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Spring 2020 Economic Outlook

The Response to COVID-19: Charting a Path for Canada

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Executive Summary

The COVID-19 pandemic has triggered the most severe economic shock since the Great Depression. Despite massive intervention by central banks and governments, real output in the advanced economies likely fell in mere weeks by more than 10% from its level at the end of 2019.

A number of factors complicate a recovery from this unprecedented crisis: unknowns about the evolution of the pandemic; lack of global policy coordination; the uncertain behaviour of consumers as lockdowns are eased; the high debt levels of households, businesses and governments going into the crisis; the risk of permanent loss of capacity as the crisis endures; and the impact on investor confidence of uncertainty about the post-COVID-19 world.

Against this backdrop, this outlook aims to present reasonable planning assumptions for Canadian businesses to the end of 2021. We offer two scenarios which we think represent possible outcomes.

- In our baseline scenario, an effective vaccine becomes widely administered in the second half of 2021, and the easing of mandated lockdowns continues prudently, without severe outbreaks requiring their widespread reimposition.

The result is that by the end of 2021, the recovery to pre-COVID-19 levels of output in the advanced economies is achieved. Interest rates and inflation stay low through the period. Oil and commodity prices firm up modestly.

Under this scenario, output in Canada by the end of 2021 returns roughly to its level at the end of 2019, although still almost 4% below where it would have been on the pre-crisis trend. The federal deficit reaches nearly $300 billion in 2020-21, even with a rapid tapering of the exceptional fiscal measures introduced through the crisis. The deficit in 2021-22 is still high, at $105 billion.

The Bank of Canada is expected to absorb a substantial portion of federal government borrowings. The capacity for Canada to attract capital inflows is maintained, and the Canadian dollar is broadly stable.

- In our alternative and more pessimistic scenario, an effective vaccine is not readily available until 2022. The relaxation of lockdowns in the summer of 2020 leads to a large second wave of disease later, prompting a reimposition of widespread restrictive measures.

By the end of 2021, real GDP in advanced economies is then about 6% below the fourth quarter of 2019. There is deflationary pressure—for example oil prices remain depressed with still large supply-demand gaps—but some prices are pushed up where supply is constrained. Governments have no choice but to prolong and enhance their support programs, and central banks to expand their balance sheets to absorb an increasing portion of new public debt.

Under this dire scenario, policy risks for Canada would be more acute. To maintain the confidence of markets, and financial stability, the federal budget for 2021-22 would have to lay out plans to raise additional revenues and reduce spending, starting in 2022.

At this time, we think that a Plan A for businesses is best made on the basis of our baseline scenario. However, developments need to be monitored

closely through the summer and early fall to see whether businesses should shift to a Plan B, based on our more pessimistic scenario. There would remain some upside risk that could crystallize with the faster availability of a vaccine.

Pulling through such a crisis is not just a matter of arithmetic, but of plans and strategy by governments and businesses to respond to new circumstances and to act in a cohesive fashion.

Global demand, and international trade, are unlikely alone to propel our growth. The multilateral trading system is weakened. The United States is not exerting global leadership; heightened political unrest amid the pandemic, and a Presidential election only months away, further erode the prospect of a constructive U.S. role over the next months. Geo-strategic conflict between the United States and China is threatening a decoupling of global supply chains. Recent developments have also elevated potential risks to Canada's relationship with China.

Thus, Canada, while continuing to engage constructively with global partners and to pursue every opportunity to expand and diversify its trade, must chart its own path to re-open, recover, and then re-build the economy for the medium to long term.

Reopening is a gradual exercise of learning to live with COVID-19—creating and adapting to a modified state of the economy that will prevail for months, perhaps years. A prudent and successful reopening requires a greater capacity for testing and for tracing the spread of the virus, as well as widespread availability of personal protective equipment (PPE) for workers.

As the economy reopens, the flow of direct support from government will need to be tapered: it is fiscally unsustainable, and it creates distortions that may slow down a return to more normal conditions for employers and workers. This will be an exceptionally delicate policy exercise.

Recovery is what will be required over the next 18–24 months to get output back to its pre-crisis level. Recognizing that the crisis started from an induced supply shock, a recovery must be founded on conditions and incentives for the re-emergence of supply. Large demand stimulus will be of limited utility and, if supply is held back, it could put upward pressure on some prices.

Governments can identify targeted measures to support and accelerate the recovery. This may include low-cost measures that can assist in restoring markets for businesses, for example, *buy local* or *travel in Canada* campaigns, as well as training for displaced workers. There are gaps to close in the public health system and in care for the elderly. Steps can be taken to accelerate investment in economic infrastructure, including by mobilizing private capital instead of public debt where there can be a stream of revenue. Access to broadband should be made universal.

Rebuilding is the enterprise for the medium to long term of growing productivity to maintain and then to raise the standard of living of Canadians, doing so in a way that is sustainable, resilient, and inclusive. This was a critical challenge even before COVID-19. It is now even more daunting.

In undertaking the rebuilding, governments and businesses must grasp the ramifications of the crisis and the risks and opportunities that will emerge in its aftermath. While there remain many questions, some trends and signals are evident.

- First, the geopolitical environment will continue to be messy and a high level of dependence on any one client, supplier, or region of the world, in either a global or decoupled marketplace, will entail material risks.
- Second, the crisis has rendered obvious, if not already clear, that all large organizations today are, or must be, digital and that intangible assets are a critical vehicle for realization of value.

- Third, with intense pressure coming out of the crisis to restore growth while pursuing environmental and climate change goals, Canada must make the energy sector a driving force of an integrated strategy.

With structural change accelerating through the crisis, and with the risk of further disruptions, governments need to review their instruments to facilitate adjustment. The income security system for working-age Canadians was not up to the task in this crisis, and it deserves review.

Fiscal management will require a medium-term plan with a solid anchor and a significant reserve for contingency in an uncertain world. To contain the growth of the debt and debt-service costs, there will be no way around raising some taxes, and cutting some spending. This will entail tough choices.

Governments will have to weigh carefully the distributional impacts of economic developments and policy. Intergovernmental fiscal arrangements will also attract attention. Indeed, when the bills from the crisis have to be paid, the pursuit of economic and fiscal stability, social cohesion, and national unity will require strong leadership.

Thus, governments will need to set out a finite set of priorities for the country, a fiscal track, principles to guide policy development, and processes for engagement with Canadians. While issues are urgent, the right solutions will not be developed overnight. There will need to be parallel exercises to develop the evidence base and solicit advice from experts and leaders in the private sector and in communities, with an imperative to follow through with timely decisions.

In Canada's history, exercises such as the Macdonald Commission made important contributions to the national debate at critical times. Governments again may find that for a specific set of issues, there would be merit in a national Commission on the economic prospects for Canada, with wise persons, expert resources, and a capacity to propose a direction for the country.

I. Introduction: An Unprecedented Economic Crisis

The Early Impacts of COVID-19

The global economy is undergoing its most severe economic shock since the Great Depression: output in the advanced economies is likely down by more than 10%, and the road ahead is uncertain. Despite unprecedented, massive intervention by central banks and governments worldwide, the economic effects of the COVID-19 global epidemic are profound, and they will be prolonged. Charting a path to reopen, recover and rebuild the Canadian economy starts with the recognition of the unique attributes of this crisis and impediments to a quick and strong rebound.

The economic downfall materialized over just months, even weeks, as governments ordered lockdowns of non-essential economic activity, asked citizens and workers to stay at home, and closed borders. The severity of the COVID-19 crisis was manifested early in global financial and commodity markets, with initial sharp drops in equity prices, pressure on interest rate spreads, and lower oil prices. The effects in the labour market, more visible in April and May, were even more severe: job losses in the United States and Canada already have exceeded by large factors those of the 2008-09 Great Recession.

The response of central banks and governments around the world has been swift and bold. Unlike their characterization in normal downturns as "stimulus", measures taken to date by authorities have aimed principally at creating a "bridge" for households, workers, and firms to the other side of the crisis. Central banks, through existing and new windows, have injected massive liquidity in the financial system to keep credit flowing across markets (government debt, subnational government debt, corporate debt), and have lowered interest rates to give relief to indebted households and firms. Governments have extended directly or backstopped credit to businesses through a range of institutions and facilities, and supplemented the wages of workers and the incomes of households. Through the expansion of the balance sheet of central banks and the assumption of credit risks by governments, significant risk has been absorbed by the public sector.

Context for the Road Ahead

While lockdowns are being gradually lifted in large economies around the world, the risk is pronounced that the recovery will be choppy, and that it will take time to get back to the level of output of the end of 2019. It was relatively easy to shut down large sectors of the economy and to ask citizens to stay at home to be safe. Matters are considerably more complicated in trying to get back to some "normal". The trade-offs and relationships between public health and the economy are complex. It is not as straightforward to reopen a business than to close it down. And for authorities, it will be challenging to taper and unwind exceptional assistance measures while aiding a recovery and implementing policies for longer-term stability and growth.

A number of factors stand in the way of a smooth recovery from the COVID-19 crisis and they require that governments, businesses, and households be prepared to confront a range of scenarios. In early April, the International Monetary Fund (IMF), while projecting as a baseline a drop of global output of 3% in 2020, and a rebound of 5.8% in 2021, set out alternative, more pessimistic scenarios and underscored the "extreme uncertainty" around the global forecast. In its April Monetary Policy Report, the Bank of Canada declined to present a base-case projection for Canada, citing the uncertainty, and opted instead to outline a range of plausible paths for the economy. More recently, China for the first time in years chose not to set a growth target for its economy in 2020.

The global and domestic economic scenarios that may be constructed for the next 18 months are critically dependent on one variable that is unknown: how the pandemic will evolve. A baseline scenario may assume that economies reopen safely, and that the epidemic is kept under control until an effective vaccine is widely available by the first half of 2021. However, as per public health experts, there are equally credible scenarios of a second wave of infections in the summer or fall of 2020, and/or of wide availability of a vaccine only in 2022.

For most economies, contributing to this uncertainty as activity restarts are gaps in capacity to test massively and rapidly, to trace contacts, and to supply workers with adequate personal protective equipment (PPE). Testing requires procedures, materials, and human resources and, to date, it has not been conducted at a scale necessary to measure accurately the incidence of infection. Contact tracing has been done mostly manually and thus, quite approximately. The availability of PPE has been hampered by dependence on global supply chains overwhelmed by demand.

Recovery from this crisis is also missing a critical ingredient: global leadership and coordination. In 2008-09, the G20 came together with a coordinated policy response, including not only synchronized stimulus but also a commitment to strengthen the foundations for economic growth, including financial sector reform. Today, the geopolitical circumstances are far less favorable.

