Economics
IN FOCUS

June 3, 2024

Finding the limit: How far can the Bank of Canada diverge from the Fed?

by **Ali Jaffery** ali.jaffery@cibc.com and **Andrew Grantham** andrew.grantham@cibc.com

Whether it begins this week as we expect, or waits until July, the process of cutting interest rates will almost certainly start sooner in Canada than in the US. The key question now is, how far can the Bank of Canada diverge from the Fed?

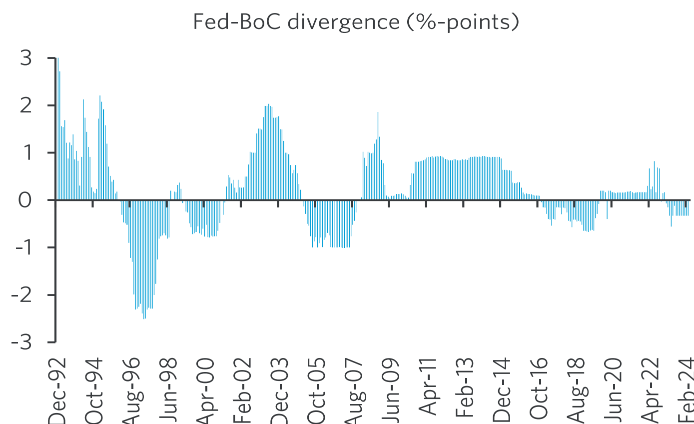
Unlike a racing driver looking for the overtake, we don't believe that the Bank is close to pushing its limits yet. They could cut 2-3 times before the Fed and could manage a 100 basis points (bps) gap for some time. While the Canadian dollar may depreciate further, the move would likely be fairly modest and the impact on inflation would be partly offset by Canadian long rates being held up by the lack of interest rate cuts stateside and softer demand for Canadian exports. And, if track conditions were to change, or in this instance if the domestic economy proves even weaker than anticipated, creating more disinflationary pressure, the Bank of Canada could risk an even wider gap and weaker exchange rate.

A historic guide

History shows that the Bank of Canada and the Fed can and do diverge. Since 2005, the widest gaps in either direction have been around 1%, or 100bp. However, that's still 50-75bp wider than the current gap, suggesting historical precedence for at least a couple of BoC rate cuts before the Fed starts to move (Chart 1). Moreover, these gaps occurred during a period of historically low interest rates globally, and the divergence in overall monetary policy was at times much greater than the difference in policy rates suggested. The best example was when the Bank of Canada raised interest rates slightly after the financial crisis, which was much milder in terms of the financial system shock than in the US, at a time when the Fed was still undertaking quantitative easing.

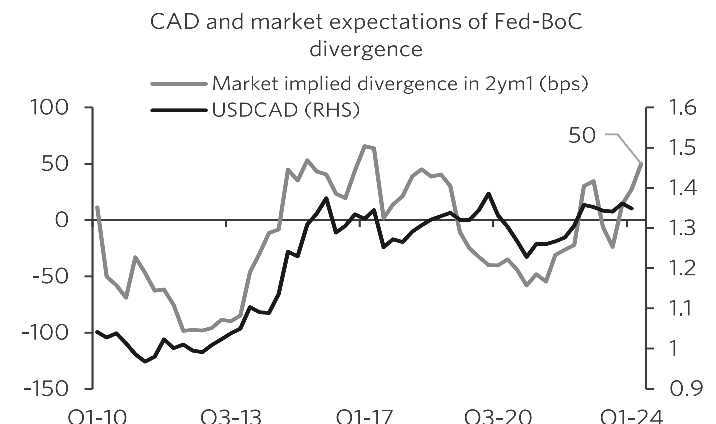
Even though there is precedence for a wider gap, markets don't appear to be taking cues from history, and expect limited policy divergence (Chart 2). That's a shift from earlier expectations when the Fed was forecast to start cutting ahead of the BoC, and as this change has been gradually priced, it has contributed

