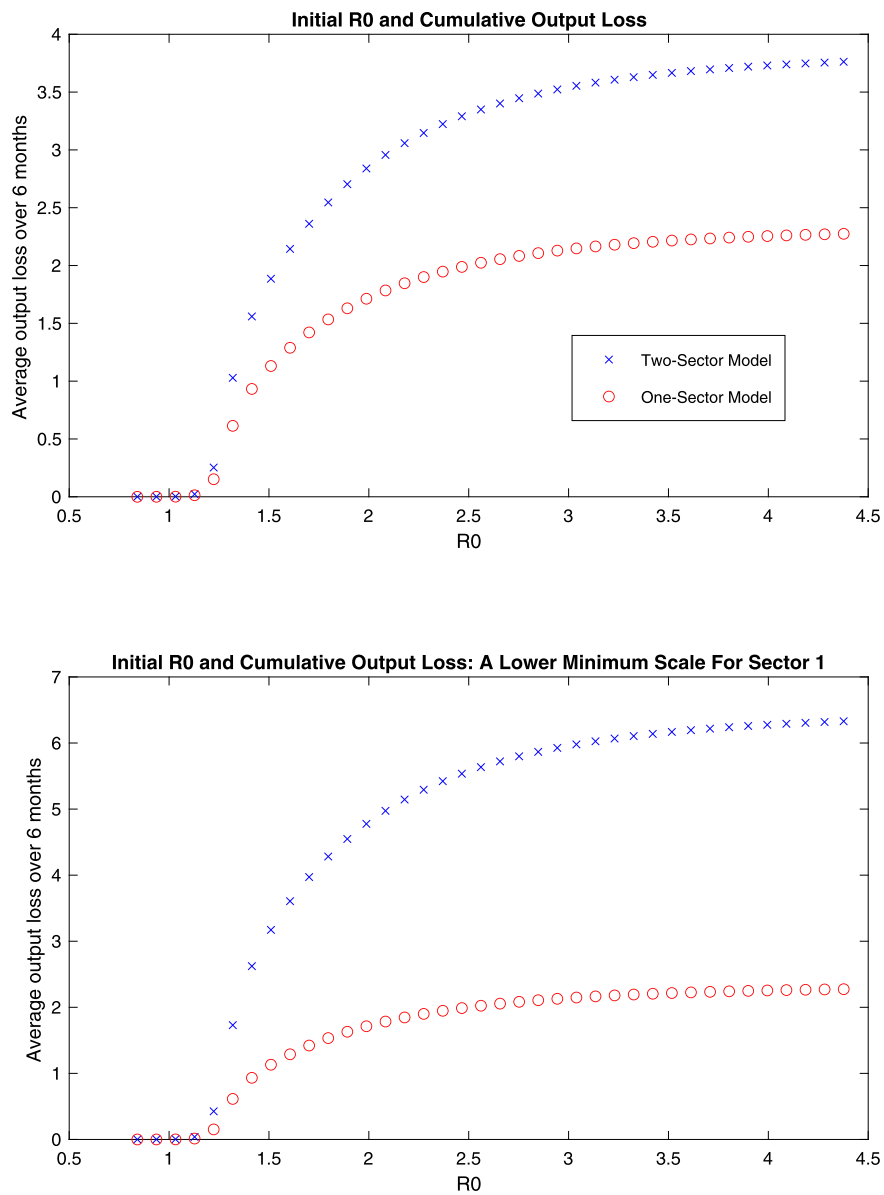


FIGURE A.2. Comparing the aggregate economic consequences of COVID-19 without social distancing in one- and two-sector models: Sensitivity to the reproduction rate. Note: We assume that no social distancing measures are taken to reduce the spread of the disease. The output loss stems from the reduction in labor supply from symptomatic infected individuals. The figure shows the cumulative output loss over 6 months alternatively based on one- and two-sector models for different values of the reproduction rate (set to 2 in our baseline). The top panel keeps all other parameters at their baseline values. For the bottom panel, we have increased the minimum scale parameter for Sector 1,  $\chi$ , to  $\frac{8}{10}$  of the steady-state labor input, as opposed to  $\frac{6}{10}$  in the baseline calibration.



