Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Monetary Policy Watchers

Date: April 15, 2020

Re: **WHY CANADIAN QUANTITATIVE EASING NEEDS TRANSPARENCY**

For the first time in its history, with the overnight rate hitting its effective lower bound of 0.25 percent, the Bank of Canada has embarked on the path of quantitative easing (QE).

This involves the outright purchase of financial assets by the bank, pushing down their yields. QE was famously used by the Federal Reserve Bank and other central banks during the financial crisis, although the Bank of Canada avoided having to use it.

This time, however, with less room to drop the overnight rate, the Bank was forced to turn quickly to unconventional monetary policy. Transparency about which assets will be purchased and about the Bank's strategy for inflation control will be imperative for the success of this operation.

In its announcement on March 27, the Bank said it would begin acquiring Government of Canada securities at all maturities, and will also acquire short-term provincial debt and commercial paper. In a follow-up announcement on March 31, it announced that the Commercial Paper Purchase Program (CPPP) would launch on April 2. The result of these purchases will be an expansion of the Bank's balance sheet, beyond normal operations that move the overnight rate up and down.

What are the implications for the Bank's balance sheet and for inflation?

Let's start with the details of the commercial plan. If the Bank makes outright purchases of commercial paper (short-term debt issues) only from banks and other institutions who hold settlement balances (accounts) at the Bank, this would be consistent with the Bank's traditional role as a lender of last resort to financial institutions.

The Bank's announcement notes that the CPPP "will be structured as a direct purchase program into a separate account held by the Bank of Canada ... managed by TD Asset Management Inc." It is unclear to us whether the Bank of Canada is the one assuming the credit risk. This should be made clear, since if the Bank is purchasing paper from non-government and non-financial institutions, it is involving itself in choices about credit allocation. And, while it appears the commercial paper buys will be short-term (maximum three months) and with a high credit rating, assuming credit risk is not normally in the Bank's purview. Such decisions are normally left to financial institutions and either the Minister of Finance or Parliament. They blur the distinction between monetary policy and credit/fiscal policy. When the government makes these decisions it is directly answerable to voters. If undertaken systematically on a large scale it could lead to questions about the Bank's accountability and potentially undermine its independence.

We think the Bank should be as explicit as possible about the counterparties to these transactions and the criteria for determining which assets it will and has purchased. Specific ground rules should be communicated through an explicit agreement with the Government of Canada.

QE will also have important monetary consequences that are still not completely clear. What is clear is that either the monetary base and/or broader monetary aggregates will be increasing in dramatic fashion. With a minimum of $5 billion per week of purchases of Government of Canada securities, the Bank's balance sheet would double within about 6 months.

In the very short run, the decrease in spending on goods and services will likely put downward pressure on inflation. However, because the supply of many goods and services has been severely constricted, this may not be dramatic.

When the economy finally does recover, the ballooning of monetary aggregates will eventually become inflationary as more money encourages more spending. The pressure on inflation will depend on how quickly supply can respond to pent- up demand. The response of supply, in turn, will depend on whether supply chains can remain intact, which depends in part on how other countries are dealing with the effects of COVID-19.

We would advise the Bank to plan for (and announce) how any excess monetary balances will be absorbed. The greatest possible clarity in communication by the Bank will be necessary so that a temporary spike in inflation does not lead to a destabilization of inflation expectations.

These are unprecedented times. Transparency will be key.

Steve Ambler is the David Dodge Chair in Monetary Policy at the C.D. Howe Institute and a professor of economics at the École des sciences de la gestion, Université du Québec à Montréal. Jeremy M. Kronick is associate director, research, at the C.D. Howe Institute.

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