

From: Jeremy M. Kronick and Steve Ambler

To: Monetary Policy Watchers

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Re: **THE BANK OF CANADA'S NEXT TRICK? BALANCING THE BALANCE SHEET**

Even before the Bank of Canada's interest rate announcement last week, the eyes of monetary policy watchers had shifted elsewhere – to the Bank's expanding balance sheet.

There was little surprise when the targets for the overnight rate and the deposit rate paid to banks both remained at 25 basis points.

It is clear that the overnight rate will not be the centrepiece of the Bank's monetary policy. It's stuck at a level at which the Bank considers further cuts to be counterproductive until at least well into 2021.

Instead, the Bank's balance sheet will play the starring role in achieving its monetary policy objectives. And, while the immediate needs of the COVID-19 crisis have meant a focus on financial stability and ensuring functioning credit markets, as the recovery gets under way, the balance sheet will also be instrumental in the Bank's ultimate objective: hitting the 2 percent inflation target.

Let us first consider the balance sheet as a tool for financial stability. As of May 27, the Bank's balance sheet had ballooned to \$465 billion, through, among other things, its "large-scale asset purchases," which is more popularly termed quantitative easing, or QE.

The Bank's asset purchases, both traditional federal government debt and non-traditional provincial and private sector debt, have ensured the smooth functioning of financial markets. It would appear the Bank's strategy has largely succeeded, with borrowing costs on federal and provincial debt coming down after huge spikes and measures of liquidity in these and private markets returning to much more stable levels.

During the shutdown, the concern has been likely more on deflation than inflation with demand suppressed by pandemic closures. Therefore, the expansion of the balance sheet was able to deal with financial stability concerns, without threatening the usual inflationary pressures.

However, as the economy starts to recover, this balance will prove more difficult. With so much uncertainty, the Bank's use of the balance sheet must achieve three things at the same time: boost demand to aid in the recovery; prevent inflation and inflation expectations from falling significantly below the 2 percent target in the short run; and ensure that inflation rises to the Bank's 2 percent target over the medium run once the recovery is under way.

A few things for the Bank to consider:

First, the precariousness of the recovery means Bank of Canada watchers should expect the balance sheet to stay big for quite some time. There is ample evidence that QE will boost private sector spending only to the extent that it is expected to remain in place over a longer period of time. Households, businesses and markets get jittery if they think the expansion will be quickly reversed. We have seen the failure of other central banks to generate robust recoveries because they shrank their balance sheets too soon.

Second, there are implications for continuing to leave the deposit rate paid to banks equal to the overnight target rate. Doing so means banks earn the same interest leaving excess reserves at the Bank of Canada as they do lending to each other. As a result, the opportunity cost to banks of holding reserves on deposit with the Bank of Canada is lower, and this may reduce incentives for banks to expand lending. This contributed to lower-than-expected inflation after the financial crisis – despite continuously big central bank balance sheets for those countries who used QE – and will be an important part of ensuring inflation – and inflation expectations – return during the recovery.

Third, allowing a period further down the road during which inflation exceeds the 2 percent target (but remains within the acceptable 1 to 3 percent band) might offset the period of lower-than-target inflation that began with the onset of the pandemic and which will likely continue for some time after lockdowns end. This will also help anchor inflation expectations, and allow the Bank to hit its 2 percent target over the more medium run.

Achieving these objectives will require a major balancing act by the Bank. It has shown immense flexibility so far. More will be needed.

A move from the overnight rate to the balance sheet as the primary monetary policy tool is a big change. Clarity and transparency, as always, will be key.

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