March 23, 2021

The BoC Tiptoed to the Exits

- **The BoC is starting the slow grind toward policy exits**
- **Underutilized programs are being shut down as expected**
- **A GoC bond purchase taper looks increasingly likely next month**
- **The BoC will reinvest and flat-line GoC bond holdings after it decides to stop expanding stimulus…**
- **...but for how long is anyone's guess**
- **Rate hikes will commence some time after reinvestment…**
- **...which is consistent with our forecast for a hike later in 2022**
- **Uncertainty over the length of a reinvestment phase will guide long-term balance sheet projections**
- **Ottawa's conspicuously timed budget date complicates things…**
- **...as the BoC will know its contents by its next meeting…**
- **...but the tight timing will make the next MPR stale on delivery**

The BoC generally reaffirmed our expectations that its nonconventional programs are on their collective way out. Deputy Governor Gravelle's speech (here) and the BoC's accompanying announcement (here) provided updated guidance.

MARCHING TOWARD AN APRIL TAPER

First (because it would be the far more significant development) Gravelle continued to tease market participants that the Government of Canada bond purchase program would be reassessed as part of a fuller forecast reassessment at the April 21st meeting conclusion that will also bring out a fresh Monetary Policy Report and forecasts plus a press conference hosted by Governor Macklem.

> "At the time of our January *Monetary Policy Report*, we indicated that if the economy plays out in line with or stronger than our economic projection, we won't need as much QE stimulus over time. And in our March policy decision statement, we said that as we continue to gain confidence in the strength of the recovery, we will gradually adjust the pace of our QE purchases. We also indicated that first-quarter growth appears to be better than we expected in January. We will have a new full economic projection at our April policy decision."

The key in this passage is that the BoC is reaffirming they know that developments have exceeded expectations in the January MPR and meet the reference in the March statement toward gaining confidence as the two criteria for reducing the pace of QE purchases. That's about as blunt as the BoC tends to be when it comes to providing advance guidance, short of whacking markets with a hammer.

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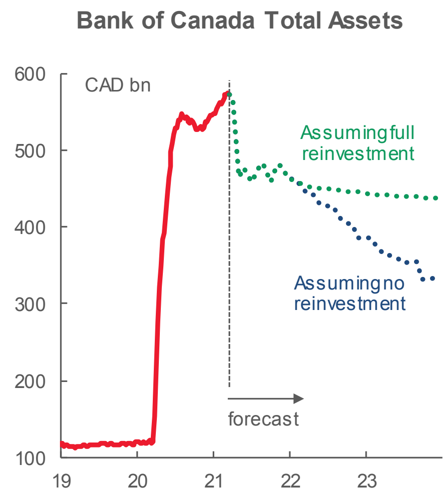
Chart 1



Sources: Scotiabank Economics, Bank of Canada.

Recall that the BoC had forecast +4.8% GDP growth in 2020Q4 and we got 9.6%, while the BoC had also forecast contraction of -2.5% in Q1 and our fresher take is tracking growth of +4–5%. As a result, the output gap is closing more rapidly than the BoC had expected. Recovering GDP lost during the pandemic is within reach by this summer. Closing off spare capacity is within reach by the end of the year. That's important because Governor Macklem has always said they would continue purchases "until the recovery is well underway" and stop purchases before closure of spare capacity.

So what we heard today was generally consistent with our expectation that the BoC will taper its purchases in April likely down to C$3B+/week from $4B+/week at present, but a lower volume cannot be ruled out. The BoC is then assumed to taper again over the summer and end its purchases toward year-end (and possibly sooner).

ENDING PROGRAMS THAT ARE WELL PAST THEIR PRIME

The BoC also stated that it will end several other facilities that are varying combinations of essentially having already ended, being minimally utilized and/or on a set path to expiration that has now been confirmed. It noted—where relevant to programs with non-zero holdings—that it "does not currently" have plans to sell down its holdings.

a) Provincial Bond Purchase Program: This program will end on May 7th 2021 as per its scheduled expiration as we had expected. The PBPP stands at C$18.2 billion as of last week (next update tomorrow) which leaves the bulk of the C$50 billion facility unutilized with the pace of purchases having markedly slowed of late. Less need for nonconventional stimulus, repaired market conditions and front-loaded issuance by the provinces this year opened the door to letting the program expire on schedule.

b) Corporate Bond Purchase Program: This program will end on May 26th as scheduled and also as expected. This program is also heavily underutilized but was set up to be small from the beginning. Only C$185 million of the C$10 billion potential size has been utilized and there have been no purchases for quite some time. Letting it expire on schedule is neither unexpected or meaningful.

c) Commercial Paper Purchase Program: This will end on April 2nd 2021 as scheduled. CP assets held in the program have been declining since the end of last April. The BoC long ago saw short-term CP and BA markets become repaired and ran the balances within both of its CP and BA facilities down to zero last July.

d) Repo programs: The Term Repo operations will be suspended indefinitely on May 10th (final operation May 4th) and the Contingent Term Repo Facility will be deactivated April 6th respectively. The rationale offered was perfectly sensible in that Gravelle said "We can take these steps because now there is ample system-wide liquidity for financial institutions to draw from. This is both in terms of their own unusually high levels of deposits, as Canadians save more during the pandemic, and the large amount of cash—more specifically, settlement balances—that we have added to the financial system."

