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The Limits of Canadian QE: A Blessing in Disguise

by Royce Mendes & Ian Pollick

A pandemic-driven recession isn't the type of problem that a central bank can solve. At a time when infection rates, not interest rates, are still top of mind, monetary policymakers in general can't do much to substantially alter the path for their economies.

But the Bank of Canada might have further limitations with which larger central banks don't have to contend. In particular, while its quantitative easing program has coincided with a significant decline in Government of Canada bond yields, those purchases likely wield far less power than is currently being assigned to them by some observers.

Since the Canadian bond-buying scheme will need to be pared back in the not-so-distant future to maintain market functioning, that ineffectiveness could end up being a blessing in disguise. It means there likely won't be a "Made in Canada" taper tantrum.

When Occam's Razor Doesn't Cut It

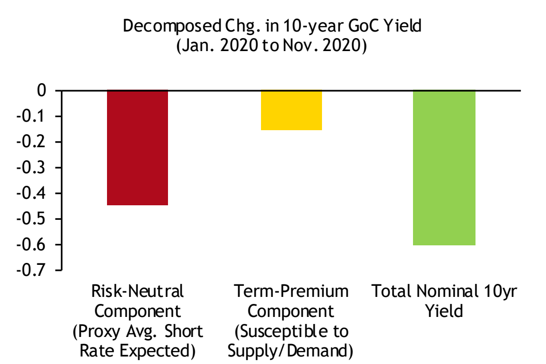
Since the pandemic began, the federal government has run a historically large fiscal deficit, the Bank of Canada has purchased roughly 30% of outstanding Government of Canada bonds, and interest rates on long-term debt have fallen 60bps.

A simple explanation would say that the Bank of Canada's bond-buying spree is all that's standing between the economy and a spike in borrowing costs. However, in contrast to Occam's famous quip, the simplest explanation is not the best one in this case. Longer-term Government of Canada bond yields are heavily influenced by global factors as well as domestic developments which have little to do with supply and demand in the bond market.

Our model[1] of decomposed bond yields shows that changing expectations surrounding the path for the Bank of Canada's overnight rate, which we represent by calculating risk-neutral yields, have been a major factor in explaining the fall in rates (Chart 1).

It's true that the term-premium, which is the component of yields that is sensitive to supply and demand in the bond market, has also fallen even in the face of the massive issuance. But it's misleading to believe that result is solely driven by the Bank of Canada's program.

Chart 1
Changing Expectations for the Path of BoC Rate a Significant Driver of Lower Yields



Source: CIBC

(1) We follow the methodology in Adrian, Crump & Moench 2013.

From January of this year, when North American markets were still shrugging off rising concerns in China regarding COVID-19, to the end of March when the world had changed, the term-premium on Canadian 10-year government debt fell by roughly the same magnitude as that on 10-year US Treasury bonds. It can be reasoned that the decline in Canada was the result of a largely global phenomenon, particularly since the Bank of Canada didn't announce its bond-buying program until almost the end of the month, with purchases beginning even later. Moreover, such synchronous moves have been observed in the past when the Bank of Canada was inactive and not expected to make any changes in policy.

A Leaf in the Wind

From the beginning of 2008 through to the end of 2012, the federal government of Canada added almost 70% to its outstanding stock of marketable debt securities. The Bank of Canada did not conduct a quantitative easing program, in fact after falling early in the period, the overnight rate was raised in 2010. However, the benchmark 10-year bond yield fell from 4% to roughly 1 ¾%.

Changing expectations about the path of the Bank of Canada's overnight target rate were again a factor, as markets realized that future rate hikes would be slow in coming and that the economy would not be able to handle peaks in interest rates as high as in past cycles. But a significant share of the drop in longer-term Canadian interest rates was also seen in the term-premium.

Of course, during that time, the US Federal Reserve was buying large volumes of Treasury securities and MBS to ease financial conditions in its battered economy (Chart 2). As the Fed scooped up those assets, demand clearly spilled over into the Government of Canada bond market. US and Canadian government bonds are reasonable, if not perfect, substitutes for each other in many portfolios and capital flows relatively freely into Canada.

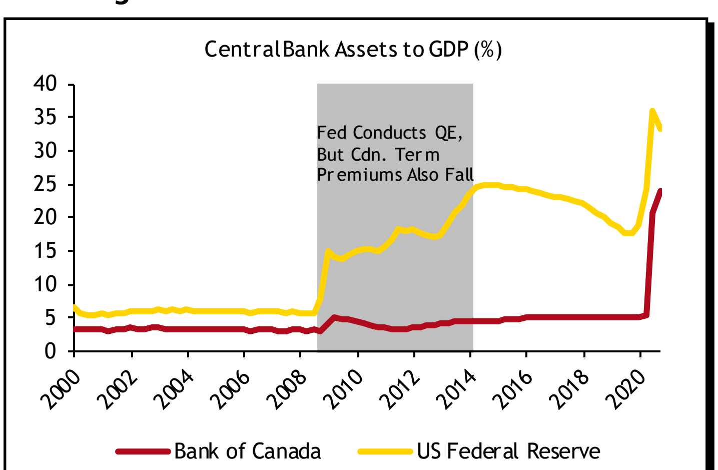
Indeed, in spite of the increasing supply of bonds and the absence of a domestic quantitative easing program, we estimate that the term premium on 10-year Government of Canada bonds fell by roughly the same magnitude as that seen on US Treasuries (Chart 3). The taper tantrum of 2013 showed an even more pronounced reaction in the Canadian bond market to what was a clearly external development, as term premiums in Canada were chased higher at a time when the Bank of Canada was holding rates steady at 1% and the Canadian federal government was actually paying off some of its debt. All that is to say that much of the containment in Canadian term premiums despite massive issuance in 2020 is likely the result of global forces.

