

# Intelligence MEMOS



From: Michael Smart

To: Bank of Canada Governing Council

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Re: **ENSURING THE INDEPENDENCE OF THE BANK OF CANADA REMAINS INTACT**

With its recent decision to extend quantitative easing policies to provincial debt, the Bank of Canada is setting off into uncharted waters.

In recent weeks, the Bank has announced new large-scale asset purchase programs permitting it to purchase up to 40 percent of new short-term paper issued by provincial governments, and up to \$50 billion in long-term provincial bonds through secondary markets.

While these interventions make good sense in the short term, they are unprecedented. The Bank's policies deserve a careful look in the coming months by Parliament and all Canadians.

Without a doubt, governments are facing extraordinary pressures in the current crisis, and a massive increase in borrowing is inevitable. These pressures are especially strong at the provincial level – where increasing health sector expenditures combine with declining tax receipts in a fiscal double-whammy – and for municipalities, which face statutory restrictions on borrowing.

Fortunately, the conditions are right for government borrowing. Short- and long-term interest rates are at historic lows. With the decline in business activity, the risk of crowding out private sector investment is small in the near term. Governments can – and must – borrow heavily to see us through this crisis.

And the Bank has a key role to play. Its asset purchases help ensure market liquidity and support the economy at a time when conventional monetary policies cannot. It is an essential move right now. As well, the Bank's decision to include provincial bonds in the plan evidently reflects real concerns about the financial health of governments and liquidity in their bond markets.

But there are caveats.

First, the Bank should make clearer the case for including provinces in its purchases. It is true that provincial bond spreads have recently widened, but this reflects the sharp reduction in Canada yields, not necessarily an increase in provincial borrowing costs. It is also true that spreads have fallen since the program was announced. But in the volatile markets of the last few weeks, it is impossible to know how spreads would have evolved if the new bond purchase program had not been announced.

Second, the move could undermine the Bank's independence from government, and bring it dangerously close to engaging in fiscal policy.

By taking this step, the Bank may end up holding a large proportion of the new debt issued by provinces in the coming months in response to the crisis. In effect, the Bank will be financing much of the provinces' fiscal response to the pandemic through an expansion of its balance sheet. This will mark its first direct intervention into provincial finances since the late 1930s, when the federal government extended loans to western provinces on the advice of the Bank.

Bailouts of subnational debt can be problematic if they lead to moral hazard among debtor governments, or to unintended transfers among regions of the country. Canada has long avoided the subnational bailout problems that have bedevilled other fiscal and monetary unions such as Argentina, Germany, and the Eurozone countries.

That reflects our sound fiscal arrangements that give provinces sufficient own-source revenues to finance operations most of the time, and rules-based federal transfer programs that step in automatically in response to fiscal shocks. All this has kept provincial balance sheets sound, and allowed the central bank to remain aloof on the sidelines with respect to sub-national governments in past crises.

Clearly, this time is different, and Canada does not have its own Greece to contend with. Not yet anyway. So naturally the concerns about bond purchases and moral hazard are not as strong in Canada today as they are in the Eurozone. But the Bank should be conscious of the precedent, and cautious in how the provincial bond program is operated.

Third, there is a need for transparency. Details of the bond purchase program [announced today](#) need to be closely scrutinized. How will it operate? Will some provinces' bonds be disproportionately targeted, or will purchases be allocated in equal per capita terms across all provinces? Under what conditions in the future would the Bank consider expanding the program, or winding up its positions? Meanwhile, the Bank has announced that it will draw on advice from BlackRock Financial, which is one of the largest players in government debt markets globally. The potential for self-dealing here is real.

The government is accountable for its fiscal policy choices through its institutions for transparency, and through the normal course of parliamentary scrutiny of budgets. This program, though operated through the central bank, deserves the same level of transparency. It is up to Parliament and Governor Steven Poloz to provide it.

*Michael Smart is a professor at the University of Toronto and co-editor of the *Finances of the Nation* project.*

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