Intelligence MEMOS

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To: Government Debt Watchers

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Re: **Financing the COVID Deficit: Short and Long Runs**

The federal government is ramping up spending to counteract the economic impact of the coronavirus.

The Parliamentary Budget Office has predicted a deficit of more than $110 billion this year. And that rises to around $200 billion – 10 percent of GDP – if Canada matches the average stimulus of other nations, according to the economic analysis group at RBC.

How will this increase in spending be financed in the short run? And what are the longer-term economic consequences?

Some historical context: Since the federal government paid down its war debt in the 1940s, the peak of the ratio of federal government debt to GDP occurred in the mid-1990s, at over 65 percent, then gradually fell to a little above 31 percent in 2008. After a spike due to the Great Recession, it fell again to 31 percent in 2015 before creeping up to almost 34 percent in 2018.

A deficit of 10 percent of GDP would lead to the largest post-war spike in this ratio, but would only take us to approximately 45 percent. If it is truly temporary, we would not reach the levels seen in the mid-1990s. Of course, if it takes time to ramp down the extraordinary spending, it could become worse.

As we have pointed out in other **work**, while the debt to GDP matters, the bigger issue is the burden of servicing the debt.

In 1990, just before the peak in the federal debt-to-GDP ratio, 10-year bond yields were above 11.5 percent. Today they are below 1 percent. And the Bank of Canada's first-ever foray into quantitative easing, i.e., buying up government securities across the maturity spectrum to lower yields, should further suppress interest costs.

This all means that the situation, while dramatic, should be manageable in the short run. The debt-to-GDP and deficit-to-GDP ratios are not unprecedented, and interest rates are historically low.

Nevertheless, the federal government will be putting an unprecedented amount of new debt onto the market.

There are several imponderables here.

The economic shutdowns to combat the spread of the virus may persist for longer than currently contemplated, especially if a second wave of the virus occurs. This could mean an even larger deficit in 2020 and an unexpectedly large deficit in 2021.

Canada's provincial governments will also be running larger-than-normal deficits. When provincial debts are added to the federal government debt, Canada's government debt-to-GDP ratio is close to 90 percent, in the same ballpark as the US and the U.K.

Moreover, the fiscal measures undertaken by the federal government are part of a coordinated international effort to counteract the economic impact of fighting COVID-19. The federal government will be increasing its borrowing along with the central governments of many other countries. Unless demand for this debt is sufficient to meet this increase in supply, its price (at all maturities) may decrease substantially, meaning an increase in yields and a higher cost of carrying the debt burden.

Of course, as we argued above, the Bank of Canada can mop up any government debt in order to keep yields low. Doing so has consequences, however.

One is inflation, as new money enters the system as the Bank expands its balance sheet. And, with fewer goods and services being produced, as a result of COVID-19, that is more money chasing fewer products.

The other is what happens when the Bank of Canada looks to reduce its balance sheet, i.e., when the bill comes due. When this happens, debt will be sold back to the market pushing yields up. The hope, of course, is that the negative shock from the virus is temporary and future GDP growth exceeds the higher interest cost on this government debt – if not, hello lower government spending and/or higher taxes.

The changing relationship between interest rates and economic growth rates, and the degree to which the negative impact of the current shock on the level of GDP is permanent are key macroeconomic variables that federal and provincial governments, and the Bank of Canada, will have to monitor closely. As will we all.

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