- Open geostrategic and economic conflict between **the United States and China**, and the risk of decoupling of supply chains are throwing sand in the gears of the global economy at the worst possible time. Rather than abating, tensions are escalating amid the COVID-19 crisis, most recently with steps by China to introduce a national security law for Hong Kong, and by the United States, in response, to possibly end the special relationship with Hong Kong.
- The ongoing threat of unilateral U.S. trade actions under the Trump Administration and its efforts to undermine the **World Trade Organization (WTO)** are diminishing further the prospect that trade may be an engine for global recovery. A Biden Administration could be expected to take a more constructive international tone, but as shown by an early undertaking to cancel the permit for the Keystone XL project, the United States will conduct economic diplomacy based on domestic political considerations. Even in the best of cases, it will take some time to re-establish confidence in a rules-based world trade order.
- In the **European Union (EU)**, while France and Germany have now agreed to advance an EU Recovery Fund, backed by EU borrowings, potentially strengthening the fiscal response to the crisis, a recent decision of Germany's constitutional court challenges the powers of the European Central Bank (ECB) to buy the debt of member countries and to implement quantitative easing, posing a new risk to the stability of the eurozone.

- The opaque geopolitical and economic strategies of **Saudi Arabia and Russia** are exacerbating the impacts of the current over-capacity of oil supply and heightening market risk for other large producers. For Canada, this has represented an added economic shock.
- Absent a coordinated global response, including a more active role by the IMF, the rising funding gaps of **highly indebted emerging and developing economies** may have disruptive spill-over effects across financial markets.

Some adjustment to de-risk global supply chains is needed but it will not happen overnight. The world is learning the hard way that dependence on a small number of highly concentrated sources of supply and distribution channels for critical goods and services creates heightened vulnerability to crises. However, diversification of supply or the building of domestic manufacturing or warehouse facilities will happen slower than may be desired to close supply gaps and support growth.

Given the health risks, and even once a vaccine is available and administered widely, it is uncertain how consumers will resume their activities and adjust their buying patterns. While there may be pent-up demand, it may be years rather than months before some industries, like air travel and tourism, recover their client base. It took nearly three years for U.S. airlines to recover the pre-crisis number of travellers after 9/11. There will be efforts in those industries to improve client safety, but these will add costs or inconvenience and hinder demand. Some of the loss of demand in some sectors will profit others. For example, domestic, short-distance travel may grow at the expense of international travel. Digital technologies may gain at the expense of business travel: electrons move between cities and across borders more easily, faster, and cheaper than people. As behaviours adjust, it is difficult to predict the net impact on the economy.

The weight of debt will slow down consumption and investment as balance sheets need to be repaired. The global economy entered this crisis with record-high levels of public and private debt, built up over years of low interest rates and low risk spreads. The IMF estimated that at the end of 2017, total global public and private debt stood at US$182 trillion, or 224% of GDP, and 60% higher than before the Great Recession. Through this crisis, new borrowings by households, firms and governments will push debt-to-GDP ratios up materially. Even if interest rates stay low, there will be no easy way to absorb debt-service costs and to re-establish sound balance sheets.

- **In the business sector, debt restructuring, and bankruptcies, are inevitable.** The retail sector, for example, may be hard hit. While this process is painful, historical experience shows that an early recognition of losses is far better than delaying adjustment.
- **In the household sector, debt sustainability is tied to the housing market.** In Canada, a six-month deferral of mortgage payments is providing room to breathe for households affected by the crisis. Pressures may grow if the crisis is prolonged, and employment and incomes are more deeply impacted or take longer to recover. Defaults on mortgage debt could then rise significantly, and house prices could fall materially.
- **In the public sector, governments will be cautious about unwinding their exceptional measures too quickly, but they will need early in the recovery to apply fiscal discipline.** The United States, with the dollar as the global reserve currency, may have the inordinate privilege of borrowing without limit. In other advanced economies, a persistent global savings glut, together with the expansion of central bank balance sheets, will help to absorb rising public debt. But governments—in Canada, both federal and provincial—soon will need to lay out plans for a sustainable fiscal

structure. This will include higher taxes and/ or cuts in expenditure, that will be a drag on growth. Tightening measures will be unpopular, but failure to act would jeopardize access to capital markets, not just for governments but for businesses as well.

The period necessary for the global and domestic economies to return to pre-crisis levels of output will be affected by permanent losses of productive capacity, or "hysteresis", that will build if and as the public health crisis endures. After recessions, some small businesses do not reopen, some physical capital remains idle, and some laid-off workers do not rejoin the labour force. Despite the sanguine view of equity markets that appear to price a "V-shape" recovery, this factor may be significant.

Finally, the efforts of authorities to build a bridge to the other side of the crisis do not answer the question of what economy lies at the end of the bridge. Investors, in particular, will be cautious about building new capacity without better visibility. They may seek short-term opportunities whereas a robust recovery will require confidence in longer-term business prospects.

This Outlook: Charting a Path for Canada

It is against this backdrop that this outlook aims to present a global and domestic economic scenario to the end of 2021 that is a reasonable planning assumption for Canadian businesses. The baseline is not a positive story, but it is plausible and still reasonably optimistic. An alternative scenario is set out to illustrate the downside risks to the baseline, driven by the evolution of the pandemic. The global trade environment is reviewed in greater detail as an important parameter for businesses.

For Canada, the outlook sets out a path for getting the economy back on track in three overlapping phases: reopening, recovery, and rebuilding. If executed well under the baseline scenario, the gradual reopening of the economy over the next months, and a steady recovery of activity, can bring Canada roughly to the pre-crisis level of economic output by the end of 2021. The rebuilding—the even harder part—is what will be necessary to adapt our economic structure and policy framework for a sustainable, productive, resilient, and inclusive economy for the longer term.

II. Recent Developments and Scenarios for the Next 18 Months

a) The Global Economy

By the end of June, world output will have plunged by probably more than 10% from the level achieved in the last quarter of 2019. While the growth trajectory over the next 18 months is highly uncertain, our baseline projection is that output in advanced economies, including Canada, will not recover to the fourth quarter 2019 level before the fourth quarter of 2021.

Background

Our Fall 2019 Economic Outlook projected advanced economies to grow in 2020 and 2021 at or close to their potential rates (1.8% and 1.9% in the United States, 1.2% and 1.4% in the euro area, and 0.5% and 0.7% in Japan), with growth in China slowing modestly to 5.8% in both 2020 and 2021, and with West Texas Intermediate (WTI) oil prices moving within a $55–$60 per barrel range.

As background to this projection, global growth in the second half of 2019 had slowed down from the very strong above-potential performance in 2018. Several headwinds were moderating growth: a notable rise in economic uncertainty; a synchronized slowing in trade, manufacturing and investment; and perceived higher risks of recession in advanced economies in a context of escalating trade barriers, increasing concerns over Brexit, intensifying geopolitical risks in the Middle East and Asia, and concerns about the limited efficiency of monetary stimulus. These headwinds, along with the diminishing effects of the 2018 U.S. fiscal policy stimulus, were expected to continue to hold back growth in 2020 and 2021, to levels closer to potential. They were not expected to precipitate a recession in advanced economies, however, as more accommodative monetary policy and a dose of fiscal easing in some countries (China and the United States, in particular) would provide support to aggregate demand, and because the prospects of an imminent phase one trade agreement between the United States and China was raising confidence.

Current Economic Performance

COVID-19 then made a thorough job of devastating the global economy. Government-imposed travel restrictions, closures of non-essential workplaces, and social distancing measures had immediate, visible effect on economic activity. Early impacts were felt most in travel and tourism, hospitality, entertainment, retail trade, and many personal services. Plant closures and broken supply chains disrupted production and trade. And as described by the IMF, "*Layoffs, income declines, fear of contagion, and heightened uncertainty make people spend less, triggering further business closures and job losses.*"[1]

The virus brought an unprecedented "sudden stop" of activity in China in February, and in advanced economies beginning in March. At annualized rates, representing the pace of change, real Gross Domestic Product (GDP) for the first quarter dropped 34% in China, 14% in the euro area, and 5% in the United States. Emerging economies were

also immediately affected. As of June 1, the Federal Reserve Bank of Atlanta "nowcast" model suggests that real GDP in the United States could fall at an annual rate of 53% in the second quarter. Overall, it seems quite plausible that the level of global output in the second quarter will be less than 90% of where it was in the fourth quarter of 2019. The economic collapse has been manifested most visibly in the United States by an unprecedented drop of employment and hours worked, a record escalation of the unemployment rate, and an abrupt fall in labour force participation.

The sharp contraction of global demand led to a plunge in commodity prices. For oil, the market disruption was exacerbated by geostrategic gamesmanship, and initial disagreement among the Organization of the Petroleum Exporting Countries (OPEC+) countries on an appropriate response to the emerging crisis. The price for WTI oil fell below US$15 in the second half of April, from US$60 at the beginning of 2020. It started to recover in early May, aided by the implementation of a supply cut of 9.7 million barrels per day agreed by OPEC+ producers. By the end of May, the WTI price was about US$35 per barrel. Non-energy commodity prices fell 10% between mid-February and mid-March before regaining 6% by late May.

Uncertainty about the future spread of the virus, and the extent and duration of the economic contraction, initially induced a marked tightening of financial conditions. Credit spreads widened, equity prices dropped in March before recovering some ground in April and May, and the U.S. dollar appreciated against other currencies by 6% between February and May.

To alleviate pressure in financial markets and to maintain the flow of credit, monetary authorities around the world launched measures described by the Bank of Canada as "*unprecedented in both their scale and speed.*"[2] All the monetary policy tools developed in the wake of the financial crisis and recession of 2008-09 were deployed, including programs to supply liquidity against a wider set of collateral. To reduce pressure on long-term interest rates, central banks engaged in quantitative easing, that is massive purchases of long-term government bonds, as well as targeted programs to purchase assets, such as commercial paper, mortgage bonds, corporate bonds and even municipal bonds. The Bank of England went so far as directly financing borrowing by the U.K. treasury.

The fiscal response has been equally swift and massive, and widespread across countries. It has comprised several elements: increased spending on health and emergency services, direct transfers to the unemployed, wage subsidies, grants to businesses, tax deferrals, aid to state and local governments, and loans and loan guarantees to businesses through the intermediary of central banks or financial institutions. While most programs are one-time, or slated to expire after a number of months given that their purpose is to bridge businesses and households until the economy reopens, their duration and size remain dependent on the evolution of the pandemic and its economic impact. The composition of the programs varies across countries, but in the G-7 economies, the loan and guarantee component is generally the most important one. As at the end of May, direct fiscal supports in the United States, Japan and Germany represented about 10% of GDP. Including injection of liquidity and government-backed credit facilities, total support measures to date have amounted to some 30% of GDP.

