April 15, 2020

Bank of Canada extends its policy reach… again

By Warren Lovely, Taylor Schleich, Jocelyn Paquet

In Governor Stephen S. Poloz's last officially scheduled interest rate decision, the Bank of Canada kept its policy interest rate at 0.25%, which amounts to the lower effective bound for a BoC that would prefer to avoid zero/negative interest rates. (That rate had been 1.75% prior to the onset of the COVID-19 crisis but was cut three times in March by 50 bps apiece, with the last two moves being unscheduled.) Importantly, the BoC unveiled significant new measures to support the financial system, including more aggressive GoC T-bill/bond purchases and new facilities to buy provincial and corporate bonds, plus lengthier term repos.

Rate statement highlights:

Naturally enough, the rate announcement dealt with the fallout from COVID-19. The virus has "caused a sudden and deep contraction in economic activity and employment worldwide", spurring a flight to safety and sharp asset re-pricing, including lower oil prices. The global economic recovery, when it comes, "could be protracted and uneven". When it comes to Canada's economic performance, the statement notes the unprecedented drop in March employment. While highly uncertain, the BoC estimates a 1-3% drop in Q1 GDP, followed by much more pronounced weakness in Q2. (Incidentally, StatCan provided a "flash estimate" of March/Q1 GDP this morning, ballparking the quarterly decline at 10% annualized, with a much, much uglier quarterly growth result coming in Q2.) CPI inflation looks to be down to 0% in Q2, on the transitory effect of rock bottom gas prices. Fiscal policy measures "will help individuals and businesses weather this shutdown phase of the pandemic, and support incomes and confidence leading into the recovery".

Additional/new BoC actions:

In addition to the 150 bps of conventional monetary policy easing, the BoC has been conducting lending operations to financial institutions and has rolled out a series of asset purchase programs. The next challenge is managing elevated borrowing needs. As such, the BoC has taken new steps today. On the GoC bond buying program, the BoC will increase the level of its purchases (having initially been set at a minimum of $5 billion/week) as required to ensure proper functioning of this vital market segment. The BoC will also increase the share of treasury bills it purchases at auction, up to 40%, which will help absorb the massive supply hitting the front end. Moreover, the Bank will expand its term repo facility to permit funding for up to 24 months.

Critically, QE is being extended to both provincial and corporate bonds. The BoC is launching a Provincial Bond Purchase Program of up to $50 billion, which supplements an existing program that buys provincial short-term paper. This program will allow the Bank to purchase CAD-denominated bonds issued by all provinces and fully-guaranteed provincial agencies with remaining terms-to-maturity up to ten years. Through a new Corporate Bond Purchase Program, the BoC will acquire up to $10 billion of senior secured and unsecured bonds originated by Canadian companies with a remaining maturity of up to 5 years and a minimum credit rating of BBB or equivalent. (*Note: Debt issues by deposit-taking institutions will not be eligible given their access to other Bank of Canada support facilities*.) Both of these new programs will last for up to twelve months and will be launched in early May.

Monetary policy report highlights:

The April MPR was more qualitative in nature as forecasts, including potential growth the output gap, were pushed to October. Still there were some hints of what may be in store, with sharp declines in output and low, potential negative inflation. "The Bank has used scenario analysis to estimate the level of real GDP to be about 1 to 3 and 15 to 30 percent lower in the first and second quarters of 2020, respectively, than in the fourth quarter of 2019…. The direct and indirect effects of COVID-19 will weigh heavily on consumer price index (CPI) inflation in the coming months, which is expected to slump to close to 0 percent in the second quarter of 2020."

Press Conference:

All things considered, Governor Poloz remained relatively optimistic of the outlook from here noting that "best case scenario is still achievable" as the introduction of labour market measures (i.e. expanded EI, CERB and wage subsidy) should help support a strong recovery and put a floor on consumer confidence. Unlike recoveries from more typical recessions, Poloz stated that "consumers won't have to be talked" into consumption this time around. A number of questions also pertained to the Bank's policy toolkit. When asked on the potential for yield curve control in Canada, Poloz noted that there was "little purpose in aiming to lower long term rates considering where rates are at the moment… Those deliberations can wait for another day". Senior Deputy Governor Carolyn Wilkins noted that they have yet to deploy funding for credit (similar to the ECB's TLTRO system), which would involve the bank lending to financial institutions to ensure credit flows to the businesses and consumers. Given that credit markets remain open and fiscal policy measures have been implemented to accomplish this goal, they opted against introducing this today. Finally, on the oft-discussed household indebtedness issue, Wilkins noted that the Bank's Financial System Review is coming in May which will include an analysis of household indebtedness, though she noted that the state of the job market will be critical for consumers with elevated debt loads.

