

From: Jeremy M. Kronick and Mark Zelmer

To: Incoming Bank of Canada Governor Tiff Macklem

Date: May 6, 2020

Re: **CAN THE BANK OF CANADA KEEP INFLATION ON TARGET WHEN THE ECONOMY RECOVERS?**

Congratulations on being appointed the next Governor of the Bank of Canada. The job is as important as ever.

The Bank of Canada's balance sheet more than tripled in size between March 11 and April 29, and is likely to continue growing.

While necessary, given the jump in financial system liquidity requirements, this massive expansion raises two questions. First, does it affect the ability of the Bank to conduct monetary policy to achieve its inflation target? The answer is probably not. And, second, when the time comes time to shrink the Bank's balance sheet again, what constraint will Canada's public and private debt overhang pose? The answer to that is less clear.

First, the expansion. On March 11, the Bank's balance sheet was a little over \$120 billion. By April 29, it was a little over \$384 billion. In normal times, the bulk of the Bank's assets are Government of Canada securities. Lately, however, the Bank has not only increased the size of its typical purchases, it has extended the term of its loans to financial institutions, broadened the type of assets it accepts as collateral, and expanded the types of assets it purchases outright. It has done this to meet the needs of the financial system's demand for liquidity to ensure markets and the banking system function as normal, and to provide easier monetary conditions when interest rates are at or near their lower bound.

Of the almost \$265 billion of assets acquired so far, around \$165 billion have been resale agreements (repos) where financial institutions agree to buy back the assets sold to the Bank after an agreed upon period of time. Of the counterpart increase in liabilities, around \$210 billion of the \$265 billion increase is excess reserves (settlement balances) held by financial institutions at the Bank of Canada. This high-power money, currency in circulation plus reserves of financial institutions at the central bank, has the potential to support credit and spending – but with so much of the economy locked down, it so far has not. For now, then, we need have no worries about inflation.

As the economy opens up, the Bank can simply let the repos run down and exchange the purchased debt for settlement balances as it matures. If timed right, its balance sheet will shrink before the additional liquidity creates inflationary pressure.

Where it might be more complicated is with respect to the other assets the Bank has begun purchasing, specifically longer-term provincial bonds and private sector debt. While the purchase amounts so far remain low, their maturities could be more difficult to time with the economic recovery. Those investments are also fraught with credit and political risk.

One way forward would be for the Bank to exchange these assets, once purchased, with Government of Canada debt more consistent with its normal operations. The government could create a new account in the Public Accounts of Canada to hold these provincial government and private-sector securities. The federal government can hold those securities until they mature if necessary and manage the risks in the interim through its own operations, making it easier for the Bank to manage its own balance sheet, and achieve its inflation target.

The good news about shrinking the balance sheet is that when it happens, the economy will be in a recovery phase. As this occurs, however, if inflation requires tightening the stance of monetary policy beyond a shrinking of the balance sheet, how easy will it be for the Bank to increase the overnight rate? Both the private (households and businesses) and public sectors (governments) will be highly levered in the wake of the pandemic. A more heavily indebted country makes any monetary policy action more potent. Calibrating monetary policy actions will be more challenging in the future.

This puts even more pressure on the Bank of Canada to ensure it gets the timing of the shrinking of its balance sheet right, and to communicate the reasoning transparently with the public, so expectations are in place before the need arises to raise the overnight rate. A not so easy challenge for you as the incoming Governor.

Jeremy M. Kronick is Associate Director, Research at the C.D. Howe Institute and Mark Zelmer is former Deputy Superintendent at the Office of the Superintendent of Financial Institutions and a Senior Fellow at the C.D. Howe Institute.

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