The Outlook to 2021

It is difficult to provide a single forecast of global economic activity with any degree of confidence, even for the short term, because of the highly uncertain future course of the virus and of restrictions imposed by governments to prevent new outbreaks. Federal Reserve Chairman Jerome Powell set out the issues well: "*How quickly and sustainably will it [the virus] be brought under control? Can new outbreaks be avoided as social-distancing measures lapse? How long will it take for confidence to return and normal spending to resume? And what will be the scope and timing of new therapies, testing, or a vaccine?*"[3] These uncertainties compound those about the trade and geopolitical climate which have increased since the end of 2018 (see Section III: The Trade Environment).

However, businesses have to make investment, production and hiring decisions and governments have to make policy decisions. We offer two scenarios which we think represent possible outcomes and provide key economic parameters for business planning.

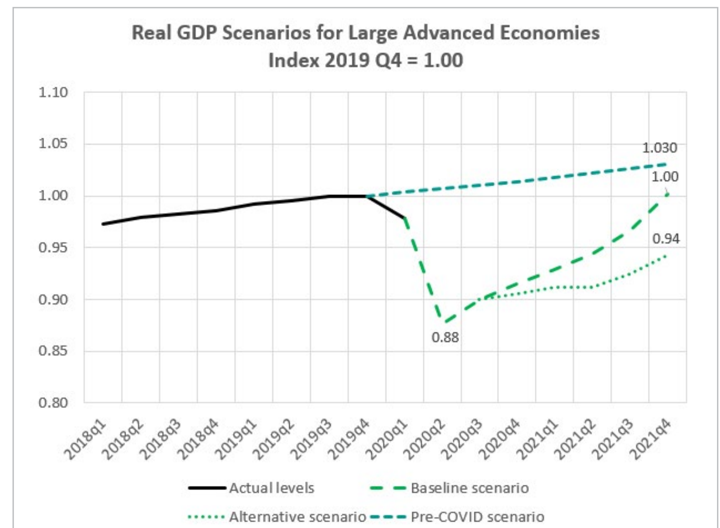
Baseline Scenario

In our baseline scenario for the advanced economies, including Canada, we assume that an effective vaccine will have completed trials by early 2021 but only will become widely administered in the second half of that year. We also assume that the gradual easing of the mandated lockdowns, which has already begun in many countries, continues prudently over the next twelve months. We further assume that during that year, increased testing, tracing and provision of PPE to workers help contain outbreaks of the virus so that no widespread reimposition of lockdowns and strict social distancing measures will be required.

Under this scenario, policy in the major economies is focused on getting economies back on track. Monetary policy remains exceptionally accommodative throughout the period as general inflation by the end of 2021 stays below, or at most, on target. The emergency fiscal measures are phased out gradually, but government debt nonetheless continues to rise materially in 2021.

The result is that by the end of 2021, the recovery to pre-COVID-19 levels of output in the advanced economies is achieved (Chart 1). Initially, and until the middle of 2021, the pace of recovery in production, employment and spending is moderated by the need for households and businesses to devote more of their reduced income to debt servicing and repayment, and to precautionary savings, given both still highly uncertain economic prospects and financial fragility. In the second half of 2021, however, the availability of an effective vaccine boosts household and business confidence, thereby supporting stronger growth in spending and production.

Chart 1:



Large advanced economies comprise the United States, the euro area and Japan.

Under this scenario, on an annual average basis, U.S. growth plummets from 2.3% in 2019 to -8.0% in 2020, before rising to 4.8% in 2021. On a fourth-quarter-to-fourth-quarter (Q4/Q4) basis, U.S. output falls 9.3% during 2020, and rebounds 10.1% during 2021. Given the exceptional degree of uncertainty, these growth rates must be considered as indicative only.

The U.S. policy interest rate is projected to remain at 0.25% through to the end of 2021, and the 10-year U.S. bond rate to remain close to its current low level. The Federal Reserve would continue its present policy of not allowing its target Federal Funds rate to go significantly negative. Other policy tools will be employed to maintain or even reduce rates on Treasury bonds and to keep the spreads on corporate, state and local bonds low. These policies are projected to offset the upward pressure on rates from continued large-scale borrowing by the U.S. government over the next 18 months.

While we anticipate upward pressure on prices of some goods over the next 18 months as supply chains adjust, we expect U.S. consumer price inflation to remain below the 2% target through 2021. Excess capacity globally should also continue to keep commodity and other product prices low. The WTI oil price, while still volatile, is projected to firm up modestly, with a price in a range of US$50 per barrel by the end of 2021.

Alternative Scenario

In our alternative and more pessimistic scenario, an effective vaccine is not discovered until later in 2021, and is not readily available until 2022. Testing and tracing capability in 2021 remains inadequate to identify local hotspots. The relaxation of lockdowns in the summer of 2020 leads to a widespread resurgence of disease later, prompting a reimposition of more restrictive measures which hold back production, employment, spending and confidence.

By the end of 2021, the level of real GDP in advanced economies is then still 6% below the fourth quarter of 2019.[4] On an average annual basis, U.S. growth is -8.3% in 2020 and 0.7% in 2021. Q4 to Q4, U.S. output drops by 10% in 2020 and increases by only 4.3% in 2021.

In this scenario, there is a great deal of pressure on governments to prolong and enhance their initial support programs, and on central banks to expand their balance sheets to absorb an increasing portion of the additional supply of government debt. Based on IMF simulations, the government debt-to-GDP ratio for advanced economies might be over 15 percentage points higher in our alternative scenario than in our baseline one by the end of 2021.

There is downward pressure on prices of many consumer goods and most services (although restricted capacity to supply may lead to price increases of specific goods), and added policy risks. There is a possibility that some months of deflation might occur in the United States and in some other advanced countries such as Japan, especially if their currencies do not depreciate much against the U.S. dollar. In this scenario, it is hard to see the WTI oil price rising much above its recent levels until late 2021. The greater expansion of central bank balance sheets in this scenario certainly increases the possibility of higher inflation by mid-decade. Continued fiscal deficits likewise increase the likelihood that some advanced, highly indebted countries (e.g., Italy) might be forced to seek a rescheduling of government debt.

While we believe this alternative scenario is less likely to play out over the next 18 months than our baseline scenario, it cannot be excluded; businesses need to recognize the risk and be prepared to deal with such a distinctly harsher environment.

b) The Canadian Economy

Background

Real GDP in Canada stalled during the second half of 2019, with annualized growth rates of 1.1% and 0.6% in the third and fourth quarters, respectively. A notable rise in global economic uncertainty had a negative impact on Canadian aggregate demand in the second half of 2019, especially on exports and non-residential business investment in the fourth quarter.

Canada continued to run a current account deficit in 2019, $47 billion for the year. Thus, Canada entered this crisis with a need on the capital account of the balance of payments for a steady net inflow of foreign capital. Of note, this requirement would have been considerably greater if not for our net exports of energy, which amounted to $76 billion in 2019 ($62 billion for crude oil), enough to offset net imports of motor vehicles and parts and consumer goods. This contribution of the energy sector to Canada's economic accounts was already under pressure because of the sharp decline in capital expenditures in the oil and gas industry that began in 2015.

Current Economic Performance

For the first quarter of 2020, real GDP fell 8.2% at an annual rate, with the largest contributions to the decline coming from exports (-3.5 percentage points (p.p)), household consumption of services (-3.5 p.p.), investment in inventories (-2.0 p.p.), and consumption of durable goods (-1.8 p.p.) and semi-durable goods (-1.4 p.p.). A surge in consumption of non-durable goods, and a drop of imports, made large positive contributions to growth (+1.6 p.p. and +3.5 p.p. respectively). As noted by Statistics Canada, "*[Household] Spending reductions were influenced by substantial job losses, income uncertainty, and limited opportunities to spend because of the mandatory closure of non-essential retail stores, restaurants and services, and restrictions on travel and tourism activities.*"[5]

Economic activity had advanced slowly over January–February 2020, partly due to a rotating strike of Ontario teachers, and rail transportation blockades in February. In the first two months, the economy was nonetheless operating relatively close to full capacity and inflation was on target. **In March, with the onset of measures to contain the spread of COVID-19, real GDP plunged 7.2% from February, with particularly sharp declines in industries for which social interactions or close proximity of persons are essential** such as entertainment and recreation, air transportation, and accommodation and food services (Table 1).

Table 1:

REAL GDP AT BASIC PRICES BY INDUSTRY		
	% Share of February Total GDP	Monthly Growth (%) March 2020
Food and beverage stores	1.0	15.2
Food manufacturing	1.4	3.1
Utilities	2.2	0.4
Agriculture, forestry, fishing and hunting	2.1	0.0
Finance and insurance	6.7	-1.0
Oil and gas extraction	5.6	-1.0
Real estate, rental and leasing	12.9*	-1.0
Information and cultural industries	3.3	-3.4
Construction	7.3	-4.4
Public administration	6.8	-4.5
Wholesale trade	5.2	-5.1
Transportation other than air, transit and ground passenger	3.4	-6.2
Manufacturing, excluding food	8.6	-8.1
Professional, scientific and technical services	6.1	-8.6
Health care and social assistance	7.2	-11.1
Educational services	5.2	-13.5
Administrative and support, waste management and remediation	2.6	-13.9
Other services (except public administration)	1.9	-15.0
Retail trade, excluding food and beverage stores	4.2	-15.2
Mining, quarrying excluding oil and gas extraction	1.9	-16.5
Transit, ground passenger, scenic and sightseeing transportation	0.5	-26.5
Accommodation and food services	2.2	-36.9
Air transportation	0.5	-40.9
Arts, entertainment and recreation	0.8	-41.3

*Including imputed rent from owner-occupied dwellings.

Source: Statistics Canada, table 36-10-0434-01.

