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Is BoC policy rate divergence possible?

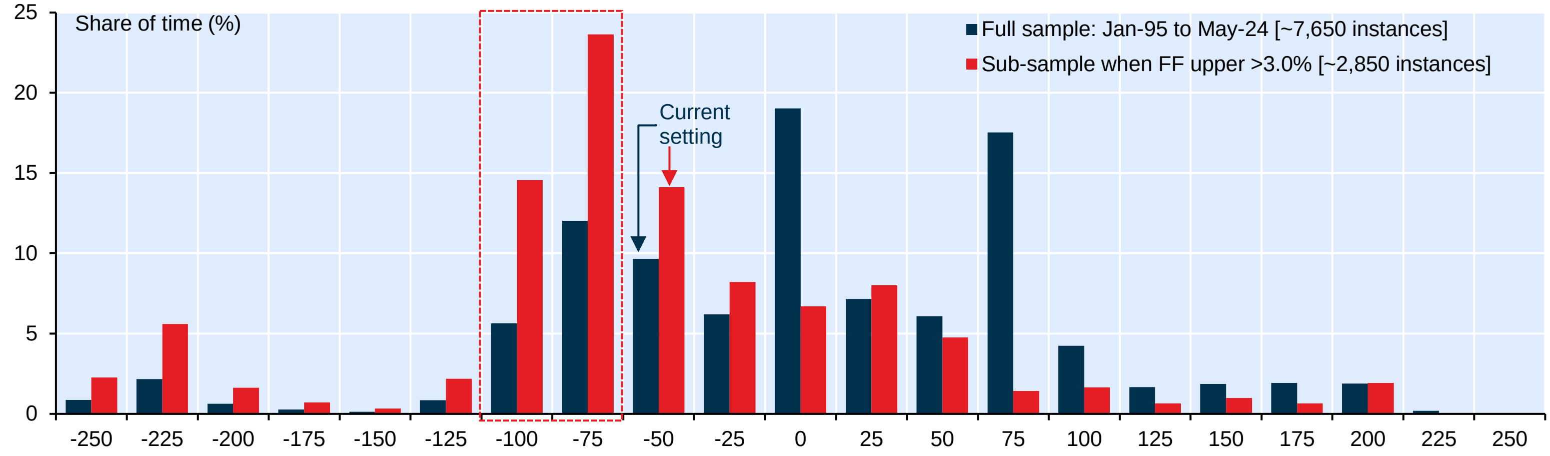
By Taylor Schleich & Warren Lovely

Earlier this week, we explored key economic and inflation data in Canada relative to an advanced economy peer set. We argued that the Canadian economy has been more adversely affected by tight monetary policy than others, which has generated a slower rate of inflation. Based on 'fundamentals' then, policy easing is/will be appropriate in Canada before other jurisdictions (i.e., in the U.S.). However, many will argue that the Bank is somewhat tethered to the Fed. Lowering rates ahead of the U.S. central bank would mean a weaker currency which would be followed by imported inflation which would render any easing counterproductive. We're not convinced, as we detail here.

First, a larger BoC-Fed policy rate gap (than today's 50 bps) is not uncommon. Nearly a quarter of the time since 1995, the BoC has set its policy rate more than 50 bps below the Fed's. That share grows to over 50% when the Fed is restrictive. While there was less divergence in the second half of this ~30-year sample, this period coincided with two recession recoveries that saw rates pinned at/near zero in both economies. That's clearly no longer the case, which creates scope for a wide(r) band going forward. What about currency/imported inflation concerns? We don't deny that a weaker C$ boosts import prices but the pass-through to consumer prices is smaller than widely appreciated. BoC research, and the model that underpins their forecasts and policy analysis, indicates a 10% CAD shock might add just 25-30 bps to core CPI. Recent episodes of C$ weakness haven't coincided with outsized inflation either, outright or vis-à-vis the U.S. Bond yields today reflect expectations that the BoC-Fed rate gap *will* grow. All else equal then, there'd need to be *more* aggressive BoC easing than is priced to produce a material FX impact. Is there an amount of depreciation the BoC won't tolerate? Probably, but to us it's much weaker than the low 1.40s that we project. It's entirely reasonable the BoC's policy rate could fall 100 bps below the Fed's without policymakers batting an eye.

