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Some Thoughts on the Bank of Canada's Current Situation

Christopher Ragan

January 10, 2023



Overview

1. Inflation and Money
2. The Bank's Operating Losses
3. Three Longer-Term Worries

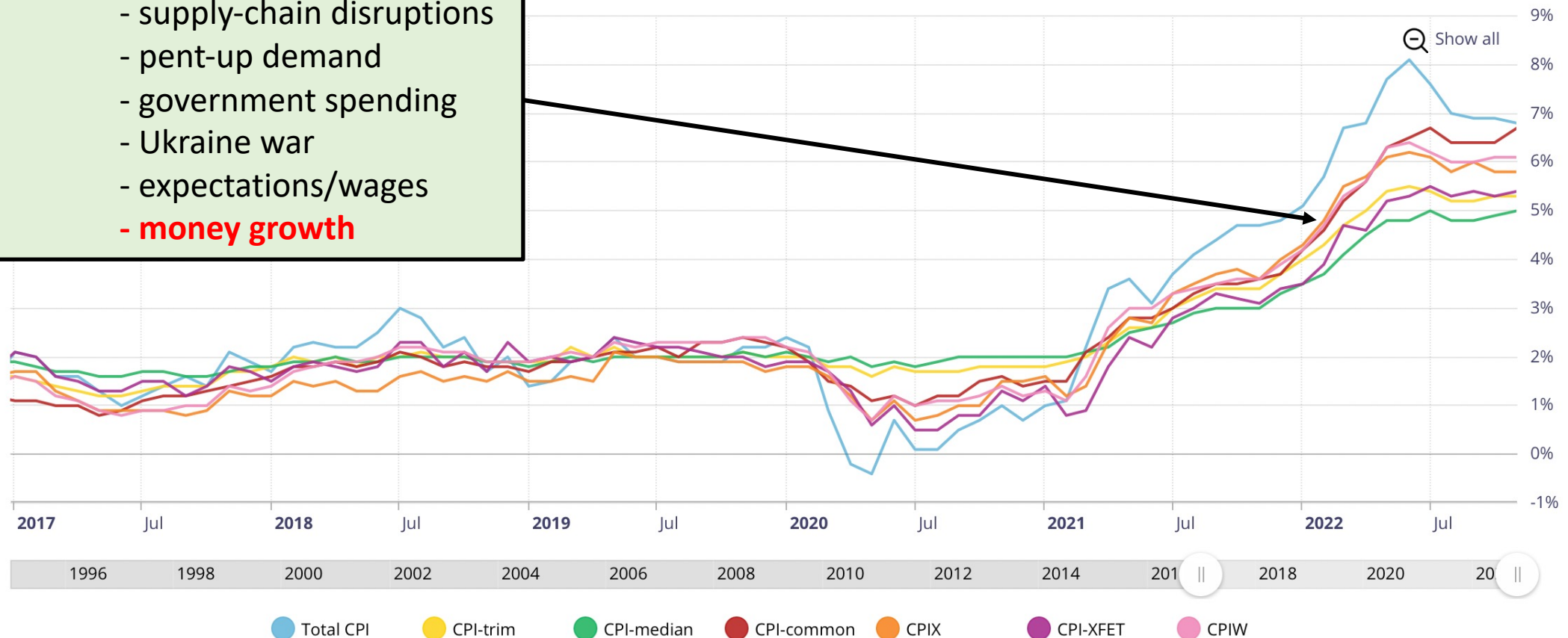
Core Inflation is Still Too High ...

Several causes of this inflation:

- supply-chain disruptions
- pent-up demand
- government spending
- Ukraine war
- expectations/wages
- **money growth**

Consumer Price Index

Percentage change over the past 12 months

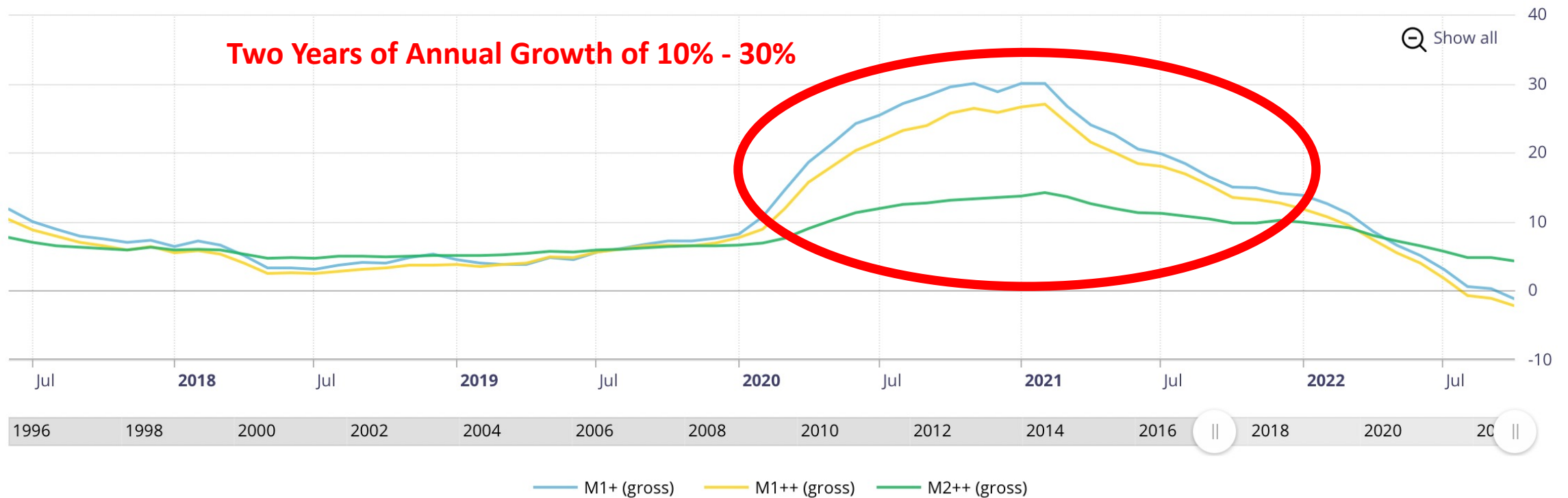


Source: Bank of Canada

... and There is Still Lots of Money “Out There”