Bennett Jones

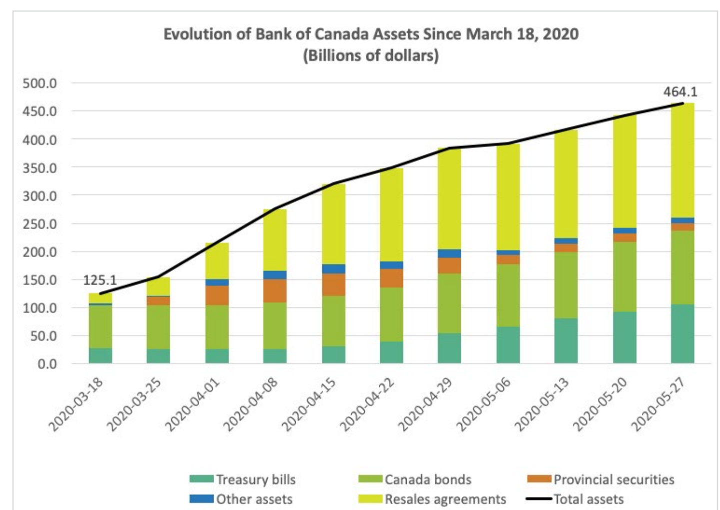
As in other advanced economies, the collapse of output was accompanied by a drop of employment and hours between February and April. There was, however, a very partial rebound in May. Employment and hours dropped 15.7% and 27.7% respectively between February and April before increasing by 1.8% and 6.3% in May. The unemployment rate climbed from 5.6% in February to 13.7% in May while the labour force participation rate fell from 65.5% to 61.4% over the same period. If not for those who decided to drop out of the labour force since COVID-19, the unemployment rate in May would have been 19.6%. Meanwhile, the number of people still working but at less than half their usual hours increased by 2.5 million between February and April before retreating by 290,000 in May.

Contrary to past recessions, this crisis is affecting women and men in roughly equal proportions in the labour market. In the recessions of 1981-82, 1990-91, and 2008-09, the proportion of net job loss incurred by men was about 80%, and by women about 20%. This time around, women account for over 50% of the job losses. This is explained by significant declines relative to past recessions in the services sector, in particular accommodation, food services, personal services, and retail trade.

Young people and recent immigrants are bearing a high proportion of the job losses. Employment declined the most for Canadians between the ages of 15 and 24. For students, the unemployment rate increased to 40.3% in May, putting at risk their ability to earn income to pay for schooling, with possible consequences for long-term employment and advancement. The sharp drop in employment for very recent immigrants reflects at least in part their representation in service sectors particularly hurt by lockdowns. As the Canadian economy moves into the recovery and rebuilding phases, some of these distributional effects will begin to unwind, barring of course further virus-induced lockdowns. That said, the likely permanent increase in the natural rate of unemployment due to business closures, along with changes in workplace practices (shedding of workers) and the slow return of industries such as tourism and accommodation, mean that some degree of distributional impact will persist.

The Bank of Canada reacted swiftly to the sharply deteriorating short-term prospects for the Canadian economy. The Bank cut its policy rate by 150 basis points in three rapid steps to 1.25% on March 4, 0.75% on March 16 (unscheduled decision), and 0.25% on March 27 (unscheduled decision), the latter rate identified by the Bank as the effective lower bound. Very importantly, the Bank said that it "*stands ready to provide all the liquidity the financial system needs so that it can continue to serve Canadians.*"[6] In mid-March, the Bank launched several large-scale asset purchase programs to increase liquidity in core funding markets and thereby support credit flows in the economy. By May 27, the Bank had increased its assets by nearly $340 billion to $464 billion relative to March 18 (Chart 2). The impact of the Bank's actions has been enormous. The interest rate on Canada 10-year bonds fell to an all-time low of about 0.55% in late May, and the spreads on provincial bonds, that had started to rise, returned to more normal levels.

Chart 2:



The response of the Bank of Canada this spring has been much bolder than at the time of the 2008-09 financial crisis. Not only has the Bank employed the traditional instruments to support credit expansion, it is buying provincial and investment grade corporate debt, and committing to a very significant expansion of its balance sheet over time. This approach reduces uncertainty in asset markets now, and it provides guidance that the Bank will not rush to sell off those assets while the economy remains weak and inflation remains at or below target. Because the Bank operates under an agreement with the government on an inflation target of 2% (mid-point of a 1% to 3% band), it retains the operational independence to expand its balance sheet as required to keep inflation from falling below target. As Senior Deputy Governor, Carolyn Wilkins said: "*the operational use of [asset purchase] programs will remain tied to the Bank's operational control objective.*"[7] Very importantly, this also means that the Bank will reduce its balance sheet in the future in order to drive up market interest rates if needed to choke off inflation. The possibility of higher interest rates must be taken into account by governments in establishing sustainable fiscal policies (see Section IV: A Path for Canada, b) The Medium to Long Term: Rebuild).

Core inflation remained close to 2% in March and April. There are different moving parts. Headline Consumer Price Index (CPI) inflation was -0.2% in April as gasoline prices plummeted in response to the collapse of oil prices. Meanwhile, the Canadian dollar depreciated by 5% against the U.S. dollar between last December and the second half of May in reaction to both the multilateral appreciation of the U.S. dollar, and the fall in the prices of oil and other commodities. It has since reappreciated to over 74 U.S. cents.

It is important to note, however, that due to COVID-19, the measured CPI is not a reliable measure of aggregate price movements. Statistics Canada has difficulty constructing data for goods and services which are essentially unavailable during the lockdown. Moreover, the index basket is based on the consumption pattern of 2017, a pattern which has changed dramatically since February, and will continue to change over the next months.

To bridge households and businesses until the economy reopens in earnest, the federal government has deployed one of the largest initial COVID-19 fiscal responses in the world. The greater share of support has aimed at alleviating cash flow shortfalls for households and businesses through tax deferrals, loans and loan guarantees.[8] However, given the magnitude of the crisis, the government has also provided direct payments to households, workers, and firms. In particular, to address the plunge in employment, especially among lower income workers who may not have been eligible for Employment Insurance, the government introduced the Canada Emergency Relief Benefit (CERB). The CERB, claimed to date by some 8.2 million Canadians, pays $500 per week, for up to 16 weeks. To assist employers that have suffered a sharp downfall of revenue and to sustain worker attachment to their job, the government created the Canada Employment Wage Subsidy (CEWS), which covers 75% of eligible wages, up to $847 per week, for 24 weeks to August 29.[9] The CERB and the CEWS, with estimated costs of $60 billion and $45 billion, respectively, are the two most expensive measures among direct supports that total over $150 billion to date.

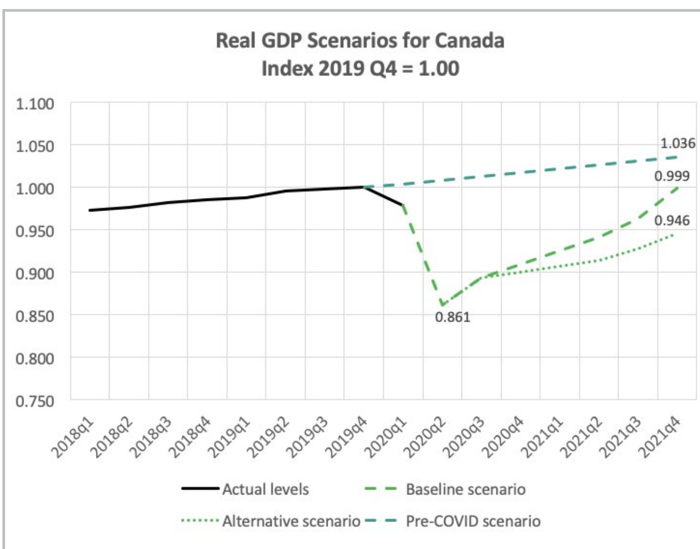
Outlook to 2021

As for the other major advanced economies, we offer two scenarios for Canada that we think represent possible outcomes and provide parameters which we think serve as a reasonable basis for business planning. The two GDP scenarios beyond Q2 2020 are based on similar assumptions with respect to the evolution of the COVID-19 virus and its economic effects as those outlined earlier for advanced economies. For reference purposes, these two scenarios are well within the range of possible scenarios that the Bank of Canada outlined in its April Monetary Policy Report.

In the baseline and more optimistic scenario, on a Q4/Q4 basis, output falls 9.1% during 2020 and rebounds 9.8% during 2021. Average annual growth rates plunge from 1.7% in 2019 to -8.5% in 2020, before rising to 5.1% in 2021.

In the alternative scenario, on a Q4/Q4 basis, output drops by 10% during 2020 and increases by only 5% during 2021. The average annual growth rates are -8.7% in 2020 and only 1.7% in 2021.

Chart 3:



Baseline Scenario

In the baseline scenario, output returns roughly to its pre-crisis level by the end of 2021 (Chart 3). The policy interest rate is projected to remain at 0.25% through to the end of this period. General inflation should be below, or at most on, target. Longer-term interest rates may edge upward from their current very low levels as the economy gradually strengthens, but they would be kept low through 2021 as a result of a still sub-par level of economic activity, the supportive actions taken by the Bank of Canada, and inflation expectations remaining broadly consistent with the inflation target. Low inflation would offset much of the upward pressure on interest rates that could arise from the escalation of the public debt.

The federal debt-to-GDP ratio (accumulated deficit) in this scenario is projected to rise by 18 percentage points to 49% in the 2020-21 fiscal year. In order to support the gradual recovery of the economy envisioned in our baseline scenario, the direct support programs are tapered (see Section IV: A Path for Canada, a) The Next 18-24 Months: Reopen and Recover). The projected deficit reaches nearly $300 billion in 2020-21. With further injections by the end of the fiscal year, the exceptional direct support programs add $192 billion to expenses, while the drop in economic activity creates a net revenue shortfall of $77 billion, adding to the deficit of $25 billion projected in the Fall Economic Update (Table 2). The existing emergency programs are projected to be almost phased out by the end of the fiscal year, and new measures, net of tax increases, of $15 billion are assumed in 2021-22. With non-budgetary measures, including tax deferrals and credit programs through Business Development Bank of Canada (BDC)/Export Development Canada (EDC), net federal borrowing requirements for 2020-21 could reach $450 billion.

Table 2:

BASELINE SCENARIO: NOMINAL GDP AND FISCAL IMPACT	$ Billions	
	2020-21	2021-22
Nominal GDP, Canada:		
Projected in Fall Economic Update	2,385	2,479
COVID-19 impact versus Fall Update	-328	-275
Projected	2,057	2,204
Federal fiscal balance:		
Deficit Fall Economic Update	-25	-19
COVID-19 impact before support measures	-77	-66
Deficit before support measures	**-102**	**-85**
Direct support measures announced up to April 30	152	5
Deficit with measures announced up to April 30	**-254**	**-90**
Extensions to the end of fiscal year + other measures*	40	15
Deficit with all direct support measures to March	**-294**	**-105**

*Assumed amounts of post-April 30 fiscal measures, both announced and expected in 2020-21. In 2021-22 this is the assumed net amount of new expenditure measures, less any tax increases.

