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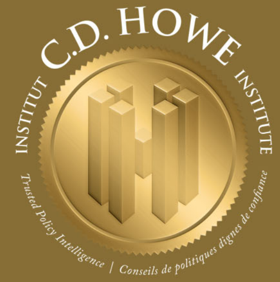

From: Steve Ambler, Jeremy M. Kronick and William B.P. Robson

To: Bank of Canada Watchers

Date: May 4, 2021

Re: **THE BANK OF CANADA'S GOVERNMENT BOND PURCHASES: THE CASE FOR LESS**

The Bank of Canada is lowering its purchases of federal government debt from at least $4 billion a week to $3 billion a week.

It has presented this change as a response to positive economic news that, it noted in its latest update, could also lead to an increase in its target for the overnight rate of interest in the second half of 2022, earlier than previously discussed.

With the Bank projecting economic growth of 6.5 percent for 2021 and inflation above target at the end of the projection period, the question has to be asked: why is it still buying any of the government's debt?

When the Bank started buying bonds as part of its quantitative easing (QE) program last year, financial stability was the concern as markets seized up. The Bank came in as lender of last resort, buying massive amounts of assets, including federal government debt, provincial debt, and private securities. But markets are orderly again, and the Bank has suspended its buying programs for everything other than federal government debt. The focus of QE, with the overnight rate still at its effective minimum of 0.25 percent, is now hitting the inflation target.

The way QE works is that the Bank buys Government of Canada debt held by the big financial institutions that participate in the payments system and pays for it with credits to the settlement balances – in effect, the bank accounts – these institutions hold at the Bank of Canada. On the Bank of Canada's balance sheet, Government of Canada debt is an asset, while settlement balances are liabilities. On their side, payments system members exchange one quality asset (Government of Canada debt) on their balance sheets for another quality asset (settlement balances at the Bank of Canada).

It is entirely normal for the Bank to hold government debt as an asset and have settlement balances as a liability. What is new with QE is the scale. In the week of March 11, 2020, before this all happened, settlement balances on the Bank's balance sheet amounted to $250 million (with an "m"). Fast-forward to the week of April 14, 2021, and the same balance sheet entry was $312 billion (with a "b").

This expansion is unprecedented in Canada. The Bank of Canada did not use QE in the 2008-09 financial crisis. The US Federal Reserve did – and many feared inflation as a result. Those fears were not realized, because US banks that sold government debt to the Fed chose not to use the resulting increases in their balances with the Fed to increase their lending. If they had, that would have triggered expansion of private-sector credit and money – which in fact the Fed probably would have liked, since the crisis had hammered both consumer and investment demand. But, as it turned out, simply exchanging high-quality debt for dollar reserves did not alter bank decision-making regarding lending. So the Fed's QE did not, on its own, increase ordinary banks' desire to lend.

That's the supply side of the credit market. What about the demand side? Borrowers typically want to borrow more when loans are cheaper. And that's where QE comes in. When the Bank of Canada buys Government of Canada debt, yields fall: when there are more bidders for its debt the government can get away with paying less interest on each loan. That downward pressure on the interest rate the government pays makes its way through to other lending rates, and that general reduction in rates causes an increase in loan demand. So QE is much more about increasing the demand for loans through lowering yields than it is about the expansion of a central bank's balance sheet.

Since the Bank plans to buy $3 billion a week of Government of Canada debt, it must feel that keeping yields low is still necessary to stimulate borrowing so it can sustainably achieve its 2-percent inflation target in the medium run.

But is it really necessary? Unlike in 2008-09, Canadians' savings have burgeoned. Bank deposits are way up. Money is already available to spend. Further juicing of credit demand seems unnecessary.

In its decision last month, the Bank presumably did not want to shock financial markets by cutting purchases more than they were expecting, and the cut to $3 billion seemed to be the consensus forecast. Looking ahead, however, further reductions – and, before long, a cessation of the program entirely – will be in order.

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