Monetary aggregates

Month end data, 12-month growth rates

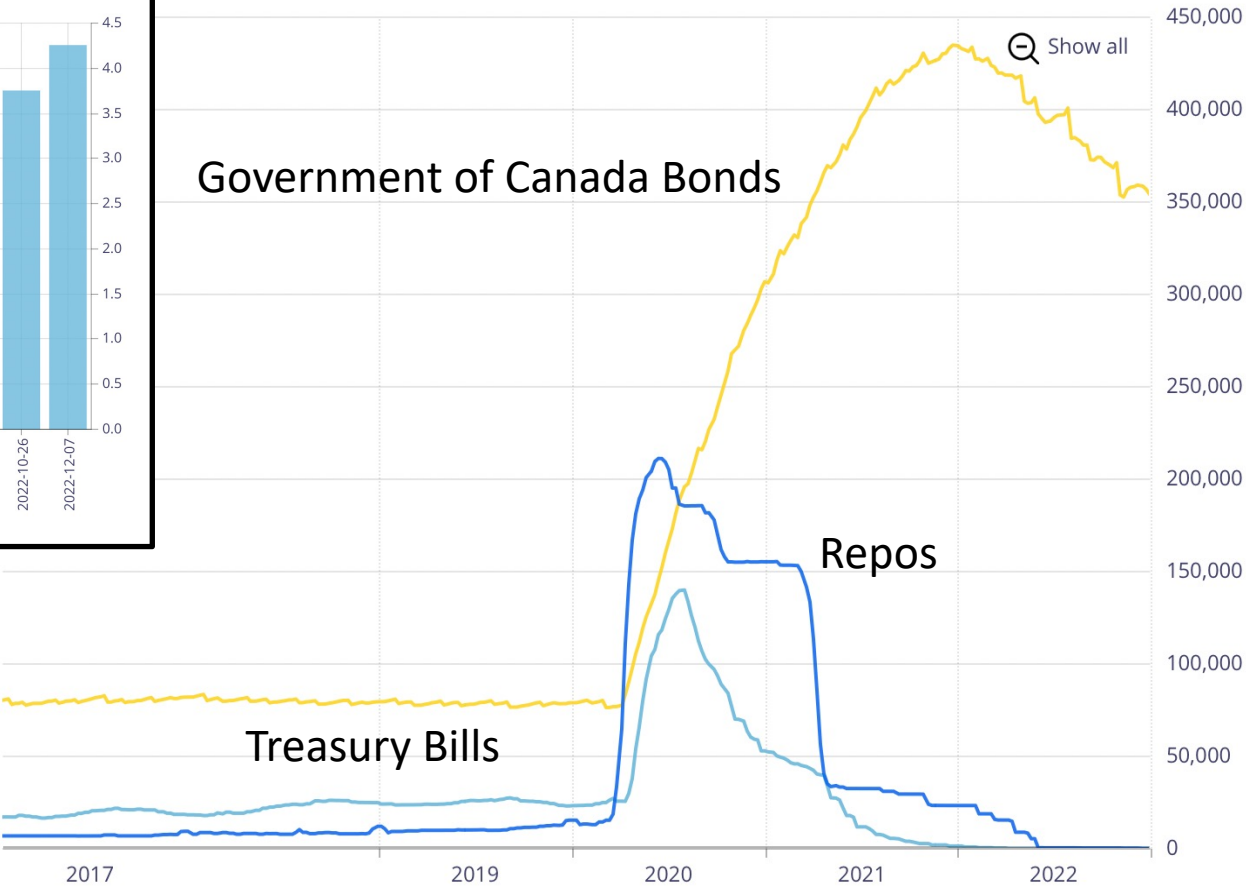
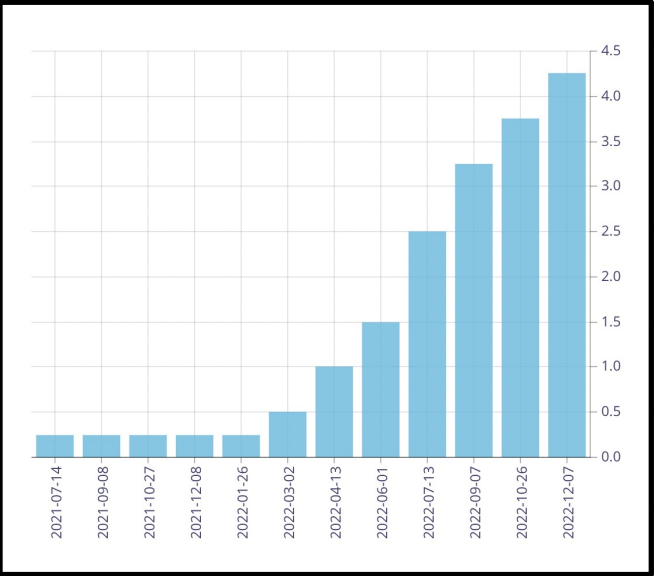