The Canadian dollar in this scenario weakens only slightly from current levels. The Bank of Canada is expected to absorb indirectly a substantial portion of the front-loaded government borrowing through purchases in the secondary market. The capacity for Canada to attract capital inflows to finance government borrowings is thus maintained, especially if the price of oil gradually rises, and if the U.S. dollar stops appreciating as the global portfolio shift toward safe assets abates or unwinds with progress in tackling the virus.

In fiscal year 2021-22, the federal debt-to-GDP ratio would rise further to 51%. The deficit would fall to between $90 billion and $105 billion, depending on whether or not discretionary net fiscal action is implemented to sustain the recovery.

Alternative Scenario

In our alternative scenario, Canada's recovery proceeds very slowly and, by the end of 2021, output remains 5% below the last quarter of 2019, and 9% below where it would have been on the pre-COVID-19 growth trajectory. Without widespread availability of a vaccine, social distancing measures would be required right through 2021. Restrictions on cross-border travel would continue (both international and interprovincial) and a weaker global economy would further constrain foreign demand for our exports. Continued high unemployment, together with the prolonged restrictions on movement and activity, would increase significantly the potential for severe social disruption.

Clearly, should this scenario play out, governments (federal and provincial) would incur added fiscal pressures, including from a necessary extension of emergency support measures for households, workers, and firms. The federal government would likely have to prolong programs such as the CERB and the CEWS, while needing to adjust the levels of benefits because of the mounting costs. There would be pressure to extend tax deferrals, and greater losses would be incurred on loans provided through BDC and EDC. Provinces would have to expand support for the health care sector, and find ways, right through 2021, to adapt school and child care services to lessen the risk of infection (for example, by expanded online learning for schools). Meanwhile, federal and provincial revenues would be weaker.

All of this implies that unprecedented government borrowing would have to continue through 2021. The federal budget for 2021-22 would likely show net borrowing requirements in excess of $200 billion. Provinces would also require additional borrowing even if the federal government increased transfers to support health care and municipal services. In this scenario, maintaining access to markets for government debt will be difficult, even though the Bank of Canada, while still committed to its inflation target, would continue to expand its balance sheet.

Should this alternative scenario play out in 2021, painful measures to raise additional government revenue and to reduce spending would be required starting in 2022, and need to grow in future years. To preserve confidence in financial markets, announcement of these adjustments would be required in the 2021-22 budget; the commitment to a necessary and sharp fiscal correction could not be delayed until the 2022-23 budget. Thus, if by early 2021, it is not clear that a vaccine will be available by late spring, the federal Minister of Finance may have no choice but to announce unpopular measures along with increased net borrowing requirements in the next budget.

In this scenario, as in our baseline outlook, we expect that aggregate inflation will remain low through 2021, but inflationary risks are greater. There could be significant price increases for specific products and services, the production of which would be severely curtailed by the continuation of lockdowns. We expect that the Bank of Canada would look through these specific price adjustments and maintain its current target for the policy rate in 2021. However, if supply continues to be disrupted and the Canadian dollar weakens in 2021 and 2022, the risk of general inflation increases, and inflation expectations may begin to change. The Bank may then have to tighten monetary conditions by curtailing the expansion of its balance sheet, prompting an increase in interest rates on long bonds for both governments and corporations.

III. The Trade Environment: Shifting Ground and Challenges for Businesses

COVID-19 Crisis: Unprecedented and Potentially Lasting Impacts

The impact on trade of the COVID-19 crisis, together with the added pressures it is creating in an already uncertain trade policy environment, pose the greatest risk in living memory to trade as an engine of growth for our economies. The world entered the 2020s with trends and developments in global trade already a dominant risk factor. Trade tensions, especially between the United States and China, and slowing economic growth, contributed to a drop in world merchandise trade of 0.1% in 2019, after reasonably solid growth of 2.9% in 2018.[10] The value of services trade was also sharply curtailed, growing only 2% in 2019, compared with 9% in 2018.

In April, the WTO forecasted that the volume of merchandise trade in 2020 would fall between 13%, under an optimistic scenario, and 32% under a pessimistic scenario. All regions, including North America, are projected to incur double-digit drops in exports and imports. The drop in trade is expected to be greater than during the Great Recession of 2008-09.

The WTO projects a recovery in 2021, but its strength will depend on the duration of the pandemic and the effectiveness of the policy response. Interestingly, the WTO does not foresee, under either of its scenarios, trade volumes returning on the prior (2011-18) 10-year growth trend, let alone on the trend that prevailed to 2008. Even with a robust recovery, crises can have lasting impacts.

Early Policy Responses and Developments

The initial policy response of many countries to the COVID-19 crisis has been a restriction of trade in some goods. By late April, some 76 countries had put in place 118 measures to restrict exports of various medical products, and many had restricted the export of agricultural and food products, despite no evidence of imminent food shortages.

While there may be a perception that all such actions are rogue violations of international trade rules, in fact they are allowed, under certain conditions. The WTO allows for export restrictions "*to prevent or relieve critical shortages of foodstuffs or other products essential to the exporting contracting party*". Governments may also take measures that would otherwise be inconsistent with their normal WTO obligations if they are "*necessary to protect human, animal or plant life or health*" or "*essential to the acquisition or distribution of products in general or local short supply*."

Indeed, the WTO provisions to enable countries to take exceptional measures in cases such as this pandemic are carefully circumscribed, and countries have undertaken to continue to work within the rules. At their extraordinary Summit on March 26, G20 leaders pledged that, "*Consistent with the needs of our citizens, we will work to ensure the flow of vital medical supplies, critical agricultural products, and other goods and services across borders, and work to resolve disruptions to the global supply chains, to support the health and wellbeing of all people.*"[11] In May, Canada and other members of

the Asia Pacific Economic Cooperation (APEC) agreed that "*emergency measures designed to tackle COVID-19 must be targeted, proportionate, transparent, temporary, and consistent with WTO rules*."[12] Preliminary discussions are now underway in the G20, the WTO and in various trade circles about possible negotiations to strengthen and clarify the rules, for example to eliminate duties on medical products needed for treatment in pandemics. Of course, how such pledges will be honoured is uncertain.

What may prove more difficult is the potential impact on the trade policy environment of the massive crisis-related government subsidies to businesses. Efforts by exporters, that may have benefited from wage subsidies or government-backed credit facilities, to reclaim or grow their market share, and by authorities to protect domestic businesses against unfair competition, could give rise to considerable tension. The EU Director General for Trade has recently underscored the need to maintain a level playing field for businesses and suggested it would be an appropriate subject for negotiation in the WTO.

The new challenges to global trade policy arrive at a moment when the WTO is incurring setbacks. The ministerial conference scheduled for June 2020 has been postponed because of COVID-19, likely to next year. Moreover, in April, WTO Director General Roberto Azevêdo announced he would resign one year before the end of this term, on August 31. Azevêdo recognized that WTO reform is essential, that the next ministerial conference should be a "*stepping stone*" on the road to reform, and that a lame duck Director General could detract from that process. In choosing the next Director General, WTO members will be making a critical decision with major consequences for the future viability of the organization.

Some countries, including Canada, are seeking through the crisis to sustain global collaboration and an effective WTO. Canada was instrumental along with the EU in setting up an interim appellate arbitration arrangement to replace the WTO's Appellate Body until a solution can be reached which would involve removal of the American blockage to appointing new judges to its roster. As of mid-May, 21 WTO members, including the EU, China, Canada, Mexico, Brazil, and Australia, have agreed to use the interim arrangement in resolving their trade disputes. Even in the best of scenarios, strengthening and reforming the WTO will take years, but it still offers the best chance of bringing lasting improvement to international trade relations and to support long-term prospects beyond this crisis.

The dominant question amid this crisis is whether we are at the threshold of a new era where countries decide to go it alone, or whether there can be a period of new collaboration and reform where governments recognize their shared interests in open trade, and act on shortcomings of the existing trading system.

If much is uncertain, it is clear that political leadership will play a critical role in shaping the prospects for cooperation among the major global players. In 2020, nowhere is the leadership question more salient than in the United States as the country continues to grapple with the pandemic while engaging in a presidential election in a socio-political environment further divided and destabilized by the response to recent events of police brutality.

U.S. Trade Policy: Signals and Noise

Under President Trump, reading signals on key trade relationships, in particular China, and disregarding noise is a consistently demanding exercise. One day, the president speaks of President Xi as his best friend, and the next he does not want to talk to him. The phase one agreement with China is heralded in one tweet as a great accomplishment and, in the next, the way forward is a decoupling of the two economies. The U.S. Trade Representative (USTR) professes to want to work with the EU and Japan to rein in Chinese behaviour, but the president pressures them on other files. Even when it comes to the Canada-United States-Mexico Agreement (CUSMA), arguably the administration's most significant trade success, the president is unpredictable, seeking to block the export of personal protective equipment to Canada, or threatening to tear up agreements that allow the export of live animals to the United States (both Canada and Mexico ship live animals to the United States under CUSMA).

There would probably be a major change in United States trade policy if the presumptive Democratic nominee, Joe Biden, were to unseat President Trump in the November elections. Biden described the broad lines of his approach to foreign policy and trade in an article entitled "*Why America Must Lead Again - Rescuing U.S. Foreign Policy After Trump*" in the March/April 2020 issue of Foreign Affairs.[13]

Essentially, Biden affirms that the U.S. must resist a dangerous global slide toward protectionism by exerting leadership in writing international trade rules and working with allies to thwart the threats posed by China. A few excerpts provide the flavour:

> *More than 95 percent of the world's population lives beyond our borders—we want to tap those markets. ... That means taking down trade barriers that penalize Americans and resisting a dangerous global slide toward protectionism.*
>
> *The question is, who writes the rules that govern trade? ... The United States, not China, should be leading that effort.*
>
> *China represents a special challenge. ... The most effective way to meet that challenge is to build a united front of U.S. allies and partners to confront China's abusive behaviours.*

Naturally, on individual files a Biden Administration would still defend specific American interests, and many decisions could run against Canadian interests. Biden's recent announcement that he would withdraw the Keystone XL permit provides a stark example. Moreover, there is no question that the Trump Administration has moved the needle on U.S. political sentiment on trade, and this will have lasting impacts under any future presidency. For example, Canada can expect vigorous enforcement of U.S. trade remedy laws, including on softwood lumber.

Still, under a Biden Administration, rules generally would matter, and the multilateral system would be valued. The United States could resume a leadership role in global trade talks. Of course, many countries, notably China, will be central to determining the future but, without a change of approach in Washington, it is hard to imagine any significant change in how leaders of major countries work together on finding solutions to global trade challenges.

