Market View
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QT to have more 'bite' in 2025

By Taylor Schleich

When it comes to Canadian monetary policy, it's naturally the BoC's policy rate that dominates the discussion. There is, of course, another tool at the Bank's disposal: its balance sheet. The ongoing quantitative tightening effort, approaching its three-year anniversary in April, has mostly flown under the radar save for some periods of repo market pressure. The Bank maintains that CORRA pressures are unrelated to its balance sheet consolidation but whether or not this is the case, QT is likely to be wound down in 2025, as we examine in this *Market View*.

In 2024, the BoC shed $55 billion GoC bonds from its balance sheet, bringing its holdings down to ~$225 billion (nearly half its 2022 peak). Recall that the effect of run-off, all else equal, is a drainage of settlement balances (also known as reserves) from the financial system. These have been the guiding light for the QT timeline, policymakers identifying $20-60 billion as the equilibrium level. But despite the steady decline of GoC bonds being held by the Bank, settlement balances *did not* decline in 2024. Rather, they modestly *increased*.

How? There are several other factors that can influence settlement balances and these more than offset 2024 bond run-off. Chief among them was the federal government working down its cash stockpile, the chequing account it holds with the BoC shrinking by roughly $40 billion in 2024. This decline includes the impact of receiver general auctions being reintroduced earlier in 2024. These allow the private sector to borrow 'excess' funds from the feds, adding settlement balances back into the system. Had the federal government opted to keep its bank account at its start-of-year level, they would've needed to issue more debt (which would've been funded by reserves). The Bank's repo and reverse repo programs contributed too. Ongoing CORRA pressures led to daily overnight repo operations, adding liquidity back into the system. Reduced *reverse* repo usage, meanwhile, re-introduced liquidity.

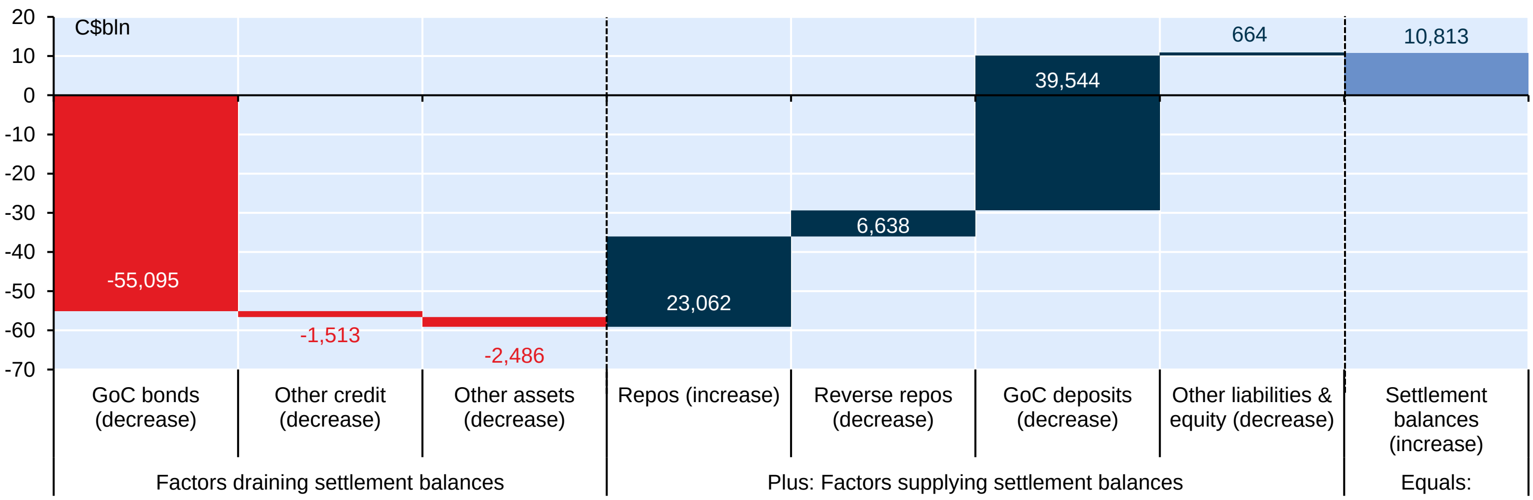
The BoC has consistently argued that $20-60 billion is the appropriate steady state level of settlement balances but this is still hotly debated. An **earlier survey** of Lynx participants suggested the optimal level could be as high as $85 billion. Some even argue that we're *already* at the equilibrium based on demands for liquidity in 2024. There have obviously been periods of CORRA setting comfortably above target, requiring injections of cash via overnight repos or receiver general auctions to relieve pressure. This, they would argue, is sufficient evidence to prove that the financial system has reached its limits. The Bank would counter that by arguing pressures in the second half of 2024 are more attributable to the transition to T+1 settlement, the associated move in repo volumes and leveraged long hedge fund positioning (see the BoC's staff analytical note from August **here**).

