‘Are we going to be able to pull this off?’: How the Bank of Canada doused a financial fire last spring

During an intense few weeks last year when the pandemic first hit, the central bank was thrust into new territory. Now it faces the delicate task of unwinding monetary support where a wrong move could trigger new economic storms
At the end of the most intense month in the Bank of Canada's 85-year history, Stephen Poloz sat at a podium in a near-empty room in the bank's near-empty headquarters in Ottawa. Outside, the capital was a ghost town. The governor was there to justify his decision to thrust the bank into uncharted territory in its quest to combat the financial mayhem of the COVID-19 pandemic.

It was Mar. 27, 2020, and the central bank had just unveiled a plan to buy Canadian government bonds at the astounding pace of at least $5-billion a week.

“Some may suggest this is using a lot of firepower,” Mr. Poloz said of the program, which would help quadruple the size of the bank's balance sheet within months. “But a firefighter has never been criticized for using too much water.”

The bond-buying program was the culmination of weeks of escalating actions by the bank as COVID-19 spiralled from a regional threat to a full-blown global pandemic, bringing the world economy to a standstill and threatening to cripple financial markets.

From Mar. 12 to Apr. 15, the bank announced nearly a dozen measures to inject cash into markets that had been in danger of drying up amid rising panic, keeping credit flowing so that households, businesses and governments could stay afloat. To date, the actions have increased the bank’s balance sheet by $450-billion.

The Globe and Mail interviewed the key architects of the response to the crisis: Mr. Poloz, who was the bank’s governor until last June; Carolyn Wilkins, who was senior deputy governor, the No. 2 official at the bank; and Bill Morneau, who was finance minister until August.

Together with accounts from chief executives at the country’s major commercial banks, they paint a portrait of precarious policy-making and peril, as the financial system teetered on the brink.

Working from home offices, kitchen tables and bare-bones trading floors, the country's top economic decision makers did more in a matter of weeks than had been done over years in the global financial crisis a decade earlier.

The Bank of Canada's response was, by almost any reasonable measure, a success. It provided a flood of cash that averted financial-system failure and greased the
wheels of an economic recovery. It did, in short, what central banks were created to do: provide the last, best defence of financial stability.

“There were some tense days, where people wondered if this was going to work. But there was not a crisis, by many of the standards that we would apply,” Mr. Poloz told The Globe. “We defused it.”

A year later, however, economists and others are starting to assess the water damage left by the firefighters, to stick with Mr. Poloz’s metaphor. Some of the emergency programs wrapped up last year, while others are winding down in the coming weeks. But the bank, under new governor Tiff Macklem, is still buying at least $4-billion of government bonds a week as part of a quantitative easing (QE) program.

As the economic recovery picks up steam, some analysts are wondering if the bank is overplaying its hand. The central bank’s ultraeasy monetary policy and record low interest rates are contributing to a housing market frenzy and fuelling fears of inflation. Traders are warning that the bank’s oversized footprint in the government bond market is impairing market function.

There are also more fundamental questions about what the crisis response means for the future of monetary policy. By testing the limits of low interest rates and opening the door to quantitative easing, the bank may be courting new risks – to both financial stability and to the confidence Canadians have in its 2-per-cent inflation target – while eroding its ability to respond to the next crisis.

“The deeper you get into this, the more difficult it is to get out of it,” said William White, an economist and former deputy governor of the Bank of Canada. “When the system is so fragile, there’s a great danger in turning off the spigots.”

Canada is not alone. Central bankers around the world responded to the COVID-19 shock with an unparalleled surge in asset purchases. Now, they stand at the brink of a great unwinding: Get it right, and they will have pulled off a historic victory for monetary policy. Get it wrong, and they could trigger new economic storms and impair their ability – and credibility – to fight them.

Bank of Canada balance sheet: select assets
Weekly, in millions of dollars
Total assets  Treasury bills  Gov’t of Canada Bonds  Securities purchased under resale agreements
Darryl White, the Bank of Montreal’s chief executive officer, recalled waking up every morning to a fresh hell in increasingly unstable markets, which lurched and jerked in dissonant unison with news of the virus. “There were days when that actually wasn’t an issue,” he said. “Because in order to get up, you have to have gone to sleep in the first place.”

