Special Report

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QE Is Unlikely To Arrive In Canada

It's unlikely that the Bank of Canada will introduce quantitative easing despite the popularity of the topic, but if it does, it would likely come well after other policy options have been explored and it is worth highlighting the associated risks and potential unintended consequences. Underlying arguments are briefly cited below.

1. We expect a moderate economic recovery to unfold

Most negative oil price shocks carry sharp but relatively fleeting short-term hits to Canadian GDP growth before the lagging benefits to the rest of the economy kick in and before the indirect benefits from a strengthened US economy materialize. We think we're approaching that point such that 2015H2-onward will introduce a moderate rebound and assuage some of the current fears. Preliminary evidence of this started to arrive in June data.

2. Other policy options would probably be exploited first

In the depths of the global financial crisis, Canada generally resorted to market-specific measures without employing the blunt instrument of QE and, if needed, I think we would see the same thing in future. That means that QE would probably be a tool of last resort in my opinion after another possible cut and a period to evaluate the lagging effects of easing to date, and after other policy tools have been deployed.

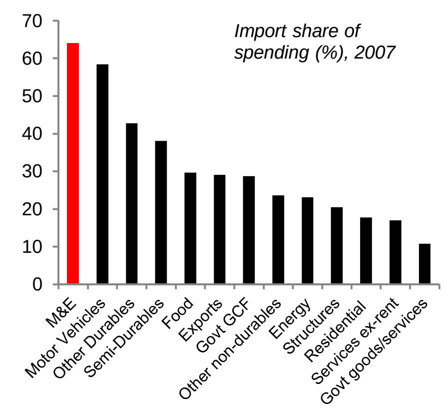
The ABCP market was one focus, as was the mortgage market through the Insured Mortgage Purchase Program that entailed a swap through the CMHC as Finance issued GoC bonds to buy mortgage product off banks in a program that by definition did not involve printing money and made a handsome return for taxpayers. Further, should concerns about elevated housing markets prompt weakness, then it's more likely that Ottawa could use easier macroprudential rules to address this rather than a blunt tool fraught with risks like QE. Given the tightening of such macroprudential rules since 2008 there is considerable room for doing so.

3. QE can make things worse for a country with high import reliance

One reason why QE hasn't done much good in Japan is because of that country's high import shares of key consumption categories. All else equal, rapidly growing the money supply debases the currency, and currency depreciation raises import costs. This squeezes consumer purchasing power by depressing inflation-adjusted wages and it adds to headwinds facing the household sector. Thus, QE applied to a country with high import shares in consumption and investment can arguably make things worse. This was the point we made about Abenomics in our earlier articles a few years ago (for example, click here).

Chart 1

Canadian Import Propensities

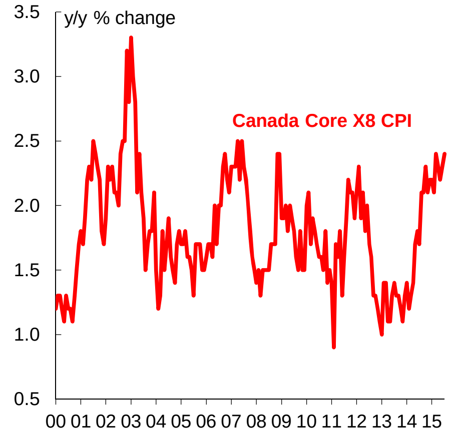


Source: Scotiabank Economics, Ministry of Finance

Chart 1 shows the import shares of various types of spending and investment in Canada. Canadians import roughly one out of two vehicles, two-thirds of equipment investment, over 40% of other consumer durables like appliances, about 30% of government investment in capital goods, and about 30% of food. Exports themselves have about 30% import content such that currency depreciation does not translate into improved price competitiveness one-for-one. If wage growth is soft to nonexistent — as would presumably be the case if things are so bad as to require QE — while a large import price shock is being imposed, then consumers would cut back spending on discretionary items (like autos, renos, electronics, etc.) to pay higher prices for more basic items. The result would be disinflationary or deflationary for sectors that produce discretionary items as an offset to inflationary consequences for imported items. It would carry important sector consequences for analysts to consider should the BoC go the QE route. Some of this imported inflation effect would be offset by substituting more toward domestically produced choices but this would be a limiting factor, not an offsetting one.

Chart 2

CDN Core Inflation Elevated



Source: Scotiabank Economics, Statistics Canada.

4. No deflation

One goal of QE is to offset deflation fears by printing large amounts of money that chase the same goods and services. I don't see signs of such deflation concerns in Canada. In fact, somewhat related to the earlier point is that a floating currency like the C$ combines with high import propensities to raise inflation risk. Various measures of inflation expectations including breakevens on real return bonds, surveys like the BoC's Business Outlook Survey, and economists' forecasts are suggesting reasonably well anchored inflation expectations that are devoid of deflation concerns. In fact, with core CPI inflation at 2.4% y/y in July and tied with March for a nearly seven year high (chart 2) and headline CPI temporarily depressed at 1% y/y, there is a case for seeking inflation protection that markets may still be underpricing. That is especially considering the underlying breadth of the price gains within the core CPI basket (chart 3).

