PIMCO

Will the April MPR Be a Battle Plan? We Hope So …

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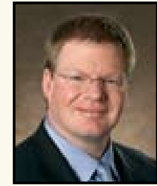

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To date, the Bank of Canada (BoC) has done an extremely good job of navigating this dire financial crisis. Over the past 18 months, Governor Mark Carney and company have earned the confidence of the marketplace, and by acting swiftly to apply monetary stimulus, the bank has spared many Canadians from the worst of this global economic crisis. However, this is a key moment for the BoC as it enters the next phase of this economic war. On April 23, the bank is expected to unveil its approach to quantitative and credit easing; PIMCO thinks a comprehensive program to buy government and provincial debt is likely to be the most effective way forward for the BoC. This comprehensive program should include an expansion of programs that can increase funding into the corporate sector and into troubled areas of consumer finance.

It is now clear that Canada will not be spared from the economic tsunami engulfing the global economy. As a small, open economy, Canada is extremely vulnerable to a pull-back in global economic activity, especially when it is coincident with a dramatic collapse in commodity prices. The positive terms of trade shock, which drove the sharp rise in domestic demand, has reversed, leaving Canada facing an economic downturn almost as grave as the crisis facing our friends to the south.

To date, the Bank of Canada (BoC) has done an extremely good job of navigating this dire financial crisis. Unlike many central banks, the BoC was quick to recognize the severity and global nature of the crisis as it took hold. Over the past 18 months, Governor Mark Carney and company have earned the confidence of the marketplace. With both a fiscal and current account

surplus, Canada was in a much better position than many other developed countries at the start of this crisis. While many Canadians were busy patting themselves on the back over avoiding most of the "subprime" crisis in the U.S., Carney understood that Canada was in a vulnerable position if the global economy continued to deteriorate. By acting swiftly to apply monetary stimulus, the bank has likely spared many Canadians from the worst of this global economic crisis.

But that was then, this is now. The time has come to announce additional bold policy actions.

Alternative Monetary Policies: The Next Phase of the Economic War

Warren Buffett called the Lehman bankruptcy an "economic Pearl Harbor," and suggested we should have a wartime mentality as we address the issues facing the global economy. We at PIMCO think Buffett was correct. The bigger mistake is doing too little, not doing too much. As with any war, there will be unintended consequences. One of the great tragedies of military conflict is "collateral damage," that is, when innocent people are killed or injured. In an economic war, a problematic byproduct is "collateral benefit." As the public balance sheet is deployed to save the economic system, reckless people and companies are bailed out by honest hard-working taxpayers who were prudent and did the right things. It is tough to swallow, and it makes it very difficult for politicians to garner public support for policies that will enable society at large to benefit while the undeserving receive taxpayer support. However, as many political leaders have stated, there are no good choices: just bad ones and worse ones.

This is the situation where we find ourselves in 2009.

It is a key moment for the BoC as it enters the next phase of this economic war. The bank has run out of conventional monetary "firepower" because it has already lowered interest rates effectively to zero. Even with its troops depleted, the bank must prepare for the next wave of the recessionary invasion. The good news is that the BoC has time. Canada does not have a major financial institution looking for a significant equity injection at this point. The Insured Mortgage Purchase Plan (IMPP) has worked spectacularly well in re-liquifying bank balance sheets. Canada remains one of only two countries in the developed world where the market is still open for banks to raise tier 1 capital, so Canadian banks have not needed to use the government debt guarantee program. That said, while it still exists, it is a reminder to investors that the government of Canada will stand

behind its banks, no matter how much worse the financial markets become. This functioning banking system is extremely beneficial, as it acts as an effective transmission mechanism that will enable quantitative or credit easing to fuel economic growth and stop deflation.

But the issue remains, what should the next phase of the BoC battle plan look like? (The central bank is expected to unveil its approach to credit/quantitative easing on April 23.) First, we have to define the objective(s).

Quantitative easing (QE) is a term that commonly refers to the targeting of the size of the monetary base (i.e., the size of the balance sheet of the central bank). The Bank of Japan (BoJ) famously implemented a QE program in 2001 after it reduced interest rates effectively to zero to counter the deflationary forces that contributed to its "lost decade" of the 1990s. Japan's experience with QE was not successful because the BoJ waited too long to implement the program and deflationary expectations were able to take root. The basic rationale behind a QE program is an acknowledgement that Milton Friedman was right when he said "inflation is always and everywhere a monetary phenomenon,"[1] and that in order to generate inflation, all a central bank has to do is print money. The objective of a QE program is to maintain inflationary expectations in the marketplace, and in the case of Canada, close to the BoC's target rate of 2%.[2] The BoC wants to pre-empt any deflationary expectations building in the marketplace. Deflationary expectations cause people and businesses to postpone discretionary expenditures and investments, leading to a more severe economic contraction. Acting early is the key to QE.