Chart 1: As fed funds heads higher, it's not unusual for Canada-US policy rate differential to widen

Histogram of BoC-FOMC policy rate differential: Full sample of daily observations from 1995 onwards & sub-sample where fed funds (upper) exceeds 3.0%

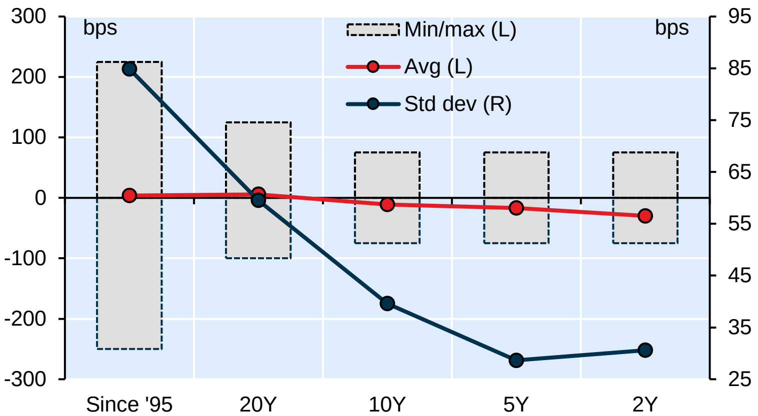


Source: NBF, Bloomberg, BoC, FRB | Note: Full sample (blue) based on >7,650 weekdays since Jan-95; sub-sample (red) includes only those periods where FF upper exceeds 3.0%

Fed & BoC policy rates have been within 50 bps of one another about half the time over the last 30 years, including today. However, the policy rate gap is related to the underlying rate level. When the Fed is above neutral (say, 3%), the BoC is more likely to lag. In this environment, the Bank has been at least 75 bps lower half the time.

Chart 2: Don't be fooled by apparent policy convergence…

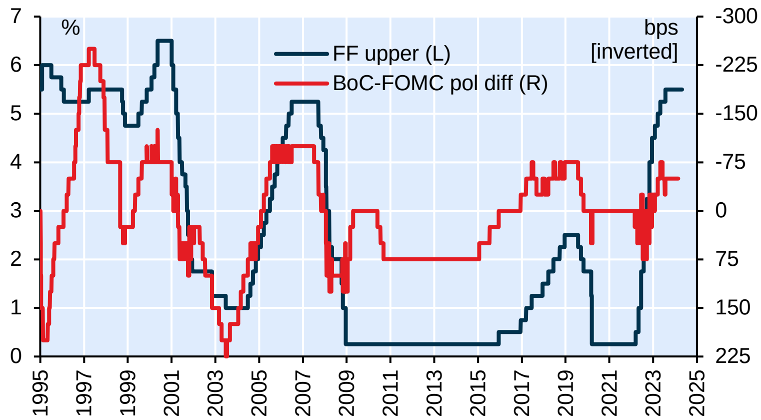
Range, avg, deviation in BoC-FOMC policy rate differential over time



Source: NBF, Bloomberg, BoC, FRB | Note: Based on daily (weekday) obs from 1995-24

Chart 3: … as we spent a *long* time at relatively low(er) rates

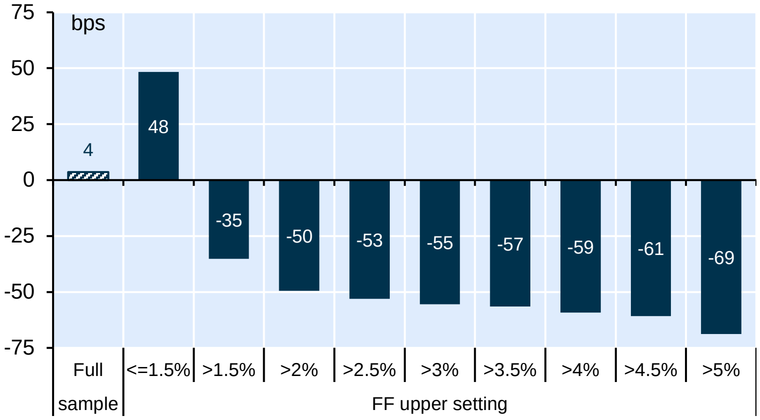
Fed funds upper & corresponding BoC-FOMC policy rate differential



Source: NBF, Bloomberg, BoC, FRB | Note: Policy rate differential is inverted at right