As the threat of a pandemic escalated in early March of last year, investors and borrowers, fearing the worst, rushed to raise cash. Mutual funds were hit by redemption requests; pension funds and insurance companies were forced to sell bonds and other assets to meet margin calls. The usual buyers, the banks, were dealing with their own cash crunch, as businesses drew on credit lines. Financial markets buckled under the strain.

The problem was liquidity – the ability for sellers to quickly find buyers for their assets, for borrowers to tap credit and for the entire banking system to have the cash on hand to make all this happen. Without adequate liquidity, these markets would cease to function properly, and that critical credit for businesses, households and even governments would run dry.

The Bank of Canada had already cut its policy rate on Mar. 4 to lean against a virus-fuelled economic downturn – and would do that twice more in the next three tumultuous weeks. But Mr. Poloz had long argued that with interest rates already relatively low, the country would need to turn to fiscal policy (government spending and taxation) not monetary policy (money in circulation and interest rates), to provide most of the stimulus in the next recession.

Mr. Morneau, the finance minister, agreed. The country’s two economic leaders had talked about this many times in their four and a half years working together.

“We both had a pretty good understanding of the effectiveness of monetary policy and the limits, based on our current situation,” Mr. Morneau said. He was confident that the government’s relatively healthy finances – boasting the lowest debt-to-GDP ratio in the G7 – would allow it to shoulder the fiscal load.
But what began to unfold – and quickly became the much more pressing issue – was something else entirely. As the coronavirus spread globally and reached Canada, raising the prospect of lockdowns and economic disruption, financial markets had begun to lurch from volatile to strained to dysfunctional.

“The usual suspects were flashing orange, then flashing red,” said Ms. Wilkins, who was the chief architect of the bank’s defences. Particularly alarming were the dramatically widening spreads between bid and ask prices in markets for U.S. and Canadian government bonds – the prices prospective buyers and sellers are offering each other. These markets are the bedrock of the entire system for borrowing and lending.

“Everything is priced off of that,” she said. “If that’s not working well, then nothing else is.”

In response, the bank rolled out a barrage of actions to inject cash – quickly – into troubled spots in the markets. The bank had been preparing for an upheaval since the 2008-09 financial crisis, researching and running simulations to be sure it was ready for whatever a future market crunch might bring. But its emergency plan was untested.

“We had significant work that had already been done on contingency planning ... [but] I hesitate to call anything a ‘playbook’, because there is no playbook for a crisis,” Ms. Wilkins said. “[It] was something that we did in real time, in consultation with people who could help us make sure that we were seeing the same things that they were seeing.”

To ensure the system had adequate funds to meet soaring credit and cash demands, the central bank quickly expanded its term repo operations, which provide the banking system with cash supplies. To unlock short-term funding for businesses, it bought commercial paper and bankers’ acceptances. To help provincial governments meet their sudden spike in immediate needs, the bank pledged to buy a portion of all new short-term provincial debt. Eventually, it began buying provincial bonds and corporate bonds.

“Things happened so fast,” Ms. Wilkins said. “The worry I had was, really, are we going to be able to pull this off?”

The bank tackled all this at a time when its operations, like those of businesses around the world, were being tested by widespread disruptions and lockdowns aimed at containing the virus. Its Ottawa headquarters, usually the nerve centre of its operations, stood virtually empty; only about 60 of the usual 1,700 employees were allowed in the building. Many critical staff,
including the bank’s top brass, had to quickly get up to speed working from home.

That in itself created a unique issue for the Bank of Canada, whose internal discussions at its highest ranks are tantamount to state secrets. The bank’s Governing Council – made up of the governor and five deputies – had critical and urgent policy decisions to make, but they couldn’t meet safely behind their closely guarded boardroom doors. The bank’s solution: specially encrypted spy phones, hand-delivered to the council members’ homes by security agents who looked like they’d stepped out of an espionage thriller.

