LONG-TERM THINKING IN EXTRAORDINARY TIMES:

POLICY-MAKING AND REGULATION DURING THE COVID-19 CRISIS

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It is challenging to think longer term in the midst of the COVID-19 crisis and an economic contraction of huge magnitude and uncertain duration. The extraordinary healthcare needs and enormous economic and financial stresses are rightly dominating the public agenda and the resources of governments.

The unprecedented issues and risks for policymaking and regulation in 2020 are compounded by the rapid decision-making required during crises to address emergency and other immediate needs. The dangers of COVID-19 give rise to uncertainty, intense time pressures, difficult tradeoffs, and numerous high-profile decisions. Further challenges arise in distinguishing short-term developments and needs from potential pandemic-driven structural changes to the economy overall.

SOME GUIDELINES FOR DECISION-MAKING DURING THE CRISIS

Exceptional times and decision-making risks make considering the post-crisis implications and prospects for Canada essential during the pandemic. In this commentary, we propose guidelines based upon three phases to assist policy-makers and regulators in making balanced choices during the crisis, including assessing the tradeoffs and issues for the recovery and expansion after the crisis.

In doing so, we recognize that the nature, magnitude and timing of both the economic recovery and future expansion are highly uncertain. The post-crisis phases may vary significantly among industries, regions and countries. Major risks include the potential for renewed outbreaks, and the length of time until most nations achieve comprehensive COVID-19 "test and trace" capabilities. There is also the critical uncertainty surrounding when a vaccine will be developed, produced, and made widely available to meet Canadian and global needs.

Accordingly, the uncertainty around these risks as of mid-April and the likely substantial variation in timing of and boundaries among our three phases bear emphasis. While acknowledging these uncertainties, our three phases for consideration in the decision-making process are the following:

1. Pandemic phase where urgency, magnitude and, often, coordination aspects of choices and responses focus on short-term needs and dominate decision-making.

2. Transition phase centred upon an exit strategy to ease back emergency initiatives with a prudent, viable approach that facilitates post-crisis success.

3. Sustainable path phase after the transition that addresses (i) longer-term issues and opportunities existing before the pandemic that were temporarily de-emphasized during the crisis, and (ii) transformative trends resulting from the pandemic.

Using this approach, we consider several risk management elements for policy and regulatory decision-making. While assessing the full range of policy and regulatory issues is far beyond the scope of this commentary, we hope to spark conversation and analysis so that these and other risks can be better identified, assessed and managed.

PANDEMIC PHASE

Speed, Magnitude and Coordination of Macro-economic Policy – swift, massive and wide-ranging responses are essential to dealing with the pace, range and severity of the demand, financial and supply shocks in 2020. Canada, continental Europe, the UK and the US have moved rapidly and on an unprecedented scale in designing and implementing a broad array of fiscal, liquidity and monetary policy stimulus. The scale and speed of these public policy initiatives have exceeded – and in a number of cases dwarfed – the size and breadth of support during the 2007-09 global financial crisis (GFC). Canadian, US, UK and European regulators have eased capital buffers and provided other substantial relief to support financial institutions' corporate and individual lending capacity. Through mid-April, the vital announcement and demonstration effects of these exceptional measures have been crucial in reducing many of the stresses in financial markets.

Beyond the massive initiatives to support individuals as well as small, medium and large-size businesses, the huge fiscal and monetary stimulus is also significant longer term in reducing the heavy dependence on monetary policy for most of the previous decade.

Design and Implementation Risks – while noting these successes, the risks and logistical complexity of designing and implementing support for individuals and business are important, beginning with distinguishing liquidity needs from insolvency conditions. Governments and regulators are under pressure to respond quickly and meaningfully with effective emergency policies to save those afflicted with significant liquidity issues. Yet, care needs to be exercised to avoid providing undue aid to structurally over-leveraged businesses and consumers. These and other policies to provide temporary relief to businesses and individuals risk unintended consequences, perverse incentive effects and moral hazard. The risks include fraud and gaming the system as noted by the government and other commentators, and the difficulties of moving recipients from short-term support back to a market-based environment after the crisis.

TRANSITION AND SUSTAINABLE PATH PHASES

Fiscal Policy Risks – the challenges of effectively winding down the emergency demand support measures after the crisis subsides warrant highlighting. Management of the massive crisis-driven deficit and debt during the transition and sustainable path phases will need to walk a fine line between being too restrictive or too modest. Japan's economic struggles resulting from its fiscal restraint attempts and challenges in coordinating with monetary policy are instructive about the risks of being aggressive in tightening. The risk of too little restraint reflects the political economy of deficits in encouraging rent-seeking behaviour, creating significant asymmetries in implementing counter-cyclical policy. Despite Canada's better fiscal shape than many advanced economies in its deficit and debt-to-GDP ratios prior to the crisis, its mixed record in reducing deficits during expansions is a cautionary tale. The challenges of future fiscal restraint are key considerations given the IMF estimate of Canada's total government deficit-to-GDP ratio increasing the most among advanced economies in 2020.

Beyond the risk of a debt trap if large structural deficits persist, unwinding demand stimulus is vital to providing more funding room to meet Canada's long-term needs. Examples include greater investment in infrastructure, human capital, and climate change mitigation as integral parts of the exit strategy and sustainable path.

Monetary Policy Risks – careful unwinding of the massive liquidity injections and other monetary easing implemented during the crisis will require effective exit strategy communications and prudent management of monetary policy for a sustainable path. Communications challenges include the risk of market over-reactions to unexpected policy changes. Careful consideration of the structural risks to asset market valuations, corporate and individual leverage, and financial stability from ongoing ultra-low interest rates would be valuable inputs in determining future monetary policy.

Financial Regulation – lastly, and in closing, carefully reversing the crisis-driven capital buffer and other regulatory relief for lenders during the transition and sustainable path phases will be important. Canada's favourable post-GFC record in mitigating the risks and costs of pro-cyclicality in regulation stands out in this regard, especially in raising minimum capital and liquidity standards in the late-cycle expansion stage of 2018-19.