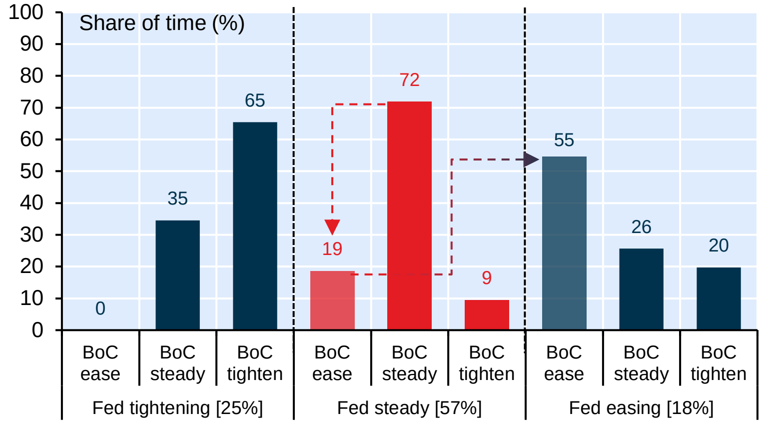
More recent samples indicate tighter policy gaps, but lower volatility can be explained by the low/stable rate settings post-GFC and in 2020-21. Policy wasn't stagnant in 2022-23 but tightening was a global phenomenon, rates increasing at a similar pace most everywhere. Pre-GFC and you'll find large deviations between the BoC and Fed were common. Looking ahead, we may not see a return to 1990s/2000s-style policymaking but there should be more variability than in the past 15 years.

Chart 4: The higher fed goes, the more BoC tends to lag
BoC-FOMC policy rate differential relative to underlying fed funds upper level



Source: NBF, Bloomberg, BoC, FRB | Note: Based on daily (weekday) obs from 1995-24

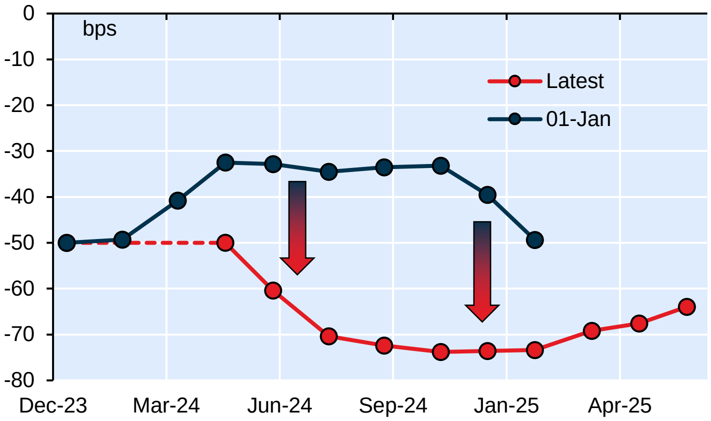
Chart 5: Fed steady and BoC easing isn't uncharted territory
BoC policy rate stance relative to FOMC policy stance



Source: NBF, Bloomberg, BoC, FRB | Note: Based on daily (weekday) obs from 1995-24

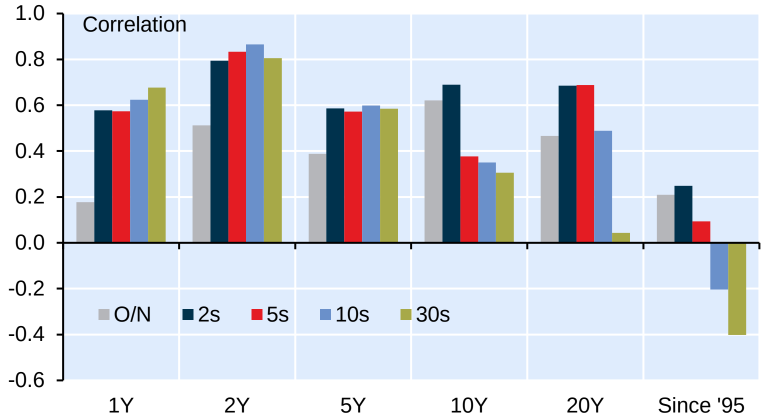
As the Fed hikes higher, the BoC has a harder time keeping pace and the differential tends to widen. Interestingly, today's policy gap is empirically small given a >5% setting. What's next? By 2025, both CBs will be easing, likely in parallel. But in the nearer-term, the BoC should go first. This set-up is less common but not *un*common.