Bottom line:

First off, there's no surprise on the policy interest rate front, which was universally seen by economists as remaining at 0.25%. But the real focus was on asset purchases and the Bank did not disappoint. As we've seen with the US Fed, the BoC has dramatically expanded its reach when it comes to asset purchases. Extra buying of GoC bonds and bills will help absorb the extraordinary amount of financing Ottawa needs to carry out its fiscal relief package. Meanwhile, the addition of provincial and corporate bonds adds material support to these sectors of the market. Collectively, the unprecedented policy response (in Canada and across the globe) should bolster investor confidence and help put in place conditions for a partial economic recovery. And there could be more yet to come, with today's statement assuring that "the Governing Council stands ready adjust the scale or duration of its programs if necessary". At this point, policy makers are focused on building the proverbial bridge to a post-COVID-19 world and at this point, have left few stones unturned. As Governor Poloz quipped in the Bank's prior interest rate decision, "a firefighter has never been criticized for using too much water."

Here is the interest rate announcement (sections highlighted by us):

April 15, 2020

The Bank of Canada today maintained its target for the overnight rate at ¼ percent, which the Bank considers its effective lower bound. The Bank Rate is correspondingly ½ percent and the deposit rate is ¼ percent. The Bank also announced new measures to provide additional support to Canada's financial system.

The necessary efforts to contain the COVID-19 pandemic have caused a sudden and deep contraction in economic activity and employment worldwide. In financial markets, this has driven a flight to safety and a sharp repricing of a wide range of assets. It has also pushed down prices for commodities, especially oil. In this environment, the Canadian dollar has depreciated since January, although by less than many other currencies. The sudden halt in global activity will be followed by regional recoveries at different times, depending on the duration and severity of the outbreak in each region. This means that the global economic recovery, when it comes, could be protracted and uneven.

The Canadian economy was in a solid position ahead of the COVID-19 outbreak, but has since been hit by widespread shutdowns and lower oil prices. One early measure of the extent of the damage was an unprecedented drop in employment in March, with more than one million jobs lost across Canada. Many more workers reported shorter hours, and by early April some six million Canadians had applied for the Canada Emergency Response Benefit.

The outlook is too uncertain at this point to provide a complete forecast. However, Bank analysis of alternative scenarios suggests the level of real activity was down 1-3 percent in the first quarter of 2020, and will be 15-30 percent lower in the second quarter than in fourth-quarter 2019. CPI inflation is expected to be close to 0 percent in the second quarter of 2020. This is primarily due to the transitory effects of lower gasoline prices.

The pandemic-driven contraction has prompted decisive policy action to support individuals and businesses and to lay the foundation for economic recovery once containment measures start to ease. Fiscal programs, designed to expand according to the magnitude of the shock, will help individuals and businesses weather this shutdown phase of the pandemic, and support incomes and confidence leading into the recovery. These programs have been complemented by actions taken by other federal agencies and provincial governments.

For its part, the Bank of Canada has taken measures to improve market function so that monetary policy actions have their intended effect on the economy. This helps ensure that households and businesses continue to have access to the credit they need to bridge this difficult time, and that lower interest rates find their way to ultimate borrowers. The Bank has lowered its target for the overnight rate 150 basis points over the last three weeks, to its effective lower bound. It has also conducted lending operations to financial institutions and asset purchases in core funding markets amounting to around $200 billion.

These actions have served to ease market dysfunction and help keep credit channels open, although they remain strained. The next challenge for markets will be managing increased demand for near-term financing by federal and provincial governments, and businesses and households. The situation calls for special actions by the central bank. To this end, the Bank is furthering its efforts with several important steps.

Under its previously-announced program, the Bank will continue to purchase at least $5 billion in Government of Canada securities per week in the secondary market, and will increase the level of purchases as required to maintain proper functioning of the government bond market. Also, the Bank is temporarily increasing the amount of Treasury Bills it acquires at auctions to up to 40 percent, effective immediately.

The Bank is also announcing today the development of a new Provincial Bond Purchase Program of up to $50 billion, to supplement its Provincial Money Market Purchase Program. Further, the Bank is announcing a new Corporate Bond Purchase Program, in which the Bank will acquire up to a total of $10 billion in investment grade corporate bonds in the secondary market. Both of these programs will be put in place in the coming weeks. Finally, the Bank is further enhancing its term repo facility to permit funding for up to 24 months.

These measures will work in combination to ease pressure on Canadian borrowers. As containment restrictions are eased and economic activity resumes, fiscal and monetary policy actions will help underpin confidence and stimulate spending by consumers and businesses to restore growth. The Bank's Governing Council stands ready to adjust the scale or duration of its programs if necessary. All the Bank's actions are aimed at helping to bridge the current period of containment and create the conditions for a sustainable recovery and achievement of the inflation target over time.

Information note

The next scheduled date for announcing the overnight rate target is June 3, 2020. The next full update of the Bank's outlook for the economy and inflation, including risks to the projection, will be published in the MPR on July 15, 2020.

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