LONG-TERM THINKING IN EXTRAORDINARY TIMES:

Macroeconomic Lessons from the Pandemic

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Plans are worthless, but planning is everything
... when you are planning for an emergency you must start with this one thing: the very definition of "emergency" is that it is unexpected, therefore it is not going to happen the way you are planning.

-U.S. President Dwight D. Eisenhower

With the world now in its second year of living with COVID-19, examining Canada's economic experience offers an opportunity to assess the fiscal and monetary policy lessons learned during the pandemic as of early 2021. In doing so, our goal is not to unduly question or second-guess the decisions that were made under intense time pressures and with inadequate information as the COVID-19 crisis unfolded. Canada's pandemic phase response needs to be seen through the lens of unprecedented "known unknowns" and "unknown unknowns" of policy risk management. The scale of the pandemic's problems and uncertainties manifested huge risks for policymakers because many issues could not be managed based on past experience.

This analysis builds upon Stewart and O'Reilly's April 2020 article on the need for policy-making during COVID-19 to reflect the three phases of the crisis — the pandemic, transition, and sustainable phases — to help better identify, assess and manage economic, financial and other risks. Canada achieved major policy successes despite COVID-19's extraordinary challenges, but also had notable issues. The need for flexibility to adjust policies when Canada's economic and financial circumstances have fundamentally changed is among the lessons learned. Pivoting from an emergency, short-term crisis response to a long-term approach is essential to make an effective transition from the pandemic to a sustainable future. Supporting the adjustment of traditional economy and gig workers, helping small businesses, and providing better and more daycare and early childhood education are vital for both economic growth and fairness.

This paper is a precursor to a much longer and more detailed policy examination to follow later this spring and is composed of three sections. It begins by exploring Canada's fiscal and monetary policy strengths, structural challenges and serious risks prior to COVID-19. The next section examines Canada's enormous macroeconomic support in 2020 and early 2021, looking at the successes and key issues. The final section sets out how Canada's fiscal and monetary policy stances need to address a very different economic environment in 2021 compared to 2020 and to the decade after the Global Financial Crisis (GFC). Macroeconomic policy faces fundamental challenges with the increasingly complex and adaptive nature of Canada's economy. The pandemic-driven surge in technology adoption and usage, paradigm shift in U.S. macroeconomic policy and other key factors differ crucially from 2020 and the post-GFC decade. Canada needs to shift fundamentally to focus on its transition to crisis resolution and to a sustainable path as set out below.

1. PRE-PANDEMIC CONTEXT: STRENGTHS, CHALLENGES AND RISKS

Fiscal Policy

Canada began 2020 in a modest federal deficit position and a national deficit-to-GDP ratio that was better relative to most other major advanced economies. Its fiscal discipline in recent years prior to the pandemic aimed to reduce and then stabilize the federal debt-to-GDP ratio to around 30 per cent and below. Federal finances had greater scope

for much increased fiscal spending in a major downturn/ recession versus most other advanced economies, and potentially huge support during a more severe economic contraction.

Despite this national fiscal flexibility, there were structural concerns. The inability to balance the federal and most provincial budgets, despite the longest economic expansion in post-WWII history, highlighted Canada's political economy deficit reduction challenges despite enjoying good times. The much higher consolidated federal-provincial government debt-to-GDP ratios in the 60 per cent area showed much less fiscal room. Numerous fiscal pressures presented themselves including helping offset weaknesses in Canadians' median income growth generally, and assisting workers in traditional jobs facing technology and other disruption risks specifically. Ongoing income issues for many other workers were also significant given the rise of the gig economy, its compensation levels and precarious employment. Gaps in the state of repair of existing, new physical and digital infrastructure presented further fiscal pressure. Looming needs to address climate change, healthcare system capacity, aging populations and income inequality posed additional long-term fiscal risks.

Monetary Policy

Canada's post-GFC decade was characterized by low and well-behaved inflation and sustained ultra-low interest rates. Neither massive quantitative easing (QE) nor credit easing (CE) was required in Canada during the GFC, and the Bank of Canada (BoC) never resorted to negative interest rates in contrast to much of Europe in the latter years prior to COVID-19. The consensus of economists was that the BoC had achieved success with its inflation targeting and its conduct of monetary policy, as well as longstanding credibility in financial markets and the non-financial economy.

Yet, the limited scope to cut interest rates to offset a major downturn or recession by early 2020, let alone a severe economic contraction, presented future risks. Unlike during the GFC and in previous recessions, the BoC had only 1.5-1.75 percentage points to cut interest rates before it would reach the effective lower bound below which the stimulus effects of rate cuts are sharply reduced or potentially reversed. Sustained ultra-low interest rates post-GFC posed structural concerns with significant side effects. These included facilitating and supporting excessive personal debt and corporate debt levels.[1] Potential limits on future monetary restraint were also notable given the vulnerability of over-leveraged homeowners to higher borrowing costs.

