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# Osler Special Advisor Stephen Poloz on the economy, inflation and COVID-19

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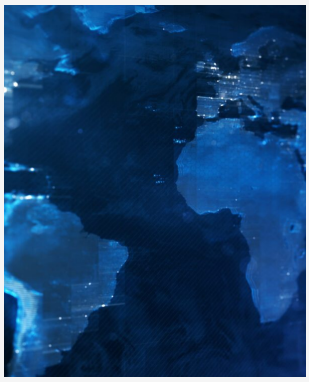

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Six months into the extreme upheaval of the North American economy by the global health pandemic, individual Canadian enterprises and various industries are engaged in planning for the future at a time when that future is still very uncertain. Navigating through that uncertainty is a strategic imperative – including capitalizing on new opportunities for growth – that will continue to emerge.

In a client event on September 10, 2020, Osler Special Advisor Stephen Poloz shared some of his views on navigating through the "unknowable" and touched on a number of timely topics, including the effects of the COVID-19 pandemic on globalization and the Canadian economy and the relationship between recent government spending and inflation.

Below are key takeaways from his remarks, including answers to some of the frequently asked questions Stephen has been fielding in the past several months.

## Will the economy ever recover from COVID-19, or will it be permanently damaged?

No one knows the answer to this question. The key is to acknowledge that uncertainty, gather more advice than you normally would and then develop a range of plausible scenarios – from best case to worst case – for your business. If you keep your options open – instead of gravitating towards the intermediate scenario as many boards seem to do – you'll be better able to pivot towards the actual scenario that does unfold.

The second quarter data came out at the end of August and the news wasn't as bad as expected. While cumulatively the economy declined 13.6% since the onset of COVID, that's actually 2% less than the Bank of Canada predicted the month before. In addition, disposable income rose by over 11% – partly because people were taking advantage of the government assistance programs – and they saved more than 25% of their income during that time since, with everything closed, there was nowhere for people to spend. These savings have helped bolster the economy's resilience. In addition, production has continued to rise after the economy bottomed out in April – by the end of July, the economy was back to 95% of what it was in February. And while 3 million people lost their jobs due to the pandemic, 2 million are back in the workforce, with unemployment concentrated in the hospitality and travel sectors. Though people may have stopped eating out and vacationing, it's important to remember to

ask what they're doing with their money instead. As a result, I believe the data points are better than what the pessimists predicted, and given the resilience of the economy, I expect that trend to continue.

## Is this really the end of globalization?

Superficially, the answer is yes – at least as we currently know it. Between trade wars, the spat over 5G, geopolitical decoupling from China and "COVID shock" – where no one wants to rely on other nations for key supplies – some say the globalization trend of the past 20 years will end here. Others are predicting de-globalization, also referred to as on-shoring or re-shoring. I'm doubtful about this – globalization is a force of nature and it could be dangerous to try to hold it back.

It's important to consider the origins of the global supply chain and the incentive of using offshore skill sets if it results in lower costs. Globalization was made possible by advances in computing which allowed for global logistics tracking and by China joining the WTO in 2001. The supply chain is a living thing – it isn't just black and white.

The pandemic has changed globalization arithmetic. Consider, for instance, the implications of the need for social distancing on the job. Companies will have to accelerate the deployment of automation or AI in response – such as inserting robots between workers so they're two metres apart. The result is fewer workers, and other costs associated with the global supply chain will take on a greater importance, such as quality control, monitoring from afar and risk of disruption due to trade policies.

It's critical to understand that politicians that force companies to re-shore their operations will necessarily increase automation at the same time – and that means fewer jobs domestically. So the whole strategy ends up backfiring. In addition, boosting production costs significantly results in a higher final price for the product which, in turn, will reduce demand and lead to lost jobs across the company – from the factory floor to head office.

I expect to see a reoptimization of supply chains, probably with some net re-shoring, with a combination of a jump in automation or AI to create distancing and reduce risk, supplier redundancy so companies aren't relying on a single country for parts, and "near shoring" which involves taking advantage of localized trade agreements like the USMCA.

## Is all this government spending sowing the seeds for an outbreak of inflation in the future?

Government borrowing is truly staggering. The International Monetary Fund (IMF) is expecting global government debt to move above 100% of global Gross Domestic Product (GDP) this year. Some argue that the debt can be managed because interest rates are low and are likely to remain low – and I agree with that for the most part.

The sustainability of government debt interacts with economic growth; the critical factor is whether the real rate of interest is less than the growth rate of the economy. It's possible to sustain a high level of debt if the debt service is actually eating away from the bottom of the level of indebtedness. Also, if government is spending money in a good way – for instance, investing in future economic growth – that adds to the sustainability of the debt. We can expect to see investments in physical infrastructure and also an emphasis on social infrastructure through initiatives like universal daycare. Though it's expensive for governments to deliver, universal daycare can be considered an investment in workforce participation which, in turn, will boost the growth rate of the economy and make the debt

more sustainable.

Central banks and governments are reacting aggressively to the crater that has been created by the explosion of the COVID bomb. They're filling the crater with money – or liquidity – to help sustain everyone as we weather the COVID storm and make our way across the crater to the other side.

Government initiatives like the CERB have provided the support people need to stay afloat. Meanwhile, the economy is adjusting, and once we're safely to the other side, the government can start draining the liquidity out of the crater.

Early signs indicate that this approach is working. The supports are stabilizing business and the economy, and the stock market is in decent shape. Oil prices have been a little soft lately, but otherwise have held up relatively well, while other commodities such as lumber and nickel are hot. Enough has been done to avoid deflation and a significant outbreak of inflation is also unlikely. Though no one really knows how this will all turn out, I believe that it will be better than the pessimists are predicting.

In the Q&A session that followed his prepared remarks, Stephen provided additional insight into the connection between the deficit and inflation, as well as commentary on the role that investment in infrastructure will play in the post-COVID recovery. Finally, he pointed to Canadian investment in green resources and education as the way of the future.

Access a replay of the webinar

*As the former governor of the Bank of Canada, Stephen is subject to certain continuing restrictions that apply to his presentations and discussions. His remarks are his own personal views and do not represent the views of the Bank of Canada, his former office, the Government of Canada or any of its departments. His presentation has been based on data and information that is publicly available.*