ECONOMIC VIEWPOINT

Grading the Bank of Canada's Pandemic Response

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School's out for summer, and students across the country are getting their final grades for the year. So, it seems like as good a time as any to give the Bank of Canada some marks, too. The Bank of Canada performed well during the early stages of the pandemic, lowering overnight rates to the effective lower bound and introducing a myriad of programs aimed at restoring market functioning. Unfortunately, these programs were not scaled appropriately during the long middle of the pandemic and created market functioning issues. In addition, restrictive forward guidance limited the Bank of Canada's ability to respond to underlying economic conditions, delaying the removal of accommodation that would have been consistent with mandated inflation. The Bank of Canada deserves a passing grade. The policies it put in place helped the economy avoid a much longer recession or even a depression. But there is always room for improvement. The Bank of Canada should perform an honest post-mortem on what went right and what went wrong.

Early Days: A-

Just over two years ago, central bankers were scrambling to support economies during what turned out to be the deepest recession since the Great Depression. The Bank of Canada (BoC) performed admirably, forging ahead with unprecedented measures to arrest the freefall in markets and economic activity.

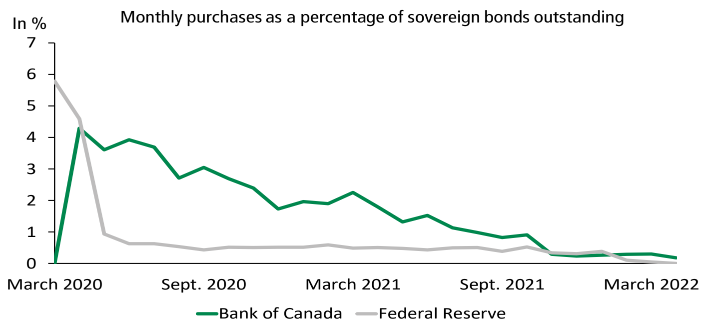
That said, central bankers could have acted sooner. While Canadian policymakers eventually took rates down to their effective lower bound, they did so two weeks after the US Federal Reserve did the same and the World Health Organization had declared COVID-19 a global pandemic.

The Bank of Canada also waited until April 2020 to formally begin purchasing Government of Canada bonds in secondary markets. And it took another two weeks before announcing asset purchase programs to support provincial and corporate bond markets. It's impossible to know whether those delays had any material impacts on the economy or markets, but they keep the Bank of Canada from getting a top grade for the early days of the pandemic.

The Long Middle: C-

The Bank of Canada made miscalculations during the long middle of the pandemic. As the Government Bond Purchase Program morphed from a measure to stabilize markets into a more traditional quantitative easing program, it wasn't rightsized soon enough (graph 1). While the central bank's holdings of sovereign bonds are low as a share of GDP (graph 2 on page 2, left), the size of holdings has ballooned as a percentage of debt outstanding (graph 2 on page 2, right).

GRAPH 1
The Bank of Canada was too slow to taper bond purchases after market functioning was restored



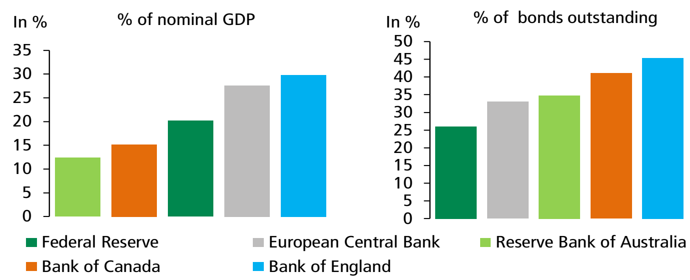
Sources: Various central banks and Desjardins, Economic Studies

The Bank of Canada's holdings relative to the size of the domestic bond market were clearly out of step with most other quantitative easing programs around the world. And by the central bank's own admission, that didn't add much additional monetary stimulus. However, it did create market functioning issues, with the institution owning more than 60% of some bond issues.