2. PANDEMIC PHASE SUCCESSES AND ISSUES

Macroeconomic Policy: Swift, Massive and Balanced Support Prevents a Much Deeper Recession

Canada's massive macroeconomic support during the pandemic was decisive in containing the most severe economic contraction since WWII and in supporting the subsequent rebound.[2] Recognizing the need "to overwhelm a crisis", enormous and rapid fiscal and monetary stimulus, beginning in March 2020, coordinated with major financial regulation relief, was timely and unprecedented in scale and scope. It was geometrically larger than what occurred during the GFC. The BoC cut its overnight policy rate by 150 basis points (bps) to 25 bps during March 2020. It embarked on its first-ever QE and CE, resulting in a quantum leap in the BoC's asset holdings from $120 billion (5 per cent of GDP) pre-pandemic to over $550 billion (more than 25 per cent of GDP) in early 2021. These measures, together with the U.S. Federal Reserve System's (Fed's) interest rate cuts and massive asset purchases, set the stage for Canadian securities, housing and other asset markets to rebound strongly for the first time ever during a recession, and to reach new heights by late 2020 and early 2021.

Soaring government spending, tax relief and other fiscal support measures led to a surge in Canada's projected deficit for fiscal 2020-21 from $28.1 billion prior to the pandemic to over $350 billion according to the Parliamentary Budget Officer. The scale of Canada's fiscal deficit and government debt surge outpaced any other major advanced economy in 2020. It dwarfed the GFC dimensions of support as the fiscal 2020-21 deficit-to-GDP reached at least 16.5 per cent. It clearly showed that

the GFC lessons had been learned — the macroeconomic response to a severe disruption must be overwhelming and balanced by deploying robust fiscal and monetary policy support.[3]

Huge government spending in support of consumers and new transfers to businesses provided critical cash flow, income and liquidity in 2020 and early 2021. Direct and indirect income support programs combined with other transfers to swamp the historic plunge in employment income in the second quarter of 2020.[4] Beyond containing the recession, enormous fiscal aid was significant in helping create the pre-conditions for growth in supporting the recovery. It helped increase Canada's economic resiliency during late 2020 and early 2021 when COVID-19's resurgence and the renewed lockdowns did not result in another widespread, major economic contraction. Federal and provincial programs kept the "K-shaped" recovery from being even more lop-sided with their support for hard-hit workers and firms in the close contact, in-person service sectors.

Excessive Magnitudes, Design Mismatches and Implementation Challenges

The speed of the rollout of many emergency programs was impressive as were the federal-provincial cooperation and use of multiple delivery channels such as Canada's banks for lending and income transfers. Yet, significant issues of cumbersome criteria, eligibility and other challenges led to various programs having minimal, delayed or partial take-up. Other programs such as the Canadian Emergency Wage Subsidy and the one-time payments to seniors did not sufficiently differentiate between those in need versus entities and individuals with deep pockets.[5] The challenges of small business were insufficiently addressed while daycare outside of Québec and early childhood education had only modest funding increases.

There were also problems with the inadequately constrained magnitudes in several core initiatives. Critics viewed the emergency income support as too large at the outset and continuing for much longer than necessary. Government transfers swamped initial declines in total employment income, and continued on a broad-based, very large scale, rather than a more targeted approach. This was despite the better-than-expected data for various key economic indicators from the fall of 2020 onwards. These programs increased federal deficits and debt unnecessarily while creating constituencies favouring this consumption assistance on an ongoing basis.

The BoC's sustained large-scale Canada bond purchases led to investment dealer criticisms that the QE magnitude was clearly excessive relative to the markets' need.[6] They cited the much larger relative scale of BoC purchases of Canada bonds versus the Fed's purchases of U.S. Treasury debt. The Fed's bond purchases were also concentrated in March-April 2020 when the financial market stress was greatest, unlike the ongoing very large size of the BoC's QE program. These dealers advocated making significantly smaller QE purchases starting in the fall 2020, stressing the excess domestic and foreign demand in need of more Canada bond supply, and risks from the BoC already owning 40 per cent of the total outstanding Canada bonds by April 2021.

3. TRANSITION AND SUSTAINABILITY PHASE ISSUES AND RISKS FOR MACROECONOMIC POLICY

In critical areas, the pandemic's severe costs and challenges continue. Far too many Canadians have lost work and income in each of the three waves of COVID-19, and the rise in the number of long-term unemployed has numerous repercussions. These will necessitate large government deficits and significant monetary support for at least the near term.