Credit easing (CE) is a term recently defined in a speech by U.S. Federal Reserve (Fed) Chairman Ben Bernanke. The goal of credit easing is to restore "normal" credit risk premiums into the marketplace. A credit risk premium refers to the spread between the rates at which private sector entities borrow and the rate at which the government borrows. During the "flight to quality" of this crisis, these spreads reached all-time highs. Some parts of the debt markets closed down completely. Tightening of credit conditions leads to lower economic activity, which in turn leads to tighter credit conditions. Preventing the negative consequences of this "feedback loop" between the financial markets and the real economy is the primary goal of a CE program. The key to a successful CE program is to identify what parts of the credit markets are creating the problem, and then use the central bank's balance sheet to reactivate the flow of credit into the economy.

QE and CE Policies: Lessons from Abroad

This is a global financial crisis, and central banks around the world are taking a variety of different approaches based on the specific issues facing each economy.

The BoJ has been buying equities to support the cross-holdings at major Japanese banks. The Bank of England (BoE) has committed to buying both government and corporate debt. The Fed has implemented numerous facilities to revive the securitization markets. Basically, central banks have been making up CE on the fly. Some programs have been very successful while others have failed. We at PIMCO are encouraged by the commitment of policymakers to do what it takes, and learn from mistakes. As one of the last central banks to announce QE/CE programs, we believe the BoC will benefit from recent experience. We also believe the Bank will announce a comprehensive program that will give it the flexibility to deal with unforeseen market contingencies. We expect they will present a framework for implementing a QE program that will have the explicit objective of stopping the recent decline of inflationary expectations in the market. We also expect they will propose a customized CE program that will take into account the uniqueness of the Canadian capital markets, with the objective of being able to stop any future possible acceleration of the negative consequences of the financial markets / real economy feedback loop. While these objectives sound good, what does this practically mean?

What PIMCO Would Like to See in the April Monetary Policy Report

Below are the potential assets the BoC could purchase, and PIMCO's positions:

1. **Government Bonds.** We think it is a foregone conclusion that the bank will announce on April 23 that it will purchase government bonds. The one common element of global central banks' implementation of alternative monetary policy is the monetary authority standing ready to support the implementation of fiscal stimulus measures by ensuring the sovereign has access to capital. Central banks are not going to permit long-term interest rates to rise due to a lack of support for government auctions from the private markets. We believe the BoC understands the counterproductive nature of higher long-term rates while the bank is lowering short-term rates. However, we do not expect the BoC to commit to any type of predefined increase in the monetary base. The bank will simply look to assure bond investors that long-term rates will not rise while the bank is explicitly trying to ease financial conditions. This is not a problem the

market is currently facing, as the fiscal stimulus announced to date has been relatively modest. However, as Canadian Prime Minister Stephen Harper said at the G-20 summit, more stimulus is on the way from Ottawa. We look for the BoC to pre-emptively assure market participants that future government supply will not result in markedly higher rates.

2. **Government-Guaranteed Paper.** PIMCO supports the purchase of debt issued by certain crown corporations. We think it is unnecessary for the BoC to purchase Canada Housing Bonds, given that the Insured Mortgage Purchase Plan is already accomplishing the objective of creating affordable residential mortgages for Canadians. The problem in Canada has not been the amount of lending by Canadian banks, it has been the pull-back in lending by non-Canadian banks and the non-bank lending channel. To fill this credit void, the BoC could finance an expansion of the domestic lending programs of the Business Development Corporation (BDC) as well as the international trade programs of the Export Development Corporation (EDC). The beauty of these programs is that the BoC can provide financing to companies without taking direct credit risk.

3. **Purchase and Resale Agreements (PRAs).** The program to open up the BoC PRA program to investors directly is an effective way to get credit flowing. One of the reasons that credit risk premiums are exceptionally high is that investors cannot count on liquidity in the secondary market. This BoC plan allows large investors to raise cash by financing positions directly with the BoC. This access to the BoC's balance sheet is especially valuable around the dealers' quarter-end and year-end. Once investors have confidence that positions can be consistently financed, they will feel comfortable taking on more credit risk in the capital markets. We see value in continuing the expansion of this program.

4. **Provincial Bonds.** We think the purchase of provincial bonds makes a lot of sense and would be a very effective element in the implementation of both QE and CE. Provincial spreads are near the widest in their history (see Chart 1).

