Covid-19 - Chapter III: Unconventional Policy Steps to Prevent a Severe Recession

The economic and financial situation has been evolving at a rapid pace since we published our second report on Covid-19 a week ago. In this third report, we share our thoughts on the unfolding recession in Canada and the unconventional fiscal and monetary tools freshly announced in Ottawa to ease the pain.

Wide economic shutdown and first unemployment wave

Canadians are currently witnessing the acceleration phase of the coronavirus outbreak. The closures of non-essential businesses in Ontario and Quebec will be very costly for several companies that were still able to operate so far. Ontario and Quebec are major suppliers for other Canadian Provinces and are significantly involved in interprovincial trade dynamics. Also, the province of Alberta intends to include oil workers in their essential list of businesses in order to allow companies to pump oil. Assuming that the coronavirus spread does not force oil sands activity to shutdown for safety reasons, real GDP in Alberta could fall to a lesser extent than in Quebec and Ontario. All in all, we currently track a 4.0% m/m decline in Canadian real GDP for the month of March and a 18% m/m drop for April.

Taking China's coronavirus curve as a benchmark, the number of new cases peaked about one-and-a-half month after the first case was detected and significantly slowed after three months. As of today, the number of new cases fell to virtually none and economic activity is slowly picking up in several regions in China. However, it would be premature to conclude on this basis that most Canadian companies will gradually turn on the lights in May and June. Activity in Canada, particularly in goods-producing industries, is likely to remain depressed as the U.S., our main trading partner, recently became the new epicentre of the global Covid-19 crisis. Combined with the non-essential business closures in Quebec and Ontario, we have no choice but to materially revise down our Canadian real GDP forecast for 2020Q2. The odds have suddenly shifted in favour of a plunge closer to 20% Q/Q annualized rather than 10%, as per our last week's estimate. This longer economic interruption will translate into a moderate real GDP contraction of about 1.5% for the entire year of 2020, assuming a robust double-digit growth rebound in 2020Q3 and 2020Q4.

The deterioration in labour market conditions is the other main adverse outcome. Faced with an overwhelming blow to cash flows, several companies are laying off staff at an unprecedented pace. The federal government expects 4M Canadians to apply to the Canada Emergency Response Benefit announced last Wednesday. This new relief fund will pay $2K per month, for up to four months, to Canadians who lose their income as a result of the COVID-19 pandemic. This amount represents around half of the labour income of Canadians, based on the SEPH data pegging the average weekly earnings of workers at $1K. Combined with other types of assistance and tax breaks at the provincial level, this broad financial bridge will contribute to contain the rise in late debt payments and consumer delinquencies as long as the money gets into the hands of Canadians quickly.

The federal government announces much-needed support to companies

Until today, most fiscal measures announced targeted individuals. The federal government decided to revise up its 10% payroll subsidy to 75% for small businesses, a rate similar to what has been announced in some European countries. In addition, Ottawa offers up to $40K in loans at a 0% financing rate for the first year. Future steps could include financial assistance to larger companies directly exposed to the pandemic, creating loan facilities and grants under certain guarantees such as maintaining payrolls and temporarily limiting dividend payouts and share buybacks.

Deferrals or breaks to GST remittances and CPP employers' contributions could also be another policy to ease cash flow pressures.

Today's new measures for small companies were necessary to prevent excessive balance sheet stress at the corporate level. Time is of the essence because of the well-known financial vulnerability of corporations. First, Canadian non-financial private companies debt-to-GDP recently reached 217% according to the Bank for International Settlements. Second, as reported in the BoC Financial System Review of June 2019, the share of companies with debt-to-interest coverage ratio below 1 is higher today (12%) than before the 2008-09 financial crisis. Third, more than half of the increase in corporate bond funding has been associated to companies in the high yield universe in recent years. Fourth, according to a mid-March survey of 8,730 SMEs from the Canadian Federation of Independent Businesses, 30% of them said they were unlikely to survive more than a month under the status quo.