“They had one of these classic government vehicles ... a black SUV kind of thing. Some serious-looking gentleman came out with a locked briefcase and gave it to me in the driveway,” Ms. Wilkins said. “My neighbours are looking, like, ‘What is going on?’ ”

In normal times, the Bank of Canada’s market operations on its own behalf are modest, dealing with a relatively low volume of routine trades – nothing like the big trading floors of Bay Street investment dealers. Now, with the bank’s trading activities suddenly far more complicated and voluminous, COVID considerations dictated breaking up the task among skeleton crews at two locations in Ottawa, and a third satellite trading desk in Calgary.

“We don’t have a really big trading floor, we don’t have a big execution group,” Mr. Poloz said. “Those folks were working incredible hours.”

The unusual nature and sheer volume of trades required some delicate footwork. For example, for the central bank’s provincial money-market purchase program – buying short-term debt from the provinces – it had to ask the provinces to stagger their schedules so they didn’t all issue new securities at once and overload the bank’s trading desk. For some of its purchases, the bank had to ask the Finance Department to sign off on indemnifications: formal assurances the government would cover the bank’s losses if the value of the assets tumbled.

Mr. Poloz and Ms. Wilkins relied heavily on the big commercial banks to feed them intelligence about the market and the effectiveness of emergency programs. At the peak of the crisis, they spoke with the banks’ CEOs daily, sometimes more. The CEOs, in turn, were in a constant back-and-forth with their own key staff and clients, gathering information; they had the central bank’s bosses on speed dial to discuss any concerns, day or night.

“Everything else dropped. We were all focused on the crisis,” Royal Bank of Canada CEO Dave McKay said. “I’d wake up at two in the morning and call my treasurer ... because I couldn’t sleep. And he was up.”

That helped a lot, Mr. Poloz said. “They could point to stresses in segments of financial markets. There was kind of a real-time feedback loop.”

As the Bank of Canada, the Finance Department and the Office of the Superintendent of Financial Institutions (which regulates banks, insurers and pension plans) worked feverishly to shore up the markets and the economy, they were also keenly
aware of another factor contributing to the fragility of the system: public confidence, which was in danger of crumbling into all-out fear as the World Health Organization declared a global pandemic on Mar. 11.

The trio of institutions – monetary, fiscal and regulatory – chose to lay out their emergency measures at a joint news conference involving Mr. Poloz, Mr. Morneau, and OSFI head Jeremy Rudin on Mar. 13. It was a display of unity aimed at reassuring the public. For the Bank of Canada, which normally guards its independence from political influence, the shared stage was distinctly unusual; but so, too, was the threat of the novel coronavirus. Only a united front would do.

“I remember Stephen and Jeremy and myself walking for that moment when we were going to get up [at the press conference] and talk about how we were going to deal with the financial issues of the pandemic, and just the momentousness of it,” Mr. Morneau said.

“It was an important moment for us to say to the markets that we were going to act forcefully, that we were going to be co-ordinated … and that people would know that there would be liquidity,” he said. “All of us, we got that we needed to move fast, we needed to move at scale, and we needed to focus on confidence.”

Over the next two weeks, as the Bank of Canada rolled out a wave of actions to address numerous market strains, there remained an elephant in the room. The biggest tool in the bank’s arsenal – outright purchases of government bonds, known as quantitative easing – still stood unused.

The basic idea is that the central bank buys huge amounts of bonds in the open market, which injects money into the financial system, stabilizes the market and brings down bond yields. The U.S. Federal Reserve, the Bank of England and the European Central Bank deployed QE on a massive scale during and after the 2008-09 crisis, but not the Bank of Canada. It would be a major step for a central bank that had never tried QE before.

That time came on Mar. 27, when the bank took its key rate down to 0.25 per cent – what the bank identified as its effective bottom – and announced the $5-billion-a-week bond-buying program.

“That put the complete package on the table,” Mr. Poloz said.

“We wanted to be sizable. So we said, what would be impressive, so the markets would be calmed by it? We picked $5-billion a week – actually, we said ‘at least’ $5-billion per week,” he said.

“Reporters were asking me, ‘What’s the maximum, how big could it be?’ I said, ‘Well, it’s unlimited. … It’s whatever the market needs.’ ”

Once the central bank launched the program, the remaining market strains seemed to dissipate. The price spreads between sellers and buyers returned to closer to
normal, and investor appetite for bonds revived.

