ECONOMIC VIEWPOINT

Exchange Rates and Diverging Interest Rates

The Loonie Could Prove Resilient Once Again

By Hendrix Vachon, Principal Economist

Interest rates in Canada and the US have followed separate paths for several months now. In fact, if the Bank of Canada (BoC) cuts its policy rate faster than the Federal Reserve (Fed) over the next year and a half, some interest rate spreads are expected to widen even more, especially spreads on shorter term rates. This will keep the Canadian dollar under pressure. Lower interest rates make investments denominated in Canadian dollars less attractive than those denominated in US dollars. But exchange rates are influenced by a whole range of other factors, and the loonie could ultimately prove more resilient than some people may think. For example, back in 1996 and 1997, interest rates in Canada fell far below US rates, but the loonie wasn't really affected.

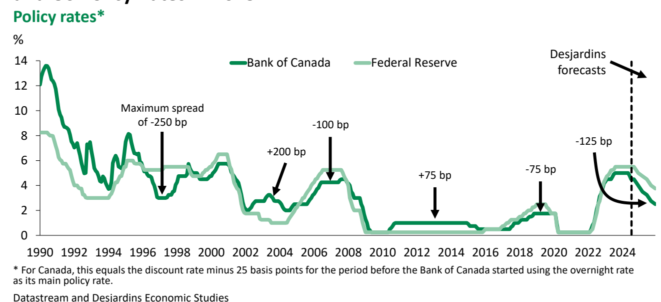
Interest Rate Spreads Are Set To Widen

The BoC started cutting rates in June, and as of this writing, the odds are high that more rate cuts will follow in July and September. In total, we're expecting Canada's key interest rate to be lowered by 100 basis points in 2024 and by an additional 150 basis points in 2025. Meanwhile, even though the latest US inflation data has improved, we don't expect the Fed to cut rates quite as much. The US economy is still in better shape than Canada's and should therefore generate less disinflationary pressure. Consequently, there isn't as much of a need to lower rates. For now, we expect the Fed to cut its key rate by a total of 50 basis points in 2024, followed by another 125 basis points in 2025.

In the end, we expect to see a 125-basis point negative spread between the policy rates in Canada and the US in 2025 (graph 1). In comparison, there was a negative spread of 75 basis points in 2019 and of 100 basis points in 2006 and 2007. We have to go all the way back to 1996 and 1997 to see a negative spread bigger than the one we expect for next year.

Yet our forecasts include a margin of error, and alternative scenarios—in which inflation would fall even faster in Canada—could result in a negative spread of more than 125 basis points. At the same time, the US economy may turn out to be more resilient than expected. This means the Fed would need to lower rates even less than anticipated, which would further increase the Canada–US interest-rate differential.

Graph 1
We Expect To See a 125-Basis Point Negative Spread Between Canadian and US Policy Rates in 2025
Policy rates*



* For Canada, this equals the discount rate minus 25 basis points for the period before the Bank of Canada started using the overnight rate as its main policy rate.

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In short, our baseline scenario already sees the spread expanding more than it has at any time in the past two decades. Some alternative scenarios even suggest it could grow almost as wide as the 250-basis-point differential seen in 1996 and 1997.

The Good News Is That the Loonie Held Up Well in 1996 and 1997

It's interesting to see that the Canadian dollar didn't depreciate much in 1996 and 1997, despite the exceptionally large interest rate spread in those years (graph 2 on page 2). The loonie essentially stayed between CAN$1.36 and $1.37/US$ as interest rate spreads widened in 1996. It then fell by only a few cents in 1997. And that's not the only time it hasn't performed as expected. From 1998 until the early 2000s, when interest rate

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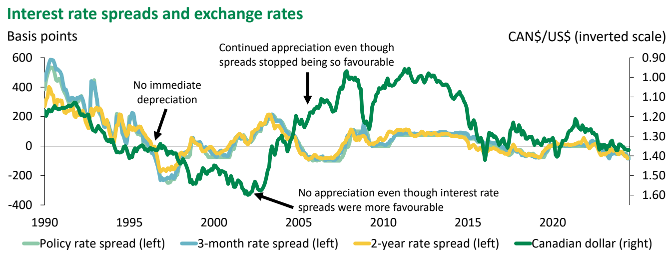
Graph 2
The Canadian Dollar Held Up Rather Well in 1996 and 1997



