Bank of Canada Goes All-In To Safeguard Financial Stability

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Highlights

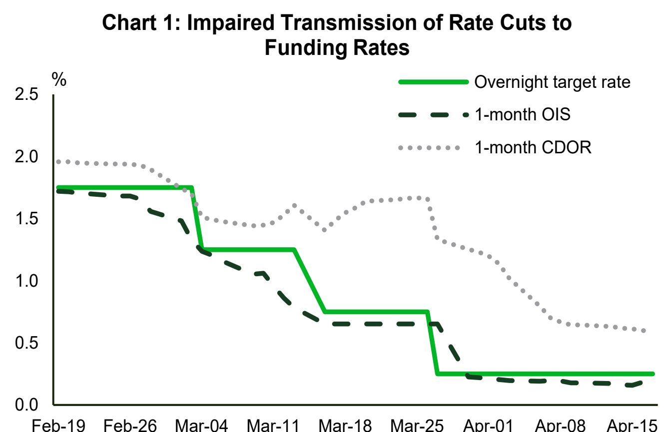
- As the severity of the economic impact of the COVID-19 pandemic became increasingly evident in March, the Bank of Canada responded swiftly and forcefully.
- The Bank cut the overnight target rate to the effective lower bound in just three weeks and established a comprehensive set of liquidity facilities and large-scale asset purchase programs in an all-out effect to mitigate pressures in core funding markets.
- Pressures have subsided but remain elevated. The new facilities and programs give the Bank unprecedented means to safeguard the stability of the financial system and help ensure that banks are able to extend credit to households and businesses at a critical time.

When the economic outlook began to deteriorate significantly in early March, the Bank wasted no time in using the tools at its disposal and developing bold, new measures. The overnight target rate was reduced by 150 bps in just three. Liquidity facilities and large-scale asset purchase programs were established to provide liquidity to core funding markets under extreme stress, demonstrating the ability and willingness of the Bank to play a central role in safeguarding stability of the financial system.

Overnight Target Rate Down To The "Effective Lower Bound" In Record Time

The Bank's initial response -- a 50-bps cut on March 4th – came the day after an unscheduled FOMC announcement of a 50-bps cut in the fed funds rate. This was followed by two unscheduled press conferences (March 13th and 27th) with two additional 50-bps cuts bringing the target overnight rate to 25 bps, setting a record 150 bps reduction in just over three weeks. During the press conference on March 27th, Governor Poloz stated that the Governing Council did not believe that reducing the policy rate below zero would be beneficial for improving credit conditions. With the overnight target rate at the "effective lower bound", the Bank is out of ammunition to further ease credit conditions through the conventional interest rate channel. Its efforts have mainly focused on the financial stability aspect of its mandate.

Chart 1: Impaired Transmission of Rate Cuts to Funding Rates



Source: Bank of Canada and Refinitiv, TD Economics

Extraordinary Measures Undertaken To Alleviate Funding Pressures

Signs of financial distress became apparent in early March when "CDOR-OIS spreads" began to widen. The Canadian Dollar Offered Rate (CDOR), the average bid on bankers' acceptances, is an important element of banks' funding costs. The Overnight Interest Swap (OIS) rate represents the financial market's expectation of the overnight target rate over a specified period. As expected changes in

the overnight target rate get reflected in bank funding costs CDOR and OIS rates of the same maturity move together. For example, the 1-month OIS rate declined steadily over the first half of the month in anticipation of rate cuts, in step with the 1-month CDOR (Chart 1). However, CDOR began to gradually increase following the interest rate cut on March 13th. The 1-month CDOR-OIS spread typically trades at around 25 bps. It widened to over 100 bps at the end of March (Chart 2), surpassing its previous peak of 92 bps reached in October 2008 when financial markets were under severe stress.