There was still some more important work to do to improve credit flows in a couple of key markets – the bank introduced smaller programs to buy provincial and corporate bonds on Apr. 15 – but by then, it was clear that a market crisis had been averted.

“The calm just kept spreading and spreading,” Mr. Poloz said.

“There was a period of about two weeks where [credit] lines were drawn [down], folks wondered whether there was adequacy on capital. That turned out to be a concern that wasn’t very warranted at all. Because it reversed itself so quickly,” Bank of Montreal’s Mr. White said.

STORY CONTINUES BELOW ADVERTISEMENT

An eerie quiet hangs over Baldwin Street in Toronto’s Kensington Market on a Friday evening last March, usually a busy time but now deserted under the COVID-19 restrictions. The first wave of the pandemic had a devastating impact on Canadian business.

MELISSA TAIT / THE GLOBE AND MAIL

Initially, the Bank of Canada avoided calling its federal bond buying program quantitative easing. It was intended to improve the health of the market, rather than provide monetary stimulus by driving down interest rates in the bond market.
(Remember that bond prices and yields are inversely related: If bond purchases in
the market drive up prices, that lowers yields.)

But Mr. Poloz acknowledged that the bank intended the program to morph into QE
once the markets had found solid footing, and that it would remain in place long
after market stability had been assured.

Today, QE remains the bank’s last major program standing from the emergency
phase of the COVID response. Just this past week, the bank announced that it will
allow several programs to expire after a year, including the little-used provincial
and corporate bond plans. The central bank now owns nearly $350-billion of
federal government bonds, accounting for the bulk of its balance sheet, which has
nearly quintupled in size since the pandemic began, to more than $570-billion.

Economists are asking if the pace of continued bond buying is calibrated to the
needs of the economy, and whether the bank’s commitment to maintain rock-
bottom interest rates for years to come is throwing jet fuel on the housing market.

“The narrative that we’ll stay on hold [with a 0.25 per cent Bank of Canada
overnight rate] for years to come and keep buying bonds till the cows come home,
is set back in the environment we were in at a far earlier stage of the pandemic,
when it wasn’t clear there would be treatments or vaccines, and it wasn’t clear
governments would be able to rise to the challenge with big and sustainable fiscal
stimulus,” said Derek Holt, head of capital markets economics at Bank of Nova
Scotia.

Canadian home buyers, meanwhile, are gorging on cheap mortgage debt and
driving real estate prices to new highs. Mr. Macklem noted in February that signs of
“excess exuberance” were emerging in the housing market. Things have become
even more frenzied since then.

“I’m not sure how prudent it is to tell Canadian household borrowers who already
had a very strong proclivity toward heavy amounts of debt, that it’s okay, go ahead
and do the same thing, we won’t raise your cost of borrowing for years to come,”
Mr. Holt said.

The challenge is that monetary policy is a blunt instrument. Raising interest rates would be the
easiest way to cool the housing market, but it
would also hinder the broader economic recovery
and make it harder to return to full employment.

Because the Bank of Canada avoided QE in the
previous financial crisis, Canadians are only now
wading into debates that dominated U.S. and
European economic discourse a decade ago.
Hanging over these debates is the issue of inflation.

There is a common-sense belief that the hundreds of billions of Canadian dollars
that the central bank essentially created to buy government bonds and other
financial assets will debase the currency and fuel inflation – if not hyperinflation.
This idea became widespread in the U.S. after the Federal Reserve embarked on QE
in 2008, and was used to great political effect by the Republican Party.
There is little evidence, however, that QE leads inevitably to high inflation. Central banks in Japan, the U.S., Europe and Britain all struggled to get inflation back up to their 2-per-cent targets despite multiple rounds of QE over the past decade or so.

A key reason for this is that most of the new money created through QE has never actually left central banks. It sits as what the Bank of Canada calls “settlement balances” – electronic funds that commercial banks keep in reserve in their accounts at the central bank. Those funds show the financial system has ample money available if needed, but most of them didn’t get converted into cash in circulation in past QE programs. So far, that appears to be the case in the Bank of Canada’s QE program, too.

If the build-up of reserves encourages more lending, there will be more money in the economy chasing the same number of goods, which could fuel inflation, said Chris Ragan, economics professor and director of the Max Bell School of Public Policy at McGill University. But if commercial banks sit on those reserves – as U.S. and European banks did after the global financial crisis – you’re not going to see the same inflationary pressures.

