COVID-19 Crisis Working Group: Monetary and Financial Measures

Communique #6: Canada Must Recommit to Fiscal and Monetary Anchors

The C.D. Howe Institute has initiated a special project to provide rapid expert insights to help Canadians and Canadian policymakers navigate the COVID-19 crisis. Its Working Group on Monetary and Financial Measures is co-chaired by David Dodge, former Governor of the Bank of Canada, and Mark Zelmer, former Deputy Superintendent, OSFI, and supported by a group of financial market experts and economists. The group's sixth meeting was held on Wednesday, May 20th, 2020.

Discussion focused on the importance of fiscal and monetary anchors in Canada and the dangers both now face as a result of the needed stimulus and support provided by all levels of government and the Bank of Canada during the crisis. Canada has benefited tremendously from having both a fiscal and monetary anchor over the past 25 years, including the very low risk premiums on government borrowing costs. However, fiscal anchors, e.g., debt to GDP ratios, were necessarily set aside with the spending programs required to overcome the government-imposed economic shutdown.

Canada is emerging from the first wave of the pandemic with very high public and private debt loads and has become even more dependent on foreign investors to finance those debt loads. While other countries are in similar situations, Canada is nevertheless highly dependent on both domestic and foreign investor confidence so that public and private debt can be carried at a reasonable cost. This reinforces the importance of Canada's monetary anchor: a low and stable inflation target. Members agreed that the Bank of Canada and federal government should reinforce their commitment to the 2 percent target. By doing so, the Bank would retain ample latitude to increase its balance sheet over the next couple of years to support the economy and the financial system in a deflationary environment but provide assurance that it will promptly move to deal with any inflation that may emerge later as global supply chains are reorganized.

In the short-run, members felt that deflationary pressures will be an elevated risk. Deflation causes an increase in the real cost of holding debt, especially important given the size of Canada's debt overhang. Deflation also limits the effectiveness of any stimulus as real rates cannot be lowered by as much as needed.

Despite these monetary concerns, members felt that greater dangers lay on the fiscal side. Placing the economy in a partial coma made sense during the first wave of the pandemic, but if there is a second wave, a second economy wide shutdown should be avoided in favor of more targeted approaches that are effective and avoid further erosion of public finances and the risk of hitting debt walls and loss of borrowing capacity. Members also recommended governments explain how they plan to stabilize public finances over the medium-term, something even more critical given the commitment to the 2 percent inflation target and the need to restore fiscal maneuvering room to cope with future shocks.

Members raised the risk that, even after some reopening, economic growth may be sluggish, and what were supposed to be temporary programs may take on more permanence, turning one-off deficits into structural deficits. Should that be the case, investors will become concerned with fiscal sustainability, Canadian dollar denominated debt will become riskier, and borrowing costs could increase rapidly.

Members then turned to the question of what can be done to ensure fiscal sustainability. Placing government finances on a more sustainable path will require fiscal policy to shift from emergency spending and tax deferrals to more sustainable and much lower levels of spending on transfers to persons and business subsidies. At the same time, the tax base needs to broaden out to capture a portion of the rents that are accruing to some firms in highly concentrated digital and other sectors, and to individuals with skills in high demand or who have benefited from large capital gains. Actions on this front are best pursued in tandem with other jurisdictions to contain the risk of tax avoidance, and to maintain Canadian competitiveness. Over the longer term, Canada's revenue sharing arrangements among federal, provincial and municipal governments should also be reviewed to promote a closer alignment of revenue generating powers with the delivery of public services.

On a practical basis, some members felt a combination of restraint, growth and revenue tools will be necessary, and governments should double down on economic growth efforts in the medium term, look carefully at all non-core expenditures, and focus any tax raising efforts in ways that have the least impact on economic efficiency and the overall competitiveness of the Canadian economy.

Members pointed out that the neutral rate of interest is lower today than it was during the financial crisis, and may fall further should excess savings arising from the economic shutdown become more permanent. This is true in both Canada and abroad. Individuals who remain employed are saving far more than they were pre-crisis, and businesses are not going to invest with all the uncertainty surrounding the pandemic. Sluggish business investment in Canada was a problem before the pandemic, indicating that this issue might be more long-term structural than related to COVID-19. Members agreed that as the recovery takes hold, governments should look for ways to work with their international counterparts to unlock savings and boost investment incentives to bring up the neutral rate of interest and ensure we do not end up permanently close to negative interest rate territory, as in Europe and Japan.

In summary, members of the Monetary and Financial Measures Working Group recommended the following:

- The federal government and the Bank of Canada should continue to reinforce that they remain committed to the 2 percent inflation target, explaining to the public why such a target is so important in light of the crisis at hand;
- Governments should make clear to Canadians how they will re-calibrate and eventually remove the temporary fiscal programs currently in place, as part of a transparent plan to stabilize public finances over the medium term;
- To ensure fiscal sustainability, governments will likely need revenue sources beyond tax rate hikes. One avenue is through the digital taxation of economic rents realized by the few dominant players in these sectors and through taxation of individuals who have benefited from large capital gains;
- Any such new revenue sources must be done in conjunction with other jurisdictions so as not to be seen as an outlier, thus harming Canadian competitiveness; and
- Over the longer run, governments should work with their foreign counterparts to look for ways to unlock excess savings for investment, in order to increase the neutral rate of interest, providing more breathing room from the zero lower bound.

The next meeting of the Monetary and Financial Measures Working Group will be on Monday, June 1st, 2020 at 3pm. The group will continue to monitor events and policy actions in determining the most relevant topics for that meeting.

Monetary and Financial Measures Working Group members Include:

David Dodge, Co-Chair, former Governor of the Bank of Canada

Mark Zelmer, Co-Chair, former Deputy Superintendent, OSFI

Riaz Ahmed, TD Bank

Steve Ambler, Université du Québec à Montréal

Dwight Duncan, McMillan LLP

Paul Jenkins, Former Senior Deputy Government, Bank of Canada

Phil Howell, Former Superintendent, FSCO

Thor Koeppl, Queen's University

Andrew Moor, Equitable Bank

Tamara Vrooman, VanCity

Jeremy Kronick, C.D. Howe Institute

Duncan Munn, C.D. Howe Institute