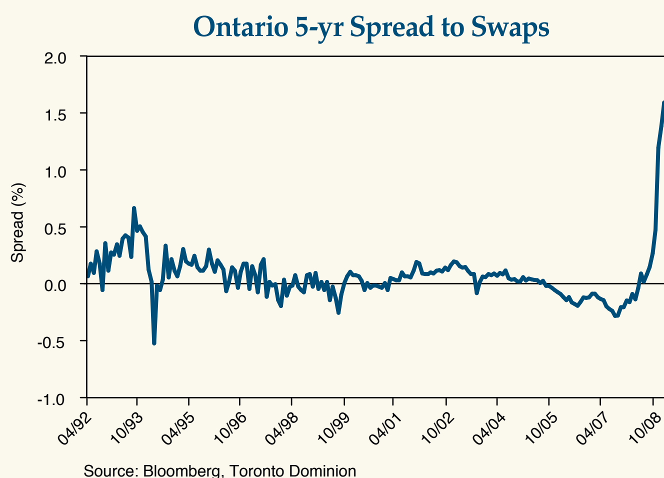

Chart 1

Purchasing provincial bonds could ease credit conditions in a number of ways. First, the higher borrowing costs the provinces currently face increase their deficits, which are already under pressure due to falling tax revenue. In the same way that the BoC wants to support the fiscal stimulus coming out of Ottawa, it should want to support fiscal stimulus coming out of the provinces. We want more infrastructure and counter-cyclical spending, not less. Provincial debt plays a unique role in the Canadian capital markets as a benchmark for credit spreads. All private sector debt trades at a higher yield than the provinces. If provincial spreads widen, they increase the cost of capital to the entire private sector. On the other hand, if the BoC buys provincial debt to bring yields on provincial bonds within any range of "normal" credit spreads, this would ease financial conditions throughout the entire economy. PIMCO believes this would be the most effective form of CE the BoC could implement. Outright purchases of provincial debt could be used as a substitute for outright purchases of government debt in order to lower overall market interest rates. Basically, this can be either a QE or CE tool which makes it an extremely valuable weapon to wield in this economic war. There are some political issues that the BoC may confront in terms of selecting the precise securities to purchase, but these should be relatively easy to overcome. We cannot imagine that too many provinces will complain when their cost of borrowing is being reduced.

5. **Securitized Bonds.** The IMPP and the Canadian Secured Credit Facility, the government program announced to provide $16 billion in financing to auto loans, credit cards and other collateral have the potential to fill some of the void left by the non-bank credit channel. We do not expect any new initiatives on this front will be announced next week, but we do think that once the government program is in place, the BoC can look to use its balance sheet to expand the facility as required. One possible way to expand this program is to provide non-recourse finance so that investors will buy the assets. This is what the U.S. government is doing with the Term Asset-backed securities Loan Facility (TALF). The advantage of a TALF-like system is it provides the central bank's balance sheet more protection against default risk, and it allows market mechanisms to determine the price of credit. These are both admirable goals.

6. **Corporate Debt.** We do not think the BoC has to announce a program to purchase corporate debt. Central banks are not normally in the business of taking credit risk – this is the job of commercial banks and bond investors. It takes

large teams of credit specialists to wisely extend credit to companies. True, the BoE, the BoJ and the U.S. Fed have all implemented programs to buy corporate debt. The BoE and BoJ have had practical issues implementing their programs, while the Fed was forced into a program to buy corporate commercial paper (CP) due to the complete collapse of money market funds after the Lehman Brothers bankruptcy. It has been a very successful program, but was not an easy step for the Fed to take, in the context of central bank orthodoxy. We believe the BoC can avoid being forced into this type of program by implementing some of the other programs outlined. That said, it would be prudent for the BoC to study how such a program could be implemented in Canada should market conditions deteriorate. Avoiding such a development is one of the primary reasons for using EDC and BDC to get funding into the private sector.

In summary, a comprehensive program to buy government and provincial debt seems like the most effective way forward for the BoC. This comprehensive program should include an expansion of programs that can increase funding into the corporate sector (via increased PRAs, BDC and EDC) and into troubled areas of consumer finance (expanding existing securitized programs).

Inspiring the Troops (a.k.a. Market Confidence)

The Bank has done an excellent job in the first phase of this economic war. It must prepare for the second wave. The second wave will be more like urban warfare where neighbourhoods are won house by house. In the economic war, this will be credit channel by credit channel. Governor Carney has a huge advantage in that he already has the confidence of the market. The bank's job will remain much easier as long as market confidence is maintained. Demonstrating a credible battle plan on April 23 will go a long way. My parents grew up in Scotland during World War II, and they recall at a pivotal point in the war listening to Winston Churchill on the radio when he said "…we shall fight on the seas and oceans, we shall fight with growing confidence and growing strength in the air, we shall defend our Island, whatever the cost may be, we shall fight on the beaches, we shall fight on the landing grounds, we shall fight in the fields and in the streets, we shall fight in the hills; we shall never surrender …"[3] Well, we may not need something quite as awe-inspiring on April 23, but announcing plans that inspire market confidence would certainly go a long way.

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[1] *Milton Friedman, A Monetary History of the United States 1867-1960 (1963)*

[2] *BoC Target Rate 2%- Bank of Canada Monetary Policy Report – January 2009 or BoC website.*

[3] *Churchill quote – "We Shall Fight on the Beaches" – June 4, 1940 – (speech delivered to House of Commons of British Parliament)*

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