Demand for credit has come surging back in the housing market, but remains depressed in other areas.

“It’s not inflation blowing up that worries me, as it worried the [U.S.] Tea Partiers in 2010 – people who were accusing Ben Bernanke of debasing the currency and saying it’s going to turn the U.S. into Germany in 1922,” Dr. Ragan said.

“But I think there are some interesting issues here about how [QE] gets pulled back, whether it has to get pulled back, and whether it continues to create problems in terms of house prices, stock prices, other asset prices,” he said.

When it comes to inflation, half the battle is keeping expectations grounded. Since the mid-1990s, the Bank of Canada has been remarkably successful at anchoring household and business inflation expectations around its 2-per-cent target. Still the memory of high inflation in the 1970s and 1980s maintains a strong grip on the popular imagination.

The risk now is that the bank loses control over the inflation narrative in the face of soaring home prices, rising bond yields and fears about money printing.

Credibility is at the heart of monetary policy, and inflation expectations have real-world implications, as households and businesses make decisions based on where they think prices will go, thus reinforcing their own beliefs.

There’s also the question of central bank independence. The central bank certainly helped Ottawa sell a record amount of debt last year, mopping up the issuance and keeping borrowing costs low. But these actions, the bank argues, were stimulus measures falling under its inflation-targeting mandate.

As far as Mr. Morneau is concerned, the bank’s independence was never in question, even as the bank, the Department of Finance and other federal agencies
co-ordinated on the response.

“The reality was that the federal government was in a strong position to be issuing debt, and we knew that that was a strong position; so that wasn’t something that Stephen and I had to discuss. Obviously, our teams were in constant communication about the market and about the market capacity. But we continued to act independently,” Mr. Morneau said.

The real test of independence will come when inflation is trending sustainably above 2 per cent. At that point, the bank’s need to raise rates and slow QE could come in conflict with the federal government’s desire to keep its debt payment costs down.

That test may come sooner than expected. Barring a disastrous third wave of the pandemic, the economic picture looks bright in the second half of the year, as hotels and restaurants reopen and people start spending their pent-up savings. Bond markets are now pricing in interest-rate hikes as early as next year.

In a speech on Tuesday, deputy bank governor Toni Gravelle gave the strongest signal yet that the bank is considering reducing its QE purchases beginning in April, although he repeated that the wind-down will be gradual: “We would be easing our foot off the accelerator, not hitting the brakes.”

The argument for the April “taper” is once again about market functioning – although this time, the bank may be causing the problem rather than fixing it.

It now owns nearly 40 per cent of the federal government’s bonds, and analysts worry that liquidity and pricing problems will emerge if the bank’s stake goes much higher. The more bonds on the central bank’s balance sheet, the fewer available for market participants who buy and sell bonds for a variety of reasons.

Mr. Macklem has said that markets become impaired once central banks own between 50 per cent and 70 per cent of the bond supply. With the federal government expected to issue less debt over the next 12 months, the bank is going to have to adjust its pace of buying so its ownership stake does not hit 50 per cent.

Longer term, the big challenge is getting back to some semblance of normal so the central bank is ready for the next crisis.

“When you explode government debt levels higher, and you use up [central bank] balance sheet room, by definition there’s less there for future crises,” said Warren Lovely, chief rates and public sector strategist with National Bank.

This process of normalization becomes harder with each emergency response, said William White, the former deputy governor. Central bankers have responded to successive crises by cutting rates, encouraging debt to build up and resorting to ever more drastic actions to stimulate the
Mr. White worries that the Bank of Canada – indeed, many central banks that have embedded themselves in ultralow rates and money creation – are taking monetary policy down an increasingly treacherous path.

“It’s totally plausible to think that we’ve got debt deflation in our future. And it’s also totally plausible to me that we could have very high inflation in our future. And maybe there’s a way we can muddle through avoiding it all,” he said.

“The path that we’re on is getting narrower and narrower. And you could fall off on either side.”

EXPLAINER

What is quantitative easing?

