Bank of Canada Goes All-In To Safeguard Financial Stability

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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.

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.¹ 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 Programii); 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

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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

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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