ECONOMIC VIEWPOINT

Strategic View: Testing the Limits of Monetary Policy Divergence

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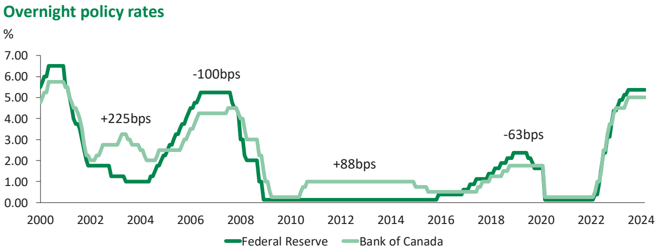
The Bank of Canada rarely strays too far from the Federal Reserve's policy path. Since the two economies share the largest trading relationship in the world, the two central banks typically exhibit a high degree of synchronization. That said, there are times when the performance of the Canadian economy deviates enough that the Bank of Canada must make its own way (graph 1).

Graph 1
The Bank of Canada Has Diverged from the Fed in the Past



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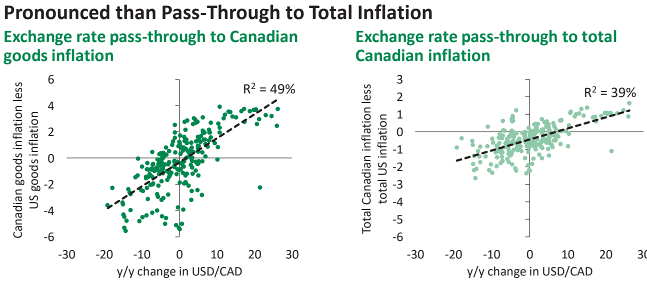
There's a strong sense among Canadians that the Bank of Canada can't diverge too far from the Fed because the resulting exchange rate depreciation would push domestic inflation too high. At the same time, a chorus of economists have been arguing that the Bank of Canada's own models say monetary divergence isn't a constraint on policymakers. As is often the case, the truth lies somewhere in between and is more complicated than either of those narratives.

While exchange rate pass-through is important, it's not typically the result of interest rate differentials. Moreover, in most situations, exchange rate pass-through doesn't guide monetary policy decisions. Still, a weaker currency can play a role in reducing the number of rate cuts necessary to achieve a desired easing in financial conditions. It's via this mechanism that a more tangible limit to monetary policy divergence begins to emerge.

The Importance of Imported Inflation

In a small open economy, imported inflation can be an important driver of both realized consumer prices and inflation expectations. But it takes a relatively large exchange rate move to show up in the headline inflation numbers. Using the difference between Canadian goods inflation and US goods inflation as a rough proxy for exchange rate pass-through, it's clear that currency moves can drive material changes in goods prices. However, the impact on total inflation is much more muted (graph 2).

Graph 2
Exchange Rate Pass-Through to Canadian Goods Is Much More Pronounced than Pass-Through to Total Inflation



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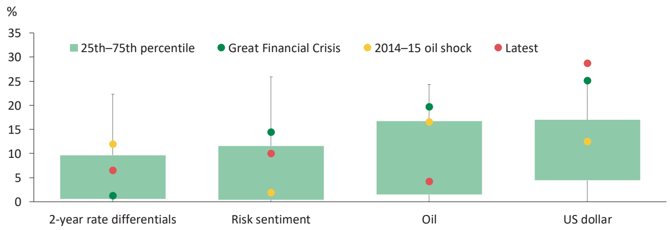
The Bank of Canada's workhorse model says that a 10% depreciation in the Canadian dollar would increase core CPI by 0.25% over the course of the following twelve months. That would be enough to raise some eyebrows at the Bank of Canada given the spell of high inflation just experienced. More empirical models show similar impacts on inflation from direct exchange rate pass-through.

But the exchange rate is typically buffeted by factors other than interest rates. That same Bank of Canada model says that a 100bp decrease in the policy rate would cause just a 2% depreciation in the Canadian dollar, which would seemingly push core consumer prices up just 0.05% via direct exchange rate pass-through. According to our analysis, risk sentiment, oil prices and broad US dollar strength have done more to push and pull the Canadian dollar in the past two decades than interest rate differentials (graph 3).

Graph 3
Interest Rate Differentials Tend to Be Overshadowed by Other Factors Driving the Exchange Rate
Factors explaining changes in the Canadian dollar*



* R-squared of 1-year rolling univariate regressions on daily returns of each factor. Risk sentiment is represented by the S&P500. The US dollar factor is represented by the DXY index excluding the Canadian dollar. Error bars represent the 10th and 90th percentile observations, while the shaded areas are interquartile ranges.

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Exchange rate pass-through doesn't typically warrant a monetary policy response either. Central bankers prefer to look through such moves, viewing them as one-time price level shifts rather than sustainable sources of inflation. Assuming inflation expectations remain well anchored, price level shifts should only have a short-lived impact on the rate of inflation. As a result, since monetary policy actions work with long and variable lags, reacting to transitory disturbances in inflation is unnecessary and can in fact be counterproductive. (See Savoie-Chabot and Khan, 2015.)

Central bankers will tend to focus their efforts on balancing aggregate supply and demand instead of chasing temporary fluctuations in inflation. (See Schembri, 2017.) Understanding that the output gap is the key driver of the monetary policy reaction function sheds light on what could limit divergence between the Fed and the Bank of Canada. To forecast the future trajectory of the economy, an assessment of overall financial conditions is crucial.

Financial Conditions to Help Limit Divergence

By making imports more expensive and exports cheaper, a depreciation in the Canadian dollar will tend to support domestic economic activity. While the Bank of Canada will look through exchange rate pass-through, policymakers will respond to a firmer domestic economic outlook. In that way, currency weakness can change the path for policy rates.

According to the Bank of Canada's workhorse model, a 10% depreciation in the currency requires as much as 100bps of rate hikes to offset the exchange rate's stimulative impact on the real economy. Put a different way, a sustained 10% depreciation in the currency has roughly the same stimulative impact on the real economy as 100bps of rate cuts. As a result, currency depreciation can limit how much the Bank of Canada needs to ease financial conditions via rate cuts this year and next.

With markets only expecting two Bank of Canada rate cuts this year, there's little divergence priced in between the Bank of Canada and the Fed. As a result, there's scope for the loonie to weaken if, as we expect, Canadian central bankers pivot to a more dovish stance in the months ahead. To calibrate the cadence of rate cuts, Canadian policymakers will need to incorporate that exchange rate weakness into their outlook. As we've demonstrated, the Bank of Canada should view currency depreciation as a substitute for some rate relief.

To account for this, we now see four Bank of Canada rate cuts this year instead of five and a somewhat slower pace to easing in 2025 as well. Make no mistake, we still expect the policy rate to fall materially from current levels as Canadian central bankers combat the effects of mortgage renewals and more muted population growth. Our new forecast simply assumes a slower pace of adjustment given the divergence in monetary policy that is likely to occur as the Fed remains on the sidelines for longer.

Unless central bankers become worried about inflation expectations, it will be more important to monitor the currency's impact on the real economy than on near-term dynamics in consumer prices. The Bank of Canada's core median and trimmed mean measures do a much better job of filtering out temporary fluctuations tied to exchange rate pass-through than CPIX or CPI ex-food and energy. Of course, we continue to believe our bias-adjusted measures of inflation are superior to all of these in terms of filtering out transitory disturbances while still tracking changes in the output gap.