

ECONOMIC OVERVIEW

Understanding the K-shaped economic recovery

COVID-19 is a natural disaster of the first order. It is altering the very fabric of our society, that much is clear. Predicting how this will all turn out is, of course, very difficult. But what we can do is to help people understand the forces acting on the economy so they can make more informed personal and business decisions.

The natural response to the pandemic last spring was to shut everything down, asking people and their children to stay home. Those who could work from home did so, while essential front-line workers went about their business, proving how essential they really are. Things stabilized during the summer, but as autumn unfolded so did a second wave. Having learned a few things, governments imposed much more targeted second-round shutdowns.

Where do we go from here? Obviously, much depends on how the infection curve plays out. For the economy, the best descriptor of the situation I have seen so far is the letter “K.” Usually, when the economy experiences a setback, economists look for a “V-shaped” recovery, where all the lost activity is made up fairly quickly. If the recovery is slower than hoped, it is called a “U”; if there is a double-dip, it is a “W”; and if it is a depression, then the dreaded “L-shape” is what emerges. The second wave could produce a “W” but looking forward the “K” is still apt. It captures a basic idea – that the pandemic is having significant

adverse economic effects on some parts of the economy (the bottom part of the K) and having very little effect on others (the top part of the K).

Understandably, most of the news and commentary has been about the bottom part of the K. There have been significant impacts on restaurants and bars, hotels, airlines, in-person retail and the oil business. As well, small businesses of all stripes are being affected by the plunge in daily commuting – with so few people going downtown, everything from the corner café to your clothing store to your drycleaner has seen a severe drop in demand.

The rest of the economy is in the top part of the K, where we see a classic V-shaped recovery from the spring shutdown. Even though the shutdown was very widespread, economic activity fell during March and April to a level 19% below where it was before all this started. The economy began to recover as restrictions were eased in May, and by autumn was operating at over 95% of its February level.

The data on employment also suggest that the bottom part of the K represents less than 5% of the economy. Some three million people lost their jobs during the shutdown and many more were working shorter hours than usual. By November, the level of employment had recovered to a point where there were less than 600,000 fewer jobs than in February. That is still close to 3% of the workforce, which of course explains why the unemployment rate in November was 8.5%, while it was 5.5% at the start of the year.

The government's income support programs deserve much of the credit for preventing a much deeper downturn in the economy. Banks' willingness to defer mortgage and loan payments also merit recognition. As a consequence, retail sales have recovered completely, and in September were 3% above the level of last February – a classic V-shaped recovery. Even so, Canadians have boosted their savings considerably.

What this means is that when we look at the economy as a whole, we need to understand that there are really two different economies operating. One economy is under considerable stress, with companies struggling for survival. The other economy is going about its business, and there are even signs of excess demand, particularly in housing construction, renovation and home resales. This is a very human reaction – when people cannot travel, dine out or socialize, they spend their money feathering their nest instead. This is exactly what people did immediately after 9-11. At that time, economists predicted a major global economic slowdown that never materialized because people chose to spend their money around the house instead of travelling.

The economy's "K" and the diverse responses of Canadian companies is clearly reflected in the activities at Osler during the past year. [Many important transactions were derailed](#) by the arrival of the pandemic, of course. But as the situation evolved, firms in the top part of the K shifted into expansion and acquisition mode and the [capital markets](#) continued to [provide investment opportunities](#). The Fourth Industrial Revolution – [the digitalization of business](#) and the deployment of artificial intelligence – appears to have been accelerated by the pandemic, both in customer service channels and in employment channels. [Global supply chains](#), already under review in light of U.S. protectionist policies, were quickly reorganized to ensure domestic supplies of strategic health care items. Indeed, Canada's [health care system](#), under strain for obvious reasons, was forced to innovate – adopting automated appointment

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management, video consultations and around-the-clock diagnostics and surgical delivery. Meanwhile, the bottom part of the K saw numerous mergers, [restructurings or, sometimes, insolvencies](#). The associated [labour market stresses meant a busy year for employment law](#). At the same time, [entrepreneurs created and investors invested in thousands of new and growing businesses in Canada](#).

Since part of the economy is struggling, it will take a long time for the total economy to return to normal, even if most of it already has. People who have been displaced permanently from their jobs will need help to shift to sectors of the economy where there is more economic growth, like the construction and renovation sector, for example. They will need government support during that transition, along with enhanced programs for training and cross-country mobility. Canada has managed through major shocks before, including the 2014 collapse in oil prices. Our system has also managed through periods of much higher unemployment than we are experiencing today.

Nevertheless, many are wondering how governments are going to pay for all this. Indeed, the International Monetary Fund has projected that public debt will exceed 100% of global GDP in 2021. However, it is worth noting that this is not unlike the situation the world faced in the mid-1940s. Most baby boomers today have no memory of labouring under the debt burden left behind by World War II. In fact, our economy grew its way out of that debt burden.

There is no reason why this cannot happen again. Technically, the critical debt sustainability condition requires that headline economic growth (including inflation) be greater than the rate of interest that governments must pay on their debt. In that situation, regular debt service payments stay low, while total debt shrinks as a share of the economy. To help ensure this outcome, governments can do three things in particular. First, they can lock-in long-term financing at today's very low interest rates. Second, they can ensure that their spending programs are aimed at [growth-enhancing investments](#) – including [physical infrastructure](#), digital infrastructure, and social infrastructure like daycare and education – and more immigration. Third, they can eliminate inter-provincial barriers to trade and worker mobility, thereby adding meaningfully to long-term economic growth.

The Canadian economy will never be the same as it was before the pandemic. A return to normalcy will mean a new normal, with many scars from this experience. But we can be confident that Canada's fundamental strengths – its unique and extensive resource base, its world-class financial system, and its diverse and talented people – will continue to serve us well.

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