Source: Bank of Canada

Massive QE Has Now Become Moderate QT

Bank of Canada assets and liabilities: Weekly

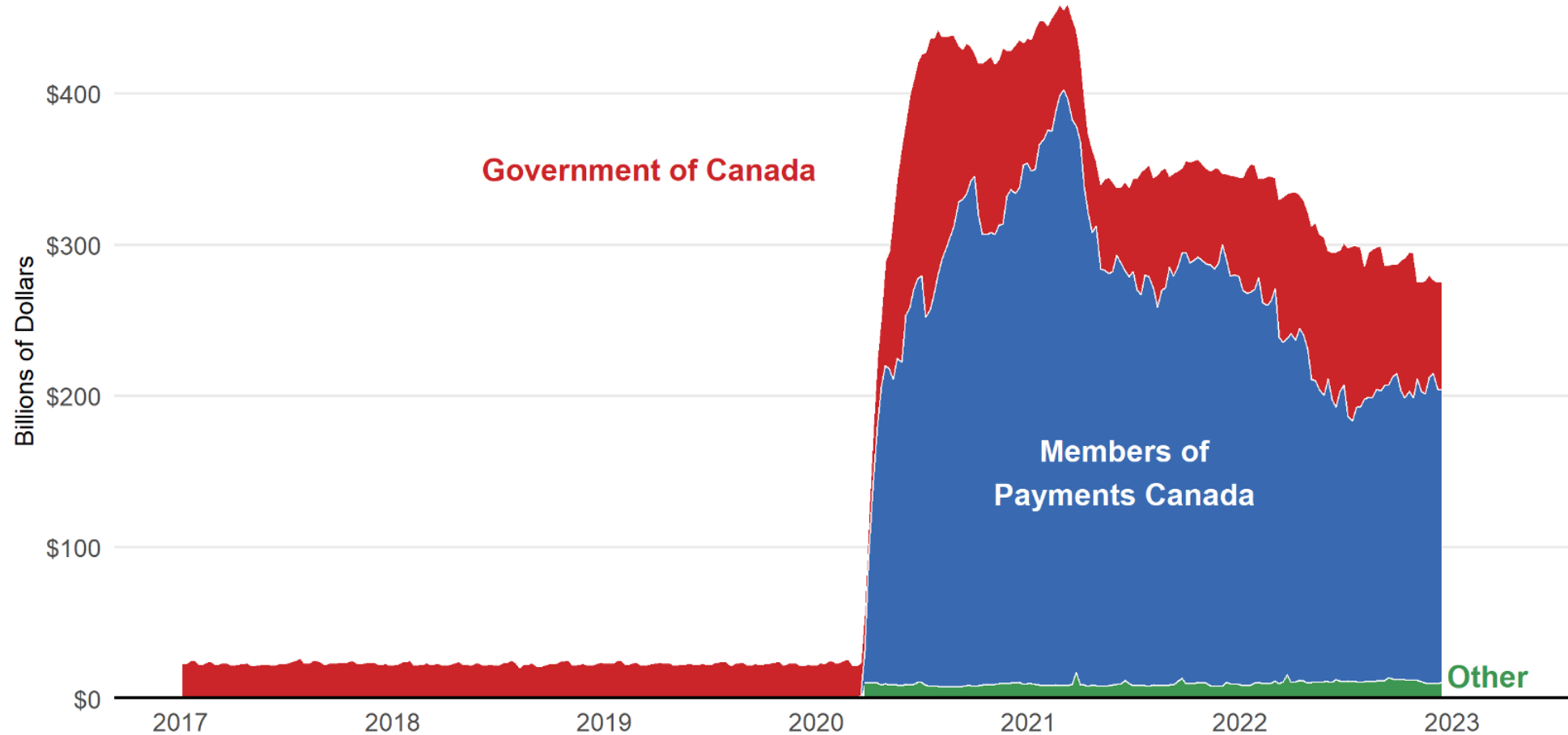
Weekly Wednesday, Millions of dollars



Source: Bank of Canada

Much QE “Resides” in Deposits at the Bank ...

(a) Deposits at the Bank



Source: Yu Chen and Trevor Tombe (2023)

... Which Receive (Rising) Interest Payments...

(b) Estimate of Interest Payments (Annualized)



Source: Yu Chen and Trevor Tombe (2023)



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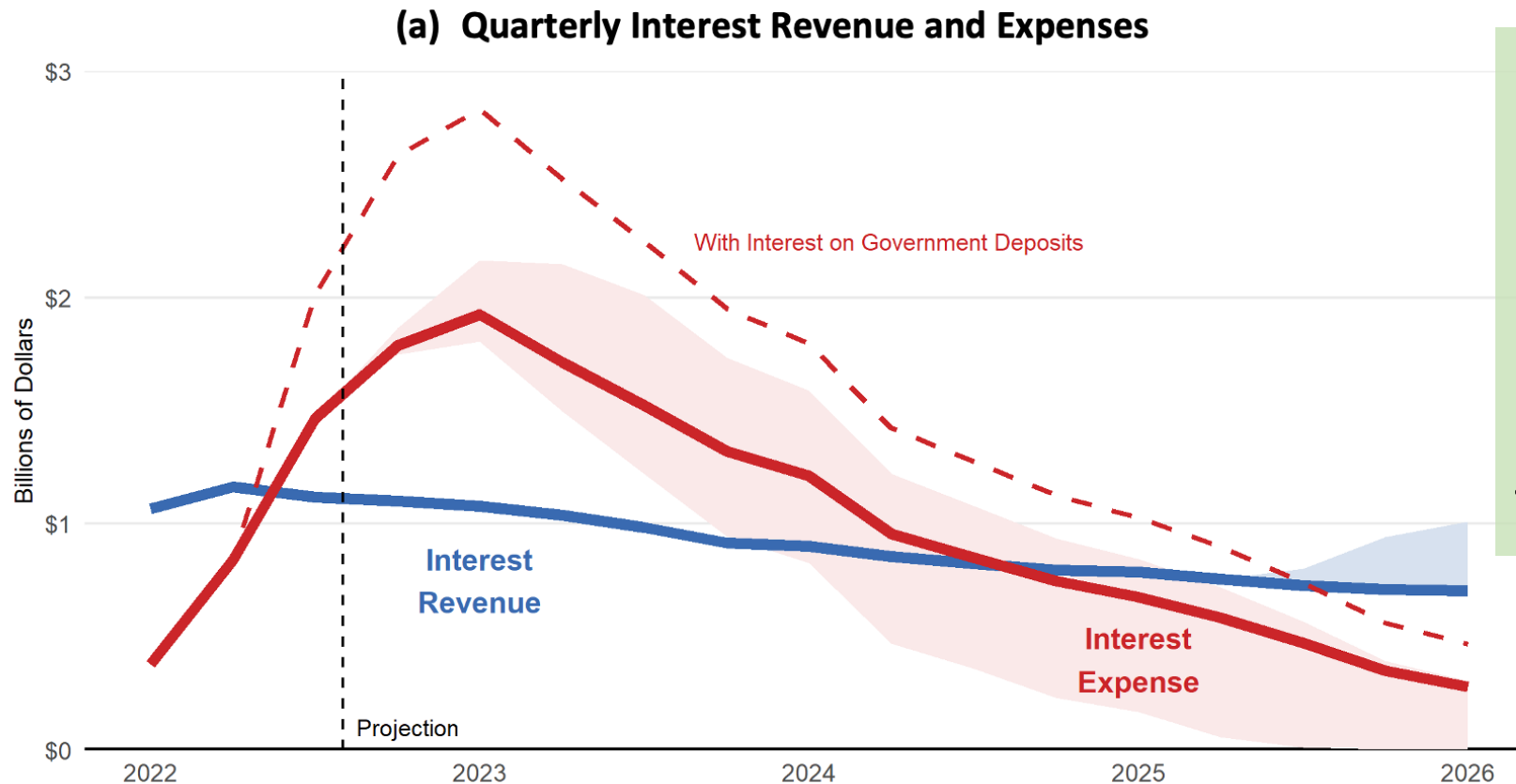
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... and Which Now Exceed the Bank's Earnings

Figure 3: Projection of Bank of Canada Interest Revenue and Expenses



Does this really matter?

