In Focus

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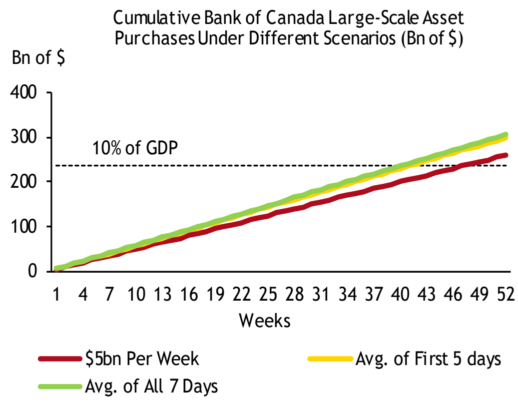
Bank of Canada: Can QE Save the Economy?

by Royce Mendes

For many investors, the financial crisis of 2008-09 served as a crash course on quantitative easing. At the time, Canadian policymakers didn't venture down that path, but they've now pulled the trigger on a form of large-scale asset purchases to combat the financial and economic effects of COVID-19.

Estimates regarding the efficacy of QE vary, but as Gagnon (2016) finds, empirical studies almost unanimously conclude that the policy significantly lowered bond yields in the aftermath of the financial crisis. For central bank bond purchases equivalent to 10% of GDP, the median estimated reduction in 10-year yields for the US, UK and Euro Area are all between 45 and 55bps. Each of those central banks actually ended up purchasing far more than 10% of GDP and, therefore, saw a greater reduction in yields.

Chart 1
Bank of Canada Bond Purchases Could Add Up Fast



Source: Bank of Canada, CIBC

Given the Bank of Canada's commitment to purchase at least $5bn worth of Government of Canada debt per week, it would take at most 47 weeks for the cumulative amount of purchases to reach 10% of Canadian GDP (Chart 1). But that doesn't mean Canada will see the same downdraft in yields. It's highly unlikely that the current iteration of the Bank of Canada's purchase program will have anywhere near the same financial or economic effect as past rounds in other parts of the world.

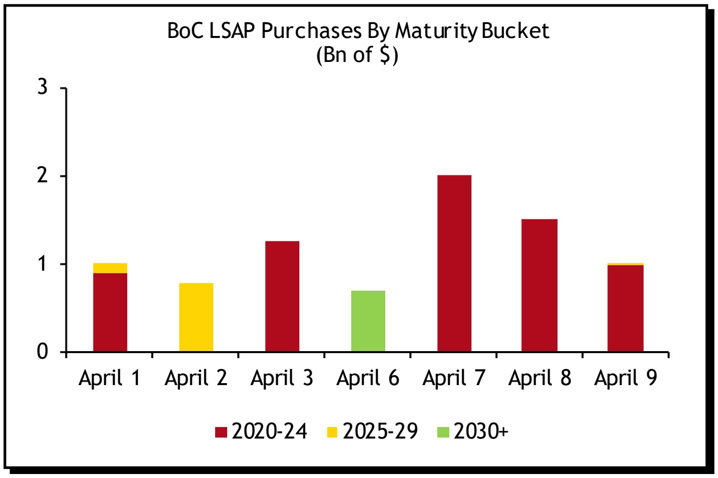
The Path Less Travelled

By purchasing Treasury bonds and removing supply from the market, the Federal Reserve's quantitative easing programs worked to lower rates by depressing the term-premiums on long-term government debt, which is the extra yield meant to compensate buyers for the risk of locking up their money. But the Bank of Canada's purchases aren't focused solely on long bonds.

The central bank is actually purchasing Government of Canada debt across a range of maturities because the current program is intended to add liquidity to problem-areas of the market, not to specifically depress long-term yields. In fact, so far, the Bank has purchased a majority of bonds at the short end of the curve (Chart 2). That's a key point of differentiation between what the Bank of Canada is conducting and the standard definition of quantitative easing. After liquidity concerns ease, though, continuing with that strategy risks inflating the Bank's

Chart 2

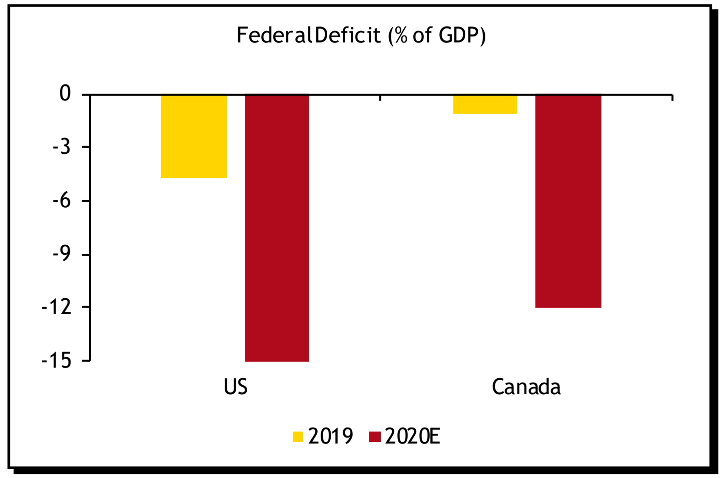
Bond Buying Not Focused on Longer-Maturities As Would Be The Case in Standard QE



Source: Bank of Canada

Chart 3

Federal Debt Issuance Set to Rise As Deficits Increase



Source: CBO, Finance Canada, CIBC

balance sheet without much to show for it in terms of lowering borrowing rates.

