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In the Dark and Flying by the Seat of our Pants

There's an old saying that, "To a man with a hammer, everything looks like a nail". Because we are armed with certain policy tools, we often attempt to employ the same tools whether they fit the requirements or not.

In economics for example, by the early 1970's most mainstream economists and virtually all Western governments had become Keynesians. Almost everyone figured that we had the miracle antidote to economic recession and depression.

Then we got hit with simultaneous high unemployment *and* double-digit inflation. That wasn't supposed to happen, given the Keynesian macro-economic models that we used at the time.

We called the new problem "stagflation" and economists went to work developing new theories of how monetary policy worked (thanks to Milton Friedman and others). We changed policy and cured that stagflation, but not without the grave economic and psychological costs of a deep recession in the early 1980's.

Once again, however, we felt that with our new models of the economy that we could "fine tune" it and make it behave as we wished, with low unemployment *and* low and stable inflation.

Then came the Great Recession of 2008 when the global financial system was threatened with meltdown. Once again, we learned from that dire experience; and then we built new models and new policy firewalls against global financial crises.

We're using those new models now, along with some of the lessons learned from even earlier. We're employing a massive and unprecedented, at least in peacetime, expansion of government spending and loan guarantees (financed in large part by central banks) as well as added protection to our systemically important financial institutions.

But the situation we face this time is different from the past.

This current economic crisis is as much a crisis of aggregate supply as it is of lack of aggregate demand. Our health strategy, the so-called "flattening the curve"¹ strategy requires us to forcibly shut down a large part of the "non-essential" economy.

¹ The simple idea is to reduce the number of deaths by spreading out the infections over a longer time frame, possibly 2 years or more before a vaccine is available or other effective treatments of active cases.

We haven't done that before. We're in for a very deep recession, if not a depression, just from what we've done so far; and, although unprecedented, few think our response to date will be enough. And we're perhaps less than a month into this crisis.

No one knows when or how our governments will exit the current "flattening the curve" strategy. How long will it last – months, years?

Most forecasters are calling for a deep recession this year, even though they assume the crisis is over by the second half. In their models, the economy comes roaring back.

But how credible is that? The government and their health advisers have terrified a large portion of the public. Will they quickly repopulate planes, cruise ships and restaurants and theatre events? I don't think so. And if they do, then the virus will come roaring back too.

In effect, we are now performing a huge real-time experiment, with the whole economy as our laboratory subject. We're going to learn what happens when you add a huge amount of fiscal and monetary stimulus to an economy that is partially shut down by government mandate. Many, many people are being paid *not* to go to work.

This doesn't happen in wartime or during normal recessions/depressions. We don't deliberately shut down part of the economy.

In the context of a massive fiscal response (financed by the Bank of Canada) are we going to create an unmanageable inflation? If we do create inflation, will we impose even greater restrictions on personal freedom and use wage and price controls and formal rationing as we do in wartime?

Or will we create stagflation, where part of the economy (airlines, tourism, entertainment, hotels) suffers from a prolonged recession and falling prices while other parts experience rapid price increases?

And what happens in the future when younger generations realize that we've added a gargantuan amount of public debt to the large burden that they are already inheriting²? Will they want to repudiate that debt?

What is the future economic fallout from large numbers of people experiencing the psychological stress, not only of the very high probability of infection before a vaccine or

This reduces the mortality rate only because infections don't overwhelm our current critical medical care capacity at any one point in time. Life or death choices don't have to be made by rationing access to ventilators for example. The total number of infections is not necessarily reduced unless we get lucky and a vaccine arrives to save us.

² The provinces will experience an avalanche of new debt, even though some of it will be monetized by the Bank of Canada, at least temporarily. Yes, it will be at rock bottom interest rates. But for how long? And monetizing the debt carries its own complications for the future in trying to unwind those positions. The Federal Reserve in the US never got very far in that regard after the Great Recession of 2008-09.

other remedy arrives, but of financial ruin as well? Post traumatic stress disorder (PTSD) may well be rampant in our society and with what long-term consequences for the economy? How many people will die from this effect? We just don't know.

After this crisis is past, governments could have a hard time extricating themselves from so much direct involvement in the economy. Or maybe they won't want to extricate. Many citizens and businesses will have become accustomed to being on the receiving end of government largesse seemingly dropping from the sky ("helicopter money").

And we'll have an even harder time when we realize that not just those in dire need were rescued, but many of the very wealthy will have been too. What if our current interventions make income inequality even greater, because we've had to go to extraordinary lengths to rescue some large corporations (and their owners and executives) from bankruptcy? Will we have made society more politically stable?

I don't have a definitive view on the possible answers to these questions. But we may very well soon find out.

The Fog of Crisis

As the former US defense Secretary Donald Rumsfeld once said about war. *"There are known unknowns. That is to say, there are things we know we don't know. But there are also unknown unknowns. There are things we don't know we don't know"*.

This is true about our current health strategy and our economic strategy too.

In novel situations of deep complexity with many interconnecting parts and considerations, everyone is doing the best they can to manage our way through. And everyone is grabbing for the tools they know best. But we simply do not have a good understanding of this virus or of the effects of our actions on the economy and society at large.

There will, as usual, be many and terrible unintended consequences from what we're doing. At the very least we should be honest that, as policy advisors, we're in the dark and flying by the seat of our pants.