Chart 6: The market is *already* pricing a more dovish BoC
OIS-implied policy rate differential over next 9 meetings: Latest vs. 1-Jan



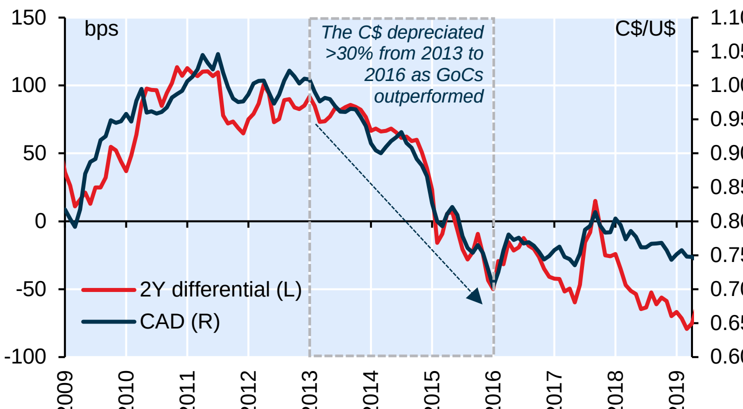
Source: NBF, Bloomberg | Note: U.S. OIS adjusted to reflect implied upper bound target

Chart 7: Yields are more predictive of C$ than policy rates
Historical correlation btw Canadian dollar & Cda-US interest rate differentials



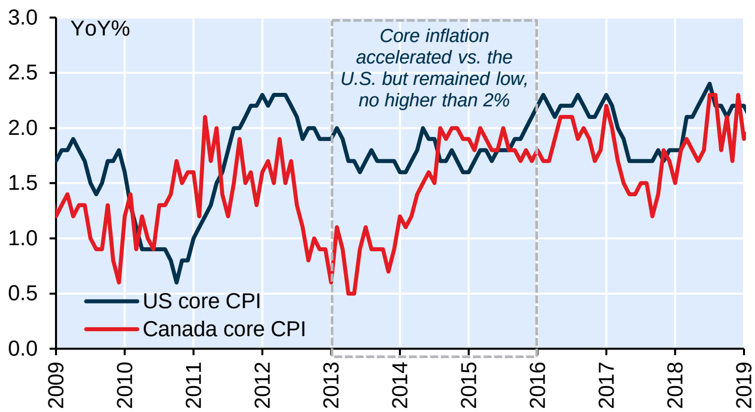
Source: NBF, Bloomberg | Note: Based on daily (weekday) obs from 1995-24

Chart 8: The CAD fell by nearly a third a decade ago....
CADUSD vs. 2-year yield differential



Source: NBF, Bloomberg

Chart 9: ...coinciding with a modest rise in core CPI vs the U.S.
CPI ex-food and energy: Canada vs. U.S.



Source: NBF, Bloomberg

All else equal, relatively lower Canadian rates = weaker CAD. A weaker CAD = higher import prices = higher inflation. This logic, some would argue, prevents the BoC from 'front-running' the Fed. We disagree. Yields/OIS pricing already reflect a growing BoC-Fed differential and C$ correlations are strongest with bond yields, *not* policy rates. In theory, there should be no FX impact from crystalizing expectations. Our base case *does* see further GoC outperformance and C$ depreciation to ~1.42 by year end but even this shouldn't be problematic from an inflation perspective. Consider the BoC's main model for its projections and policy analysis: ToTEM III. A technical report on ToTEM notes that an exchange rate shock of 10% adds just 25 bps to core inflation at its peak. That's consistent with BoC empirical research too. The <5% depreciation we expect would represent a rounding error on CPI then. There's also a somewhat recent episode we can look to: From 2013 to 2016, the C$ fell over 30%. Core inflation did pick-up vs. the U.S. but only by ~1%-pt (again, on a 30% move). It also remained at/below 2% and at/below the rate of U.S. inflation during that time. We're not trying to deny that this inflation channel exists, but the direct pass through from a weaker C$ to consumer prices may be smaller than is broadly appreciated. More fundamentally, the BoC will be set domestic monetary policy based on domestic conditions. Macklem has said as much. To us, it's clear domestic conditions currently warrant earlier cuts.

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