But even if the Bank pivoted to a more typical QE program, it probably wouldn't have as pronounced an effect on term-premiums in Canada as it did in the US or Eurozone since much of the movements in Canadian bond yields are dictated by those in larger economies. Indeed, Kabaca (2016) finds that the direct effects of quantitative easing programs on term-premiums in small-open economies is only one-third the size of the effects of programs in larger economies.

It's true that small-open economies have the potential to receive a greater economic boost from a weaker exchange rate because they're more reliant on trade. But with so many central banks globally now implementing some form of asset purchase program, the effects on the loonie from Canadian monetary stimulus are likely to be largely offset by monetary stimulus in other jurisdictions.

The fact that large central banks in other parts of the world are now engaged in QE again doesn't, however, imply that the Bank of Canada can simply rely on the Federal Reserve or European Central Bank QE programs to push global term-premiums much lower like they did post-financial crisis. Rates in developed markets entered the COVID-19 situation at historically low levels, and evidence from numerous rounds of quantitative easing around the world suggest that the effect on yields seems to dissipate when the starting point is lower.

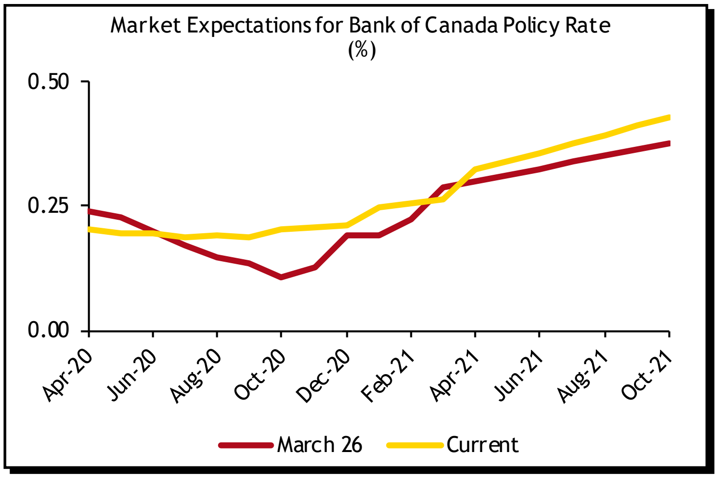
In addition, with developed-market government bond issuance set to reach record levels in light of the fiscal stimulus on tap (Chart 3), monetary policymakers will actually be fighting an uphill battle. Central bankers will be removing bond supply from the market in an attempt to push rates lower just as governments are flooding the market with additional supply. That might help keep borrowing rates for the government from rising in light of the issuance, and potentially allow for larger fiscal stimulus programs, but won't have as much of an effect on lowering risk-free rates in the style of standard QE.

The current design of Canadian QE seemingly also hasn't had an effect on expectations for future policy. In the past, as central banks have deployed asset-purchase programs, expectations of future policy rates have come down as market participants took it as a sign that the central bank was more likely to keep the policy rate at its effective lower bound for longer than previously anticipated. But, so far, the somewhat surprising announcement of asset purchases by the Bank of Canada has actually seen an increase in the expected path of rates (Chart 4). That likely occurred for two reasons.

First, the Bank of Canada announced that 0.25% would be the effective lower bound on rates (ELB), whereas prior to the announcement some market participants still believed that the central bank was willing to take the overnight rate into negative territory. Second, the asset purchases also came alongside a large fiscal stimulus announcement. So, in that sense it could have actually kept a lid on the path moving even higher. But, either way, neither term-premiums nor expectations for future policy have been pushed lower following the Bank of Canada's first foray into large-scale asset purchases, as standard QE models would suggest.

Chart 4

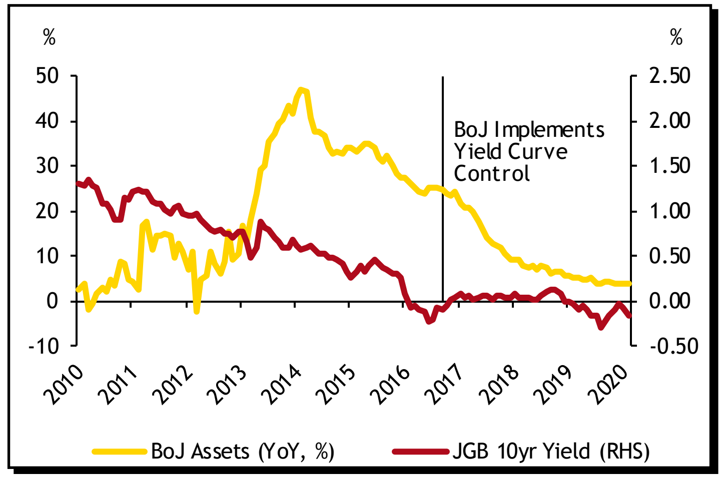
Market Expectations Have Increased Since the Last Policy Announcement



Source: Bloomberg

Chart 5

Bank of Japan Purchased Fewer Assets After Implementing Yield Curve Control



Source: FRED, Bank of Japan

Transmission Not Received

For now, though, lowering Government of Canada borrowing rates via quantitative easing is not the most important task for monetary policymakers, with yields on government debt already having fallen dramatically ahead of the announcement. The immediate challenge is to see those prior declines transmitted to the private sector.