QE is a tool central banks use to stimulate the economy when short-term interest rates are at rock bottom – the “effective lower bound” in economist-speak – and cannot be cut further. It involves buying billions of dollars worth of government bonds in an attempt to bring down longer-term interest rates. As with other forms of monetary policy easing, the goal is to make it cheaper to borrow money to encourage economic activity and boost the rate of inflation (the Bank of Canada’s inflation target is 2 per cent)

HOW DOES QE WORK?

Debt throughout the economy is priced relative to “risk-free” federal government bonds. Holding down yields on Government of Canada (GoC) bonds pushes down other bond yields and interest rates too.

The key thing to remember is that bond prices and interest rates are inversely related: As the price of a bond goes up, its yield falls. By buying billions of dollars worth of GoC bonds on the secondary market (where investors trade bonds that have already been issued), the Bank of Canada bids up their price and lowers their yield. The bank uses a reverse auction process, in which it announces how many bonds it’s willing to buy, and bond owners bid to sell bonds to the bank.

HOW DOES THE BANK PAY FOR THESE BONDS?

By creating money – although not literally printing bills. Large commercial banks have accounts with the Bank of Canada, which hold a type of electronic money called a “settlement balance.” These balances are used to settle transactions among banks, similar to “reserves” in the U.S. Federal Reserve System.

When the Bank of Canada buys a bond from a commercial bank as part of QE, it credits the bank’s account with settlement balances. This expands the Bank of Canada’s balance sheet with assets (the bonds) and liabilities (the settlement balances, on which it pays interest). This new electronic money increases Canada’s
monetary base, but it does not necessarily increase the cash in Canadian wallets and bank accounts. To increase the money in circulation, commercial banks need to make additional loans.

HOW BIG IS CANADA’S QE PROGRAM?

Since March, 2020, the Bank of Canada has bought about $243-billion worth of GoC bonds as part of the QE program. That’s more than 35 per cent of all federal government bonds outstanding. The bank now owns around $350-billion worth of GoC bonds, which make up more than 70 per cent of the assets on its balance sheet.

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MARCH 12: TERM REPO PROGRAM
- Status: Ends May 10, 2021
- Amount purchased (to be swapped back): $213-billion
- Purpose: To provide liquidity to banks by temporarily swapping assets for cash

MARCH 13: POLICY RATE CUT
- 50 basis points to 0.75 per cent

MARCH 13: BANKERS’ ACCEPTANCE PURCHASE FACILITY
- Status: Ended Oct. 26, 2020
- Amount purchased: $47-billion
- Purpose: To support short-term funding for companies

MARCH 16: CANADA MORTGAGE PURCHASE PROGRAM
- Status: Ended Oct 26, 2020
- Amount purchased: $8-billion
- Purpose: To encourage mortgage lending

MARCH 19: STANDING TERM LIQUIDITY FACILITY
- Status: Continuing
- Amount purchased: n/a
- Purpose: To provide liquidity to banks

MARCH 20: CONTINGENT TERM REPO FACILITY
- Status: Ends April 6, 2021
- Amount purchased: Not published
- Purpose: To provide emergency funding to banks facing liquidity strains

MARCH 24: PROVINCIAL MONEY MARKET PURCHASE PROGRAM
- Status: Ended Nov 13, 2020
- Amount purchased: $12.4-billion
- Purpose: To support short-term provincial debt markets

MARCH 27: POLICY RATE CUT
- 50 basis points to 0.25 per cent
**MARCH 27: COMMERCIAL PAPER PURCHASE PROGRAM**

- Status: Ends April 2, 2021
- Peak holdings (no transaction data): $2.9-billion
- Purpose: To support short-term funding for companies

**MARCH 27: GOVERNMENT OF CANADA BOND PURCHASE PROGRAM**

- Status: Continuing
- Amount purchased: $243-billion
- Purpose: To support the Government of Canada bond market. Later (as QE) to keep interest rates down

**APRIL 15: PROVINCIAL BOND PURCHASE PROGRAM**

- Status: Ends May 7, 2021
- Amount purchased: $17-billion
- Purpose: To support provincial bond markets

**APRIL 15: CORPORATE BOND PURCHASE PROGRAM**

- Status: Ends May 26, 2021
- Amount purchased: $253-million
- Purpose: To support corporate bond markets

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