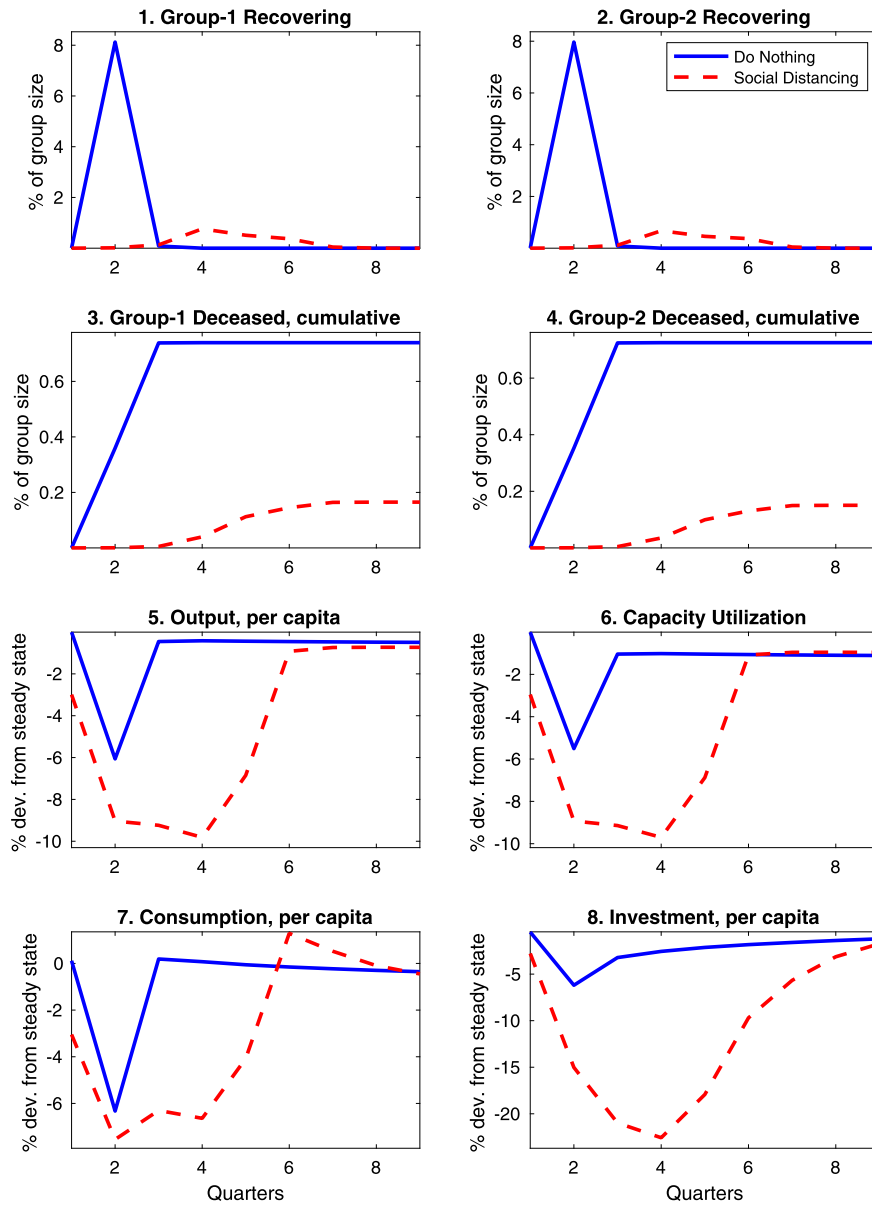


FIGURE A.3. Waiting for a vaccine: A lower effectiveness of the lockdown at reducing contact rates.

### B.1 Sensitivity analysis

Figure A.2 offers sensitivity analysis pertaining to the comparison on the economic effects of the spread of COVID-19 without any social distancing measures. We compare the economic effects using one- and two-sector models. Figure A.2 considers sensitivity to a range of values of the initial reproduction rate. It shows that the differences between

the one- and two-sector models persist as long as the reproduction rate does not drop below 1.2, a level that would also curtail the spread of the disease.

