What We Learned—And Didn't—From BoC Governor Macklem Today

- **A bit more guidance was added to exit sequencing…**
- **...while repeating how tapering fits into the bigger exit scheme**
- **Important reinvestment assumptions were informed…**
- **…but there are still some big unanswered questions**
- **Q2 GDP was dismissed as not being a demand-side problem**
- **The BoC is reassessing labour slack…**
- **...which could be very important to the wage-price connection**

Bank of Canada Governor Tiff Macklem delivered a useful speech that achieved four main purposes today. First, he reminded markets of the broad exit framework and the steps that need to be taken along the way while adding a bit of further information to the framework. Second, he filled in *some* of the blanks on how the BoC will reinvest maturing holdings of Government of Canada bonds that are very important to bond markets. Third, in so doing, Macklem also took the opportunity to further emphasize that the soft patch in the economy is not terribly concerning to them. Fourth—and interestingly on the eve of another jobs report—Macklem indicated that the BoC is having second thoughts about how much slack there may be in labour markets which could feed back upon how it views bottlenecks and inflation risk. Elaborations follow.

A. Exit Sequencing Keeps Tapering On Track

Think the BoC has the luxury of skipping opportunities to taper? Perhaps think again.

Macklem reinforced previous exit guidance provided in the speech last March by BoC Deputy Governor Gravelle which serves as an important reminder about the exit framework. He reiterated they will move gradually and adjust bond purchases based on the outlook and strength and durability of the recovery with decisions distinct from determining when to raise the policy rate (something the BoC emphasized well ahead of the Fed). After completion of net purchases they will shift to reinvesting "for a period of time, at least until we raise the policy interest rate." Following a reinvestment period, the BoC intends to raise the policy rate when slack has been absorbed. Raising the policy rate will be the "first move" in tightening policy as opposed to shrinking the balance sheet.

What does that mean for tapering the present rate of $2B/week of GoC bond purchases? Since the BoC expects slack to close by 2022H2, it is saying it expects to begin raising the policy rate at a similar time. Working backwards from reinvesting for a meaningful period of time before getting to this point means ending net purchases fairly soon over coming meetings and likely this year or early next year. I think there are strong odds they will come back with another taper in October. This approach would preserve optionality on the length of the reinvestment period and how quickly to raise the policy rate rather than bunching

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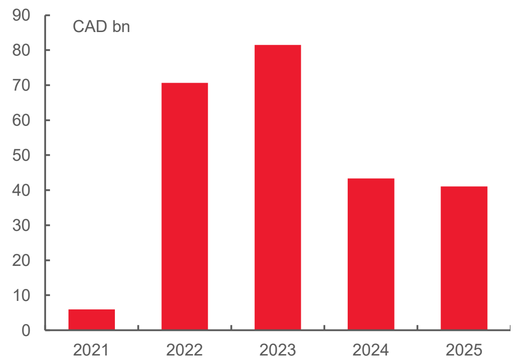
Chart 1

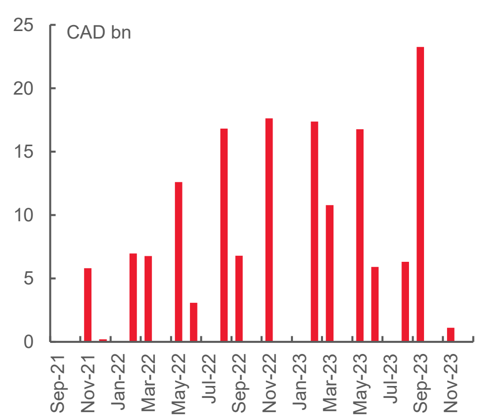
Bank of Canada Bond Maturities



Sources: Scotiabank Economics, Bank of Canada

Chart 2

BoC Distribution of Bond Holdings



Sources: Scotiabank Economics, Bank of Canada up decisions. It's this framework and sequencing that always has to remain front and center when working backward from the end goal of hiking by around 2022H2 and the timing of the steps that need to be taken before then.

B. Important Reinvestment Details

Because the BoC faces hundreds of billions of maturing bond flows over the next several years and because it is closer to the end of net purchases rather than the beginning, it was becoming increasingly important for the central bank to lay out its reinvestment strategy in greater detail once it arrived at the point of $0/week in net purchases. The effects on flows in and out of the bond market could be destabilizing in the absence of a well orchestrated and well communicated plan. Macklem went part of the way today.

Chart 1 shows that over C$235 billion of GoC bonds on the BoC's present balance sheet will be maturing over 2022–25. The flows are concentrated in 2022–23 when over C$70B and just over $80B mature in the two years. Subsequent maturities fall back toward the $40B annual pace. Chart 2 shows how volatile these maturing flows will be.