Chart 1: BoC and the Fed divergence is not uncommon over history



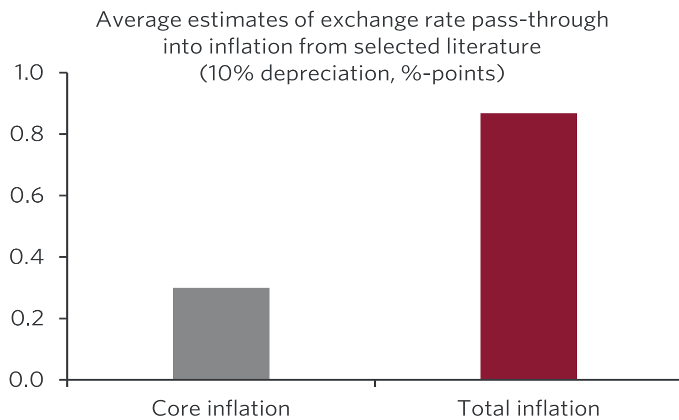
Source: Bloomberg, CIBC calculations

Chart 2: Markets have priced in only about 50bps of divergence and the CAD has weakened by 5-6% since the end of 2022



Source: Bloomberg, CIBC calculations

Chart 3: Research points to CAD weakness impacting total inflation much more than core



Source: Gervais and Gosselin (2014), Savoie-Chabot and Khan (2015), Devereux et al (2017), Forbes et al (2018), Forbes et al (2020), Corrigan et al (2021), Alexander and Reza (2022), CIBC calculations

to the Canadian dollar depreciating by 5-6%. However, our analysis shows that a modestly wider gap could persist through 2025, without causing too many headaches for policymakers on the inflation front.

The FX factor

The main argument for a limit existing on how far the Bank of Canada can diverge from the Federal Reserve stems from the inflationary impact of a sustained currency depreciation. A central bank will look through short-lived movements in the exchange rate as affecting the level of prices, but not inflation (continued price growth). Sustained moves in a currency, however, can be important for inflation. As trade makes up a greater proportion of our economy, and because contracts are usually priced in USD (Devereux et al, 2017), the inflationary impact of a persistent FX depreciation in Canada is greater than in the US or the Eurozone (Gopinath, 2015).

But the size of the inflation impact can vary over time and ultimately depends on what is driving the exchange rate movement, and the state of the Canadian economy at the time. The depreciation we see today has largely been driven by expectations for higher-for-longer interest rates in the US as insurance against "bumpy" inflation. At the same time an interest-sensitive Canadian economy has shown clearer signs of buckling. In this environment, importing firms in Canada don't have a lot of room to pass on higher prices to consumers, and will likely be forced to absorb some of the higher cost of imports through lower margins. The inflationary impact should therefore be somewhat smaller compared to an environment where both economies were strong.

Academic research and analysis from Bank of Canada staff generally finds that headline inflation is moderately responsive to exchange rate movements, while the pass-through to core inflation is much smaller (Chart 3). Looking across a range of studies, including those that take into consideration weaker demand conditions and international monetary policy transmission, the average impact sees a 10% decline in the loonie adding about 0.9%-points to inflation in the long-run, and 0.3% to core inflation. Headline inflation has a larger impact because it includes commodity-related items like gasoline and fresh produce priced in USD that adjust very quickly to changes in the loonie.

High tolerance for divergence

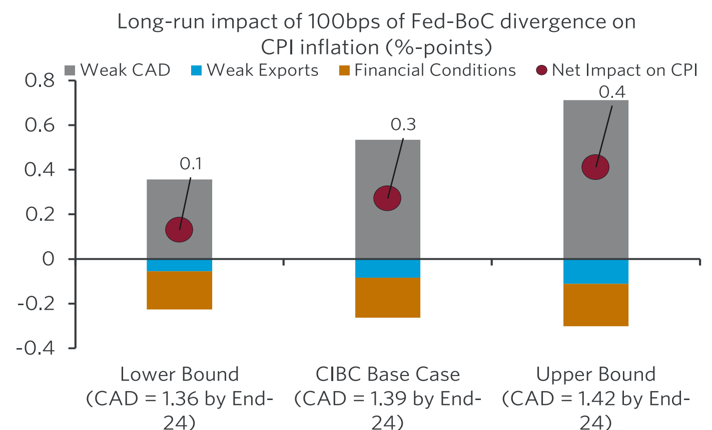
Translating these FX impacts into their implications for an interest rate policy divergence will depend, of course, on just how much weakness we would see in the Canadian dollar from a given interest rate gap. Canada's actual inflation path will also depend on the reasons why the Fed and the Bank of Canada opted for a different interest rate path.