Either way, QT is likely to run its course in 2025. On one hand, if we are already at or near the steady state, we should see repo and receiver general auction usage climb higher as bond run-off drains liquidity further. That might lead policymakers to conclude that the $20-60 billion estimated range was too low. On the other hand, if $20-60 billion is truly the optimal range, then regular course run-off and the normalization of other balance sheet components should bring settlement balances close to this point in the second half of the year. Indeed, the factors that kept reserves elevated in 2024 shouldn't repeat in this environment. The government's bank account is now back to its pre-COVID size so spending can't come out of cash balances (and the feds will always keep a minimum of $20 billion on hand). The reverse repo program is no longer being tapped and thus, there is no cash here that can return to the private sector. Overnight repos are the major wildcard but if usage moderates, it would help accelerate settlement balance drainage with the $60 billion upper limit breached later this year.

Fortunately, guidance straight from the source will arrive soon. A Toni Gravelle speech on January 16th will "provide an update on the balance sheet normalization process and how the Bank will manage its balance sheet once normalization ends." Mark your calendars.

Chart 1: The federal government's cash drawdown is biggest contributor to 2024 settlement balance growth

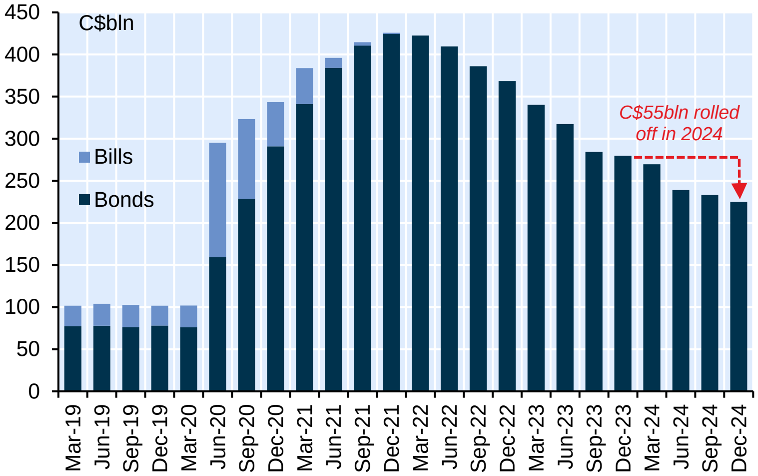
Change in the Bank of Canada balance sheet in 2024 by component and impact on settlement balances*



Source: NBC, BoC | Note: Last 2024 data point = December 25. Some balance sheet components have been combined for simplicity. Direction of bar consistent with offsetting move in settlement balances. E.g., A decreasing asset needs to be offset by a decreasing liability (i.e., settlement balance). A decreasing liability needs to be offset by decreasing liability (i.e., settlement balance).

Chart 2: BoC continued to shrink its GoC holdings in 2024...

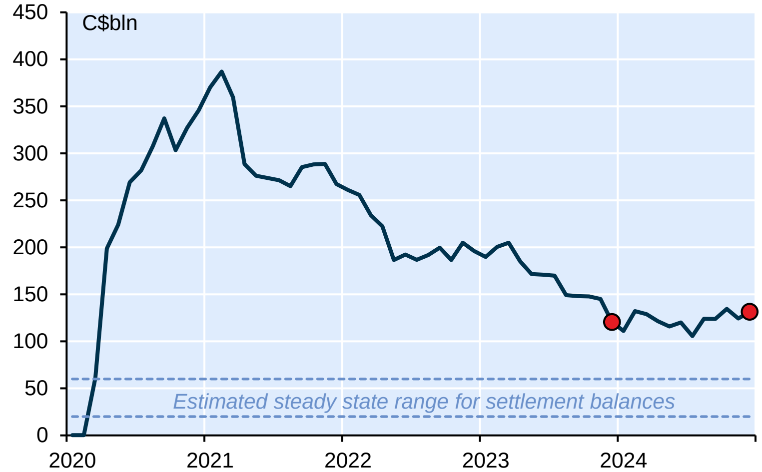
Bank of Canada holdings of GoC bonds (end of quarter, book value)



Source: NBC, BoC

Chart 3: …yet settlement balances slightly *increased*

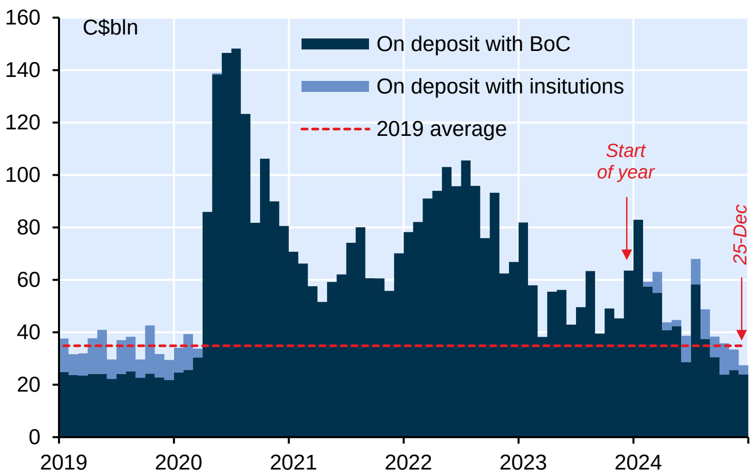
BoC deposits made by Payments Canada members (i.e., settlement balances)