Under a renewed Trump Administration, Canada and global partners would have to brace themselves for four more years of disruptive U.S. trade policy. In a recent interview, the USTR said that the administration needed another four years to implement the president's trade agenda—showing that progress has not been as easy as the president touted in 2016, but also that the agenda would stay the same.

The Key Trade Relationships

The U.S.-China relationship is the dominant bilateral relationship of the 21st century, and it continues to be the major source of tension in the global trading system. The phase one deal is little more than an uneasy truce and most of the duties imposed by President Trump as leverage for a better deal remain in place. The Chinese move toward imposing its national security laws on Hong Kong and the President's reaction on May 29 further heighten tension. Friction over responsibilities for the origin and management of the COVID-19 crisis also compound differences.

There will be no real progress in managing the U.S.-China relationship before the U.S. election, but it is also unlikely that the president will want to take action in the interim that would have negative economic effects on the U.S. economy. There can be lots of verbal fireworks, but major protectionist action is unlikely.

After the U.S. election, regardless of the outcome, what the administration describes as "strategic competition" with China will endure and there will be ongoing tension in the economic and trade relationship.[14] Global collaboration and reform of the WTO are probably the best levers to advance real change in China and to stabilize U.S.-China relations, but, as already observed, negotiations will take years.

Other key trade relationships, while also subject to tension, pose a lesser risk for the global economy. The United States and the EU are still far from a comprehensive agreement but there appear to be efforts to manage rather than inflame conflict. For example, the president has not followed through with his threats to impose tariffs on European cars. The EU Director General for Trade has indicated a willingness on the part of the EU, at the right time, to negotiate a solution to the long-standing dispute with the United States over their respective subsidies to Boeing and Airbus. Moreover, there are indications that both the EU and Japan may be prepared to cooperate with the United States in pressing at the WTO for major changes in China's trade regime, including with respect to disciplining state-owned enterprises, and the use of subsidies.

With Brexit, the United Kingdom runs the risk of being the only G7 country that will not have a free trade agreement with any other member of the G7 at the end of 2020. The transition period for the United Kingdom leaving the EU will expire at the end of the year (in the absence of a decision to extend it for one or two years—something which the United Kingdom government says it is not prepared to countenance). Little progress has been registered on difficult issues with the EU, including EU access to British fishing zones, and EU proposals for a "level playing field" on subsidy practises which the United Kingdom sees as intruding on its sovereignty. The first round of U.S.-U.K. negotiations was described on May 18 as "positive and constructive" by the U.K. Trade Secretary, but these negotiations have only started. The United Kingdom has also set its sights on negotiations with Japan. Canada is not listed among the U.K.'s priorities.

As of January 2021, the United Kingdom will no longer be applying the rates in the EU's common external tariff; for Canadian exporters this means that exports to the United Kingdom will no longer benefit from the lower rates provided under the Comprehensive Economic and Trade Agreement (CETA) with the EU. On May 19, the details of the new U.K. tariff regime were announced. While some rates will be lowered, the current EU Most-Favoured Nation (MFN) rates will apply on certain agricultural products like beef, lamb, and poultry; automobiles will be subject to a 10% tariff.

Canadian Trade Policy: Achievements and Challenges

The CUSMA is scheduled to come into force on July 1, providing a measure of protection for Canadian exporters from erratic action by the Trump Administration. However, there is still uncertainty about how the new rules of origin on automobiles will work in practice.

The CETA and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) are showing modest positive results. What matters now is steps by Canadian firms to take full advantage of the improved access to these vast markets.

Trade relations with China, the world's second largest economy on the road to become the largest, remain a major challenge for Canada, with no fix in sight. The May 27 decision of the B.C. Supreme Court not to dismiss the extradition proceedings against Huawei executive Meng Wanzhou will stymie any effort to improve the trade relationship for the foreseeable future. Indeed, this development may provoke an intensification of Chinese retaliatory actions against Canada. Canadian exporters and investors with business in China face elevated risks, and the federal government is not in a position of strength to offer practical help.

Even with some normalization in the bilateral relationship, Canada's best bet for a major improvement in Sino-Canadian trade relations probably rests, in the foreseeable future, in multilateral efforts within the WTO. Immediate efforts to improve trade rules with China bilaterally are futile; China will prefer the use of muscle to a rules-based approach. It is only in working with partners, and appealing to reformers in China, that Canada may contemplate substantive progress.

Trade Challenges for Businesses

The combination of a global pandemic, government responses to the public health and economic crisis, and underlying tensions in the global trade environment poses unprecedented challenges for Canadian businesses with international reach. After living for three years under the cloud of NAFTA uncertainty, companies must now react to a worldwide supply and demand shock that is disrupting supply chains and conditions of competition for a range of goods and services. Companies have to rethink the sourcing of inputs, where production should be located, and how to ensure greater resilience in their supply chains.

Not only must firms adapt to a changing world, they may also face, in both the domestic and export market, foreign competitors receiving disproportionate assistance from their governments. In addition, with the collapse in demand for many products, excess stocks may develop in other countries and cause inventory overhang. These surplus supplies will substantially increase the risk of these products being sold at distressed prices, causing potential injury to Canadian producers. Canadian producers who feel they have been injured by such competition may wish to initiate domestic legal proceedings to seek relief under Canadian trade remedy law in the form of anti-dumping or countervailing duties, or other safeguards.

Overall, trade developments are taking governments and businesses into uncharted territory. Returning to business-as-normal after the crisis may be a comforting prospect for some businesses. However, it is unlikely to be a feasible, satisfactory, or promising future for many others that will have to build new markets and new supply relationships in a trade environment that will remain under stress.

IV. A Path for Canada

a) The Next 18-24 Months: Reopen and Recover

With the range of scenarios and deep uncertainty in the economic and trade environment described in the earlier sections, a path for the Canadian economy can be charted that comprises three overlapping phases: the reopening, recovery, and rebuilding of the economy. The first two phases are focused on getting the economy rolling again and back, more or less, to its pre-crisis level of output. The rebuilding, discussed in the next section, is the task of creating a more productive, sustainable, resilient, and inclusive economy for the medium to long term.

The Reopening: Living with COVID-19

Reopening is a gradual exercise of learning to live with COVID-19—an evolving and modified state of the economy that will prevail for months, perhaps years. It starts by applying the necessary measures in the workplace, on work sites, in the public infrastructure, and in gathering places to contain the risk to public health of renewed activity. It is important to get this phase right: false starts and new lockdowns will depress confidence and be exceedingly costly.

The reopening of the economy will be an adaptive process that will best be informed in the next weeks and months by a greater capacity for testing and for tracing the spread of the virus. It is critical that the sources of any new outbreaks be quickly identified and isolated so that responses may be targeted instead of requiring wider lockdowns. For contact tracing, while privacy commissioners in Canada have enunciated principles, and while some provinces have rolled-out a voluntary approach,[15] there is no national framework that balances privacy, public health, and economic outcomes. Canada can do better than a patchwork of technology and manual processes, and pan-Canadian collaboration could spark a competitive Canadian technology.

Personal protective equipment (PPE) must be widely available. Where social distancing cannot be assured, workers and citizens need the confidence that the risk of contacts to their health will be minimized to the extent practicable. This includes respect for workers' right to a healthy and safe working environment. Governments can work with the private sector to ensure that the supply chains for PPE are reinforced and that the proper standards are applied in the workplace.

The costs of public health measures—testing, tracing, PPE, as well as social distancing guidelines—may be high and the inconvenience for firms, workers, and citizens may be significant, but they pale in comparison to the cost of again locking down the economy. Canada can look to the experience of jurisdictions (from British Columbia at home to Germany internationally) that have been relatively successful at controlling the epidemic, and apply lessons learned.

With expanded testing and tracing, federal and provincial and territorial authorities will be in a position to adapt policy and guidance related to the movement of people within and across jurisdictions in a manner that is responsive to evolving risk.

The management of international borders, in particular the Canada-U.S. border, is a delicate part of the reopening of the economy. The federal emergency order under the *Quarantine Act* that imposes a mandatory 14 days of self-isolation for persons entering Canada currently applies to June 30. The closure of the Canada-U.S. border to

non-essential travel extends to June 21. The lifting of some of the restrictions may facilitate a return to normal for the economy, but domestic efforts to control the virus should not be undermined by entering or returning travellers. Earliest signals on how those policies may be extended or amended, taking into account both economic and health considerations, and the perspectives and interests of provinces and regions, will be important.

Governments as employers, and public services, will play an essential role in the reopening of the economy. The prudent restart of daycare centres, schools, and the safe operation of public transportation, will be essential to enable Canadians to get back to work. The gradual reopening of government workplaces and university campuses, even with a greater proportion of tele-work than before the crisis, will also send a strong signal and help revitalize communities and local commerce.

As activity restarts and as a new normal sets in, the federal government will need to taper the exceptional measures introduced during the lockdown for households, employers, and workers. The fiscal cost of direct support measures for individuals and businesses introduced in the period of mid-March to mid-May 2020 is over $150 billion. The deferral of income tax payments to the end of August 2020 and the deferral of remittance of sales taxes and customs duties to the end of June have represented cash flow aid of some $85 billion. The government has also opened funding windows through EDC, BDC and other facilities for an amount of up to some $400 billion, not counting the Large Employer Emergency Financing Facility (LEEFF) for which estimates are not yet available. The flow of direct support will need to be phased out: it is fiscally unsustainable, and it creates distortions that may slow down a return to more normal conditions for employers and workers. Monies owed to the government under deferrals and loans will need to be repaid.

Even in the best of scenarios, the tapering of aid will be a delicate policy exercise.

- **From a macroeconomic perspective, the government must be mindful of aiding a reopening and recovery by offsetting some loss of private income and cash flow, but within a fiscal strategy that brings fiscal costs and exposure to business risk down decisively.** The scenarios in Section 2 provide the illustration of a fiscal deficit that realistically will still be large into the next fiscal year—in part because revenue will still be deficient—but a sustainable fiscal track must be one of sharply lower discretionary spending.
- **From a debt management perspective, taking into account fiscal expenditure and loans and other cash flow aids that also require higher government borrowings, the signal to markets must also be one of a tapering.** There can be no assumption that the financial market response in an uncertain world will be benign and that the federal government will continue to borrow at near zero interest rates; if rates on the federal debt are pushed up, provinces and private sector borrowers will also pay higher debt-service costs.
- **From a microeconomic perspective**, programs have to be tapered in such a way as to lessen and ultimately remove distortions, notably in the labour markets, such that the decisions of workers and firms are again driven by underlying economic realities and not by government programs. There must be steady adjustment toward some new normal.