For a clean look at the role of the rate differential itself, we look at a scenario in which the Fed opts to take out more insurance against future inflation, and lets Bank of Canada easing open up a 100 basis point gap in rates, versus an alternative scenario in which the Fed maintains a zero gap with Canada. While the loonie would be weaker with a wider rate gap, the overall impact on Canadian inflation would be cushioned by other impacts of a more hawkish Fed approach.

As a result, our analysis finds estimates that with a 100bps of divergence between the Fed and BoC, the long-run impact on CPI inflation in Canada would run at only 0.1 to 0.4%-points (Chart 4). These numbers are based on rules-of-thumb in Chart 3 and assume the exchange rate would either stay where it is or depreciate further to 1.42 at the top end of the range (based on work of Ha and So, 2023), with our base case view somewhere in the middle.

Remember that the Canadian dollar has already seen a depreciation owing to the opening up of a rate gap as the Fed pressed on to a higher rate in 2023 than the Bank of Canada,

Chart 4: 100bps of Fed-BoC divergence would be manageable for Canada



Source: Statistics Canada, Bloomberg, Bank of Canada, Ha and So (2023), Alexander and Reza (2022), CIBC calculations

Note: Exchange rate-pass through is based on the depreciation since the end-2022 and these estimates are measured relative to a case of no divergence.

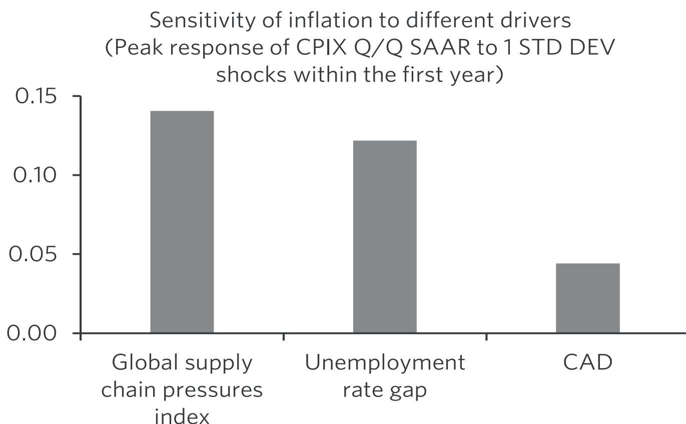
and as the market started to price in an earlier ease from the BoC. Moreover, the Canadian dollar tends to strengthen or weaken against the US in sync with how other majors are faring against the greenback. Even a modest weakening in the USD against European majors from what is a historically-strong current level would provide a significant cushion against the Canadian dollar tumbling in its own cross with the dollar.

What brings these estimates a bit lower in each of the exchange rate scenarios are a couple of important offsetting disinflationary forces that also stem from monetary policy divergence. If interest rates come down in Canada but stay higher for longer in the US to slow the economy, that would also cool demand for Canadian exports, exerting downward pressure on inflation in a slower Canadian economy. Because Canada's exports are generally priced in USD, this channel is fairly modest (Alexander and Reza, 2022).

We believe the largest offset comes from the spillover of tighter financial conditions. Higher for longer short rates in the US impact Canadian longer-dates bond yields (and by extension mortgage rates), keeping financial conditions tighter than the Bank might want. Using results from the literature and estimates from structural vector autoregression models, we find that these two factors would offset just under half of the inflationary impact of a weakening in the Canadian dollar as interest rate spreads grow.

The bottom line here is that the Bank has a higher tolerance for divergence than the market seems to be believe, and could live with a 100bps gap — and possibly even more — for some time. The impact on total inflation would likely take over a year to build and then would gradually fade, while the impact on core inflation would be essentially negligible. This process has already started given the adjustment of the exchange rate over the past year and where market expectations sit today.

Chart 5: Underlying inflation is much more sensitive to surprises in global supply and slack than to FX movements



Source: NY Fed, Statistics Canada, Bank of Canada, CIBC calculations

Note: Estimate from a 5-variable SVAR identified with short-run restrictions. Variables include CPIX, UR Gap, NY Fed Global Supply Chain Index, USDCAD and the overnight rate.

CAD is not the only game in town

The exchange rate is also far from the only factor that the Bank of Canada needs to consider in judging whether it can plot a different interest rate path than the Federal Reserve. Indeed, it isn't even the most important factor. The steadiness of inflation expectations in Canada and changes in slack within the domestic economy are the Bank's main focus. They are also very attuned to the influence of global forces and in particular, the evolution of global supply chain pressures and how they impact goods prices. Indeed, we find that core inflation is at least three times more sensitive to surprise changes in a global supply chain index or the unemployment rate gap, a measure of labour market slack, than a persistent shift in the currency (Chart 5).