The Bank of Canada also tied its hands with overly restrictive forward guidance. By committing to keep rates on hold until slack had been completely absorbed, it was acting like it

GRAPH 2
Bank of Canada holdings are large relative to bonds outstanding

Sovereign bond holdings as a percentage of nominal GDP and bonds outstanding



Sources: Various central banks and Desjardins, Economic Studies

was 2008 and the economy was suffering from weak demand. However, the pandemic took a major toll on both supply and demand and therefore required a different calibration for monetary stimulus.

In 2020, slack was being measured by traditional yardsticks such as the unemployment rate and capacity utilization rates. But that didn't account for the containment measures and disruptions restricting other forms of supply. As consumer prices began increasing more rapidly in 2021, the Bank of Canada's pledge to keep rates on hold until "slack" was completely absorbed looked more and more out of touch.

While certainly not alone even in early 2022, economists at the Bank of Canada still considered pandemic waves to be much more of a demand shock than a supply shock. But we now know the demand side of the economy was more resilient to subsequent waves of the virus. The limitations of the policy tool and the way it was used were on full display when officials cited their binding forward guidance rather than economic realities as the main reason not to hike rates in January. In hindsight that wasn't the right call. While unnecessarily large quantitative easing purchases and overly restrictive forward guidance weren't catastrophic, they were clearly suboptimal in retrospect. They contributed to the inflation problem and housing market excess. As a result, the Bank of Canada's grade for this period reflects the fact that there was clearly room to do better.

Turning Off the Taps: B

The speed of rate moves is far less important for the economy than the level of rates. So, once it became clear that hikes were necessary, we began calling for faster adjustments to get rates to more appropriate levels that would have done more to cool inflation. But the Bank of Canada didn't fully follow that prescription.

The market opened the door to a 75bp move in June, and we actually went so far as to call for it. However, central bankers eschewed 75bps of tightening in favour of a second consecutive 50bp hike, which left rates lower for longer.

The Bank of Canada has also thus far chosen not to sell any bonds from its balance sheet. Some market participants see this as both too timid a response to high inflation and contributing to ongoing dislocations in bond markets.

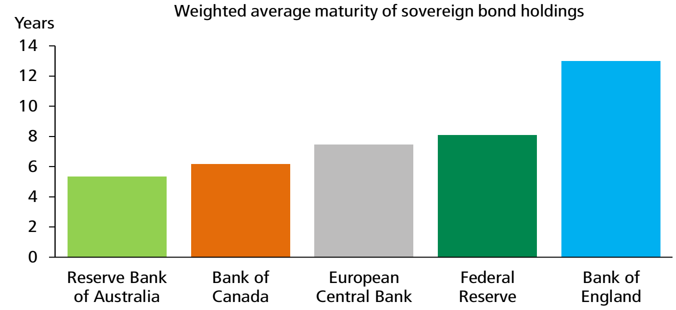
This policy could also create more practical challenges in the future. When a central bank doesn't have a good handle on inflation heading into an economic slowdown, the appropriate monetary policy response is less clear. Cut rates to support economic activity? Or hike rates to slow inflation?

Furthermore, in the event of serious market functioning issues, it won't have the same ammunition it would have had if rates had been higher and the balance sheet smaller. As a result, we can't give the Bank of Canada full marks here.

That said, the Bank of Canada isn't alone and deserves to be graded on a curve. Some of its peers are in more precarious positions. Inflation is higher in the US and could be more difficult to bring down. The Bank of England (BoE) not only has a larger balance sheet, but its bond portfolio also has a longer weighted average maturity (graph 3). That means without a change in policy, the Bank of England's holdings will shrink at a much slower pace than those of its peers.

GRAPH 3
The BoE's bond portfolio has the longest weighted average maturity

Weighted average maturity of sovereign bond holdings



Sources: Various central banks and Desjardins, Economic Studies

Overall, there's little doubt that the Bank of Canada deserves passing grades for its performance during the pandemic, but falls well short of top marks. It should perform an honest post-mortem on what went right and what went wrong. The policies it put in place, especially earlier on in the pandemic, helped the economy avoid a much longer recession or even a depression. While it's true that a firefighter can't be criticized for using too much water when the fire is blazing, keeping the taps open and soaking reconstruction crews doesn't do anyone any good.