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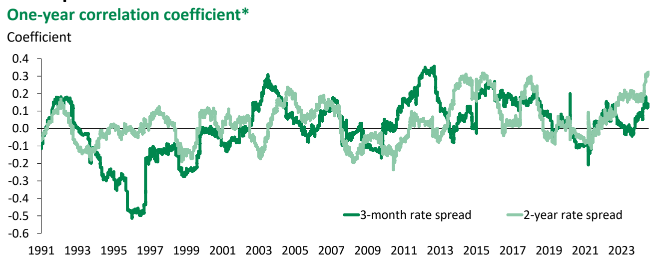
spreads were more conducive to a strong Canadian dollar, it remained weak. The loonie then appreciated for a long time—from 2003 to 2007—even though interest rate differentials were no longer quite so favourable.

That shows how little we can rely on interest rate spreads to forecast currency movements. In addition, an analysis of the Canadian dollar's correlation with the 3-month and 2-year interest rate spreads shows significant volatility over time (graph 3). The correlation was very low, even negative, in the 1990s, but has recently strengthened. However, we can't assume that this improvement in the correlation between exchange rates and interest rate spreads will last. We expect it to keep fluctuating over time. In addition, the CAN$/US$ exchange rate will still be influenced by other factors, such as changes in commodity prices, the state of the Canadian and global economies, market sentiment and the US dollar's own movements.

Graph 3
The Correlation Between Currency Movements and Changes in Interest Rate Spreads Varies a Lot Over Time



* Correlation between daily fluctuations in the CAN$/US$ exchange rate and daily fluctuations in interest rate spreads between Canada and the United States.
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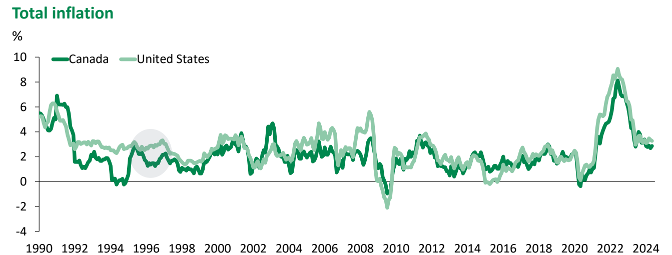
Context Matters

In fact, there were many positive factors driving the loonie in 1996. First, the reason why interest rate spreads widened that year was because the BoC managed to bring inflation under control. Inflation had fallen to below 2% in Canada, while it remained close to 3% in the United States (graph 4). So when the BoC cut rates after several years of restrictive monetary policy, the markets welcomed the news. This was the era when central banks started implementing inflation targeting. They had to work harder to build their credibility and ensure expectations were anchored to the established target.

Graph 4
Inflation Was Weaker in Canada, Giving the Bank of Canada Room To Cut Rates



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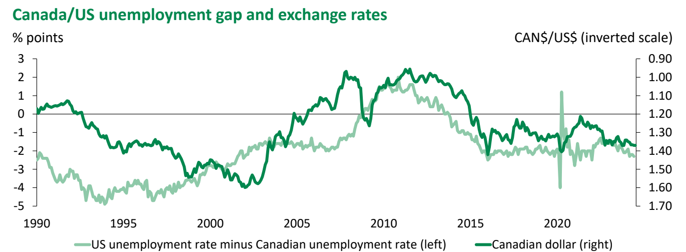
The preceding years had been tough for Canada, where the unemployment rate was much higher than in the United States (graph 5). There had also been great uncertainty over the Constitution—not to mention the Mexican peso crisis, which dragged the Canadian dollar down in its wake. Mexico's financial problems also drew investor attention to structural weaknesses in Canada, especially its large public deficits and balance of payment pressures. In 1994, public deficits still amounted to approximately 7% of Canada's GDP, and the country's current account balance was also deeply in deficit. But then the situation

Graph 5
Economic Challenges in the Early '90s Had Already Weakened the Loonie



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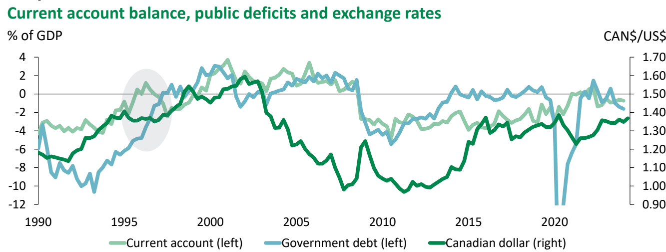
quickly turned around, driving up the Canadian dollar (graph 6). Consequently, 1996 seemed like the calm after a storm. This could also be seen in financial markets, which demonstrated a greater appetite for risk while stocks soared higher (graph 7).