Politically, with a reopening that may be slower than desired, the necessary tapering of the measures will also be exceptionally challenging, and if not executed well, may be deeply divisive and cause social tension. For some measures, like the one-time enhancements of the Goods and Services Tax (GST) Credit and the Canada Child Benefit, the government may decide on future aid based on the evolution of the pandemic, and need for the most

vulnerable. If conditions improve, they need not be renewed. Matters will be more difficult where aid has been granted in the form of payment deferral or government-backed credit. For example, with the pandemic not yet abated, individuals and businesses may seek a deferral of income tax owed beyond August 31. Some businesses not yet recovered will seek deferral of loan repayments or loan forgiveness to avoid bankruptcy. The government will have a difficult task of maintaining the integrity of programs against claims of hardship. However, leniency could fuel a dynamic for ever more relief for more groups.

Decisions will be most difficult for programs that deliver ongoing aid, in particular the CEWS and the CERB. The two programs deliver relief to employers, and to workers sidelined by the crisis, respectively. The CEWS (revised estimated cost of $45 billion) was announced with a sunset date of end of June, but the government already has indicated that it will be extended to the end of August. The CERB ($60 billion), claimed to date by 8.2 million Canadians, with much broader application and more generous benefits for some workers than Employment Insurance, officially carries through to October 3. It will be unrealistic—and politically unfeasible—for these programs to fall off a cliff in what will still be an uncertain reopening. Yet, extension at their current amounts would simply push off decisions needed to re-establish conditions for an efficient and sustainable recovery.

Thus, as the economy reopens, the federal government will need to send timely and clear signals to households, businesses and workers about the principles and conditions under which the exceptional aids will be tapered at the end of the summer and through the fall. The tapering of programs, will need to recognize the interaction between measures, for example between the CEWS and the CERB, and follow a path that will enable the most efficient adjustment of the economy.[16]

In short, with careful and vigilant public health risk management, Canada must reopen the economy in a manner that will provide the strongest probability of a steady resumption of activity. There must be preparedness for a second wave of infections and possibly even another lockdown, but the target baseline should provide for the economy to get back earliest to some normal and to accommodate a rapid tapering of the exceptional transfers to households, workers, and firms.

The Recovery: Getting Back to the Pre-Crisis Level of Output

As the economy reopens, an interim goal is recovery: getting output back to its pre-crisis level. As per our baseline for the Canadian economy, this will take some 18-24 months. In the more pessimistic scenario, the goal will not be achieved until well into 2022 or later.

A plan for recovery needs to recognize the unique attributes and impacts of the COVID-19 crisis. This economic crisis started by an induced supply shock. The recovery must be founded on conditions and incentives for the re-emergence of supply. Large demand stimulus will be of limited utility and, if supply is held back, it could put upward pressure on some prices. Plans for the recovery must consider not only the goods sector but also the services sector that has been hit as hard in this crisis. They must be responsive to the impacts of the crisis on women, as well as on young workers, recent immigrants, and other vulnerable workers hit disproportionately.

The timeline for recovery will be differentiated by sector. While some sectors carried through the crisis relatively unscathed (telecommunications, e-commerce, some parts of the transportation and distribution sectors), and some may bounce back quickly (e.g., resumption of activity on some construction sites), others will come back much slower because of the health concerns of consumers (e.g., air transportation, accommodation), global

market factors (oil and gas), and in some sectors a high rate of small business closures (e.g., restaurants, small retail, start-ups). Some impacts of the crisis will be permanent, and capacity will need to be replaced.

While tapering exceptional aids, governments can identify targeted measures to support and accelerate the recovery.

Some low-cost measures can assist in restoring markets for businesses. Governments and industry can work together to develop *buy local* or *travel in Canada* campaigns that can support demand in the local economy and in sectors most affected by the crisis. At the same time, EDC and the Trade Commissioner Service can be mobilized to assist exporters that may have been sidelined during the crisis in regaining and growing market share.

Training opportunities on the job or in educational institutions must be readily available for displaced workers to renew, upgrade, or complement their skills. As the CERB and the CEWS are tapered, governments can collaborate on solutions for workers and firms where jobs are not coming back. For example, support for on-the-job training could be a transition from the CEWS.

Investment in infrastructure may not have the same role as in recovery from the last recession but there are opportunities for short-term and longer-term contributions to a stronger economy.

- **Public infrastructure projects—including digital infrastructure—already built into fiscal plans can be accelerated.** Even where projects are not "shovel ready", the planning and engineering work can support activity and build confidence. The crisis will have raised the urgency of implementing plans for universal access to broadband services.
- **Some gaps in the social infrastructure revealed by the crisis require investment.** Provinces must ensure that their health care system has the appropriate surge capacity in the event of crises, including potential resurgence of COVID-19. In some jurisdictions, there must be investment in long-term care facilities, seniors' residences, and other institutions to ensure the well-being of those most vulnerable to health risks.
- **Efforts to mobilize private capital for infrastructure that delivers public benefits can also be accelerated.** With governments deeper in debt, and with institutional investors in search of prudent investment opportunities, there can be stronger interest in launching projects that can generate a stream of revenue by charging users (e.g., tolls) instead of current or future taxpayers. The Canada Infrastructure Bank, with an original capital of $35 billion already booked in the federal fiscal framework, can ramp up and, with governments, other project sponsors, and investors, stimulate a flow of projects.
- **Private infrastructure projects (including projects to advance energy and environmental objectives) can also be facilitated by streamlining regulatory and permitting processes and by creating a more certain pathway for project decisions.** A lower volume of active and new project applications should enable faster treatment without lowering environmental standards or requirements for engagement with communities.

It matters in the recovery not only to support resumption of activity and jobs but to repair, strengthen, and build productive capacity, and economic and social infrastructure, for the economy of the future. With the right public health framework, sensible risk management, and properly sequenced and targeted policy interventions, Canada could be in a position, within a period of some 18-24 months, as per our baseline scenario, to get the level of output back to where it was before the crisis.

b) The Medium to Long Term: Rebuild

The Pre-Crisis Starting Point

Before the COVID-19 crisis, Canada entered the 2020s with moderate growth prospects for the medium term. Productivity and labour market trends were suggesting a growth potential of some 1.8% per annum—or less than 1% on a per capita basis. While such growth could not be taken for granted, and while there were flashing lights of economic or financial disruption, there was an expectation that Canada could and should do better through sound policies and mobilization of the country's full assets.

The collective challenge was to raise productivity growth as the lever to improve our standards of living. For a small open economy like Canada, this entailed trade expansion and diversification. While grappling with an uncertain world, as discussed in Section 3, Canada could count as assets a just ratified CUSMA, the CPTPP with Asia Pacific partners, and the CETA with the EU. Success in global markets for both our traditional and emerging industries in turn required a focus on competitiveness. This included policy frameworks from regulation, to labour markets, to taxation, to infrastructure, for firms to secure the access to markets, talent, and capital necessary to meet and beat global competition. It also included ramping up business investment in innovation, including in drivers of productivity like machinery and equipment, information and communications technology, and intellectual property where Canada's performance has been sub-par.

Even before the pandemic, opportunities had to be seized amid an uncertain geopolitical climate and the disruptive and transformational forces of technology, demography, and climate change. There was an imperative to adjust and, where Canada has world-class talent and resources, to capitalize on change.

Beyond COVID-19: A Necessary Response to Structural Change

After a recovery from COVID-19, with a diminished starting point, and a yet more uncertain world, Canada's challenge will be even more daunting, and the climb ahead even steeper. Even under our baseline scenario, it will take 18-24 months to bring output back to its pre-crisis level. The lower terms of trade and exchange rate that are likely to prevail by that time relative to early 2020 mean that Canada will in fact be poorer. Our households, our firms, and our governments will carry more debt, a higher portion of which will be owed to non-residents. The level and trendline of global output may also be lower and competition for markets will be fiercer.

It is early to grasp the full ramifications of the crisis and the risks and opportunities in the economy that will emerge in its aftermath, but some trends and signals evidently call for strategic attention. It is essential that as workers, firms, and governments work through the reopening and the recovery, there also be strategic thinking about the rebuilding of the economy—the innovation and the transformation necessary to prosper in a new world after the crisis.

First, the geopolitical environment will continue to be messy and a high level of dependence on any one client, supplier, or region of the world, in either a global or decoupled marketplace, will entail material risks. Canada already had learned the tough lesson of over-reliance on one trading partner, the United States, and also the challenges of developing a solid and predictable relationship with China. A deteriorating U.S.-China relationship, and ongoing tension between Canada and China over the Meng Wanzhou extradition case and the detention of Canadians in China, create a difficult environment for Canada to advance its economic interests. Moreover, these and other vital relationships for

Canada are harder to manage in a word where multilateral institutions and rules are weakened. A decoupling of the global economy and supply chains may entail greater challenges still. Our economic and national security interests already are closely intertwined and some policy choices, for example on a 5G infrastructure, involve trade-offs. Without neglecting the world's two foremost economies, Canada must cultivate a range of other alliances and economic partnerships, including with countries of the Asia Pacific, Europe, and the Americas. Economic diplomacy will need to be of variable geometry in advancing Canada's interests.

Correspondingly, sectors and individual firms, in advancing their commercial interests, are likely to place a greater premium on diversification and resilience in their markets and supply chains. The lesson from the global financial crisis was that banks and large financial institutions internationally needed greater regulatory and capital buffers against the risk of financial disruption. The response paid off in this crisis, with the financial system weathering the storm, supported by the timely intervention of central banks to enhance liquidity. What this crisis has shown is that some parts of the economy (e.g., PPE, medical devices, meat processing and agri-food), in Canada and other jurisdictions, have under-invested in resilience in favour of just-in-time, highly concentrated production and distribution supply chains that are vulnerable to disruption. It makes no sense for Canada strategically or individual firms commercially to pursue domestic supply capacity for all critical inputs, but there must be attention by firms and governments to diverse and resilient supply chains and prudent inventory capacity.

Second, the crisis will have made obvious if not already clear, that all large organizations today are, or must be, digital and that intangible assets are a critical vehicle for realization of value. Much of the economy moved online during the lockdown, and technology-driven organizations from infrastructure providers to digital platforms demonstrated and enhanced their value for consumers, workers, firms, governments, and citizens. Increasingly, economic agents rely on networks and data to connect with their clients, their suppliers, their workers, their operations in the field, and their transportation and distribution infrastructure to supply goods and services. The crisis has also revealed progress to date in digital government—for example, the rapid treatment of millions of applications for the CERB—but also the vulnerability of existing systems to abuse, and the huge gaps to address in such critical domains as health care and education.