Source: NBC, BoC | Note: Last data point as of 25-Dec

Chart 4: The government's cash balances are back to normal

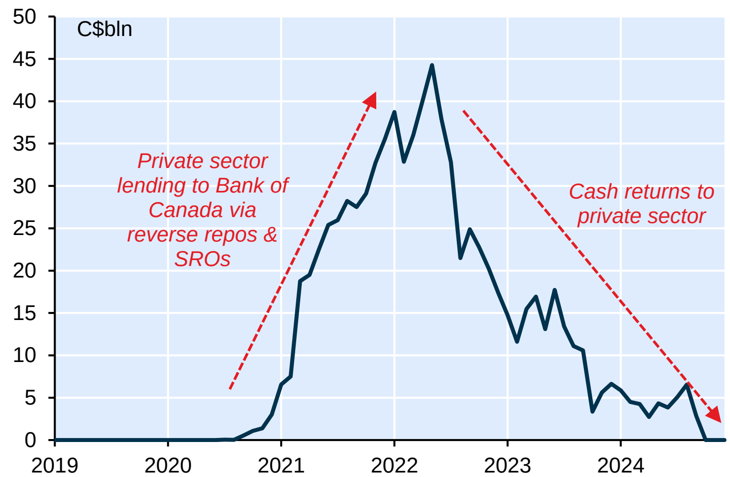
Government of Canada deposits



Source: NBC, BoC | Note: Last data point as of 25-Dec

Chart 5: Reverse repo wind down *had* propped up SBs

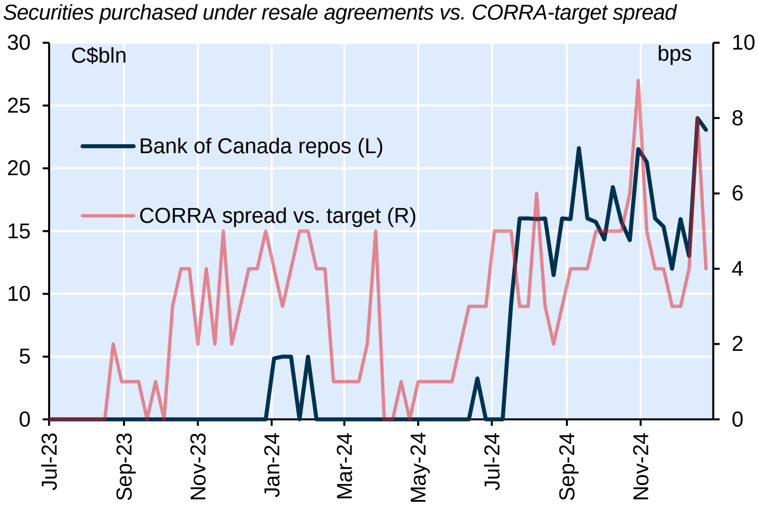
Securities sold under repurchase agreements



Source: NBC, BoC | Note: Last data point as of 25-Dec

Chart 6: BoC injected liquidity as CORRA pressure mounted

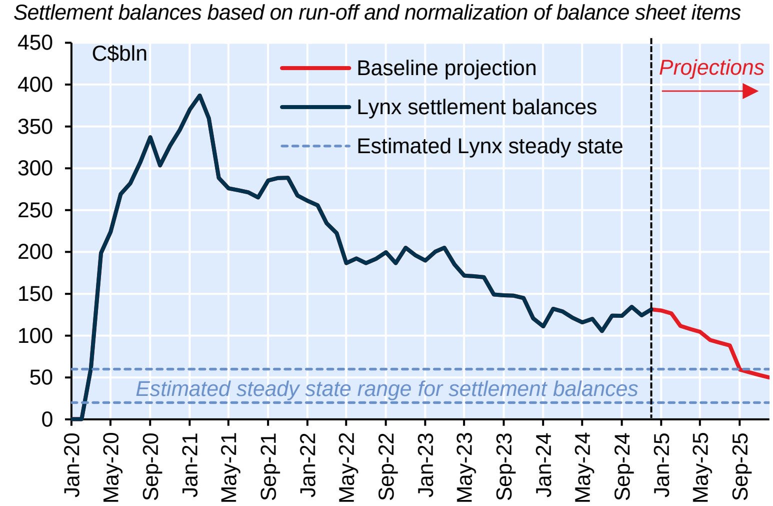
Securities purchased under resale agreements vs. CORRA-target spread



Source: NBC, BoC | Note: Data refers Wednesday levels. Last data point = 25-Dec.

Chart 7: Settlement balance to reach 'steady state' in H2

Settlement balances based on run-off and normalization of balance sheet items



Source: NBC, BoC | Note: Projections are on a month-end basis. Assumes cash balances hold steady, and repo usage gradually tapers. This is the major wildcard. Persistent or increased overnight repo usage will slow settlement balance drainage

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