Bank of Canada Goes to Zero with QE — Federal Government to Offer Lots of Debt to Purchase

- **Bank of Canada launches QE, cuts to lower bound…**
- **…with GoC buying likely in the C$200–300B range…**
- **…and adds a CP facility likely in the tens of billions**
- **…but leaves markets speculating on program details …**
- **…while ruling out negative rates**
- **Was not buying credit a mistake?**
- **Federal Government stimulus is sharply raised…**
- **...with more to come…**
- **...and will give plenty of bonds to buy!**

Well Ottawa sure caught up! The Bank of Canada and Federal Government provided a great deal of additional stimulus to counter the COVID-19 and OPEC+ shocks to the economy. The initiatives were rolled out in collaborative form because a) that tends to be the way of a parliamentary democracy like Canada's system, and b) because monetary policy expansion coincides with expensive price tags on fiscal programs that have considerable merit requiring further details to assess them properly.

BANK OF CANADA MEASURES

Consistent with our long-held expectations, the Bank of Canada jumped into markets with multiple forms of aggressive easing. Pegging the timing was uncertain, but what explains choosing to announce today is the heavy policy coordination between the central bank and the Federal government's own announcements. To our international audience, the strong reminder here is that Canada usually announces crisis policies in tandem with the Governor and Minister of Finance standing shoulder to shoulder. The C$ instantly depreciated on the back of the BoC announcements but is currently little changed. The Canada curve rallied hard in the wake of it all with the two year GoC yield down 15bps on the day and the 10 year yield down 10bps.

The punchline is that at 0.25%, the policy rate is now as low as it will go and will stay there for a long time, while the BoC is likely to wind up purchasing an estimated C$200–350 billion of Government of Canada bonds and commercial paper. These are my estimates on what could be the case given they are open-ended programs with neither flow nor stock estimates provided for a new CP buying program nor a stock or horizon estimate to attach to the disclosed flow rate of GoC purchases. The aim is simply to provide rough parameters to evaluate the size of the overall effort as shown in chart 1.

The statements (here, here, here and here) introduced three forms of easing and remarks are supplemented by guidance from the ensuing press conference hosted by Governor Poloz and Senior Deputy Governor Wilkins.

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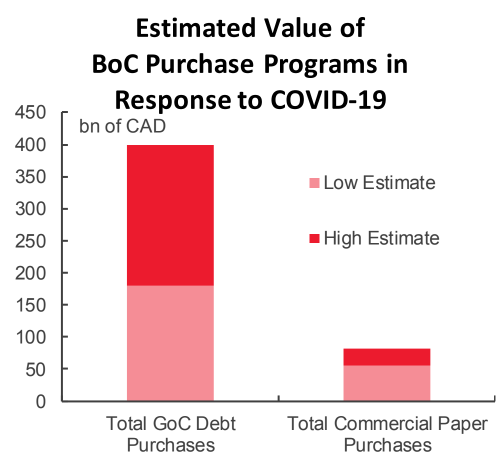
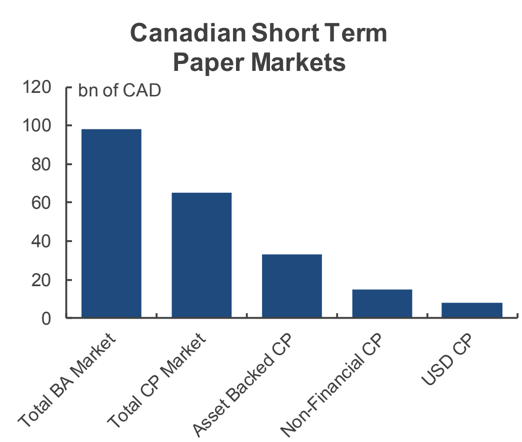


Source: Scotiabank Economics.



Sources: Scotiabank Economics, Bloomberg.

HALF POINT POLICY RATE CUT

The overnight lending rate was dropped by 50bps to 0.25%. The deposit rate is the same given the previously announced changes to the rate corridor.

Governor Poloz ruled out negative rates in his press conference and that might explain why CAD reversed course at about the same time given that the actual half point cut was already priced. He noted that in the past the BoC has stated that they are open to negative rates but that they now judge there to be the risk of causing greater damage to the financial system than the benefits of going negative. We forecast no further change in the BoC overnight rate throughout 2020–21 at a minimum.