Yet, in other crucial ways, Canada in 2021 faces a very different economic landscape and new challenges relative to 2020, beginning with changes in the known unknowns and unknown unknowns. Known unknowns at the outset of the pandemic included the Canadian economy's ability to recover with the help of extraordinary macroeconomic support in peacetime and the outcome of the 2020 Presidential election. Unknown unknowns in March 2020 included the dramatic acceleration in technology adoption and usage that enabled remote work, and the surge in digital payments and e-commerce supporting a much

stronger-than-anticipated recovery. A paradigm shift in U.S. fiscal policy in 2021 was also an unknown unknown a year ago.

Major changes begin with increased inflation expectations and higher bond yields that have characterized early 2021 versus 2020. The much greater role for fiscal policy in the post-pandemic world is complicated as Canada and other advanced economies have started 2021 with far greater deficit-to-GDP and debt-to-GDP levels relative to the GFC aftermath. The Canadian economy's growth prospects are far more promising this year for numerous reasons. These range from very high personal savings levels and business liquidity in early 2021 to enormous new U.S. fiscal stimulus and the Fed's explicit policy stance to boost short-term inflation to average 2 per cent inflation over the medium to long term. The divergence in traditional industries versus the financial and technology sectors is far too large and looks set to increase again in 2021.

Accordingly, Canada's macroeconomic policy in 2021 needs to pivot from its short-term emergency focus on consumption in 2020 to a growth-driven, more socially-inclusive approach. We focus on four essential policy needs for a successful transition from the pandemic to a sustainable growth path on an equitable basis, starting with monetary policy.

Addressing QE and Near-Zero Interest Rates Challenges to Macro Financial Stability

The BoC's policy challenges in 2021 differ fundamentally from 2020 with overheated housing markets across Canada, a much-improved economic outlook and the challenges of managing the adjustment of its unprecedented QE.[7] Looking ahead, Canada needs to be mindful of the long-term monetary policy risks tied to sustained dependence upon QE and near-zero interest rates.

In our view, monetary policy's careful lessening of comprehensive large-scale monetary ease is the first step in the transition phase for macroeconomic policy, albeit with a clear need for effective communications and prudence in making this adjustment. The BoC has a difficult task ahead, first in calibrating its tapering of QE without triggering excessive market volatility, and in changing interest rate expectations without causing a sharp appreciation in the Canadian dollar. Notably for QE, thoughtful commentators have offered a useful potential roadmap for designing and implementing the sustained decrease in the BoC's Canada bond purchases.[8]

The next policy need is to address financial market and real economy complacency that the BoC will not raise interest rates if inflation accelerates as Canada's output gap is reduced in 2021 and 2022. It is a complex challenge where signalling is crucial. While the excessive expectations built into housing market psychology are the highest profile and most immediate problem, risk taking in financial markets has also risen sharply. At a minimum, the BoC needs to communicate to financial and housing markets that its commitment to hold policy rates near zero is much more conditions-dependent rather than time-dependent. A careful, measured signalling that the BoC's policy rates may rise sooner than 2023, if economic growth is even stronger than forecast and/or inflation rises above 2 per cent, would have beneficial effects upon financial market risk-taking and personal and business debt leverage.

Our advocacy for monetary policy changes in 2021 is based on multiple factors, beginning with the need to contain inflation expectations. Near-term causes of upward price pressures include the index effects as weak monthly base levels in 2020 drop out of the 12-month moving indicators of inflation, and as large pent-up demand and savings enable spending to jump when sufficient vaccine uptake is in place. Longer-term international trends such as the structural decline in the global labour supply,[9] pandemic-driven supply chain problems and other developments, have created new foreign price pressures. Political economy realities give rise to other concerns. Ultra-low rates create constituencies that seek to limit monetary restraint and central banks face an asymmetry of minimal political risk in easing versus major political and financial market risks in tightening. These concerns, and future monetary policy needs, must be balanced against key considerations such as the reality that some of these factors are transitory (the index effects) and that the structural disinflationary impacts of technology, and the technology sector, will continue.

Calibrating Fiscal Policy: Avoiding too Early Restraint but Incorporating Anchors and Guidelines

Canada's fiscal stance needs to avoid tightening too early and doing so too aggressively in fiscal 2021-22. We underscore the need to avoid both this post-GFC policy mistake and Japan's experience since the late 1990s. The timing of fiscal policy changes will also need to reflect the uncertainties regarding COVID-19 variants, the impacts of renewed lockdowns this spring in central and western Canada, and the time until vaccine uptake is fully in place.