The Bank initially responded (on March 12th) with measures to enhance liquidity in short-term funding markets. It broadened the scope of its government bond buyback program and introduced new Term Repo operations, measures similar to those adopted in early stage of the global financial crisis.[i] Funding pressures continued to mount, however. The Bank responded much more forcefully with a wide-ranging set of unprecedented measures:

- Liquidity facilities -- established to alleviate strains in the short-term funding market (Commercial Paper Purchase Program, Bankers' Acceptance Purchase Facility, and Contingent Term Repo Facility).
- Large-scale asset purchase programs -- established to reduce pressure on long-term funding costs for the federal government (Government of Canada Bond Purchase Program and Canada Mortgage Bond Purchase Program[ii]); provincial governments (Provincial Money Market and Bond Purchase Programs), and investment-grade corporations (Corporate Bond Purchase Program).
- Standing Term Liquidity Facility (STLF) -- established to enhance liquidity in the banking system, helping to ensure that banks are able to extend credit to households and businesses at a critical time.

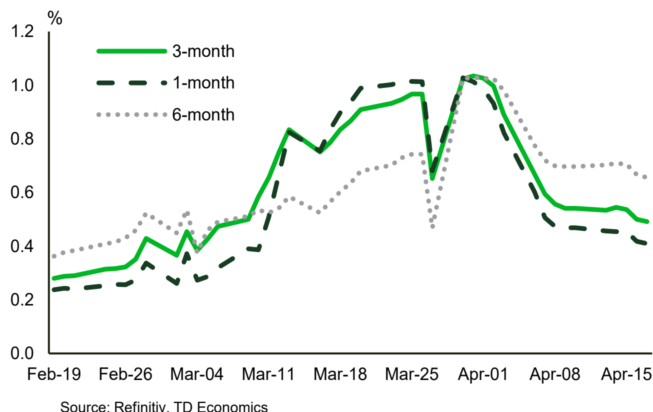
Although it's much too early to draw conclusions on the overall effectiveness of these measures, there are some encouraging signs. CDOR-OIS spreads narrowed somewhat in early April but remain elevated (Chart 2).

A Major Change In The Bank's Operations

Major central banks (notably the Fed, ECB, Bank of Japan and Bank of England) introduced large-scale asset purchase programs ("quantitative easing") to support the recovery from the global financial crisis. Central banks in Canada, Australia and New Zealand did not adopt such measures. The 2008-09 recession was less severe and financial distress was brought under control with other means. The Bank of Canada developed liquidity facilities to help stabilize the financial system. In late 2007 the Bank used term purchase and resale agreements (term PRAs) to alleviate pressures in short-term funding markets. Total repo operations expanded to $35 billion in early 2009, having a sizeable impact on the Bank's balance sheet (Chart 3).

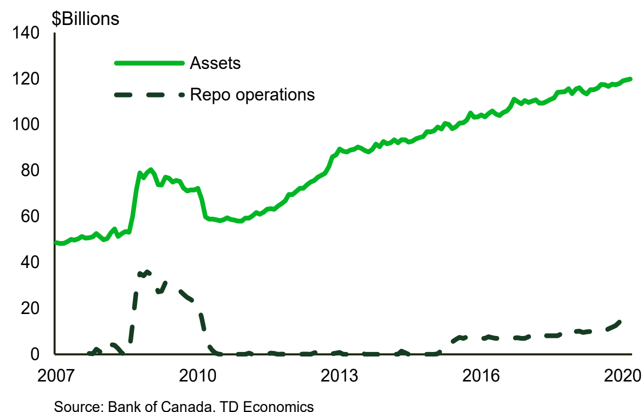
The Bank's total assets increased from $53 billion (3.1% of GDP) to $79 billion (5.1% of GDP) over this period. This pales in comparison to the current measures. The Bank has so far cumulated just over $200 billion in new assets, largely in bankers' acceptances and repo operations (Table 1). The Bank plans on purchasing at least $5 billion per week of Government of Canada bonds in the secondary market (the amount "could be increased at any time, should market conditions warrant it"), along with $500 million per week of Canada Mortgage Bonds. This would expand the Bank's

Chart 2: Funding Pressures Have Dissipated but Remain Elevated (CDOR - OIS Spreads)



