

Intelligence MEMOS



From: Mark Zelmer

To: Governing Council and Minister Morneau

Date: April 27, 2020

Re: **FACILITATING AN EXIT STRATEGY FOR BANK OF CANADA MARKET INTERVENTIONS**

The Bank of Canada balance sheet has ballooned by more than \$200 billion over the past six weeks.

This has been accompanied by an unprecedented expansion in the range of assets held by the Bank as it began purchasing short- and longer-term provincial government securities and private sector debt to provide liquidity. The Bank financed these transactions by crediting the settlement balances held by financial institutions with the Bank with additional Canadian dollars; thereby expanding base money in Canada accordingly.

When the pandemic subsidies and economic activity recovers, the Bank will need to shrink its balance sheet, and hence the amount of base money outstanding, to keep inflation on target.

Expanding the Bank's investment portfolio beyond its traditional holdings of Government of Canada securities exposes the Bank to new credit and political risks. It may also make it more difficult to shrink its balance sheet on a timely basis as most provincial government and private-sector securities tend to be less actively traded than Ottawa's issues.

One way to manage those risks would be for the federal government to create a new account in the Public Accounts of Canada to hold the provincial government and private-sector securities acquired by the Bank, thereby removing the securities from the Bank's balance sheet. In exchange, the government would issue new Government of Canada securities to the Bank, which would now be held on its balance sheet. The net debt of the federal government would not change because the additional debt issued by the government would be offset by the new assets acquired.

This would help separate the conduct of monetary policy from operations in support of financial markets.

Or, to put it another way, separate transactions conducted for quantitative easing purposes – normally within the realm of monetary policy – from credit easing transactions, which are more in the realm of financial stability. Government of Canada securities are the lowest risk and most liquid instruments in Canadian dollar markets. As such, they are the easiest for the Bank to sell when it eventually needs to shrink its balance sheet. Moreover, holding those instruments insulates the Bank from any credit risk or political issues that may arise if it were perceived to be involved in credit allocation decisions for other levels of government or the private sector. And from an operational perspective, Government of Canada securities are the easiest instruments for the Bank to manage on its own given its past experience in operating in that debt market.

Of course, the issues and risks associated with holding provincial government and private sector securities still remain. But they are ultimately issues and risks that are borne by the federal government in any event and for which it is better placed to manage. That said, the Bank is well placed to continue to provide advice to the government as to which markets might need support and to oversee the execution of that support on the government's behalf.

Indeed, this is very much in the spirit of how the Bank currently operates with respect to the management of Canada's foreign reserves and exchange rate where the Bank serves as the federal government's fiscal agent when it buys and sells foreign currency and borrows and invests on Ottawa's behalf using the federal government's Exchange Fund Account, which is also part of the Public Accounts of Canada rather than an account on the Bank's balance sheet.

The pandemic-driven need to quickly provide liquidity support to the broader marketplace was perfectly understandable. The Bank was able to promptly provide that support using its own balance sheet. It was a quick way of launching operations for the affected markets.

But now that those operations are underway, it would be a good idea to consider how best to organize them and help facilitate a future exit strategy from this unprecedented balance sheet expansion, and preserve the independent conduct of monetary policy that has served Canada well for many years.

Creating a new government account to hold the provincial government and private-sector securities acquired by the Bank should do the trick. The federal government can hold those securities until they mature if necessary and manage the risks in the interim through its own operations, while the management of the Bank's balance sheet can return its focus to achieving the inflation target.

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