Intelligence MEMOS

From: Trevor Tombe and Yu (Sonja) Chen

To: Bank of Canada Governing Council

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Re: **BoC losses are just getting started. What to Do?**

While the full effects of the Bank of Canada's rate hikes are not yet known, there is an immediate effect on the central bank's own finances: growing interest expenses and large financial losses. The Bank's recently released third-quarter financial results showed that for the first time, it incurred a net loss: $511 million. This is only the beginning.

This matters, especially at a time of heightened political attention toward monetary-policy issues.

The Bank's revenue is largely derived from its asset holdings, which mainly included Government of Canada bonds and treasury bills. Pre-pandemic, these bond holdings cost the Bank very little, and their returns normally exceeded expenses by a wide margin.

The pandemic changed this picture dramatically.

During the significant disruptions early in 2020, the central bank lowered its target interest rate to 0.25 percent and began large-scale asset purchases – broadly dubbed quantitative easing – to lower longer-term interest rates. There were many specific programs, but the largest – the Government of Canada Bond Purchase Program – came within weeks of the world's March, 2020, lockdown. At its peak, this and other purchase programs increased the Bank's balance sheet by well over $400 billion. Not since the Second World War has it expanded its holdings so much so quickly.

These bonds were largely purchased from financial institutions, who overwhelmingly held them as deposits – settlement balances is the term of art – at the Bank of Canada. And since those deposits earn interest, the rapid increases through this year increased the Bank's interest expenses.

We capture several plausible scenarios for future changes in Bank of Canada revenue and expenses in our new C.D. Howe Institute paper, and find cumulative losses from 2022-23 to 2024-25 may range from $3.6 billion to $8.8 billion, depending on the scenario.

Should Canadians be concerned?

To be sure, the Bank of Canada is a Crown corporation fully consolidated within the government's books. Rising interest rates naturally increase government debt-service costs; and the Bank's interest expenses are just that.

Similarly, on the one hand, financial losses do not impede the bank's ability to conduct monetary policy. It can, after all, create settlement balances on demand to purchase assets, and can adjust its policy rate at any time.

However, financial losses do create a novel communications and reputational challenge for the Bank. We are already seeing some political leaders raise concerns.

And confidence in a country's central bank affects its ability to conduct monetary policy and achieve low and stable inflation. If confidence is high, then individuals and businesses may be more likely to anchor their inflation expectations to the bank's target, which makes it easier to achieve.

Clear communication will not be easy and can be helped with clear accounting.

There are several approaches.

It could accumulate losses in a negative retained earnings account, which it is currently doing. But future amendments to the *Bank of Canada Act* may be necessary to unwind that appropriately.

Alternatively, it could carry negative balances in its reserve account, which would be replenished with future surpluses without the need for an amendment to the Act. These options would result in central-bank equity turning negative, however, leading some to (wrongly) conclude the Bank is insolvent.

To avoid this, another approach follows the practice of the US Federal Reserve system, which is accumulating losses in a deferred account, and must be paid back before any future surpluses are remitted to the government. This allows the central bank to avoid negative equity. It also makes crystal clear that current losses are offset by future surpluses.

Whatever the eventual details, a better understanding of central-bank finances in Canada among political leaders, policymakers and the public is necessary.

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