Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Bank of Canada Watchers

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Re: **Choreography for the Bank of Canada's Delicate Dance**

The Bank of Canada recently announced an end to two short-term lending programs it introduced at the start of the pandemic. Their winding down is welcome news: it means the Bank has been successful in stabilizing financial markets.

Now comes the tricky part: encouraging economic expansion, which traditionally is inflationary, even while reassuring buyers of Canadian government bonds that it will not enable those same governments to inflate away the debts they are incurring.

Key to such a strategy is recommitting, alongside the federal government, to the two percent inflation target, even as short-term tactics may require temporary overshooting. Sticking with a target you may permit yourself to miss temporarily conveys a mixed message, meaning the Bank will need to prepare the ground carefully to preserve the credibility it has built over three decades of inflation-targeting.

Though the Bank is ending the two short-term measures, it is continuing its large-scale purchases of government bonds, both federal and provincial. Its focus here is on the stimulus needed for the recovery and getting inflation back up to its two percent target within the Bank's planning horizon of six to eight quarters. With its overnight interest rate target at 25 basis points, which is about as low as it can go, the main policy tool is now quantitative easing (QE) – the active management of its balance sheet for monetary policy purposes. Or, as the Bank put it in September, its continuing purchases of Canada bonds would be "calibrated to provide the monetary stimulus needed to support the recovery and achieve the inflation objective."

How will that play out? The economy is currently operating well below potential, which means inflation is likely to remain muted for some time to come. So there is room for the Bank to be expansionary – especially since the inflation average for the pre-COVID decade was only 1.7 percent, well under the official two percent target.

As we argued in a **recent** C.D. Howe Institute paper, one problem with QE is that when the Bank buys bonds from financial institutions, nothing guarantees they will actually lend out the cash they get in return. If they don't, no new money is created, and no new economic activity occurs. To get around this problem, the Bank could instead buy government bonds directly from people and businesses who own them. If those selling the bonds wish to maintain a stable ratio of liquid (think cash) to illiquid assets (think a car), they will spend a portion of the cash they receive, thus boosting economic activity and inflation. So far, however, the Bank has not announced any plans for direct purchases of this sort.

It is also fair to wonder whether QE will provide the necessary stimulus when interest rates, both long-term and short-term, are already very low. When nominal interest rates have little room to fall, the only way to lower real interest rates (in order to encourage borrowing and spending) is to increase inflation expectations. To that end, the Bank might consider announcing plans to temporarily overshoot the two percent target. This temporary overshoot, compensating for low inflation during the pandemic, would boost spending by boosting inflation expectations.

To convince the public this overshoot would be truly temporary, however, the Bank would have to begin dealing with its inflated balance sheet, which currently stands at $531 billion, more than four times its pre-crisis level.

Meanwhile, political pressure continues on the Bank to keep interest rates low given Canada's debt loads, both public and private.

This makes the 2021 inflation-control renewal even more important. The federal government and the Bank need to recommit to the two percent inflation target so that investors, both domestic and foreign, know the debt they hold will not be inflated away.

This would also be particularly important if there is a need for a temporary inflation overshoot. Investors need certainty that the Bank will act firmly if inflation seems to be getting out of hand.

The Bank ending its liquidity support programs is good news and should be treated as such. But the difficult work of getting inflation back to target still remains.

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