Proactive BoC brings on asset purchases and forward guidance

The BoC is reacting to the Covid-19 and oil shocks at an unprecedented pace. During the last few weeks, it bought Canadian mortgage bonds in the secondary market, started to purchase provincial short-term debt in the primary market and conducted $10B in BAs weekly purchases. Following these measures, market functionality and liquidity has improved somewhat.

The obvious next move, announced on March 27th, was to lower the overnight rate target from 0.75% to 0.25%. In the press conference following this morning's statement, Governor Poloz clearly stated that he does not contemplate to bring the policy rate in negative territory. In our view, one reason explaining Poloz's comment are the mitigated results of the negative rate experimentation conducted by the Swedish Riskbank between early 2015 and late 2019. In a 2019 article, former U.S. Treasury Secretary Larry Summers found that negative policy rates in Sweden failed to stimulate lending activity. Deposit rates of Swedish banks became unresponsive and did not follow the Riskbank's repo rate into negative territory. More precisely, the pass-through of the policy rate to deposit rates crippled down to less than 10%. In another article, Riskbank's economists found a weaker initial pass-through to lending rates when the policy rate was negative.

Under current market circumstances, the BoC decided to announce a Commercial Paper Purchase Facility (CPPF). Furthermore, the BoC will use two unconventional tools in the tool kit: large scale asset purchases (LSAP) and forward guidance. First, the BoC committed to purchase $5B per week of benchmark federal bonds in the secondary market. The primary objective of this tool is to prevent market functioning from breaking down rather than compress the entire yield curve to zero or into negative territory.

Second, the BoC is using forward guidance in its March 27th statement: "The (LSAP) program will be adjusted as conditions warrant, but will continue until the economic recovery is well underway". Clearly, the BoC wants to lay down a solid foundation for the eventual economic rebound. Market participants should expect $5B weekly purchase of federal bonds at least until the end of 2020, for a total of $195B or the equivalent of 8% of GDP. The cumulative impact of these purchases would approximately equal to a 150bps cut in the policy rate under normal financial conditions. Indeed, a QE bond purchase program of 1.5% of GDP equals to a 25bps cut in the policy rate according to the rule of thumb suggested in a the research paper by *Gagnon and Sack* published in 2019. Ultimately, this will help to maintain 2-Year, 5-Year and 10-Year bond yields closer to their record-low of 0.50% until a potential economic recovery in 2020H2 contributes to steepen the yield curve. In other words, the LSAP will put a lid on Ottawa's borrowing costs as the fiscal deficit is expected to reach at least $113B (5.2% of GDP) in FY 2020-21 according to PBO new projections.

Adding the overnight rate target cumulative 150 basis points cut of recent weeks (from 1.75% to 0.25%) to the rule of thumb estimate that LSAP represents an additional 150bps cut, the BoC has reduced its policy rate by 300bps, a notch less than during the 2008-09 financial crisis period (375bps). The good news is that the BoC has plenty of other powerful unconventional tools available if the economic situation unfortunately worsens. For instance, the BoC could simply increase asset purchases, or announce an unlimited QE like the Fed. If needed, the BoC could also opt for yield curve control like the Bank of Japan. Furthermore, asset purchases could be expanded to corporate and provincial bonds in order to ease the cost of capital. According to section 18 of the Bank of Canada Act, BoC officials can eventually buy pretty much anything: “if the Governor is of the opinion that there is a severe and unusual stress on a financial market or the financial system, buy and sell from or to any person any securities and any other financial instruments, to the extent determined necessary by the Governor”.

Finally, under extremely difficult market conditions, the BoC could launch a funding facility for financial institutions called “funding for credit”. Governor Poloz mentioned during a key speech in December 2015: “The central bank would provide collateralized funding at a subsidized rate as long as banks met specified lending objectives”. All in all, there is no pre-ordained order attached to the BoC’s next move. The next appropriate unconventional step will ultimately depend on economic and financial circumstances.

Sébastien Lavoie | Chief Economist
514 350-2931 | lavoies@vmbl.ca