Resistance Isn't Completely Futile

Still, the Bank of Canada's bond buying isn't completely futile. From April 2020, when asset purchases began, even if they weren't called quantitative easing yet, Canadian term premiums have been more resistant to the rise in US term premiums than would be expected in their absence (Chart 4). The more than 20bps

Chart 2

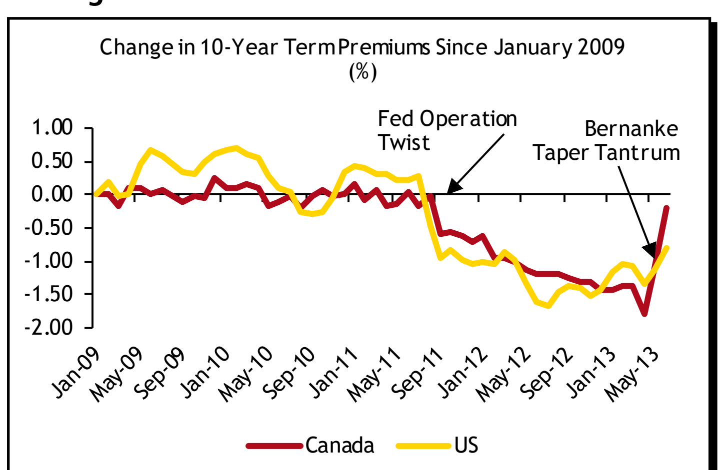
US Quantitative Easing Was The Main Factor Affecting Canadian Term Premiums



Source: Bank of Canada, Federal Reserve, Statistics Canada, BEA

Chart 3

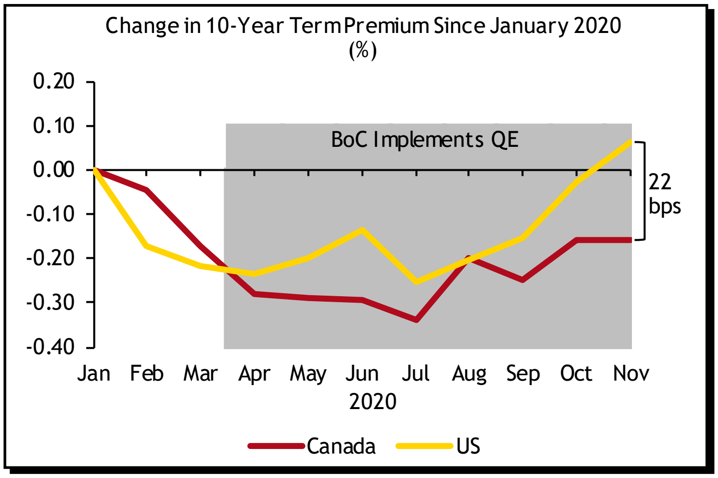
Canada's Term Premium Followed That of The US During the Financial Crisis



Source: Adrian, Crump & Moench, CIBC

Chart 4

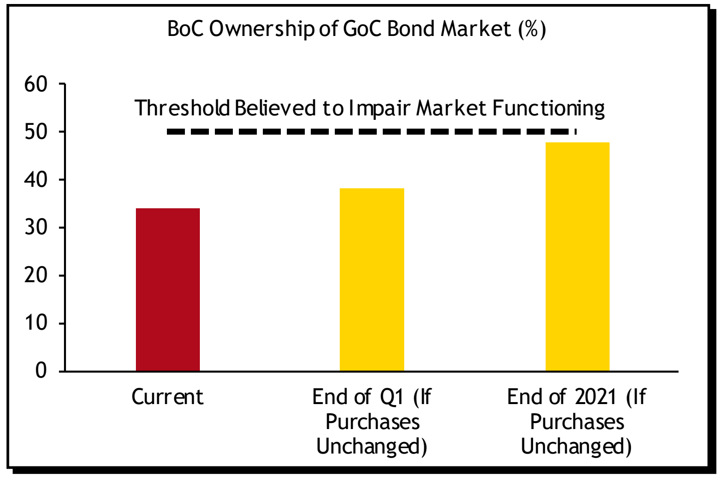
Canadian QE Adding Extra Pressure on Government Yields



Source: Adrian, Crump & Moench, CIBC

Chart 5

Bank of Canada Needs to Taper Before Endangering Market Functioning



Source: CIBC

of divergence between the Canadian and US term premiums seems homemade. That's hardly enough to risk a taper tantrum, but a meaningful bit of extra stimulus if Canadian policymakers decide they really can't reduce the overnight rate any further.

Boon or Bane?

With the Bank of Canada set to own roughly 40% of the Government of Canada bond market by the end of Q1, it's fast approaching the 50% threshold that Governor Macklem suggested could begin to cause market disfunction (Chart 5). So, it's very likely the central bank will need to pull back on purchases before the midway point of 2021 for reasons other than those tied to achieving its inflation target. The good news is that such a taper shouldn't lead to a severe tightening in domestic financial conditions, particularly if other, larger central banks maintain their purchasing volumes.

But that upshot also means that the Bank doesn't have as much firepower to combat the effects of a rise in global term premiums. Therefore, much of the story for Canadian long-term bond yields will be left up to decisions being made by central banks like the Fed. Fortunately, we see them maintaining much of their current stimulus for some time. While it will likely still add up to a modest increase in long-term bond yields in 2021, the Canadian economy will be healing and better able to absorb that type of blow.