5. The GoC curve is already richly priced

Another goal of QE can be to push term rates lower to benefit lending rates across a variety of products, but they are already very low including the 5 year GoC at about 0.6-0.7% of late. This is unlike when QE1 and QE2 were implemented by the Fed. At such low yields, it's possible that over time QE backfires by further raising inflation expectations and with it bond yields. This would be a policy success if the starting point was marked by deflationary concerns but that is not the case.

6. Credit channels are not impaired

A third goal of QE can be to address impaired channels for credit creation by buying credit products where the market might otherwise choose not to do so. It's important to note that wider spreads are not a sufficient condition for this argument that instead arguably requires evidence of a market failure as opposed to simply allowing price discovery to unfold. This was a reason behind buying MBS/agency product in the US. This is unlikely to become Canada's issue with its strong banks, limited dealer leverage, limited use of off balance sheet leveraged conduits, and mortgage guarantees. Households are leveraged, but the broader financial system is generally healthy and far less leveraged than elsewhere going into the crisis and in many instances through to today. Thus, it's unlikely that a vicious reversal of leverage would create market failure conditions. Five year CANHOU mortgage bonds at 94bps and 10 year at 1.8% suggest continued healthy appetite for credit and the possibility that the world sees Canada for sale given where the currency is. High yield has been mixed by segment but it's highly improbable the BoC would view this as disturbing enough to roll out blunt policy instruments. The high yield market is not large enough to

Chart 3 **Breadth to Core CPI Gains**

Source: Scotiabank Economics, Statistics Canada.

prompt a QE program. Targeting the investment grade corporate market and provincials offers the added complication of potentially adverse liquidity effects and political risks.

Also, if the policy aim is to control all-in credit yields, then the BoC would have to buy both base yields and spread product. This was why we had argued at the time that the Fed's QE1 program had to transition toward buying *both* credit and base yields otherwise investors would follow what is being targeted and not what isn't and thus put movements in spreads at loggerheads with movements in base yields.

7. The currency is already much weaker

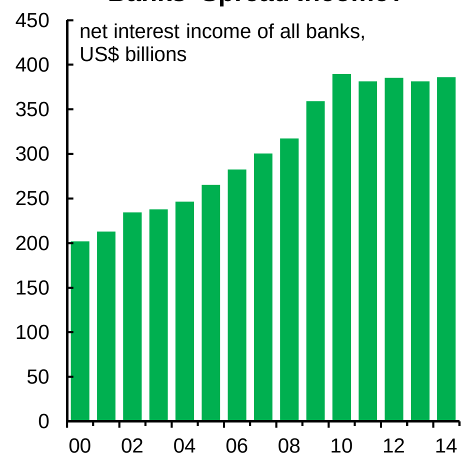
A fourth goal of QE that is often denied by central banks including the BoJ is to debase the currency. With USDCAD at its weakest since 2004 and about 36 cents weaker than its peak in 2011, a combination of conventional monetary policy and lower oil prices has already weakened the C$ with possibly further weakness ahead — even without QE. This is not like when the yen was pushing into the 70s range versus the greenback and the BoJ then set about to destroy its value as part of the Abenomics agenda that has contributed to the yen's fall to about 124 versus the USD today. QE on a sizeable scale in Canada could have the currency plumbing the depths of the early 2000s and light up destructive inflation.

8. Canada is a price taker in global capital markets

The BoC is likely to be less successful than bigger central banks in larger markets when it comes to sustainably impacting domestic interest rates and it cannot influence global commodity prices as the Fed's actions probably did to the upside and more recently to the downside. A synchronous global rates sell-off motivated by, say, Fed actions could be tough for the BoC to lean against, and I view oil as difficult to forecast in the near-term but likely cheap over the longer term.

Chart 4

Did U.S. QE Help Or Hinder Banks' Spread Income?



Source: Scotiabank Economics, FDIC.

9. Could negatively impact the financial sector

Pushing the term structure of interest rates lower could diminish appetite for taking term risk on lending books and impose some form of supply-side motivated deleveraging. I believe this is one of the costs to QE in the US in that it has arguably made the intermediated credit cycle worse.

QE could also depress loan spreads relative to the lower funding bound in a market that is more reliant upon retail funding. Note that in the US there has been no growth in aggregate net interest income across all commercial banks over the period since 2010 and that's likely reflecting a combination of economic weakness and policy distortions (chart 4).

10. Don't give away Canada's edge

We've always maintained that one of the Canada advantages is that when faced with tough times the country has tended to hunker down, pay its bills, and do what is necessary to come out brighter on the other side. This was done through painful sacrifice in the 1990s following the excesses of prior decades and that in turn set the stage for much of why Canada's economy outperformed the rest of the world during the global financial crisis. This approach lies in contrast to printing money. I believe that over the longer run, markets like Canada that resist QE will hold an advantage in terms of investor reputation with concomitant advantages to the economy and domestic markets. Persistent efforts to debase the currency would run counter to this aim. This is especially so in the face of a heated ongoing debate over the merits of applying QE elsewhere (recently surveyed here especially in section 4).

In conclusion, we don't see QE as arriving in Canada, but should it, one must be cognizant of its potentially damaging consequences within the unique Canadian setting. Further yet, I continue to believe that conventional monetary policy has become too easy, market pressures on the BoC's bias will intensify into next year, and this will evolve from the current market environment that is too richly priced for further monetary policy actions over the years ahead.