Graph 6
Improvements in Public Finances and in the Current Account Balance Helped Curtail the Loonie's Slide
Current account balance, public deficits and exchange rates



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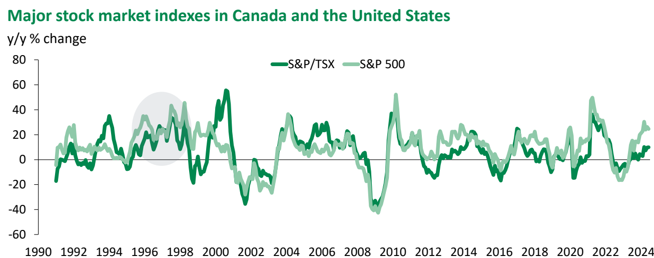
Graph 7
Risk Appetite Returned in 1996

Major stock market indexes in Canada and the United States



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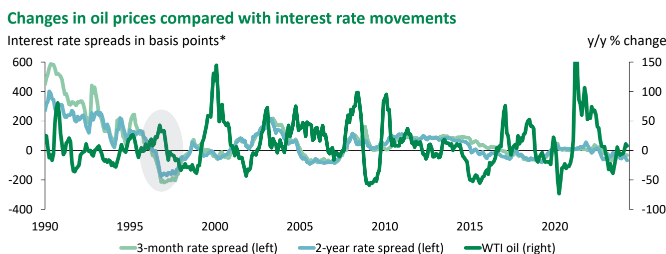
But the biggest boost for the Canadian dollar was the oil price rally, which improved Canadian terms of trade and helped bring the current account balance back into the black (graph 8). However, the emerging financial crisis in several Asian countries caused oil prices to lose momentum in the second half of 1997.

Graph 8
Oil Prices Rose in 1996 While Interest Rate Spreads Were Growing

Changes in oil prices compared with interest rate movements



WTI: West Texas Intermediate; * Spreads between Canadian and US rates.
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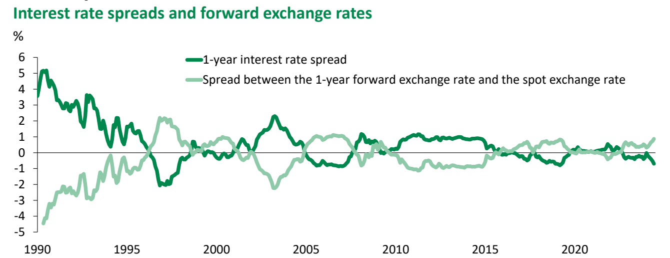
The value of the Canadian dollar didn't immediately plunge, as the BoC had initiated a rate-hiking cycle. The complications arising from the Asian crisis increased in 1998, bringing on sharper corrections in the prices of oil and other commodities. This ended up hitting the loonie hard. Meanwhile, the market's appetite for risk had also shrunk.

We Also Can't Forget About Interest Rate Parity

Another aspect of forex rates that we can't forget about is the forward market, which maintains interest rate parity. When interest rates are lower in Canada than in the US, investors have to be compensated by an expected rise in the Canadian dollar. This means that the loonie's value on the forward market would have to be higher than its current value to maintain interest rate parity (graph 9). For example, if the Canadian 1-year interest rate is 1% lower than the equivalent US rate, investors will need the Canadian dollar to appreciate by 1% over the same period to compensate for it.