Not much, but it sure sounds bad to many people!

Source: Yu Chen and Trevor Tombe (2023)



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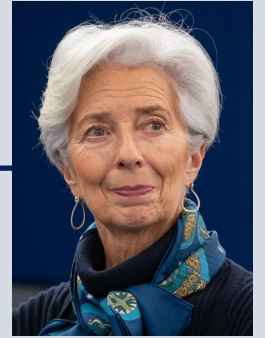
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Three Longer-Term Worries

1. The inevitability of higher inflation? —



— 2. The fiscal-monetary policy mix.

3. Central banks are in a two-front war.



Front #1



Front #2

Where To From Here: Bank of Canada Policy in 2023

Warren Lovely

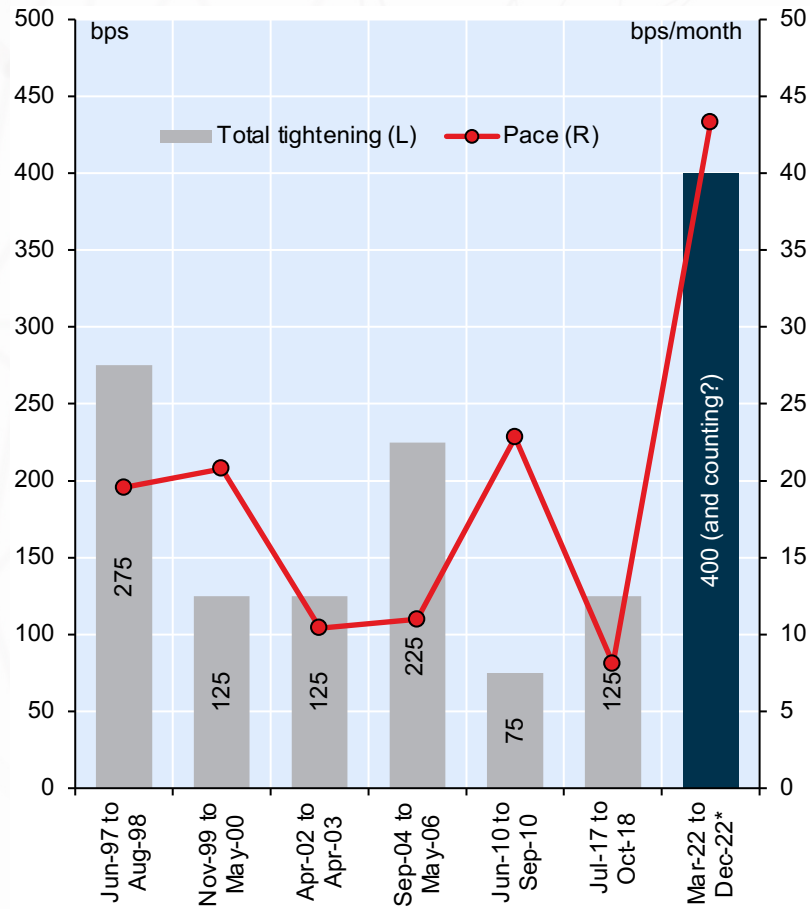
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No two BoC tightening cycles the same, but this is truly extraordinary

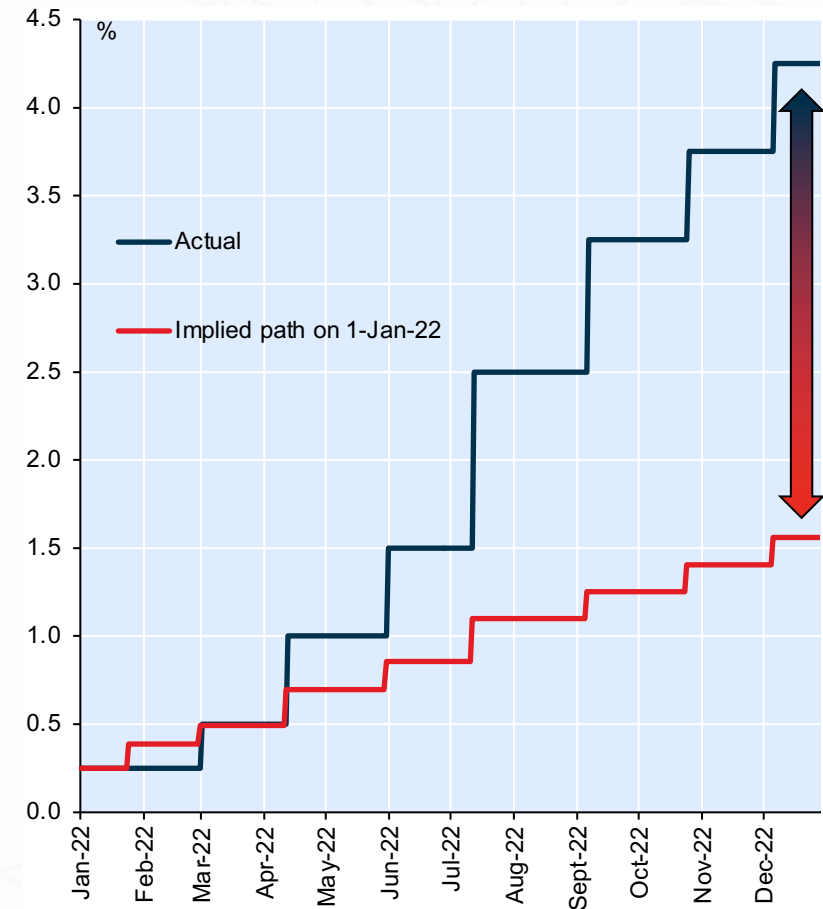
The old rules have not applied, as markets (and economists) vastly underestimated last year's response

BoC tightening cycles: Past & current



Source: NBF, BoC, Bloomberg | Note (L): Pace of tightening from first to last (or latest) hike