Source: Refinitiv, TD Economics

Chart 3: The Bank Expanded Its Balance Sheet During the Global Financial Crisis



Source: Bank of Canada, TD Economics

Table 1			
$ billions	**Mar/04**	**Apr/15**	**Change**
Total assets	**118.7**	**320.3**	201.6
GoC securities	102.0	123.1	21.1
Treasury bills	25.0	29.9	4.9
GoC bonds	76.5	90.2	13.8
Can. mortgage bonds	0.5	3.0	2.5
Prov money market	0.0	2.8	2.8
Banker Acceptances	0.0	37.6	37.6
Commerical paper	0.0	2.9	2.9
Advances	0.0	9.9	9.9
Repo operations	15.5	142.8	127.3
Source: Bank of Canada, TD Economics			

balance sheet by $286 billion if maintained for a year. The Bank is also able to purchase $50 billion under the Provincial Bond Purchase Program and $10 billion under the Corporate Bond Purchase Program. In total, large scale asset purchases could amount to $346 billion in new assets, an amount equal to around 15% of GDP (as of 2019Q4). This would result increase total assets from around 5% to 20% of GDP.[iii] These calculations do not include assets purchased under liquidity facilities which could be substantial if funding pressures were to persist.

One could argue the expansion of the Bank's balance sheet constitutes "quantitative easing". This is accurate from an accounting perspective. However, it's important to recognize that the objectives are quite different. The measures introduced by the Bank of Canada are primarily centered on enhancing liquidity in core funding markets whereas existing large-scale asset purchase programs adopted by major central banks were undertaken to ease credit conditions by reducing bond yields. Government of Canada bond yields are at close to record low levels (the 10-year benchmark yield is currently trading below 75 bps).

Modifications To The Operating System

The adoption of large-scale asset purchase programs required a change in the Bank's monetary policy implementation framework. Under the previous system, the Bank set the overnight target rate within a 50 bps band ("corridor system"). At the end of each trading day, members of the Large Value Transfer System (LVTS) in a surplus position earn interest at the deposit rate set 25 bps below the overnight target rate (the lower band); those in a deficit position are required to take an advance at the rate set 25 bps above the target (the upper band). The 25 bps differentials give LVTS members incentives to minimize their expected deficit or surplus position by borrowing and lending in the interbank market, bringing the overnight rate in line with the target rate.

The corridor system has worked well in enabling the Bank to keep the overnight rate close to the target under normal circumstances. It was modified to be compatible with the adoption of large-scale asset purchases. Asset purchases will result in a significant cumulation of excess reserves in the banking system. Under the corridor system each bank would have an incentive to reduce reserves by lending at the overnight rate (25 bps above the deposit rate). The modified system sets the deposit rate to the overnight target rate giving banks an incentive to hold excess reserves.

Bottom Line

With a comprehensive set of liquidity facilities at hand, the Bank has the means to provide liquidity where needed across a wide spectrum of core funding markets. When concerns about the financial stability subside, the Bank's attention will shift to supporting a recovery. With the overnight target rate at the effective lower bound, the Bank will have to rely on asset purchases and forward guidance to ease credit conditions.

The expansion in the Bank's balance sheet will ultimately depend on financial market developments. Once liquidity pressures subside, purchases made under liquidity facilities will no longer be needed. The Bank's holdings of short-term assets will decline as they mature. Holdings of longer-term assets can be maintained until a recovery is well underway and then sold at a measured pace to avoid putting upward pressure on bond yields. The US experience suggests that the tapering process will likely be gradual.

The Bank's large-scale asset purchase programs certainly marks a radical change in its operations. However, this is not unexplored territory. If the Bank's balance sheet were to expand to 20% of GDP, this would be well short of levels reached in other major advanced countries (Bank of Japan: 104% in 2019; ECB: 40% in 2018; Bank of England: 29% in 2018; US Fed: 25% in 2014). Experience in each case indicates that large-scale asset programs do not inevitably lead to inflationary finance. On the contrary, central banks in all four countries have been struggling to curtail disinflationary pressures (the ECB and Bank of Japan in particular).

References

1. Zorn, Lorie , Carolyn Wilkins, and Walter Engert (2009), "Bank of Canada Liquidity Actions in Response to the Financial Market Turmoil", Bank of Canada Review Autumn 2009.

Endnotes

1. Zorn et al (2009) discuss the series of liquidity actions that the Bank undertook over the course of the global financial crisis.
2. Canada Mortgage Bonds are issued by Canada Housing Trust, a special purpose trust created by CMHC, guaranteed by the federal government.
3. The Bank's assets totaled almost $120 billion as of March 2020, an amount equal to 5.1% of GDP (2019Q4).

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