UNWINDING PANDEMIC STIMULUS:

THE BANK OF CANADA'S NARROW PATH TO SUCCESSFUL POLICY NORMALIZATION

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EXECUTIVE SUMMARY

Canada's monetary policy shift to contain inflation through significantly-higher interest rates was facing difficult challenges even before the Ukraine War's shocks to global inflation and growth. This paper explores the Bank of Canada's (BoC's) reactive policy pivot, examining lessons from its major success during COVID-19's economic crisis and key problems from its ultra-easy policy continuing for too long. The BoC has a narrow path to normalize policy successfully with quantitative tightening (QT) and faster rate hikes given multi-decade highs in inflation, broadening price pressures, elevated house prices, higher yields and the Ukraine War.

Our paper uses a three-phase framework to assess BoC policy during the pandemic's economic recession, transition (recovery) and sustainable path (expansion) stages. Swift, massive and broad-ranging macroeconomic support was crucial during Canada's economic and financial markets crisis. The BoC's rapid cuts to near-zero policy interest rates and first-ever quantitative easing (QE) bear emphasis. The surge in government spending for individuals and firms, plus tax relief and generous credit provided vital boosts to the economy and financial markets, and buttressed consumer and business confidence. The extraordinary fiscal and monetary measures combined to "overwhelm the crisis" from COVID-19's economic and financial market shocks.

Yet, Canada's financial market rebound in 2H2020, and robust growth and jobs recovery by mid 2021, furnished solid reasons to re-assess ongoing, ultra-easy monetary policy. Extensive research prior to COVID-19 set out the costs and risks of continuing with ultra-low interest rates and QE for too long after an economic and financial crisis was resolved. Major side effects included soaring private and public-sector debts, growing investment distortions, reduced potential growth, and increased financial stability risks.

However, the BoC's QE policy evolved from emergency support during March-June 2020 into ongoing QE stimulus. Its holdings rose to over 40% of the Canada bond market by mid 2021 despite the continuing large excess of domestic and foreign demand for Canada bonds by 2H2020, and QE's far greater merits during crises relative to normal conditions. There was also a serious risk of exiting from QE too slowly and too late.

The BoC's use of near-zero rates also continued for too long. By 2H2021, Canada's growth and employment recovery was faster and stronger than any rebound of the past four decades. Serious worker shortages were evident in a range of sectors. Housing markets had been overheated for many months. Overall and core inflation measures had jumped to multi-decade highs. Key international factors suppressing inflation – globalization of production, and the excess supply of labour and savings globally – had also changed. Given this economic environment, prudent policy risk management suggested starting to communicate pending higher policy rates, and then undertaking at least modest rate hikes in late 2021.

The BoC waited until early March 2022 for its first policy rate hike of 25 basis points (bps), but accelerated and strengthened its policy shift by mid April, raising its policy rate by 50 bps to 1.0 percent, and starting QT. Although

reactive and delayed, the BoC's faster policy pivot included stronger guidance that "interest rates will need to rise further", including signalling the potential for large future increases of 50 bps. Its QT will be substantial from mid 2022 onward.

The issues and risks for the BoC are numerous and wide-ranging in engineering an economic soft landing. Upward rate pressures begin with the reality that its policy rate hikes and modest QT through April have only lessened its highly-stimulative stance. Policy rates adjusted for inflation and inflation expectations are deeply negative, and house prices remain highly elevated. Business and consumer price expectations are well above the BoC's 2 percent inflation target, and significant labour shortages persist in a range of industries. Front-loading rate hikes and QT is also vital to restore the policy rate and balance sheet room to counter future downturns and/or recessions.

Global headwinds are arrayed against these upward rate pressures, especially the impacts of higher inflation from the Ukraine War's shock waves and global supply chain issues, and of higher interest rates from the US Federal Reserve's policy shift. Growth momentum weakened globally while financial volatility increased sharply in early 2022. Surging food and energy prices have reduced disposable personal income in Canada while higher inflation overall, rising interest rates, and the Ukraine War are affecting consumer confidence. High levels of household indebtedness in Canada further complicate the BoC's task of raising borrowing costs significantly without triggering large decreases in consumption of indebted households and substantial declines in house prices.