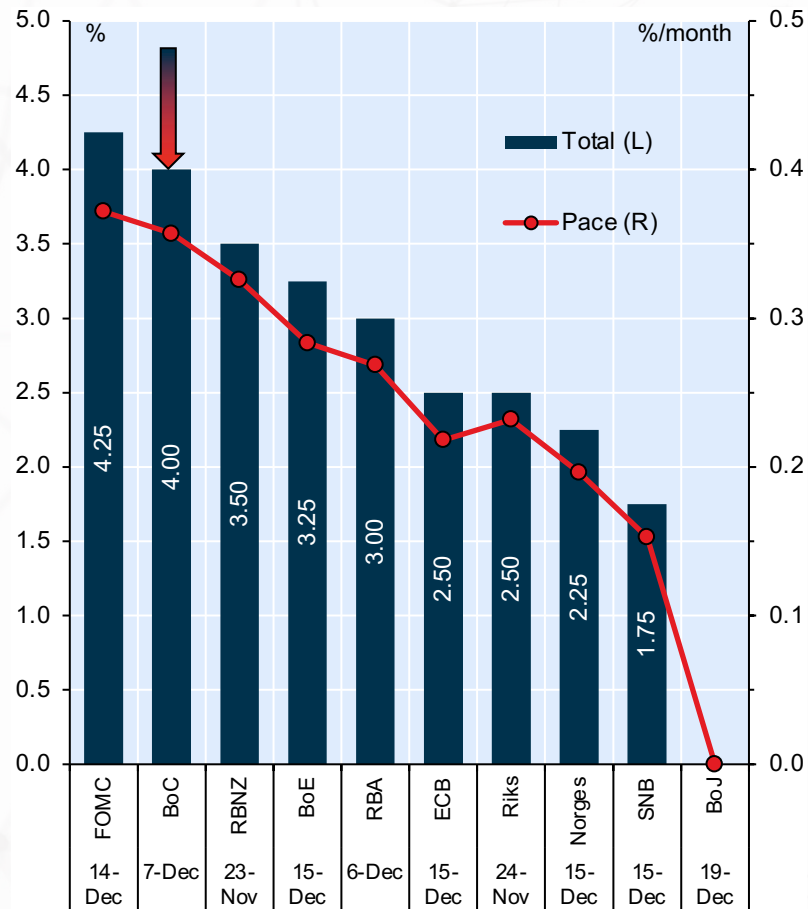
BoC tightening in 2022: Actual vs. expected



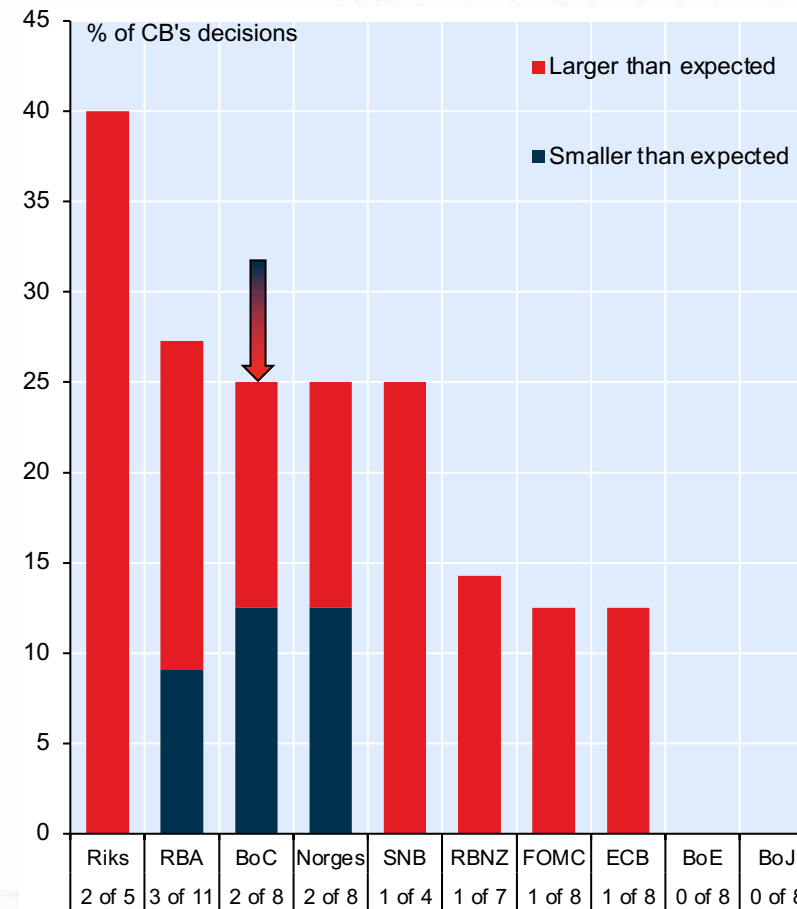
Global context: This is what 2,700 bps of central bank tightening looks like

Bank of Canada hardly the only central bank throwing policy 'curve balls'