Here is what we learned today about how the BoC will manage those flows:

1. We know they will reinvest "at least" until they raise the policy rate. I'll come back to how the math behind the guidance may imply they intend to reinvest for a potentially lengthy period of time.

2. We know *how* they'll reinvest. They hadn't said whether they would reinvest as flows mature in lumpy and volatile fashion, or on a steady drip basis. He's saying steady and week-by-week. Macklem said "In general, our purchases during this period will not match the maturities rolling off one-for-one because the maturities are large and unevenly spaced. We will therefore adjust our purchases to match maturities over a longer period, so our purchases are not unduly volatile."

3. We know a little bit more about *where* they will reinvest. Macklem said they'll reinvest in the primary and secondary markets. That may not surprise a whole lot, but that stands in contrast to the period to date marked by positive net purchases that have been focused upon the private secondary market in a competitive reverse auction process. The BoC pledged to reduce purchases at primary auctions as part of regular conduct and in the secondary market during the reinvestment phase.

4. We know how much they are targeting to reinvest on a steady basis. Macklem said they will reinvest at an average pace of about C$1 billion per week or C$4–5B/month.

5. How did they arrive at this drip rate and are there any signals provided by the estimate? Note that what is implied here is an averaging of the drip rate using maturing flows over *multiple* years. For instance, had they used maturities over 2022–23 then the average weekly reinvestment amount would have been quite a bit higher in the C$6–7B/mth range. Instead, by using the full amount of maturing flows over 2022–25 that's how they arrive at the C$4–5B/week range. I'm a bit surprised they averaged over such a long period, but maybe the intent is to avoid anyone speculating that a shorter averaging period implied a short-ish reinvestment phase. In other words, the BoC is signalling they might reinvest for a whole lot longer beyond the early stages of hiking the policy rate.

Here are some remaining questions on their reinvestment approach where information is still lacking:

1. He did not say, however, how the weighted average maturity of the reinvested flows would evolve relative to the weighted average maturity of the maturing flows. Will they aim toward a neutral approach that matches WAM of reinvested flows to WAM of maturing flows over time? Will they target an average WAM to go with the steady drip rate of purchases? They've been reticent to adjust WAM of purchase flows for a while now after having tilted it somewhat earlier on, but we're left to speculate upon how they will manage the distribution of reinvested flows across the curve over time which could be an important matter to relative attractiveness of various points along the yield curve.

2. We don't know any more about how to define "period of time" in terms of the lag between when they get to net zero purchases and shift to reinvesting versus when they hike. We're still left to infer, however, that it's likely 6–12 months or so between hiking in 2022H2 when spare capacity shuts versus ending net purchases well in advance

3. When might they shift to allowing balance sheet run off? Is there some magical policy rate threshold? BoE Governor Bailey has said that reinvestment could stop when Bank Rate hits 0.5% and that the BoE will consider selling assets outright on

“autopilot” when the policy rate hits 1%, but there is nothing to this effect so far from the BoC. That's hugely important given the flows that are involved.

C. On Looking Through the Soft Patch

Macklem might be a little overly charitable to the BoC’s Q2 GDP forecast miss (and ours, and everyone else’s) in saying “we expected growth to moderate….but the slowdown was more pronounced than we anticipated.” Ya think?? The BoC expected +2% growth and instead the economy contracted by 1.1% due to large and silent revisions from Statistics Canada that blew away all of our forecasts based on StatCan tracking but don’t get me started on that again.

Still, Macklem added a little more to yesterday’s statement that said they are looking through it to a 2021H2 rebound and that the weakness was mostly in exports and housing with encouraging signs elsewhere across overall domestic demand. Today, he placed the emphasis upon supply-side problems and COVID-19 restrictions and by corollary dismissed concerns about a deeper problem with demand:

> "Growth in the second quarter was affected by disruptions to global supply chains as well as the impact of necessary public health measures."
>
> and
>
> "We expect these global supply chain problems will gradually be resolved, but it could take some time."

D. On Revisiting Labour Market Tightness

Hold on here, what’s this?? Is the BoC rethinking labour slack? Macklem’s speech noted difficulties in hiring, rising job vacancies and rising hours worked and noted that the BoC is reassessing the amount of labour market slack that exists. “Bank staff are studying this process carefully to help us assess what it means for overall labour market slack.” He noted that a forthcoming BoC Staff Discussion paper by four staffers titled “Assessing Labour Market Slack for Monetary Policy” will explore the issue. With the August jobs report due out tomorrow there is a chance we should be on watch for the piece rather soon. For now, the hint is that Macklem acknowledged “the unevenness in the labour market is moderating” which reins in a bit of the strong earlier emphasis upon how the recovery is not fully inclusive. It still probably isn’t, but the BoC is signalling a potential reassessment of the degree.