ECONOMIC POLICY TRENDS

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THE BANK OF CANADA'S RESPONSE TO COVID-19 AND THE COLLAPSE IN WORLD OIL PRICES

The Canadian economy is being hammered by global demand and supply shocks from the COVID-19 crises and a collapse in world oil prices. Much attention has been on the various fiscal policy measures introduced by governments in Canada, but the Bank of Canada has also been actively engaged in companion emergency monetary policy measures.

The Bank of Canada announced two emergency policy rate cuts (a combined 150 basis points to reach the effective lower bound) and created several emergency asset purchase facilities to increase liquidity in core funding markets—all before its scheduled April 15th Monetary Policy Report. The Bank's unconventional interventions include:

- Increasing purchases of federal treasury bills at auction from 20% of new issues to 40%, and for the first time purchasing up to 40% of new provincial money market (short term) securities.
- Implementing quantitative easing (a first for Canada), which includes purchasing at least $5 billion a week of Government of Canada securities of durations across the yield curve and up to $50 billion of provincial government bonds in secondary markets.
- A slew of other measures such as enhanced repo facilities (overnight collateralized lending contracts) to provide liquidity and reduce short-term funding costs to a broad range of financial institutions, businesses, mortgage lenders and public authorities with the ultimate goal of ensuring firms and households have access to credit.

These measures left observers wondering how they relate to financing the enormous emergency fiscal responses of governments, unseen since the great wars, and whether Canada should be concerned with the macroeconomic consequences. There are four points to consider to understand the monetary policy measures taken.

1. The Bank is responding to two crises

Some observers questioned how interest rate cuts can help a pandemic economy in which businesses are locked down and consumers are confined to their homes. But the Bank has been clear it is also responding to a collapse in world oil prices (made worse in subsequent weeks), which alone would warrant cuts of this size for Canada's resources-sensitive economy. Further, monetary policy famously has "long and variable lags." The Bank is putting the clutch in gear so that the economy can be bump started when lockdowns are lifted. Although there remain a minority of observers concerned with having no gas in the reserve tank for post-containment recovery, the Bank's Governing Council has learned hard lessons from the Global Financial Crisis: act fast and be bold.

2. The Bank insists it is a plumber, not a public utility provider

Governor Poloz has emphasized that the Bank's actions are merely for unsticking markets by ensuring adequate demand for debt and that the Bank is not in the business of financing governments. The former squares with the modern role of central banks as large clearing houses for transactions between commercial banks, accommodating demand for settlement balances within the inter-bank reserve system (although Canada has no reserve requirements, chartered banks maintain reserves for their own business concerns).

But as the Bank gets deeply involved in federal and provincial bond issues that may be rolled over indefinitely, is it correct to say that these actions bear no hallmarks of directly financing governments with the money printer?

3. The Bank is printing money (sort of)

Although the term "printing money" (or, as it has become known on social media, "money printer go brrr") lacks nuance, the short answer is that as the Bank of Canada intervenes in markets to ensure adequate demand for government securities, it is creating much of the money that governments will use to fight the COVID-19 crisis.

There are two colours of ink in this printer. First, the Bank is buying government securities at primary auction by typing a new asset on its balance sheet (the government's liability) and new cash in the government's chequing account (the

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Bank's liability). The government will spend this new cash on programs such as the Canada Emergency Response Benefit. This is "direct" monetary financing or *monetizing the debt*—generally what people refer to as printing money. This is not new. The Bank does it all the time when it buys 20% of federal new issues as part of the government's prudential liquidity plan to manage its cash balances. It is now doubling these purchases to 40%.

Second, the Bank is also doing "indirect" monetary financing with its new quantitative easing program by buying government bonds from the private sector. It then holds these bonds on its balance sheet. There is little difference in the impact on the monetary base between direct and indirect monetary financing if quantitative easing is not eventually reversed (though there may be short-run distributional concerns).

Whether these programs produce permanent debt monetization depends on future action. For example, if the government repays its liabilities and wipes them off the books with tax revenues, it will be destroying newly created money. If the government defaults or the Bank writes off the liabilities, the printer's ink stain will be permanent and the Bank's own solvency may be threatened. If, as is most likely, the government perpetually rolls over its liabilities, new money will persist but proportionally shrink in the rear-view mirror of a growing economy.

The Bank is doing this of its own independent initiative (not at the direction of the Finance Minister); however, it probably has no choice—there is great demand for federal and provincial bonds, but not infinite. If the Bank does not act, markets would likely jam, causing a system-wide financial crisis.

4. Inflation is very unlikely

Inflation is very unlikely given current slack in the economy. In fact, if the Bank's actions generate enough inflation to hit its 2% target—something at which central banks have been failing since the Global Financial Crisis—it would be heralded as a landmark success.

When the Bank's balance sheet expands to support either direct or indirect monetary financing, the newly created money does not cascade directly to the rest of the economy. If the government or commercial banks use newly created funds for activities that compete for real resources and drive output above capacity, then price rises are possible. But that is hardly a risk in the economy now (outside of a few essential industries). The government's fiscal transfers are largely filling a hole in household and firm incomes.

Concerned observers should note that direct monetary financing was part of the Bank's core activities since its nationalization in 1938 through to the early 1970s and was a key factor in pulling the economy out of the Great Depression, fighting two world wars, and implementing an enormous industrialization program. During this period, the Bank's balance sheet was relatively larger than at present, and inflation was generally low and stable.

That said, many central bank mandates, such as in the United States, forbid direct debt monetization out of concern for its political moral hazard. Other countries, such as the United Kingdom, are having national debates before wading as aggressively into it. However, most observers relying on modern evidence and theory consider Canadians lucky to have a central bank with the option and determination to pursue monetization in response to the COVID-19 crisis. Although perhaps the Bank could come right out and say it is doing so.

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