Total change & pace of policy rate adjustment: 2022



Policy rate 'surprise factor' vs. consensus: 2022

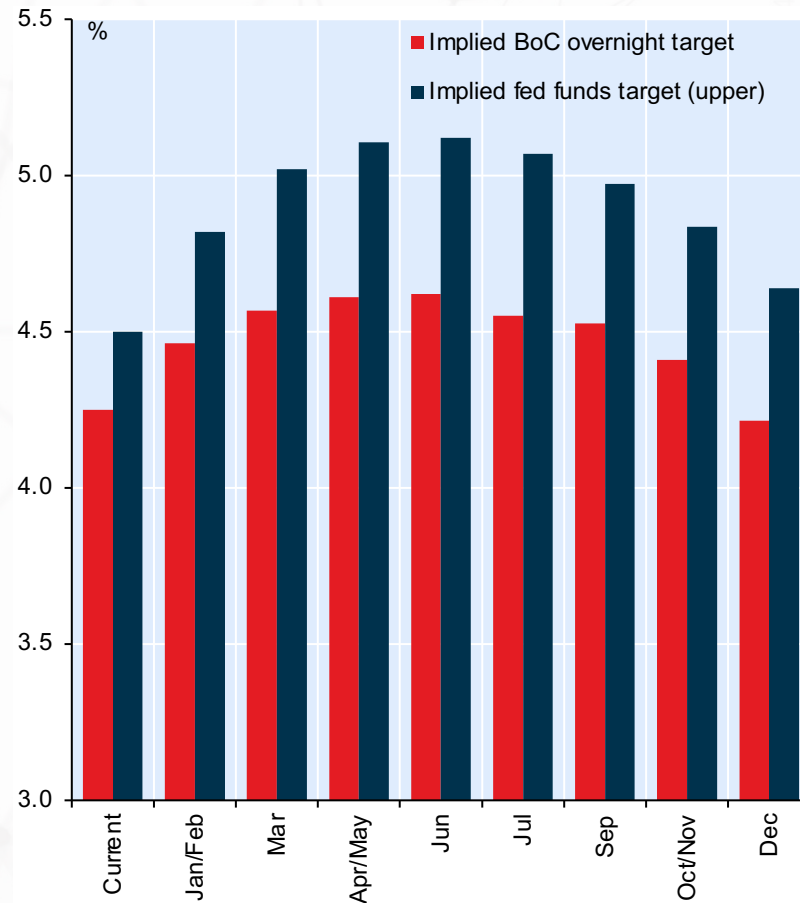


Source: NBF, major central banks | Note (L): Pace from start of 2022 to latest policy decision | Note (R): 'Surprise factor' represents decision different than Bloomberg consensus

It's now less about the *journey* & more about the *destination* (i.e., terminal)

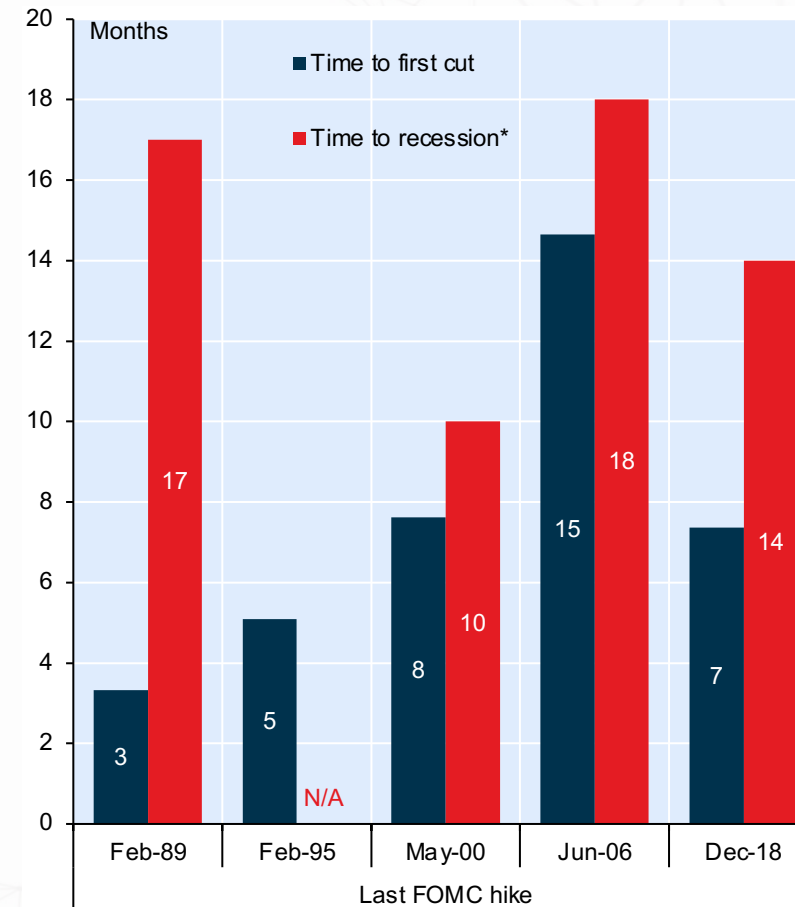
Just how long North American policy rates remain ultra-restrictive a source of some debate

Market-implied path for BoC/FOMC target rates: 2023



Source: NBF, Bloomberg, FRB, NBER | Note (L): Implied rates as at 6-Jan-23 | Note (R): No recession following last hike in Feb-95 before onset of next FOMC tightening cycle

Delay from last FOMC hike to first cut & recession



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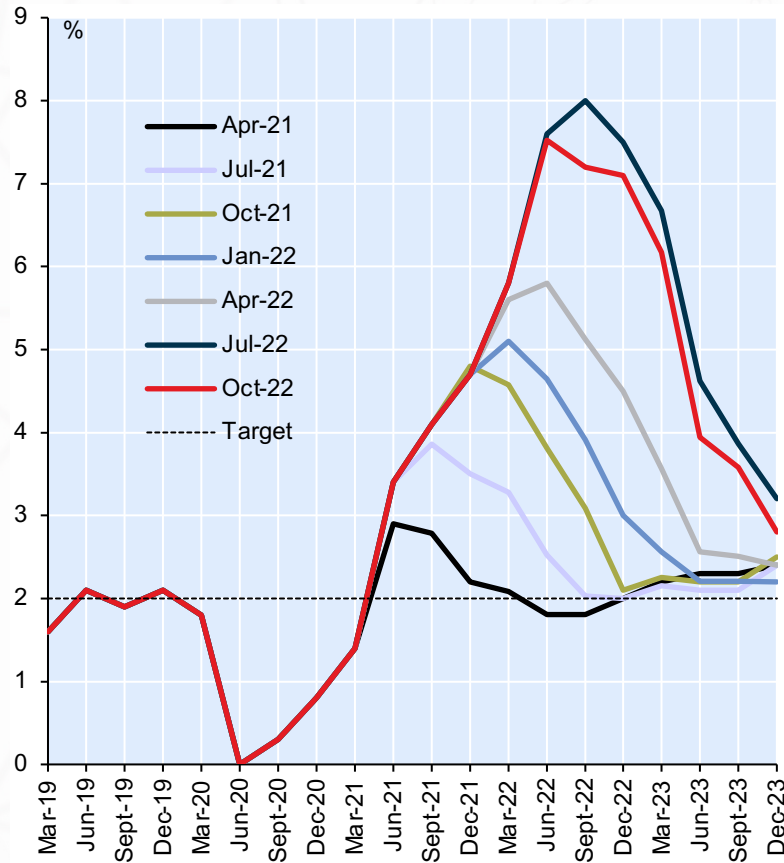