Corporate bond yields in Canada have increased in recent weeks, as have mortgage rates. In the past, quantitative easing programs have been shown to support a wide range of risky asset prices, something that not only lowers financing costs for companies and homeowners, but also has a wealth effect for households that own those assets in their portfolios. But that transmission mechanism had been faltering, a key reason that Canadian policymakers have been so focused on liquidity measures to support credit channels. On that front, there have been some encouraging signs lately, with key funding markets showing fewer signs of stress and borrowing rates starting to come down.

Change Can Be Good… Eventually

Drastic changes in the parameters of the QE program, such as purchasing corporate bonds or equities, could allow it to have more of an effect on private sector financing conditions. However, the Bank will probably do its best to keep credit flowing through the provision of liquidity to financial institutions rather than to directly intervene in corporate bond or equity markets, which could be seen as picking winners and losers.

More likely, the Bank of Canada will eventually transition its current QE program to a system closer to the Bank of Japan's yield curve control (YCC) policy of targeting specific levels for yields. We say eventually because that strategy actually required fewer bond purchases than prior iterations of QE in Japan to keep yields in check, as investors seemed hesitant to fight the central bank in reaching its desired destination (Chart 5). As mentioned, in Canada, purchasing fewer bonds would be contrary to the current goal of adding much-needed liquidity support to the market. Still, if the Bank of Canada eventually follows that path, yields in Canada, while higher than in some parts of the developed world, aren't high enough to provide much room to fall.

Going Big, But Still Not Getting Much

Even in the unlikely event that the Bank of Canada's actions, combined with those of other major central banks, are able to generate an easing in financial conditions similar to what the Fed generated with past rounds of QE, there are reasons to believe that the macroeconomic effects wouldn't be enough to alone bring the economy back to full capacity.

Earlier this year, former Fed Chairman Ben Bernanke, relying on the estimates of Wu and Xia (2016), deemed that the unconventional tools used in the aftermath of the crisis equated to roughly 300bps of additional easing in the fed funds rate. While his post was meant to affirm the effectiveness of those tools, the estimates are somewhat underwhelming when compared to the 400 to 600bps of rate cuts that the central bank has needed to combat just ordinary recessions in the past.

Using the relationships for Canada found in Dorich et al (2013), it appears then that the Canadian economy would receive a boost of roughly 1 ½% even if the Bank of Canada generated the same effect that the Fed did with all of its unconventional tools after the financial crisis. A quick look at our forecasts suggests that would be nowhere nearly enough stimulus to bring the economy completely back to life.

Even with the Bank of Canada already having cut its policy rate by 150bps and assuming that much of the social distancing measures and required shutdowns are no longer in place by the fourth quarter, we expect that the Canadian economy will still be operating more than 4% below its capacity at the end of the year.

It's possible that there is marginally more appetite on the part of financial institutions to lend during this recovery than in the aftermath of the financial crisis, since regulatory capital requirements were rapidly increasing in the years following 2008. But what will truly determine the pace of acceleration in broader monetary aggregates will be the appetite to borrow on the part of qualified businesses and households when the dust settles.

Even after the shutdowns, many businesses and households will already have taken on additional debt to weather the storm and will therefore likely be restrained in terms of spending and investment plans.

Fiscal Stimulus in a Time of Quantitative Easing

The type of environment where monetary policy is largely ineffective at bringing the private-side of the economy back to life is one where fiscal stimulus can step in without crowding out private activity. In normal times when the unemployment rate is low, if the government provided too much stimulus, the central bank would raise rates to keep the economy from overheating and inflation under control, crowding out private sector activity by raising borrowing costs.

Even after the most severe elements of the current shutdowns are lifted, the Canadian economy will likely be operating far enough below its capacity that a large fiscal stimulus package won't push the Bank of Canada to tighten monetary policy. Indeed, monetary policymakers will likely still be using large-scale asset purchases to keep the government's borrowing costs in check. The federal government has already committed hundreds of billions of dollars to bridge the gap, but remember that money is just replacing lost income in the private sector from shutdowns. There will still be an important role for fiscal policy when the economy begins to recover to support the healing process. One of the central lessons from the financial crisis was that those governments which chose to provide adequate stimulus for their economies healed much faster than those that didn't.

The bottom line is that Canadian QE likely won't work in the typical fashion by substantially lowering longer-term yields and depressing the exchange rate. What it will likely be best suited for is keeping a lid on the government's borrowing costs at a time when fiscal policy has the most scope to provide stimulus during the recovery.