US Rates Watch

# BoC liquidity facility risks later QT end date

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## BoC liquidity facility puts downward pressure on CORRA

The Bank of Canada (BoC) recently reintroduced the daily Receiver General (RG) cash balance auction to help add liquidity to funding markets. The RG cash balance is analogous to the US Treasury's cash balance (TGA). The facility allows the government of Canada to invest excess cash at a market rate while boosting overall liquidity in the financial system. Since the daily auctions began on Feb 21 the BoC's policy rate, CORRA, has come down to their target of 5% from a peak of 5.07% on Jan month-end (Exhibit 1).

## BoC QT could continue for longer

The implementation of the facility comes as concerns arose around the BoC's ability to continue quantitative tightening (QT) given upward pressure in repo. The BoC has been draining settlement balance—which are analogous to Fed reserves—via the rolling off of maturing securities on their balance sheet since April '22. BoC previously guided that QT should end when settlement balances are between C$20b to C$60b, or 1% to 2% of GDP. Upward pressure in repo made it appear their estimate of the optimal level of settlement balances was too low. Settlement balances fell to a trough of C$108b, when CORRA was printing at 5.04%, just before the implementation of the facility, but quickly jumped to C$138b the following week (Exhibit 2). In the first week of Jan, when CORRA was +5bp over the target rate, the BoC had added liquidity via repo operations but has now changed course to make use of the RG account.

## Liquidity facility offsets settlement balance drain from QT

The daily RG auction has helped to offset the liquidity drain in funding markets which will likely allow the BoC to continue QT for longer. The question is how long the BoC will be comfortable with draining liquidity via QT while offsetting that drain via the RG auction facility. The liquidity facility allows the BoC to shift excess cash from one liability to another, without growing the balance sheet, unlike the earlier repo program which was a pure cash add. The BoC can take the excess cash that is sitting in the Government of Canada's cash balance and place it in settlement balances, which should allow for a continued drain of the overall size of the balance sheet via QT and reduce excess liquidity over time.

## QT forecast unchanged, risk to continuing for longer

We have long expected the BoC to end QT with the first rate cut, which our economists forecast for June. At this point, we forecast settlement balances will still be well above the BoC's estimate of the optimal level of settlement balances, at around C$90b. The implementation of this liquidity facility likely avoids the BoC having to end QT near-term as upward pressure in repo has dissipated. We expect to hear more on the BoC's plan for QT during Deputy Gov Gravelle's speech on March 21 and a confirmation of whether the BoC is comfortable with continuing QT beyond the first rate cut.

## Limited upward pressure in US repo

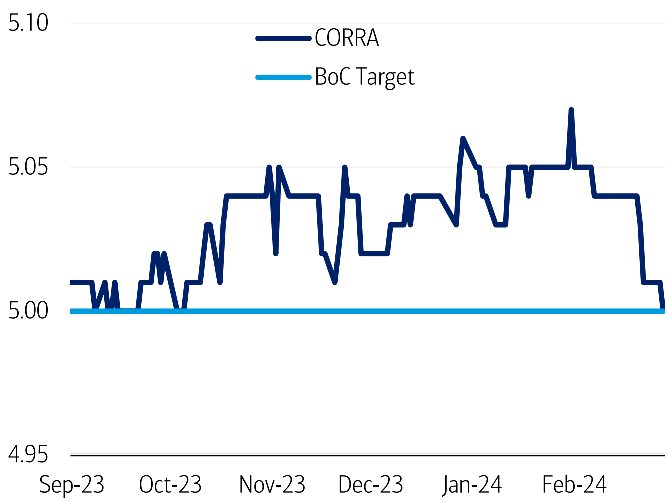
While we saw consistent upward pressure in CA repo up until the implementation of the liquidity facility, repo has been relatively stable in the US. Despite a significant reduction of liquidity via QT and a wave of collateral from the US Treasury, SOFR is little changed from the start of QT. Both central banks can likely continue QT for some time as long as funding markets remain stable.

## Larger balance sheet is a risk to financial stability

Several important factors likely encourage these central banks to continue reducing the overall sizes of their balance sheets. As recently highlighted by Kansas City Fed President Schmid, a large balance sheet poses risks to financial system stability. A large UST portfolio can create distortions in the price and allocation of credit. QE allows for lower long-term rates and flattens the yield curve, which can hurt banks' ability to borrow short and lend long. Additionally, Fed research has also found that elevated reserve balances increase the risk of recording a quarterly loss as hikes increase the cost of their liabilities. Central banks will also want to reduce the size of their balance sheet before the next crisis and recapture capacity for a future round of QT.

**Bottom line**: The RG cash balance auction allows for increased liquidity in the financial system and in turn should allow for a longer timeline of QT. The facility has been successful at reducing the cost of funding to align with the BoC's target rate. A more efficient distribution of liquidity should allow for a smaller terminal BoC balance sheet.

**Exhibit 1: CORRA vs BoC target rate (%)**
The RG operation has helped to bring CORRA back in line with BoC target




**Source:** Bloomberg

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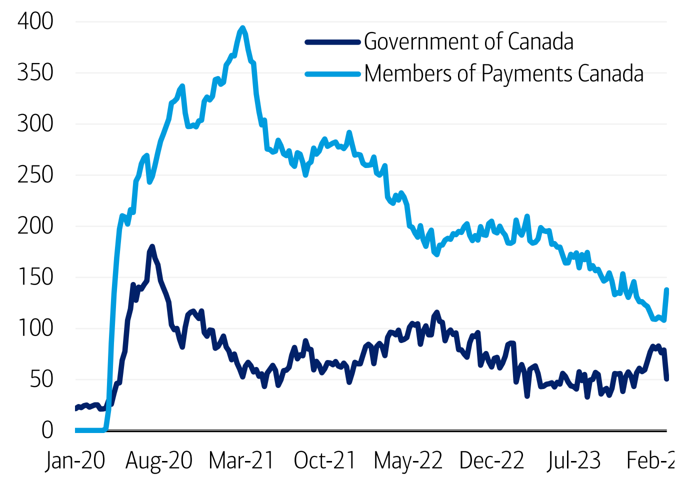
**Exhibit 2: Select Bank of Canada liabilities (C$bn)**
The recent addition of RG cash balance action has driven Government of Canada (GoC) holdings lower and increased settlement balances




**Source:** Bank of Canada

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