Intelligence MEMOS

From: William White

To: Canada's COVID Policymakers

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Re: **The Recession and the Pandemic: Cause or Trigger?**

The pandemic and the decision to use social distancing to combat it, have already sparked a global recession.

A "V" shaped recovery is plausible but, should the recession destabilize an increasingly indebted global economy, a worse outcome can be envisaged.

Urgent and perhaps unprecedented policy measures are therefore warranted to support a "V" shaped recovery.

But the need for urgency should not preclude reflection on the effectiveness of the policies chosen and plans to deal with their longer run consequences.

While it is perfectly clear is that advanced economies face a very serious recession, its severity and length are less clear.

In an optimistic scenario, the only economic costs will be those caused by the pandemic itself and its attendant social distancing. However, in a more pessimistic scenario, further costs will emerge as the recession triggers an unwinding of the many economic and financial "imbalances" built up over the last few decades.

In the optimistic case, the pandemic and social distancing reduce aggregate supply and demand both. The former falls as parts ordered "just in time" fail to arrive, as workers fall sick, cannot get to their jobs, or stay home to care for family. The latter falls as incomes decline, pools of saving prove inadequate to stabilize consumption, and as non-essential shops close.

As consumption declines, fixed investment generally follows. However, the crucial point is that these painful effects are likely to be temporary and can to some extent be alleviated by fiscal, regulatory and central bank policies. Then, as the pandemic naturally recedes, both supply and demand will recover and a "V" shaped recovery might be expected. This profile of recession and rapid recovery is obviously very different from that seen in the years following the recession of 2008-9.

The pessimistic case begins with the recognition that the 2008-9 recession was caused by accumulated "imbalances" within the economy. Excessively easy monetary policies in the world's largest economies, and particularly the United States, caused a credit boom that culminated in a credit bust.

Unfortunately, the underlying problems have not been resolved but have worsened over the last 10 years. Still more exaggerated versions of the same policies have led to similarly exaggerated side effects. Should an initial recession, caused by the pandemic, unleash these underlying and disruptive forces once again, then a more serious downturn would surely follow.

Evidence of this inherent fragility is not hard to find. The ratio of global debt (government, corporate and household) to GDP is now well above that seen prior to the previous crisis.

Moreover, the increase has been driven in large part by increases in emerging market economies. Whereas they were part of the solution to the 2009 crisis, they are now part of the problem.

Stability in the financial sector is now threatened by lower profit margins at regulated financial institutions, a migration of business to unregulated and highly levered lenders, an explosion of lower-grade and covenant-lite corporate credit, and increasing signs of disorder in key markets like those for US Treasuries.

Finally, there is growing evidence that ultra easy monetary conditions have actually lowered potential growth by reducing investment (to finance share buybacks) and by encouraging the misallocation of capital on a grand scale.

These problems have built up over decades and cannot be easily reversed. That said, we should begin seriously to reflect on the measures needed to make the system more robust over time; not least, better insolvency procedures for both the private sector and governments.

And taking robust measures now to reduce the immediate COVID-19 fallout can buy time for such reflection. Here, there are some grounds for optimism. Concerted efforts by central banks to reliquify financial markets, in particular to provide US dollars to those in need of them, seem to be working and government support for companies and workers is being announced on an unprecedented scale.

To avoid triggering a downward tipping point, it is important that announced measures are implemented quickly, and that they be scaled up if circumstances deteriorate further. However, the trade-off between urgency and longer run effectiveness must also be recognized.

Targeted fiscal measures are likely to work better, and to have fewer costs than universal programs, but should companies or people be the targets?

Further support for companies that are already "zombies", or seem likely to have no viable business model in a post-pandemic world, hardly seems optimal.

Preparing plans for the post-pandemic world of monetary and fiscal policies would reassure financial markets and lessen the risk of future instability.

For policymakers to take a little time to think about the longer term might seem a luxury in current circumstances. However, the precariousness of our current situation largely reflects policymakers' failure to do so in the past.

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