Figures A.3 and A.4 complement the discussion of the cost of waiting for a vaccine in Section 5.3. They pertain, respectively, to sensitivity analysis to the effective-

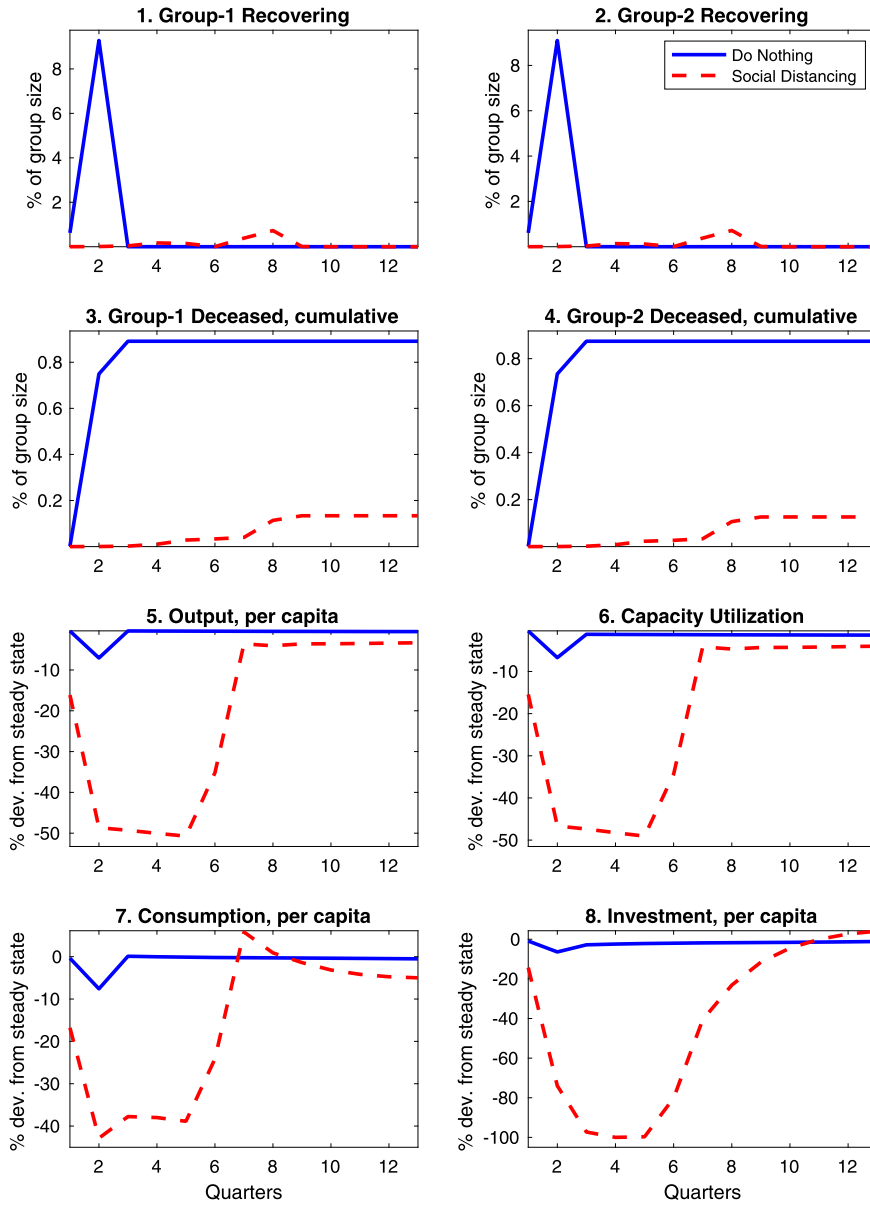


FIGURE A.4. Waiting for a vaccine: A 70% increase in the transmissibility of the virus.

ness of the lockdown and to the probability of transmission of the disease for given contacts.

Co-editor Tao Zha handled this manuscript.

Manuscript received 30 April, 2020; final version accepted 28 July, 2021; available online 2 December, 2021.