Graph 9
Interest Rate Spreads Need To Be Offset by Expectations of Equivalent Currency Movements
Interest rate spreads and forward exchange rates



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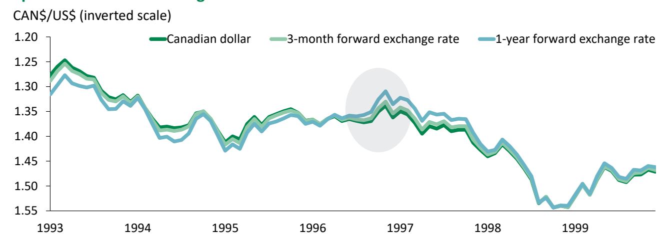
In 1996, as interest rate spreads grew, the difference between the spot exchange rate and forward exchange rates also widened (graph 10). More specifically, while the spot exchange rate remained relatively constant, forward exchange rates reflected an expected rise in the value of the Canadian dollar. This expected appreciation meant that investors could look forward to a gain

Graph 10
The Spot Exchange Rate Remained Relatively Constant in 1996, but Forward Exchange Rates Reflected an Expected Rise in the Canadian Dollar
Spot and forward exchange rates



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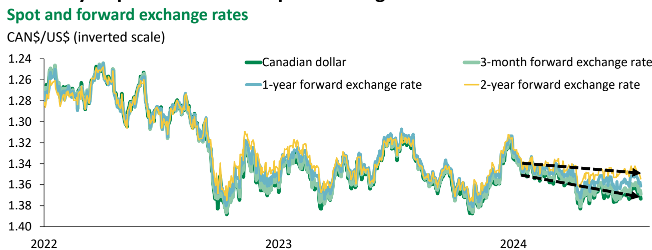
in the forex market that would offset lower interest rates on investments denominated in Canadian dollars.

Forward exchange rate movements are hard to predict. They don't always appreciate when interest rates go down in Canada. To return to our example from 1996 and 1997, the favourable economic and financial conditions that prevailed back then could very well have made it seem more likely that the Canadian dollar would appreciate. But once the Asian crisis complicated matters, investors weren't convinced that the loonie would go up, so its spot value had to go down.

Over the past few months, the growing difference between Canadian and US interest rates hasn't been offset by an appreciation in the forward value of the Canadian dollar. The 1-year forward exchange rate is currently around CAN$1.36/US$, whereas it was around CAN$1.34/US$ at the start of this year. Interest rate parity has been maintained by further depreciation in the spot exchange rate, rather than a change in the forward exchange rate (graph 11). However, as has been the case in the past, if interest rate spreads get any wider, they could be compensated by an appreciation in the loonie's forward value.

Graph 11
So Far This Year, the Increase in Interest Rate Spreads Has Mostly Been Offset by Depreciation in the Spot Exchange Rate
Spot and forward exchange rates



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Finally, What Can We Expect for the Rest of 2024 and 2025?

The biggest takeaway here is that interest rate spreads aren't always a reliable indicator of what's going to happen with exchange rates. There are many other variables to consider. As in the past, the Canadian dollar may avoid further depreciation, even if the BoC cuts rates faster than the Fed. In fact, that's what we expect. The loonie is currently over CAN$1.37/US$ and could remain under pressure over the very short term. But we think it will start trending back upward by the end of this year and should close 2025 somewhere between CAN$1.34 and $1.35/US$.

Of course, some factors will have to give the loonie an added boost to compensate for the expected increase in interest rate spreads. First, we're still relatively bullish on prices for oil and, especially, natural gas. Prices for many other commodities will probably stay high, as long as global demand remains high. This is one of the key assumptions for our scenario. Although we don't expect a strong economic recovery, we do expect growth to gradually accelerate in a number of countries. These kinds of economic conditions would also be good for financial markets overall, with risk premiums remaining relatively low and stock markets continuing to rise.

We also need to put expectations regarding interest rate cuts into context. As in 1996, we should look at rate cuts as good news for the economy. They won't solve all our problems, but they could help accelerate economic growth. Also, remember that lower interest rates will reduce the payment shock for households that need to renew mortgages taken out at record-low interest rates during the pandemic. This would obviously be a boon for financial stability, which could help keep the loonie afloat. Investors would find it easier to accept an increase in the Canadian dollar's value on the forward market, which would minimize the need for the spot value to diminish in order to maintain interest rate parity. All told, the current environment seems to offer attractive opportunities for forex investors who want to position themselves for an appreciation in the value of the Canadian dollar.