Intelligence MEMOS

From: Jeremy M. Kronick and William B.P. Robson

To: Monetary Policy Watchers

Date: March 11, 2020

Re: **The Bank of Canada and COVID-19**

With 50-basis-point cuts in their policy interest rates last week, the Bank of Canada and the US Federal Reserve sharpened debate about how central banks should respond to the threat to our health and our economy posed by the COVID-19 virus. While we do not yet know how serious that threat will turn out to be, we can set out the considerations the Bank of Canada and other central banks need to weigh as we learn more.

In normal times, a central bank tries to foster steady economic growth and stable inflation – 2 percent in the Bank of Canada's case. The economy's productive capacity is expanding at a fairly steady rate, as the workforce grows and productivity rises. Spending moves more cyclically, as events outside Canada and changes in consumer and business sentiment boost or depress it.

The current and expected difference between spending and productive capacity is a key driver of monetary policy. If spending looks likely to exceed productivity capacity for a while – an inflationary output gap – the Bank of Canada may raise the overnight rate to dampen it. If spending looks likely to fall short of productivity capacity for a while – a disinflationary output gap – the bank may lower the overnight rate to support it.

The impact of COVID-19 on spending is clearly negative: demand for Canadian exports is weakening, and consumers and businesses are fearful about the future. In business-as-usual mode, the Bank of Canada should lower the overnight rate.

At the same time, however, COVID-19 is also a threat to the economy's productive capacity. People who are sick, or trying to avoid becoming sick, cannot work, and disruptions to domestic and international supply chains may cut off access to key inputs.

Suppose that the resulting reduced workforce and lower potential output per worker cause the economy's productive capacity to fall, before resuming growth from a lower base.

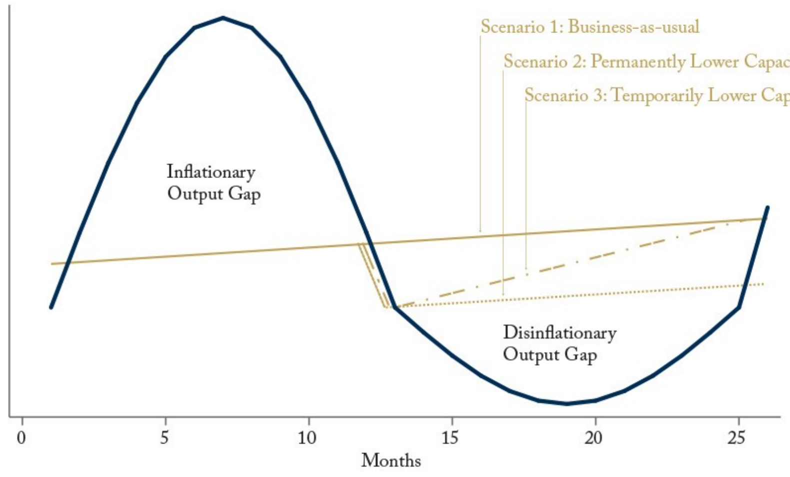
Spending is falling, but the resulting disinflationary output gap, the excess of supply over demand, is less than it would have been without disruptions in productive capacity. That means that the interest-rate cut consistent with 2-percent inflation will be smaller and/or shorter in duration than in the business-as-usual case when productive capacity kept growing steadily.

For the sake of covering an important, and happier, possibility: what if the hit from COVID-19 on productive capacity is temporary?

Productive capacity falls as people get sick and supply chains get disrupted, then returns to the path it was previously on as people and supply chains recover. In this optimistic scenario, the disinflationary gap created by lower spending is not as big as in the business-as-usual case, and not as small as when productive capacity faces a longer-term disruption. This in-between scenario would warrant an in-between interest-rate cut.

Scenarios like these, and variations on them, are at the heart of discussions of demand and supply shocks from the coronavirus.

At this point, there is no reason to question the Bank of Canada's and the Fed's decisions to cut interest rates. Debate on the depth and duration of central bank interest rate cuts remains another matter. Answers here will depend on the longer-term impact of the virus on people's health and the economy's productive capacity.



Jeremy M. Kronick is Associate Director, Research of the C.D. Howe Institute where William B.P. Robson is President and CEO.

To send a comment or leave feedback, email us at blog@cdhowe.org.