On June 29th, we'll learn a lot more on a granular level about how the BoC conducted its purchases when it releases information at the transactional level including names of individual issuers among provinces and companies.

REINVESTMENT GUIDANCE

Gravelle also guided that the BoC would shift toward flat-lining its GoC bond holdings after it reaches the point of no longer making net positive purchases and will simply reinvest enough flow to offset maturing amounts. His quote was as follows:

> "When we start gradually dialling back the amount of incremental QE stimulus that we are adding, we will eventually get down to a pace of QE purchases that maintains—but no longer increases—the amount of stimulus being provided. That is, a pace where our GoC bond holdings are largely stable and we reinvest the proceeds of maturing assets. At that point, the accumulated amount of GoC bond holdings would still represent a significant amount of stimulus in the system."

If the BoC tapers as we expect, then this reinvestment phase marked by flat-lining GoC bond holdings is likely to arrive by year-end. **Announcing a reinvestment phase may assuage any residual market concerns about an likely April taper and as such almost serves as a set up of sorts.**

WHERE TO NEXT?

Chart 1 shows our projection for the Bank of Canada's balance sheet from now through to the end of 2023 under two different scenarios. It had already incorporated most of the generally expected policy guidance that was received today but the scenarios show how reinvestment of GoC holdings could affect the balance sheet. The BoC's balance sheet will fall to between about C$330B by the end of 2023 assuming no reinvestment to about one hundred billion higher than that assuming full reinvestment throughout 2022–23. No guidance was provided with respect to the length of time that the BoC would pursue reinvestment in full or in part. It's therefore prudent to consider the range. Still, the BoC may be copying the Fed's exit playbook after it shifted to flatlining its SOMA portfolio toward the end of 2014, reinvested for a full year until hiking a first time in December 2015 and then began allowing roll-off of maturing securities in 2018 after the rate normalization process was well underway.

Either way, that's still going to remain a huge balance sheet that will be around $200–300 billion or so larger than it was before the pandemic. Given the different nature of this shock versus the GFC, I'm not sure that such a prolonged period of full reinvestment is going to be suitable.

RATE HIKES TO FOLLOW A PERIOD OF REINVESTMENT; 2022H2 LIKELY

Our forecast for the commencement of rate hikes continues to be 2022Q4 with solid risk of earlier. Gravelle's guidance was that a hike would happen "some amount of time" after arriving at the reinvestment phase of QE. If the BoC ends net purchases of GoC bonds toward the end of this year then it could reinvest for a considerable portion of 2022 before hiking. Our yield curve assumptions then embed 2–3 hikes in 2023. That would mean that the policy rate would remain at roughly half our estimate of the nominal neutral rate of 2% as the mid-point of the lower half of the BoC's 1.75–2.75% neutral rate range.

In other words, the debate at the margin is about much more than the next taper, the end of bond purchases and the first hike. It should be more centered around the suitability of a below-neutral policy rate and still bloated balance sheet almost three years from now. Scenario analysis around altered reinvestment and hike assumptions has merit.

THE FEDERAL BUDGET WILL INFORM GOVERNING COUNCIL'S STANCE AT THE APRIL MEETING

Finally, while the timing was rather conspicuous, Federal Finance Minister Freeland announced shortly after Gravelle's speech that the Federal Budget would be delivered on April 19th. That's just in case you needed another reason to hate Mondays! Bear in mind that this will be two days before the next BoC meeting that will include a full Monetary Policy Report and forecasts followed by a press conference.

The Budget is likely going to be too close to the BoC meeting to enable its inclusion in forecasts, but it will be known information to further inform a potential taper at that meeting. That's disappointing because on the assumption that the MPR forecasts won't include the Budget's effects, the BoC's forecasts are going to be stale on arrival. To an extent, Governing Council will incorporate the Budget's consequences in their internalized thinking and policy stance, especially given how close knit Ottawa's policymakers tend to be, but it's too close for the MPR to formally include the effects given the process that works from staff forecasts through recommendations prior to Governing Council deliberations and decisions. Recall that we have rough guidance to expect C$70–100 billion of added initiatives over a three year period of time, but a) we don't know the distribution of this amount while nevertheless assuming more of the spending will be front-loaded, and b) we don't know how it will be funded and hence how much of this may be net stimulus worked through reasonable multiplier assumptions.