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Op-ed: The myth of monetization in Canada

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If you've been following Canada's first-ever experiment in quantitative easing (QE) over the past year or so, you've likely heard or seen the words 'debt monetization' bandied about. Some might look at the Bank of Canada's large-scale bond purchases—and the money creation that's resulted—as designed to directly finance government spending. The odd economist or strategist has made the oh-so-clever observation that the pace of BoC bond buying more-or-less lines up with Ottawa's budgetary shortfall and net financing requirement. Just yesterday, BoC Governor Tiff Macklem was fending off this accusation from riled up parliamentarians. Invoking the non-too-minor charge of debt monetization may be a way to score political points (or drive a few website clicks), but it's an allegation that rings hollow to us.

No question, since initiating QE, the BoC has bought *a lot* of Canada bonds. Throughout fiscal 2020-21, Bank holdings of GoC bonds soared C$265 billion, offsetting fully 95% of the increase in the sovereign's bond stock. This was part of an unprecedented expansion of the Bank's balance sheet, which coincided with a record budget deficit in Ottawa. But to the monetization theorists out there, this isn't exactly a 'gotcha' moment. Rather, after quickly arriving at the effective lower bound for the policy rate last March, the BoC cast about for other ways to support the economy and shore up financial markets (pursuant its clearly stated mandate). That involved a massive term repo effort and purchase programs covering everything from BAs, CP, provincial short-term paper, provincial bonds, corporate bonds and, of course, Canadas.

No one should be surprised by the apparent relationship/correlation between the BoC's balance sheet and measures of economic and fiscal health. Monetary accommodation is meant to be counter-cyclical, not static. When out of room on policy rates, monetary authorities must turn to asset purchases to ensure the effective transmission of monetary policy. The alternative is sitting on your hands, watching individuals and businesses needlessly suffer, and resigning oneself to missed policy goals. Is that really a viable or attractive option? Of course not.

BoC bond buying has two main purposes: to provide stimulus (above and beyond the policy rate setting and forward guidance) and to support market functioning. QE, in particular, drove yields all across the benchmark/risk-free curve lower than where they would have otherwise been, spurring interest-sensitive demand and offsetting the hit to confidence from a once-in-a-lifetime pandemic. Judging from the red-hot housing market, we'd say mission accomplished. Just as important, BoC purchase programs (including QE) helped to forestall or at least limit financial market seizures. Again, we'd tend to give a passing grade here, both in terms of timeliness and overall effectiveness.

The real test is what a central bank does once an economy starts to recover and financial markets normalize. And it's here where BoC actions have begun to invalidate monetization concerns. More than other major central banks, the BoC has shown itself willing to step back when and where it can. There are more than a few examples. How about the rapid reduction in term repos currently underway (draining excess reserves from the system without destabilizing markets)… or the earlier wind-down of various market functioning-focused purchase programs … or the discontinuation, effective next week, of a year-long Provincial Bond Purchase Program… or the observed moderation in QE itself.

The weekly QE pace has been chopped twice, from an original (and in our opinion too large) C$5 billion to C$3 billion currently. Another C$2 billion stands to be erased from the weekly clip, leaving gross QE at C$1 billion/week (the net neutral run rate) in roughly a year from now. Consider the latest QE taper, announced on April 21st. Just two days prior, Deputy PM Chrystia Freeland used her first budget to push fresh fiscal stimulus to the upper end of promised range (beyond it technically). So here was the fiscal authority opting to spend, spend, spend, whether fully needed or not. The monetary authority, in contrast, responded with less accommodation.

For markets, this means BoC bond purchases will be slowing faster than net GoC issuance. Unlike 2020-21, when the Bank pretty much sopped up everything, it will be for end investors to clear the GoC bond market this fiscal year. Imagine that. We've estimated net GoC issuance to the Street at C$60 billion for 2021-22 vs. barely C$10 billion in 2020-21—this despite a smaller overall bond program.

Aside: Net GoC supply is due to average C$3.56 billion/week in fiscal 2021-22. QE is currently C$3 billion/week. Cue righteous indignation from some corners. But hold up. Statistical analysis of monthly changes in BoC holdings and GoC outstandings reveals a R-squared of 0.32 for 2020-21. Meh. That and a buck-seventy-five might get you a medium double-double from Tims. Moreover, we've reached an inflection point, whereby the overlap in issuance and QE will break down further as we progress through 2021-22. This time next year, the BoC won't be absorbing much of anything, beyond passive reinvestment of maturing positions and its regular auction allocation (which isn't really QE at all).

The Bank has more recently resisted the government's efforts to term out its debt portfolio, even if it means less support for longer-term yields. So there's evidence of independence in portfolio management too. As a reminder, the BoC is removing itself from the provincial bond market, even though borrowing rates are up and provincial funding requirements remain heady. Monetization of sub-national debt? Not happening.

In a sense, the BoC is the only major policy maker in Canada legitimately willing to scale back extreme accommodation. Federal and provincial treasurers are opting for fresh stimulus, a portion of it looking pro-cyclical. On housing, the federal government seems reluctant to cool things off, beyond the minor tweak of a vacancy tax for non-residents. OSFI's recent move on housing likewise comes across as fiddling at the margin. Here again, it may be left to the BoC to temper activity via a quicker taper and earlier rate hikes than might have otherwise transpired.

In sum, those with an axe to grind on debt monetization may be better off looking elsewhere, to the U.S. perhaps or across the pond. We've heard strategists opine that Biden's enormous stimulus package (and the mountain of debt needed to finance it) may make it hard for the Fed to taper. We'll see. The Fed (and the ECB) have certainly had difficulty weaning markets in the past. As for the Bank of Canada, disabuse yourself of the notion that it's focused on monetizing government debt. Inflation management remains the overriding concern, consistent with a cleaner and clearer policy mandate than some other central banks. And if you're not yet convinced, we think you will be soon enough.

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