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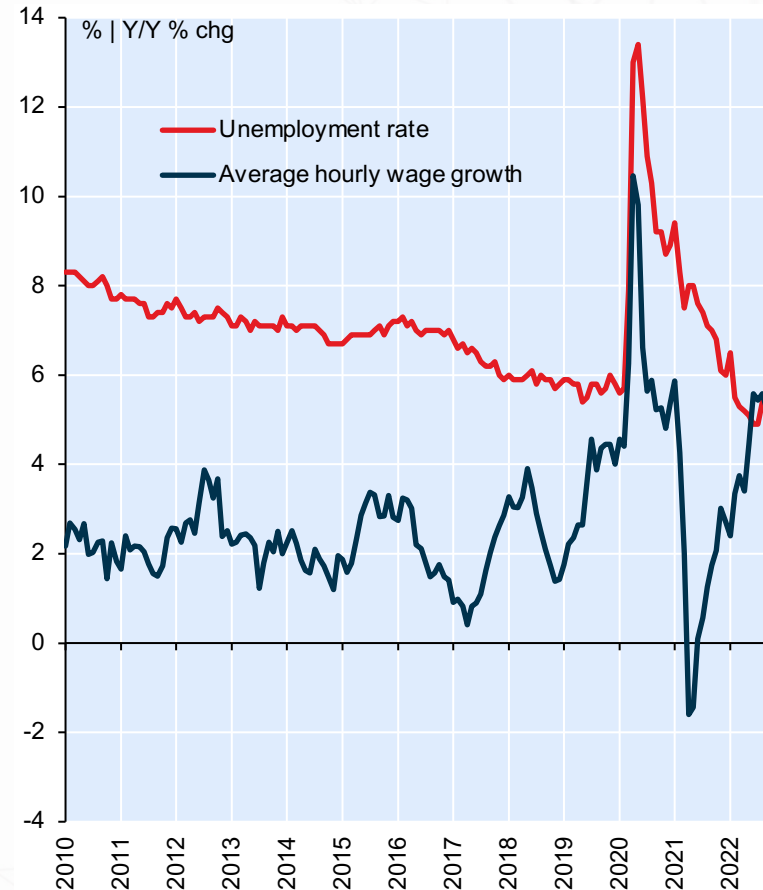
What to watch for (among other things)

Serious inflation relief a necessary but not necessarily sufficient condition for a monetary policy pivot

Evolution of BoC forecasts for Canadian inflation



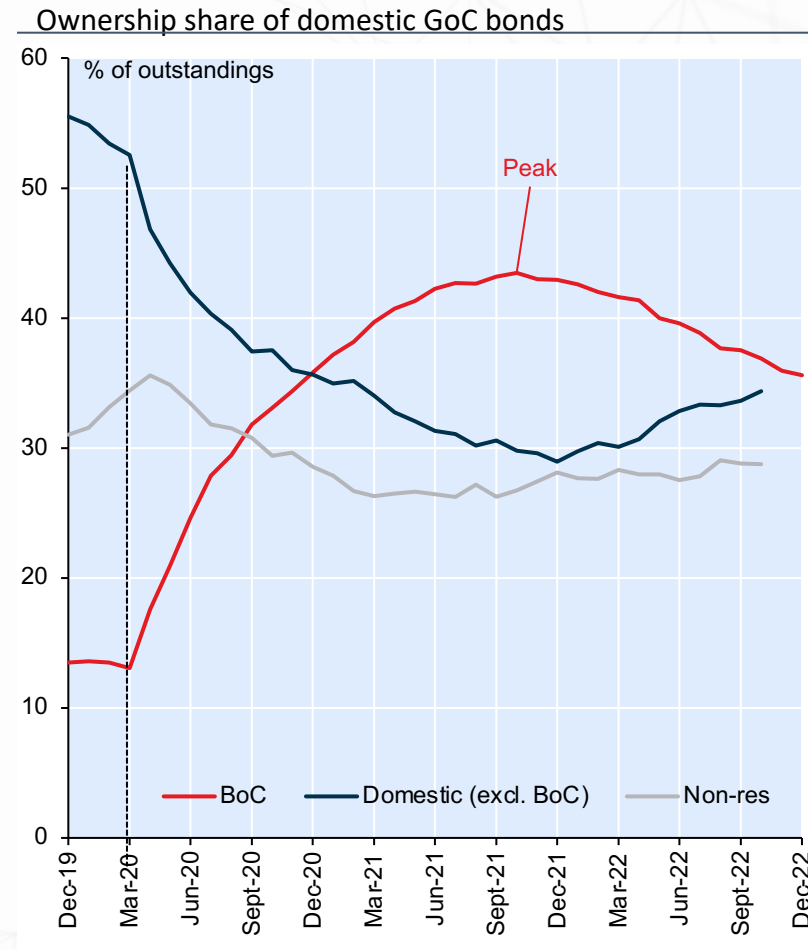
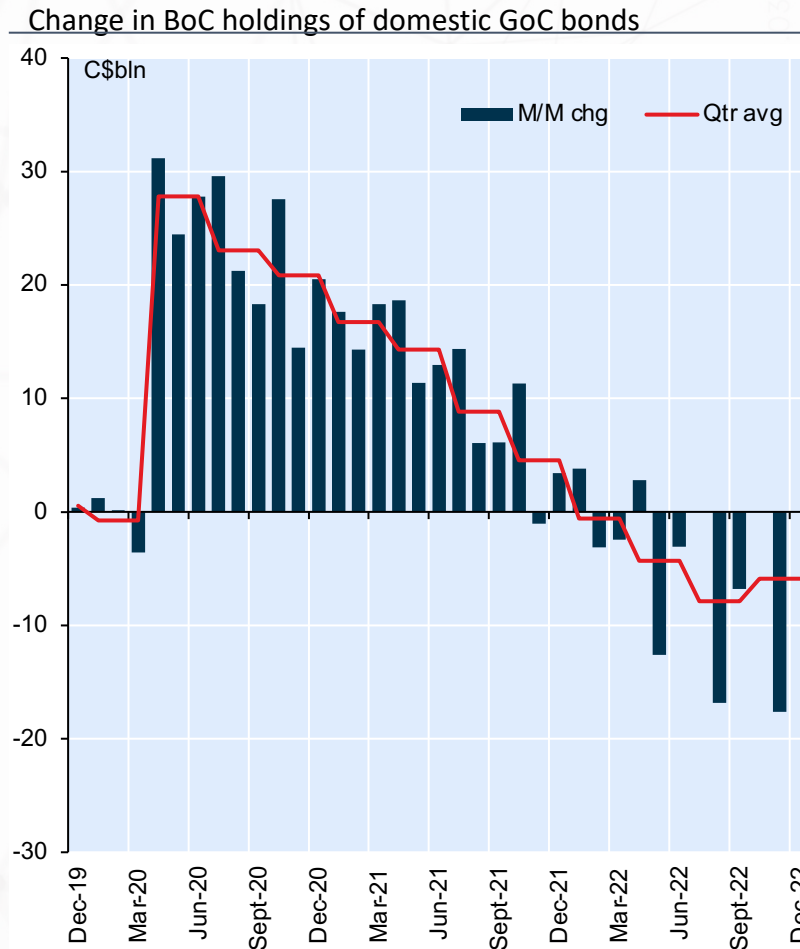
Canadian unemployment rate & wage growth



