BANK OF CANADA
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Our COVID-19 response: Large-scale asset purchases

The Bank of Canada has taken many actions to support Canadians since the COVID-19 pandemic struck. These include large-scale asset purchases—buying a substantial amount of government bonds and other financial assets. Our purchases serve two purposes. They help key financial markets work properly, and they can help increase spending in the economy. This leads to more employment and stronger economic growth.

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Let’s explore why we are making these transactions and how they work.

Keeping markets working properly

To recover from the impacts of the pandemic, Canada’s economy needs a financial system that works well. Our economy depends on credit. When the financial system is working, households and businesses have access to credit. For example, people might take out a mortgage to buy a house or use a line of credit to pay for their child’s braces. And companies may need money to expand and create jobs, so they might borrow from investors through financial markets.

When the pandemic hit, activity in many financial markets almost stopped completely. Few investors wanted to buy assets—instead, most wanted to sell them to have more cash on hand. In response, the Bank started several programs to get these markets working more normally. We began to buy Canada Mortgage Bonds, commercial paper, bankers’ acceptances, corporate bonds, and federal and provincial government debt. These **purchases** have helped restore activity in markets. And this is helping keep credit available for Canadian companies and households.

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> One program that is particularly important is our purchases of Government of Canada bonds. That's because prices in the government bond market help set prices in almost every other credit market. The market for Government of Canada bonds has to work well in order for other credit markets to work, too. And when it is working well, Canadians can benefit from our very low policy interest rate.
>
> ***Paul Beaudry, Deputy Governor***

How asset purchases can also encourage spending

Now that financial markets are functioning well again, our asset purchases can work with our record-low policy interest rate to encourage spending and investment. The goal is to make sure there is enough demand from households and businesses to match what the economy can produce. When spending is high enough, the economy will operate close to its capacity, leading to full employment and inflation near target.

Here's how it works. When the Bank of Canada buys bonds, this raises the price of the bonds and lowers their return, or yield. Lower yields make it cheaper to access credit. And this encourages households and businesses to borrow so they can spend and invest. When we buy Government of Canada bonds, this is called quantitative easing, or QE for short.

QE can encourage spending and investment by households and businesses in a few ways. For example, if our purchases lowered the yield on five-year government bonds, this would be reflected in lower interest rates on five-year fixed-rate mortgages. And that makes it cheaper to borrow to buy a house.

QE stimulates the economy in other ways, too. It can make banks more likely to offer loans to households and businesses. That's because our purchases leave banks with more **liquidity**, so they can lend to a wider set of borrowers.

What's more, QE sends a signal that we intend to keep our policy interest rate low for a long time, as long as inflation remains under control. It's an approach we use after we've already lowered our policy rate as far as we can. If the economy needs QE, it also needs our policy rate to be as low as it can go. By giving investors more certainty that our target for the overnight interest rate will remain low, QE can help reduce longer-term borrowing costs for businesses and households.

The Bank is also buying existing corporate bonds. This can support the economy by making it cheaper for companies to invest and create more jobs. Generally, companies pay a higher interest rate than governments to borrow money. Our purchases can narrow that difference in interest rates paid by companies and governments when they issue bonds. This makes it easier for companies to borrow so that they can invest in hiring or expanding their business. This is often called credit easing, or CE.

For both QE and CE, we buy assets from financial institutions, not from businesses or governments.

Paying with settlement balances

How are we paying for these assets? There is a common misconception that we are just printing money, but this isn't the case. We pay for these purchases with settlement balances. In effect, settlement balances act like loans from financial institutions to us. When we buy assets, we borrow from financial institutions by crediting them with a deposit of settlement balances in the accounts they have at the Bank of Canada. Like the deposits you may have at your bank, settlement balances earn interest. Right now, we pay an interest rate of 0.25 percent on settlement balances, the same as our policy interest rate.

Why would financial institutions want to sell us assets in return for a deposit? For financial institutions, settlement balances are useful because they:

- are completely safe
- generate revenue because they receive interest
- can be used to settle transactions with other financial institutions at the end of every day

To buy the assets, we hold a type of auction. We buy from the financial institution that is willing to sell them to us at the lowest price.

Eventually, when the crisis has passed and we no longer want to hold the assets, we can sell them back to financial institutions. This will shrink their deposits of settlement balances. Or we can hold the assets until they mature and use the proceeds to reduce the amount of settlement balances.

Asset purchases and inflation

> Like all our policy actions, our asset purchases are guided by the need to reach our 2 percent inflation target. Low, stable and predictable inflation is the Bank of Canada's prime mission. Remember, the point of these purchases is to boost demand and spending. When demand and spending match what the economy can produce, we can keep inflation close to our 2 percent target.
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> But if we see that spending is rising too quickly and inflation is threatening to take off, we can act to keep inflation under control. For example, we could increase our policy interest rate to cool economic activity and keep inflation in check. Or we could stop our asset purchases and reverse them.
>
> ***Paul Beaudry, Deputy Governor***

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