Crisis Working Group Report

COMMUNIQUÉ

April 23, 2020

COVID-19 Crisis Working Group: Monetary and Financial Measures

Communique #4: Expanded Bank of Canada Balance Sheet Requires Balancing Act

The C.D. Howe Institute has initiated a special project to provide rapid expert insights to help Canadians and Canadian policymakers navigate the COVID-19 crisis. Its Working Group on Monetary and Financial Measures is co-chaired by David Dodge, former Governor of the Bank of Canada, and Mark Zelmer, former Deputy Superintendent, OSFI, and supported by a group of financial market experts and economists. The group's fourth meeting was held on Monday, April 20th, 2020.

The focus of the meeting was on the massive expansion of the Bank of Canada's balance sheet over the last month. Between early March and mid-April, the Bank of Canada's balance sheet more than doubled. It now sits at approximately 10 percent of GDP, which dwarfs anything seen in 2008.

Moreover, unlike 2008, the Bank of Canada has expanded its normal purchases of federal government debt to include provincial debt of both short- and longer-term maturities, as well as private-sector debt. As a result, the increase in the liabilities side of the balance sheet is not due to higher government deposits – which would offset, or sterilize, the impact of assets purchased on the monetary base – it is due mostly to higher deposits held by financial institutions (settlement balances).

In 2008, settlement balances increased to $3 billion; today, they are over $130 billion. During the pandemic, members pointed out that these new settlement balances are unlikely to cause inflation since lending in such an environment is difficult for lenders when borrower finances are disrupted for an unknown period of time. Unlike last time, however, the increased monetary base has implications for inflation in the future.

With this context in mind, two sets of critical questions arise:

1. How can the Bank of Canada manage the credit and political risks of its new assets? In other words, how should the large-scale asset purchase program (LSAP) be operationalized?
2. What will be the more medium-run inflation risks for the Bank of Canada? What are the options for mitigating these risks, and what are the consequences of these actions?

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The conversation began with members reiterating some of the key principles the Bank of Canada laid out in 2009, then again in 2015, around conducting monetary policy in a low interest rate environment. Members pointed out that these principles apply just as much today and can be used to help guide the operationalizing of the Bank's expanded balance sheet. While continuing to focus on the underlying inflation control objective, the Bank will look to:

1. Maximize the economic impact of a given policy action;
2. Ensure market neutrality; and
3. Minimize risk to the balance sheet.

To minimize credit risk on the balance sheet, the Bank could ask for some sort of guarantee from the federal government. The Treasury has done something similar for the Federal Reserve in the US, by backing the first round of losses. The group discussed whether this guarantee should be an open-ended indemnity agreement or a first-loss agreement – a key question for the Bank and federal government if that option arises.

The Bank should also be clear on the parameters for deciding which assets to purchase; i.e., what criteria guide its portfolio allocation. This becomes especially important when buying non-sovereign and private-sector debt, as it reduces the politicization of its operations. Members felt an explicit agreement with the federal government could be helpful for maintaining its independence.

Communication will also be critical for laying out an exit strategy. The Bank should not lay out a timeline, as to not jeopardize the potency of their large-scale asset purchases, but indicating how it intends to exit down the line will be important in order not to destabilize inflation expectations. This exit strategy would be facilitated by adjusting the portfolio towards securities that mature and simply run off, as opposed to having to be sold in secondary markets.

The group then transitioned more fully into the question of unwinding the Bank of Canada's balance sheet expansion.

Members discussed first and foremost the extent to which it was necessary to unwind these positions. To the extent the Bank of Canada buys up shorter-term assets, e.g., commercial paper, it can let it simply run off, adjusting the balance sheet accordingly. For longer-run debt, one option is to do what the Fed did after the financial crisis, which was maintain the floor system they implemented during the crisis. In a floor system, which the Bank is essentially using now, the overnight rate and the deposit rate financial institutions earn on excess reserves at the Bank are equal. This dis-incentivizes interbank lending, keeping the size of the Bank's balance sheet intact, and may also help keep inflation in check

if financial institutions do not lend as much as they otherwise would. If the Bank is considering a more permanent switch to a floor system when the economy returns to normal, the group felt they should be upfront, given the consequences to the interbank system.

Members felt there was no easy solution to the inflation problem in the medium term. Decisions on selling longer-term assets are fraught with political risk. Alternatively, maintaining a floor system has very clear tradeoffs. To have the greatest impact, while mitigating as much risk in both the short- and medium-run, the group recommended that the Bank should:

- Buy debt at the shortest term possible to allow as much roll-off as possible;
- Ensure some form of federal government guarantee or backstop on non-sovereign and private-sector debt to minimize credit risk;
- Set a target for the intervention for a particular asset-class based on the estimated size of the market disruption, starting small to see the impact from the Bank's mere presence in that market;
- Be transparent about the criteria on what assets to buy, and on any third-party or parties used to buy these assets;
- Operate under an explicit agreement with the federal government to minimize politicization;
- Be transparent on exit strategy, and if considering the longer-term use of a floor system, be upfront.

The Monetary and Financial Measures Working Group will reconvene on Monday, May 4th, 2020 at 3pm. The group will continue to monitor policy actions taken over the course of the next two weeks, and from there determine the most relevant topics for its May 4th meeting.

Members of the Monetary and Financial Measures Working Group include:

David Dodge, Co-Chair, former Governor of the Bank of Canada
Mark Zelmer, Co-Chair, former¬ Deputy Superintendent, OSFI
Riaz Ahmed, TD Bank
Steve Ambler, Universite du Quebec a Montreal
Dwight Duncan, McMillan LLP
Paul Jenkins, Former Senior Deputy Government, Bank of Canada
Phil Howell, Former Superintendent, FSCO
Thor Koeppl, Queen's University
Andrew Moor, Equitable Bank
Tamara Vrooman, VanCity
Jeremy Kronick, C.D. Howe Institute
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