Source: NBF, BoC, StatCan | Note (L): CPI forecasts represent quarterly averages as per BoC MPRs

Good initial progress on draining Canada's bond market holding tank

Quantitative Tightening (QT) means BoC holdings & ownership share of Canada bonds declining

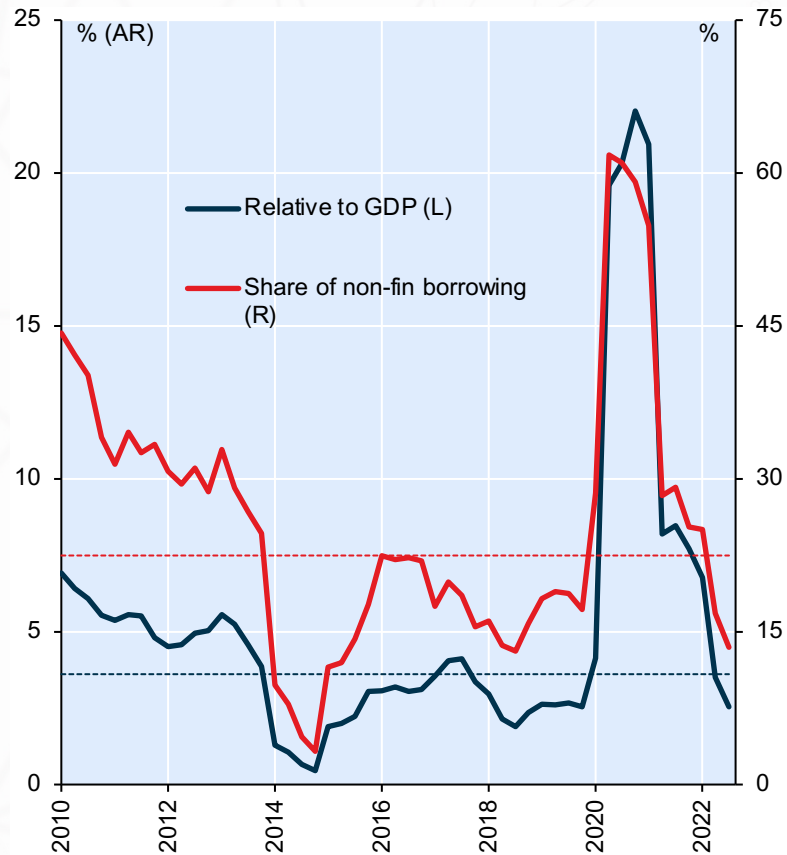


Source: NBF, BoC | Note (R): BoC ownership share to Dec-22; domestic investor & non-resident ownership share to Oct-22

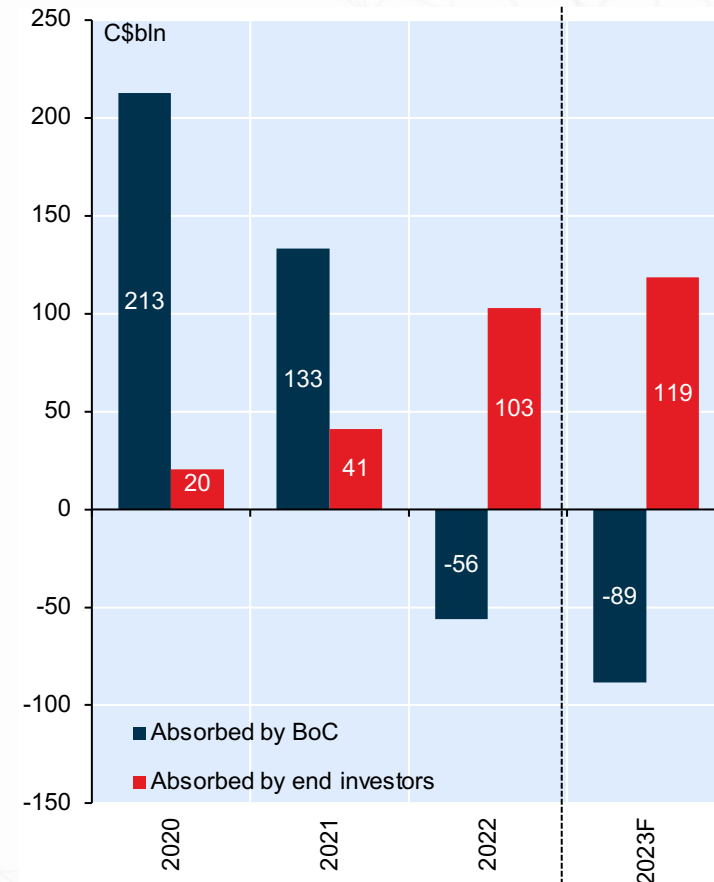
Initial phase of BoC QT aided by reduced government net borrowing

Massive upgrades to federal-provincial finances in 2021 & 2022... but 2023 could be more challenging

Net borrowing by Canadian governments



Absorption of net GoC bond issuance



Source: NBF, StatCan, BoC | Note (L): Dotted lines refer to pre-COVID trend | Note (R): 2023 absorption assumes continued run-off & includes NBF assumption for net GoC issuance