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Economics

FAQ on QE, Canadian Style

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Of late, we've had a string of meetings with institutional investors in which they have enquired about the possibility of quantitative easing coming to Canada if the economy continues to sag. Here's some answers for those frequently asked questions:

Is QE "On the Table"?

At this point, fans of QE in Canada are like those rooting for young Prince George in the UK; Charles and William still have their turns at the throne ahead of him. The Bank of Canada still has two more instruments that it will tap before even thinking about QE.

Next up for monetary policy, and likely not under serious consideration until after October's election, would be a final quarter-point cut, taking the overnight rate to 0.25%. In the Canadian money market structure, that's as low as she gets, and effectively represents the zero lower bound for monetary policy.

Should the economy remain weak through year-end, consideration would then be given to "forward guidance." Governor Poloz didn't rule it out, but said it only made sense when overnight rates were at their lower bound. Pledging to not hike until certain conditions were met, and giving a time date for when the Bank viewed that as likely, can serve to pull 2- to 5-year yields down if the market was otherwise priced for earlier hikes. Note that during the global Great Recession, a 0.25% overnight rate and forward guidance were as far as the BoC was prepared to go, even with the unemployment rate up at 8.7%. Today, we're sitting at a 6.8% jobless rate, so it will be some time before QE is the question before Governor Poloz.

How Would QE Operate in Canada?

Unlike the US, banks are not required to hold reserves at the central bank. Under QE, Canadian banks would be selling their bonds to the Bank of Canada and in exchange would be building up large overnight settlement balances held on deposit at the BoC. The Bank of Canada would not call it QE if the asset purchases were sterilized by short-term repo or other operations that withdraw excess funds from the banking system.

Are There Enough Bonds Out There?

Maybe, but the BoC would face a bit more of an issue than the Fed in terms of eating into the liquidity of the bond market if QE really ramps up. Even if the Bank decided to extend the definition to include CMBs, the stock of bonds outstanding is less than half the size of the bonds that were eligible for the Fed's three rounds of QE, as a share of GDP (Chart 1). Many of these Canadian issues are at terms of five years or under, where bond-buying wouldn't have much scope to lower yields further. The long end of the Canadian curve has been more heavily

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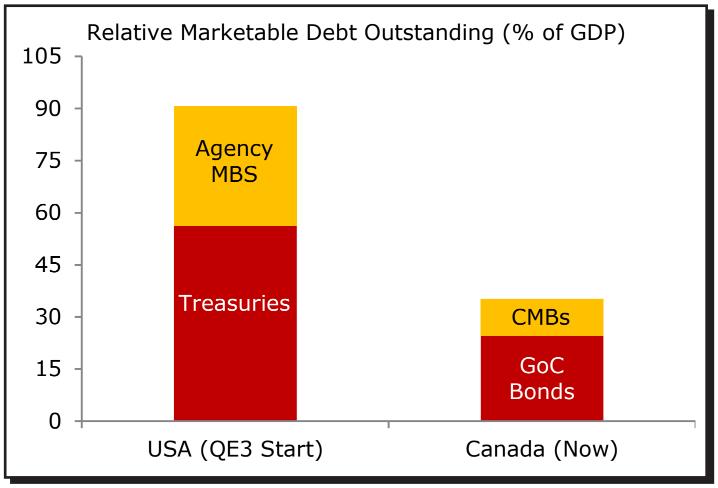
Chart 1