Yet, continuing large-scale federal deficits and debt beyond this fiscal year, especially without medium-term fiscal anchors and shifting towards capital-augmenting expenditures, will create numerous risks, including political backlash. Canada's policy regarding its largest-ever peacetime deficits will need to be significantly counter-cyclical over the medium and long term to avoid large-scale structural deficits and excessive debt interest costs. Various leading economics studies have shown declining productivity and lessening GDP gains from increasing government debt from already high levels. A meaningful medium-term fiscal anchor must also be combined with credible economic indicators that will be actively monitored "guardrails".

Addressing Adjustment and Income Needs of Traditional and Gig Economy Workers

Canadian fiscal policy must also shift fundamentally towards fostering innovation, investment, productivity and skills upgrading to boost actual and potential growth.

It is essential to pivot from supporting consumption broadly with emergency programs in the pandemic phase to supporting the adjustment and competitiveness of workers in traditional industries and the gig economy in the transition phase.[10] Canada's income, wage and other initiatives, designed to assist laid-off workers and those with insufficient incomes, must become more transitional through coordinated federal-provincial assistance that equips traditional and gig economy workers with the education, skills and training needed to secure better jobs and incomes.

We emphasize the need for effective and swift measures to support much better, widespread daycare availability beyond Québec and much enhanced early childhood education. These are foundational investments in the economy as well as in social equity, and are long overdue. The challenges of working from home during COVID-19 have highlighted the importance of daycare and the economic penalties for parents of young children, especially mothers, imposed by its inadequate provision outside of Québec. As important, investment in high-quality early childhood education is essential for those families that cannot afford it, as well as for Canada's future workforce, incomes and growth.

A better policy foundation for small business success is also essential given how this sector has been slammed by each wave of COVID-19 and multiple lockdowns. Relief measures to boost cash flows and other income support measures are vital to facilitate this sector's recovery.

Above all, the shift in fiscal policy to boost the productivity of people and businesses needs to begin in fiscal 2021-22. The full effects of many such measures occur over the medium to long term. Meaningfully increasing capital-augmenting fiscal measures supporting digital and physical infrastructure, innovation, research and development is key to the April Budget.

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ENDNOTES

1. See for example, William White "Recognizing the Economy as a Complex, Adaptive System: Implications for Central Banks" in *The Changing Fortunes of Central Banking*, P. Hartmann, H. Huang, & D. Schoenmaker (eds.), (Cambridge: Cambridge University Press, 2018), chapter 21.

2. Lawrence Schembri, "Living with limits: household behaviour in Canada in the time of COVID-19", Remarks to the Greater Saskatoon Chamber of Commerce, *Bank of Canada*, June 18, 2020; and IMF, "Canada — Staff Concluding Statement of the 2021 Article 4 Mission", February 16, 2021 and IMF, "Fiscal Monitor Update", January 2021.

3. *The Economist*, "Starting over again: The covid-19 pandemic is forcing a rethink in macroeconomics", July 25, 2020; and the BoC's Carolyn Wilkins, "Opening remarks", pp. 1-2, and "Closing Remarks", p. 2, BoC Workshop, *Toward the 2020 Renewal of the Monetary Policy Framework*, August 26, 2020.

4. "Compensation of employees fell 8.9% — the steepest drop ever recorded. [Yet] this was more than offset by a significant increase in government transfers to households …, the result was a 10.8% increase in household disposable income." Statistics Canada, "Gross domestic product, income and expenditure, second quarter 2020", *The Daily*, August 28, 2020.

5. Michael Smart & Nick Mahoney, "Large Corporate Groups that Received CEWS Payments", *Finances of the Nation*, December 29, 2020.

6. Warren Lovely & Taylor Schleich, "*This is 40* (percent ownership of GoC market", *Market View: Economics and Strategy,* National Bank of Canada Financial Markets (NBCFM), April 6, 2021, pp.1-2; and Taylor Schleich, "Is QE in the eye of the beholder?", *Market View: Economics and Strategy,* NBCFM, February 16, 2021, pp. 1-2.

7. On housing, see Robert Kavcic & Benjamin Reitzes, "Canadian Housing Fire Needs a Response", *Special Report,* BMO Economics, March 30, 2021. On growth, note the multiple upgrades in late 2020 and early 2021 of the IMF, OECD and major banks' economic forecasts; and on QE, Taylor Schleich & Warren Lovely, "QE Questions for the BoC", *Market View: Economics and Strategy*, NBCFM, March 25, 2021, pp. 1-2.

8. See Schleich & Lovely, "QE Questions for the BoC".

9. See Charles Goodhart & Manoj Pradhan, *The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival*, (London: Palgrave Macmillan, 2020).

10. See Joel Blit, "COVID-19 Will Transform our Economy if we get our policies right", *Intelligence Memos*, C.D. Howe Institute, July 16, 2020.