Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Canadians Worried About Inflation

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Re: **YOU CANNOT FIGHT INFLATION ON THE DOWNLOW**

With inflation on the rise, the Bank of Canada kicked its tightening cycle into high gear with a 50-basis-point increase in the target for its overnight rate – the first non-25-point hike in more than 20 years. It also modified its stance concerning its over-sized holdings of Government of Canada bonds, which swelled its balance sheet during so-called Quantitative Easing (QE). Those days are over: it will now initiate Quantitative Tightening, or QT, by not replacing bonds on its balance sheet as they mature, thus reducing its bond holdings over time.

Some might be disappointed the Bank didn't go further on QT by announcing it would actually start selling its holdings of government bonds. Not to worry. Shrinking the balance sheet is the right signal to send the market but it's the overnight rate that will have to do the heavy lifting to bring inflation back to target.

The 50-basis-point hike shows the Bank understands it has fallen behind the curve in terms of fighting inflation and is now playing catch-up. Headline inflation reached 5.7 percent in February and has been above its 2 percent target for each of the last 12 months and outside its 1-to-3-percent target range for each of the last 11. The Bank's measures of core inflation have also edged up over the same period: all three are above the 2-percent target, while two are above the target range.

The Bank now acknowledges that headline inflation is likely to average six per cent in the first half of 2022, though it expects it will decline to 2.5 percent in the second half of 2023, not returning to the 2-percent target until 2024. Its rate announcement also acknowledged that inflation expectations are becoming less well anchored, citing "an increasing risk that expectations of elevated inflation could become entrenched."

With that backdrop, the Bank needs to show Canadians it is using all the tools at its disposal to get inflation under control. Enter QT.

QT is the counterpart of quantitative easing (QE): buying up longer-term Government of Canada bonds to push up their prices, thus driving down their interest rates. The Bank used QE during the pandemic first to shore up financial markets and then to provide economic stimulus by keeping longer-term interest rates low.

The Bank now says QT "will complement increases in the policy rate."

Complement, yes, but how much will it really help the Bank fight inflation?

With all the usual caveats, the Bank's own research concluded that QE had only minimal impact on interest rates, which is consistent with what we saw after the financial crisis in countries like the US and Britain that implemented QE. Though the Federal Reserve Board and Bank of England engineered huge increases in their respective balance sheets, the resulting effect on interest rates, inflation rates and the two countries' real economies was not great. This time around we obviously have more inflation than we desire, but research suggests it's at best unclear whether QE has played much of a role in generating it. Which means QT is unlikely to be the inflation-killer we all would like to see.

The small effects from QE and QT, notwithstanding the gigantic amounts of money involved – literally hundreds of billions of dollars – is a result of how they affect the balance sheets of federally regulated financial institutions, primarily the big six banks.

When the Bank of Canada buys a federal government bond from a financial institution, its balance sheet increases: it gets an asset (the bond) and pays for it with a deposit into the account of the financial institution. But the financial institution's balance sheet size stays the same: it merely trades one type of high-quality, riskless financial asset (the bond) for another equally high-quality asset (the Bank of Canada's deposit). The two types of assets are highly substitutable. Exchanging one for the other on its balance sheet will have very little impact on the number of loans the financial institution extends or the amount of deposits it creates for borrowers.

What really matters is how much QE lowers interest rates and therefore increases loan demand. And, as mentioned, the research suggests its impact has been far from earth-shattering. Since QT is simply the reverse of QE, don't expect it to tame inflation.

To get inflation under control, the Bank of Canada will have to make heavy use of the overnight rate. It began doing so in March and it kicked things up a couple notches this month. More is to come.

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