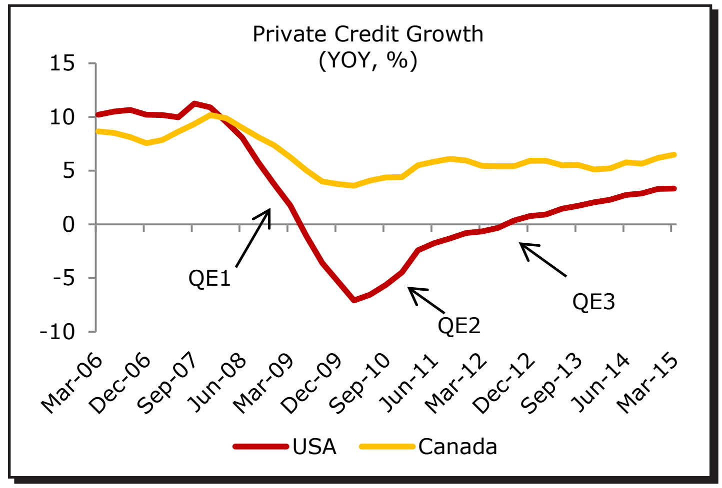
Proportionately Fewer Bonds to Buy



Source: Bank of Canada, US Treasury, SIFMA, CMHC, CIBC

Chart 2

Credit Growth Not Yet an Issue



Source: Federal Reserve, Bank of Canada, CIBC

tapped by provinces, but wading into those waters might be considered a half-step toward "credit easing". The Bank of Canada appears to treat buying spread product as a further step down the path of unconventional policy beyond straight QE buying of federal government issues.

Would QE Provide Meaningful Stimulus?

A bit, by further weakening the exchange rate in support of net exports, and encouraging banks to seek higher yielding assets to balance off against low (25 bp) yields on settlement balances. But overall it would be much less effective than in the US.

At least at this point, one of the objectives of QE, which is to stimulate credit growth, hasn't really been the problem for Canada (Chart 2). Unlike the US when it launched the first round of QE, the Canadian mortgage market hasn't been frozen, but instead has been under the microscope for perhaps having expanded too quickly for longer-term financial stability. The pace of credit growth could of course slow if the economy remained mired in a downturn, but so far, credit growth isn't the problem that it was in post-crisis US, Europe or Japan.

More importantly, lowering long-term rates just isn't as stimulative in Canada as it can be in the US. Americans have 30-year mortgages that can be refinanced if rates fall, providing monthly savings that can be shifted into consumption. Canadian mortgages are almost all 5-year terms or less. By cutting the overnight rate to 0.25%, and then pledging to keep it there for an extended period, the Bank of Canada would already have 5-year Canada yields below 0.5%, leaving little room for QE to materially affect the part of the curve that feeds into mortgages and consumer finances.

Are There Better Alternatives?

Yes, and Canada has shown its willingness to use one of them. At the height of the global recession, Canada didn't wade into QE. Instead, it reached into the fiscal tool box, launching a major federal-provincial stimulus package. Then, as now, monetary policy would have been running up against diminishing returns, while borrowing at ultra-low bond yields to finance deficit spending was a much more powerful tool. Indeed, even Ben Bernanke advised Congress that while the Fed felt that QE would be beneficial, fiscal stimulus would have been more efficacious.

Political realities in Canada suggest that, should the economy remain under stress through the end of 2015, fiscal stimulus would indeed be on offer, at least at the federal level. Although some provinces might not be as eager to dip into more red ink as they were in 2008, Ottawa's debt/GDP ratio is still relatively contained. Remember that while then minority-government Conservatives initially went into a stimulative deficit with some reluctance, they subsequently championed the wisdom and benefits of their "Action Plan".

The Conservatives have advocated a balanced budget law, but one that would specifically allow for stimulus and deficits in the event of a recession. Neither the NDP or the Liberals are at this point campaigning on a plan to run deficits, but both parties were strong advocates of doing so during the last economic downturn.

Even for the Bank of Canada, there's a form of easing that might be more powerful than conventional QE. Why "print money" to buy Government of Canada bonds and drive rates down trivially, when one could instead use unsterilized intervention to directly weaken the exchange rate, a not-too-hidden objective of QE when it was used in Europe and Japan. Instead of buying Canadian bonds, the BoC simply buys US Treasuries to build up its foreign exchange reserves.

So Should We Expect QE?

No. QE looks to be the fourth or even fifth line of defense after one more conventional rate cut, forward guidance to lengthen the timeframe for the first hike, fiscal stimulus and perhaps even foreign exchange intervention. QE is still technically "on the table," if Canada's economic malaise persists longer than we or the Bank of Canada now expect. But given how far it is down the list of policy options, it's very premature for fixed income investors to start building such a scenario into their base case outlooks.