Intelligence MEMOS

From: Paul Jenkins

To: Bank of Canada Watchers

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Re: **The Bank's Balance Sheet: A Perspective**

Bank of Canada watchers, rightly, have been giving considerable attention to the unprecedented expansion of its balance sheet, which has increased since mid-March by approximately $410 billion to $530 billion – a nearly 4.5 fold increase equivalent to 30 percent of GDP.

This increase in asset purchases can usefully be divided between those providing liquidity support and those representing monetary policy action. Doing so gives us insight in understanding the potential consequences of such an expansion.

On the monetary policy front, we are in a world where unconventional monetary policy has become the conventional, shaped largely by the Bank's overnight policy rate at the Effective Lower Bound (ELB), where, at 0.25 percent, it has sat since the end of March.

When they are constrained at the ELB, central banks rely primarily on the use of forward guidance (conditional statements about the future path of policy rates), quantitative easing (the outright purchase of government bonds through creation of excess settlement balances – reserves held by financial institutions at the central bank), and credit easing (the purchase of assets in certain credit markets, such as mortgage-backed securities or bonds). Typically, quantitative and credit easing get lumped together as Large Scale Asset Purchases.

These monetary policy instruments stand in sharp contrast to the array of initiatives introduced starting in mid-March to provide liquidity support for funding markets in government, corporate and household obligations and for individual financial institutions.

These are temporary, stop-gap measures designed to improve the functioning of the financial system in times of stress.

One simple way to distinguish between these initiatives and unconventional monetary policies is that the former is designed to impact yield spreads (i.e., the difference in interest rates between one asset, say provincial bonds, and benchmark federal government securities), while for the latter the impact is on yields themselves (i.e., the yield curve of government securities) and on asset valuations (i.e., equity values).

Using this distinction, the Bank's current liquidity support can be defined to consist of: repos at $155 billion, provincial money market instruments at $6 billion, and Government of Canada Treasury Bills at $84 billion, for a total $245 billion, or roughly 46 percent of the Bank's balance sheet.

In terms of monetary policy, the balance sheet would consist of: Government of Canada bonds at $259 billion, provincial bonds at $11 billion, Canada mortgage bonds at $10 billion, and corporate bonds at $.2 billion, for a total of $280 billion, or 53 percent of its balance sheet.

Based on the narrowing of spreads back down to more normal levels and the decline in yield curves, the conclusion would be that the Bank has been successful in its two policy objectives.

Clearly, though, what other major central banks, especially the Federal Reserve, have done in the way of balance sheet growth has also been an important factor in these asset price movements and in shaping market expectations.

Still, given the unprecedented expansion of the Bank's balance sheet, important issues and concerns have been voiced. Let me touch on three, and my view on how much of a concern they represent:

- Balance sheet credit risk exposure: This risk is greatly mitigated by: (i) the federal government's indemnification against market losses on the sale of federal, provincial and corporate bonds; (ii) collateral against repos and (iii) what is now primarily a (riskless) Government of Canada bond portfolio.
- Political interference/independence: This is a concern voiced from at least two perspectives: (i) pressure on the Bank to continue portfolio purchases of provincial obligations whenever there is stress in these markets for whatever reason; and (ii) pressure to fund federal deficit spending. The small size of non-Government of Canada asset purchases, together with the indemnifications provided by the federal government to preserve the Bank's capital, and thus the integrity of its balance sheet, guard against this concern. The independence of the Bank, however, remains an issue related to calls for the Bank, as part of its 2021 policy renewal, to pursue objectives outside of what it can control and be held accountable.
- Debt levels: This is a serious concern, and one the Bank has repeatedly stressed. With the likelihood that policy rates will remain close to the ELB for some time yet, the time has perhaps come for a formal framework for macroprudential policy in Canada to manage debt vulnerabilities and other systemic risks to our **financial system**.

In summary, to understand the consequences of the unprecedented expansion of the Bank of Canada's balance sheet, it is instructive to distinguish between liquidity support and monetary policy actions. Based on this distinction and the provisions to guard the integrity of its balance sheet, it is reasonable to conclude that the Bank is fully in control of its balance sheet.

Going forward its evolution should be guided by the Bank's remit: supporting the functioning of financial markets and institutions; and providing the appropriate monetary stimulus to achieve its inflation objective. A formal macroprudential policy framework would be a useful further supporting step in this regard.

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