Intelligence MEMOS

From: Angelo Melino

To: Governing Council of the Bank of Canada

Date: January 10, 2022

Re: **A New Year's Resolution for the Bank – Slim Down!**

Slimming down is usually a New Year's resolution for individuals. This year, it would also make sense for the Bank of Canada. In addition to lowering its policy rate close to zero in response to the pandemic, the Bank dramatically expanded its balance sheet. Inflation is now well above target, and the policy rate should soon rise. Some critics say the Bank's funding of federal government spending may compromise its independence. It is time for the Bank to shrink its balance sheet.

The Bank's aggressive purchases of assets – designed both to provide liquidity and influence longer-term interest rates beyond what it could do with its policy rate and forward guidance – have made its balance sheet larger, and more complicated. From an initial level of about $120 billion, the Bank's balance sheet has grown by a factor of four. In normal times, the Bank's liabilities are largely the bank notes that it provides to the public and the deposits of the Federal government. During the pandemic, the Bank greatly expanded the deposits of commercial banks and other members of Payments Canada, also called settlement balances, from a few million to $270 billion. In addition to Government of Canada Treasury Bills and bonds, the asset side of the balance sheet now holds term repos (a collateralized loan from the Bank of Canada to financial institutions), corporate bonds, provincial bonds, Canada Mortgage Bonds, and Real Return Bonds (RRBs). Some assets added because of emergency liquidity programs have run off, but others won't do so for years or even decades. None of the RRBs mature before 2026 and some will hang around for another 45 years. Some housekeeping is in order.

The RRBs are a particular problem. In its own words, "The Bank generally does not purchase Government of Canada Real Return Bonds, given the low level of issuance of such bonds and to avoid any perceived conflict with monetary policy." It now holds almost $5 billion of these assets. The Bank shouldn't hold assets that pay off well when inflation turns out to be higher than its target – the source of the "perceived conflict" – it's like a goalie betting against his own team. The Bank has announced that it no longer plans to purchase RRBs. That's good but it should go further. At a time when there is much concern expressed by the public and in financial markets about whether inflation will be brought back under control, the Bank should put its money where its mouth is and sell them.

The largest item on the asset side of the Bank's balance sheet is its holdings of regular Government of Canada bonds. Since the start of the pandemic, the Bank has reduced its holdings of Treasury Bills by about $20 billion but increased its holdings of Government of Canada bonds to almost $350 billion. The Bank has stopped increasing its stock of Government of Canada bonds and shut down its quantitative easing program. But it has announced that it will reinvest any maturing Government of Canada bonds at least until it decides to raise its policy rate above 25 basis points. Why? Bay Street economists and the Bank itself estimate, albeit with a wide margin of error, that the quantitative easing program reduced the average yield on these bonds by only 10 basis points. Reducing its holdings of Government of Canada bonds should not put much upward pressure on interest rates. It will, however, defuse criticisms that the Bank has been an ATM machine for the federal government.

Critically, shrinking its balance sheet will mitigate the excessive growth in the aggregate supply of money since March 2020 that some blame for the current spike in inflation and will reduce the risk that this excessive money growth will drive future inflation. Although the Bank's policy rate is 0.25 percent, the actual overnight lending rate has been between 0.05 to 0.20 percentage points below that for months. The extra liquidity created by quantitative easing is no longer needed – indeed, it has become a problem. Reducing the asset side of the balance sheet will reduce the liability side and lower settlement balances. Engaging in reverse repos (a collateralized loan from a financial institution to the Bank of Canada) is an additional tool to lower settlement balances and should be used aggressively as well.

Inflation is too high, and the Bank needs to move to rein it in. Raising the policy rate will be a gradual process as the Bank balances the need for tighter monetary policy with concerns about economic growth and financial stability. Reducing the size of its balance sheet is something the Bank can get started on right away. For 2022, the Bank's resolution should be to slim down.

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