The Governor was somewhat defensive sounding when he described the economy as in fine shape before the crises, as opposed to our view that weakness was long in evidence before the shocks and the BoC was falling behind the curve before the shocks.

A NEW COMMERCIAL PAPER PURCHASE PROGRAM

Details were in rather short supply with further announcements forthcoming next week. The CPPP will purchase primary and secondary market CP, secured ACBP and unsecured issued by Canadian firms, munis and provincial agencies with an existing CP program. Tenor will go out to 3 months with a short-term credit rating of R-1 (high/mid/low). We do not know purchase amounts but the program will last for one year. We do not know when the facility will commence operation.

We can set very broad parameters, however, in that we know the size of the paper markets in Canada (chart 2). The whole CP market is about C$65B and hence smaller than the BAs market that is just under C$100B. BAs are a more prevalent funding option for smaller firms that cannot access the CP market and need the stamp. CP is extremely important, however, including sectors that rely upon secured paper backed by their loans including credit card trusts, and recall ABCP is the market that blew up during the GFC and took down auto dealer financing. Within the CP market, about C$15B is non-financial CP, $33B is ABCP and $8B is US$CP. They are not buying US$ CP, so the maximum size of the CP facility if they bought up absolutely everything would be around C$55B at present. **I'd crudely figure a ballpark estimate in the C$20–30 billion range to very roughly estimate the magnitude of the stimulus.** This is targeted stimulus, pointed at a specific but extremely important market to multiple classes of borrowers. It's nevertheless modest in a C$3.3+ trillion economy.

THE BOC WILL NOW PURCHASE GOVERNMENT OF CANADA BONDS

The rate of purchase will be at a minimum of C$5B per week with operations conducted daily "across the yield curve." We do not know whether that means a weighted average approach to spreading purchases across maturities or something more flexible. It is an open-ended purchase program but guidance that purchases will continue until "the economic recovery is well underway" which leaves market participants guessing at the criteria the BoC will employ to halt purchases.

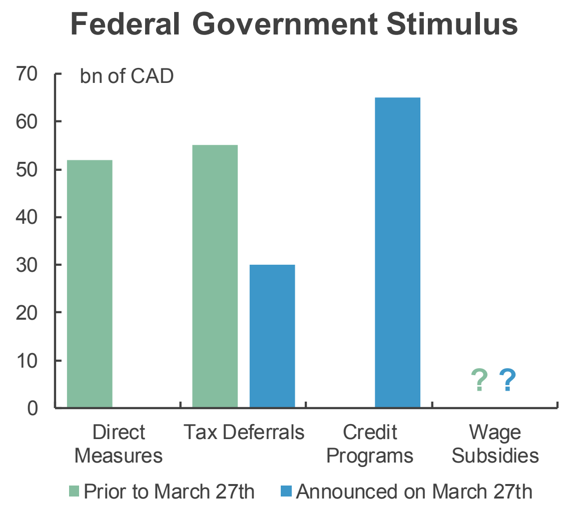
What exactly is meant by "well underway"? The first one or two positive quarterly GDP prints? The full recapture of lost output and a shut output gap? This matters enormously and the BoC said nothing to inform markets. A reasonable approach that is internally consistent with our views could peg it to our macro forecasts (the BoC has not provided any but will in mid-April). Our forecast expects GDP to contract by 28% in Q2 and then expand by 12% in Q3 and 16% in Q4 before growth decelerates but remains strong in 2021. This is frankly a lot of guesswork on the timing and magnitudes obviously, so in one sense, it's understandable that the BoC is reticent to weigh in more explicitly.

If the BoC were to buy through to year-end at which point we may have a couple of quarters of improving data in the books, then 'well underway' could mean about C$180 billion of bond buying or higher depending upon the exact purchase flow. If the BoC were to buy until mid-2021 when hopefully recovery evidence will be well underway and much of the added spare capacity may have been absorbed, then the purchase program could be about C$300 billion or greater. Scale up or down to suit your views on the duration and magnitude of the shocks at hand as not even the scientists know.