Tangible assets and physical capital remain at the heart of our modern economies, but intangible capital generates and captures a growing share of the economic value. It was already plain that Microsoft, Apple, Alphabet, Amazon, and Facebook as well as China-based Alibaba and Tencent dominated global rankings of market capitalization. This position has been reinforced during the crisis. In May, Shopify overtook Royal Bank of Canada as the largest market capitalization for a Canadian firm. However, the significance of intangible assets is not a "tech" sector phenomenon: all across the economy, the intellectual capital and property (IP), the data, and creative content are now instrumental. It is noteworthy that the firm that was awarded the most patents by the Canadian Intellectual Property Office (CIPO) in 2018-19 is Halliburton (485 patents granted in a single year): a U.S.-based multinational energy services firm selling expertise to maximize value from hydrocarbon reservoirs. Natural resources, agriculture, transportation, manufacturing, services, indeed virtually all industries depend increasingly on innovation, IP, and data analytics for productivity and competitiveness. Transformational technologies like 5G, big data, artificial intelligence, robotics, will further intensify this shift of value from tangible to intangible capital.

Firms and government have to take the full measure

of the digital transformation and re-think and adapt strategies and policies to generate, protect, grow, and commercialize intangible capital. Canada has not been a leader at this game, for example under-investing in intellectual property assets, and being better at invention than commercialization. It must bring together the full range of its strengths—its talent, institutions, and technological capacity—and the policy architecture to be more competitive in both traditional and emerging sectors of the economy. For example, governments and Canadian businesses have an obligation to work together toward capitalizing on the major public and private investments in artificial intelligence, and to convert talent and knowledge into assets that can be utilized and commercialized for Canadian prosperity.

Third, with intense pressure coming out of the crisis to restore growth while pursuing environmental and climate change goals, Canada has an obligation, and an opportunity, to make the energy sector a driving force of an integrated strategy. With a current account that will be under even greater pressure coming out of this crisis, with large net borrowings to sustain our consumption and to fund investment, there is no source of earnings that can readily replace our energy exports. If the demand stays depressed, or if prices do not cover the costs of supply, then Canada will have to live with lesser oil production and exports, and it will end up poorer. However, if demand and prices pick up, including with access to offshore markets through projects like TMX and LNG Canada, the industry's contribution to our external account and to our economy will be critical. Meanwhile, the fight against climate change may be pursued after this crisis with more or less vigor internationally, including in the United States after the 2020 election, but access of our industry to markets and to investors is vulnerable unless there is a strong and concerted action by industry and governments working together on an ambitious goal of lower emissions.

Under the right market conditions and policy framework, Canada can deliver more energy to the world, with leading environmental, social and governance (ESG) standards, while growing its capacity to invest in clean technology and in the transformation of the energy system. As the oil and gas sector works through the crisis, there is a need for some restructuring and consolidation to enable, with improved cash flow, continued investment in a stronger, cleaner industry. Some industry leaders have committed to net zero emissions by 2050. A path and interim targets for the industry would help create momentum and build credibility. For its part, governments have to establish the conditions that can bring equity capital back into the industry, including by setting out clearly the emissions and environmental performance expectations and then enabling good projects to get built after a rigorous and predictable regulatory review. Policy and legislation must pursue greater legal certainty and promote productive partnerships with Indigenous Peoples without conferring a right of veto over projects of national or regional interest to any one community. Such efforts can be integrated into a broader plan for the economy and for climate change, including decarbonization and electrification of the domestic energy system.

Adjustment to Change and Fiscal and Policy Pressures

With structural change accelerating through the crisis, and with the risk of further economic disruptions, governments need to review their instruments to facilitate adjustment. While this crisis was truly unprecedented in many ways, and while no policy suite could have delivered adequate responses on automatic pilot, it is evident that some policy instruments require reform. The income security system for working-age Canadians—with the poor integration of Employment Insurance, provincial social security, and taxation—was nowhere near the task of delivering timely and sufficient income

support to workers affected by the pandemic. The case for some basic minimum income may be strong but the design of a more responsive, integrated, affordable, and efficient structure will be a complex enterprise for the federal and provincial governments.

Intense fiscal pressures for federal and provincial governments will entail a focus on clear priorities, a review of the structure of expenditure and taxation, and hard choices to raise new revenue and cut spending. While the economic recovery will help restore fiscal revenue and unwind emergency spending, governments coming out of the crisis, like the private sector, will be worse off than at the end of 2019—carrying far more debt. Moreover, they will face new fiscal pressures, including public expectations for added investment in the health care system. Governments will have to set out a realistic track to return to a sustainable fiscal framework. This will include assessing more fundamentally the structure of their spending, the alignment with priorities, and the structure of their revenue, including the level and mix of personal and corporate income taxes, sales taxes, and other revenue, including the carbon tax. To contain the growth of the debt and debt-service costs, there will be no way around raising some taxes, and cutting some spending.

Fiscal management will require a medium-term plan with a solid anchor and a significant reserve for contingency in an uncertain world. The growth of program spending will have to be kept well below the rate of growth of revenue, to place the deficit on a downward trajectory while making room for the increased debt-service costs that will be incurred as interest rates rise over the medium term. In combination with a renewed agreement in 2021 between the government and the Bank of Canada on the inflation target, a well-anchored fiscal plan will be essential to preserve confidence in the "Canada brand" in global capital markets and to assure our businesses access to the capital they need to innovate, grow, create jobs, and generate rising incomes.

Policy choices will need to be attentive to income distribution. The crisis will have hit households and workers across Canada, and disproportionately women, young workers, and recent immigrants. Some of the workers most valued during the crisis, from nurses and auxiliaries in health care facilities to grocery clerks and truckers, earn low to moderate wages. Some entrepreneurs may have abandoned their small business yet still carry their start-up debt. It will be difficult, coming out of the crisis, to ask such groups to pay more in taxes or to lose services. Thus, fiscal choices will need to weigh carefully distributional impacts, for example of expenditure reductions or tax increases. In the past, public sector wage freezes have been used to close fiscal gaps—they will be strongly resisted. Private sector workers who rely on defined contribution pension plans or their private savings for retirement may find that their situation has worsened relative to public sector workers who have a more secure, defined benefit pension plan. Younger cohorts of workers, entrepreneurs and households will be concerned that the debt accumulated through this crisis will bear disproportionately on the prosperity of their generation.

Intergovernmental fiscal arrangements will also require examination. The federal government, appropriately, will have borne the larger share of the fiscal costs of the crisis and emergency supports. It is the insurer of last resort in the federation and, as sovereign, it is the government with the lowest borrowing cost. Still, provinces, including some like Newfoundland and Labrador, Alberta, or Ontario that entered this crisis under pressure to reduce fiscal deficits, may require added assistance to establish a sustainable fiscal structure for the medium to long term. The Canada Health Transfer (CHT) and the Stabilization program, in particular, may require expansion. A restructuring of the income security system would also have impacts for fiscal federalism.

Coming out of the crisis, the pursuit of economic and fiscal stability, social cohesion, and national unity will require strong leadership. Interest groups will each claim specific needs, including some pre-dating or succeeding the crisis. If the response of government is perceived to be inadequate, or the burden of fiscal adjustment unfair, there can be rising disenchantment. Unity achieved during the crisis will be tested when the bills have to be paid.

Charting a Path: A Collective Enterprise

Thus, governments will need to set out a finite set of priorities for the country, a fiscal track and a fiscal anchor, principles to guide policy development, and processes for engagement with Canadians. Given the complexity of structural challenges and the significance of the stakes for generations of Canadians, there will need to be parallel exercises to gather the evidence and to solicit advice from experts and leaders in the private sector and in communities. While the issues are urgent, answers cannot be developed overnight, and governments will need to set out realistic timelines. There will be different perspectives on solutions for Canada, but there should be, as part of each discussion, a place for non-partisan, expert assessment and a clear exposition of options and trade-offs. Process must aid, and not be a reason to delay, difficult decisions.

In Canada's history, exercises such as the Macdonald Commission made important contributions to the national debate at critical times. Governments again may find that for a specific set of issues, there would be merit in a national Commission on the economic prospects for Canada, with wise persons, expert resources, and a capacity to propose a direction for the country.

The overarching goal in rebuilding the economy after COVID-19 must again be to grow productivity and to preserve and then raise the standard of living of Canadians, doing so in a way that is sustainable, resilient, and inclusive.

V. Proposed Planning Assumptions for Businesses

As both the former Governor of the Bank of Canada and the Chairman of the Federal Reserve have indicated, this is a time of radical uncertainty. Thus, we provide not a single forecast subject to risks, but describe two possible scenarios for the Canadian economy. Governments and businesses must plan on the basis of some parameters, but be willing to modify their plans as events unfold. At this time, we think that planning should be made on the basis of parameters in our baseline scenario—that is Plan A. But the evolution of the virus, and the progress toward a vaccine, should be monitored closely through the remainder of 2020. Faster progress in vaccine development may mean growth in 2021 will be slightly stronger than our baseline scenario indicates. But if there is little evidence of success in clinical trials or if there is a renewed major global outbreak of the virus, then planning should shift to Plan B, based on our more pessimistic scenario.

"Radical uncertainty" notwithstanding, businesses can expect policy interest rates to remain at their "lower bound" levels in both Canada and the United States, with longer-term interest rates rising from their current record-low levels, but only very modestly (Table 3). The WTI oil price is projected to strengthen gradually from current levels, but still be lower at the end of 2021 than before the crisis. The Canadian dollar is expected to be close to 73 U.S. cents by the end of 2021.

Table 3:

PLANNING PARAMETERS: BASELINE COVID SCENARIO

	United States	Canada
GDP growth (% at annual rates)		
2019	2.3	1.7
H1 2020	-14.4	-15.8
H2 2020	-5.6	-4.0
2021	4.8	5.1
GDP level as % of Q4 2019		
Q4 2020	-9.3	-9.1
Q4 2021	-0.1	-0.1
Policy interest rate (%)		
End 2019	1.75	1.75
End 2020	0.25	0.25
End 2021	0.25	0.25
10-Year Treasury yield (%)		
End 2019	1.92	1.70
End 2020	0.80	0.70
End 2021	1.10	1.00
Canadian dollar exchange rate versus U.S. dollar		
End 2019		0.76
End 2020		0.73
End 2021		0.73
WTI oil price (US$ per barrel)		
End 2019	61	
End 2020	40	
End 2021	50	

Notes

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