Intelligence MEMOS

From: Mark Zelmer and Jeremy M. Kronick

To: Bank of Canada Governing Council

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Re: **Let's Not Roll Out QT on the QT**

As the Bank of Canada prepares to begin raising interest rates to get inflation back to target, there is also the issue of how quickly it should reduce the size of its balance sheet.

No matter where the Bank lands on the speed of balance sheet reduction, it will be critical to lay out a path with principles and rules. Transparency in both interest rate settings and balance sheet management is key to keeping inflation expectations anchored.

The Bank's total assets ballooned from about $120 billion at the start of the pandemic to more than $575 billion in early 2021, as the Bank intervened, first to help ensure financial markets could continue to function, and then to facilitate easier monetary conditions and support the economy after interest rates approached zero across the maturity spectrum.

This unprecedented expansion helped everyone, from households, to businesses, to governments at all levels.

After reducing the overnight interest rate as low as it could go, the Bank turned – for the first time – to quantitative easing (QE), the purchase of Government of Canada bonds and treasury bills, paid for with increases in settlement balances, which are deposits that financial institutions hold at the central bank.

With inflation now well above not only its target (2 percent) but also above the upper end of the band (3 percent), the Bank needs to begin the task of tightening monetary policy to rein in inflation, while doing so in a way that minimizes economic harm.

The Bank has two options for tightening monetary policy: first, the more traditional increasing of the overnight rate; and second, reversing the QE operations by shrinking its balance sheet – quantitative tightening, or QT.

Interest rate hikes are likely to have more potency, given the large debts carried by Canada's households and businesses.

Nonetheless, it is important that the Bank demonstrate that it is using all its tools to bring inflation back within the 1- to 3-percent target range that was reaffirmed two weeks ago.

This means that the Bank's investment portfolio needs to shrink over time so that it returns to its steady state of broadly matching the amount of bank notes in circulation (paper and possibly digital in the future) and the normal demand for settlement balances in the financial system.

At a minimum, it is important that the size of the Bank's holdings of government debt not be interpreted as a sign that the government's debt load is becoming unsustainable. This means the Bank should plan on reducing its balance sheet at the same pace as major central banks, especially the Federal Reserve. Simply allowing its holdings of government securities to roll off the balance sheet as they mature may not be sufficient in this respect.

Moreover, the Bank should not be shy about moving faster than other central banks should there be indications in the market that Government of Canada bonds and treasury bills, individually or collectively, are in short supply relative to demand.

Whatever pace the Bank settles on, we recommend that it issue an official statement in the near future setting out the principles that will guide the shrinking of its balance sheet.

Such a statement would be very helpful in conditioning the market and the public as to what to expect. It might also help reduce the risk of a "taper tantrum" in financial markets such as the Federal Reserve experienced in 2013 when it first tried to reduce its balance sheet after the global financial crisis.

Monetary tightening is coming. While the overnight rate will do most of the heavy lifting to bring inflation back on target, the balance sheet needs to be a part of the plan. A plan the Bank should share as soon as possible.

Mark Zelmer is former Deputy Superintendent at the Office of the Superintendent of Financial Institutions and a Senior Fellow at the C.D. Howe Institute, where Jeremy M. Kronick is Associate Director, Research.

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