Combining reasonable estimates for the size of the GoC bond purchase program and the size of the CP facility would bring total buying to possibly well over C$300B. The fraction of the CP market, the duration of the GoC bond buying and the exact flow will determine upside and downside risks to this. For now, pencil in over a quarter trillion by my judgement and probably spread it on a weighted average maturity basis over time.

Further, the door remains wide open for the BoC to buy a greater variety of credit products including corporate bonds but the BoC is arguably done for some time barring a greater shock yet. Poloz appeared to downplay buying of provincial bonds during the press conference when asked as he remarked that all borrowing costs are low even with financial strains. One criteria for evaluating this risk of purchasing a broader suite of spread products will be the impact upon spreads. Asset buying that purchases sovereign product and not credit risks triggering portfolio substitution effects toward what is being targeted and hence relatively more attractive from a relative return standpoint and away from what is not being targeted. To reinforce the effects of overall asset purchase programs, buying base yields and spread is complementary toward the end goal of repairing financial market functioning. Regardless, recall that the Bank of Canada Act has long afforded the BoC the power to buy any securities for years now.

During the press conference, the BoC explained that it has other potential tools at its disposal which are generally well understood. Reference was made to scaling existing programs, offering credit easing to purchase other assets (like corporates…), and a funding for lending scheme like the Bank of England's.



Sources: Scotiabank Economics, Government of Canada.

FEDERAL GOVERNMENT INITIATIVES

The BoC arguably had to step in to buy GoC bonds as fiscal stimulus will add to the stockpile of bonds and bills outstanding including about C$625 billion in direct GoC bonds which was already up by about C$40 billion y/y to February before the stimulus measures. This perhaps explains part of the motivation to coincident measures beyond the niceties of being collaborative Canadians. I'll offer brief highlights to these programs below because of this connection to bond buying but much further analysis and details will be forthcoming from Scotia's Rebekah Young.

The Federal government also stepped in with its own complementary initiatives this morning that were delivered in collaborative form with the BoC. It did so at first with remarks from the Prime Minister Trudeau then in a press conference hosted jointly by Finance Minister Morneau and in a release. Salient highlights follow.

The total estimated cost of the programs announced to date is offered in chart 3. Initiatives launched before today added to C$107 billion. They included C$52 billion in direct measures particularly including the Canada Emergency Response Program that offers C$2k/mth for four months, plus C$55 billion in deferred taxes.

New initiatives announced today add C$95 billion including C$30 billion of deferred taxes and C$65 billion of credit measures including a new interest free loan program for small businesses.

Two huge cautions on the fiscal ramifications include the uncertain cost of wage subsidies and sector-specific assistance including what appears to be in the works for airlines. The implications for government finances will be further assessed later.

EXPANDED EDC/BDB FUNDING

The Fed Gov't seems to have gone the route of expanding the prior EDC/BDB option rather than a credit guarantee facility or some other option. The original C$10B into the ECB and BDB has now been raised to C$22.5B which adds C$12.5 billion to the deficit. An uneven playing field has been further amplified by leveraging up government business lending entities that will come back to drive future debate but for now these entities are being relied upon to basically transfer credit risk to the government.

WAGE SUBSIDIES

The Federal government will cover 75% of the wages of small businesses affected by the COVID-19 shock back-dated to March 15th. Employers who keep their workers will get this coverage but who qualifies and whether there is a cap on the program are unknown. Employees at receiving firms will not receive the Canada Emergency Response Program benefits which would recover some of the costs.

This is still nevertheless potentially a massive price tag with major implications for the deficit but we do not as yet have details to judge the parameters. A clear risk is that many businesses may still think they don't wish to foot the remaining 25% absent any business and could instead opt to recall workers when a recovery is more evident. Is this the slippery slope to full coverage? The backdating is an uncertain factor in that many businesses have already let go of their workers.

GOVERNMENT GUARANTEED SME LOANS

The government will also offer guaranteed bank loans up to C$40,000 for small businesses that are interest-free for the first year. Recipients that pay back the loans in full by the end of 2022 will get 25% of the loan forgiven. This is an estimated $65 billion in access to credit program.

TAX DEFERRALS

GST/HST payments will be deferred until June which offers C$30B in interest free loans.

More business support is expected to be announced on Monday according to the Prime Minister and the Minister of Finance that may include details on the wage subsidies and airline support.