So in reality, the ability for Bank of Canada policy to diverge from that of the Fed is fairly wide. Policymakers will first look towards how restrictive monetary policy needs to be to bring inflation back to target, and also how important global forces such as the health of supply chains and commodity prices are impacting inflation and the exchange rate.

Finding the limit

In our base case forecast, the Bank of Canada cuts interest rates twice, by 25bp each time, before the Federal Reserve starts to lower interest rates in the US in September. The 100bp of cuts we predict in Canada will be double that seen in the US, and widen the current spread up towards 1%. With markets already pricing in one more cut from the Bank than the Fed this year, just one additional 25bp move relative to that pricing shouldn't weaken the currency too much more.

Our main takeaway is that the market seems too concerned about the inflationary consequences of a Fed and BoC divergence. As has happened in the past, a 100bps gap will be manageable and it seems the Bank also shares our view that a persistently weaker dollar is not a large risk for inflation, especially in the face of a weak economy. We believe the Governor when he says he views the exchange rate as shock absorber, and the implication that there is no particular level of the Canadian dollar that the Bank wants to see to feel comfortable to ease policy. So as the Bank tries to find the limit of how far it can diverge from the Fed, for now, it should be free to run its own race.

Contacts:

Avery Shenfeld
avery.shenfeld@cibc.com

Benjamin Tal
benjamin.tal@cibc.com

Andrew Grantham
andrew.grantham@cibc.com

Ali Jaffery
ali.jaffery@cibc.com

Katherine Judge
katherine.judge@cibc.com

CIBC Capital Markets
PO Box 500
161 Bay Street, Brookfield Place
Toronto, Canada, M5J 2S8
Bloomberg @ CIBC

economics.cibccm.com

CIBC World Markets Inc., CIBC World Markets Corp., CIBC World Markets Plc., CIBC Australia Limited and certain other corporate banking and capital markets activities of Canadian Imperial Bank of Commerce operate under the brand name CIBC Capital Markets.

This report is issued and approved for distribution by (a) in Canada, CIBC World Markets Inc., a member of the Investment Industry Regulatory Organization of Canada, the Toronto Stock Exchange, the TSX Venture Exchange and a Member of the Canadian Investor Protection Fund, (b) in the United Kingdom, CIBC World Markets plc, which is regulated by the Financial Services Authority, and (c) in Australia, CIBC Australia Limited, a member of the Australian Stock Exchange and regulated by the ASIC (collectively, "CIBC") and (d) in the United States either by (i) CIBC World Markets Inc. for distribution only to U.S. Major Institutional Investors ("MII") (as such term is defined in SEC Rule 15a-6) or (ii) CIBC World Markets Corp., a member of the Financial Industry Regulatory Authority. U.S. MIIs receiving this report from CIBC World Markets Inc. (the Canadian broker-dealer) are required to effect transactions (other than negotiating their terms) in securities discussed in the report through CIBC World Markets Corp. (the U.S. broker-dealer).

This report is provided, for informational purposes only, to institutional investor and retail clients of CIBC World Markets Inc. in Canada, and does not constitute an offer or solicitation to buy or sell any securities discussed herein in any jurisdiction where such offer or solicitation would be prohibited. This document and any of the products and information contained herein are not intended for the use of private investors in the United Kingdom. Such investors will not be able to enter into agreements or purchase products mentioned herein from CIBC World Markets plc. The comments and views expressed in this document are meant for the general interests of wholesale clients of CIBC Australia Limited.

This report does not take into account the investment objectives, financial situation or specific needs of any particular client of CIBC. Before making an investment decision on the basis of any information contained in this report, the recipient should consider whether such information is appropriate given the recipient's particular investment needs, objectives and financial circumstances. CIBC suggests that, prior to acting on any information contained herein, you contact one of our client advisers in your jurisdiction to discuss your particular circumstances. Since the levels and bases of taxation can change, any reference in this report to the impact of taxation should not be construed as offering tax advice; as with any transaction having potential tax implications, clients should consult with their own tax advisors. Past performance is not a guarantee of future results.

The information and any statistical data contained herein were obtained from sources that we believe to be reliable, but we do not represent that they are accurate or complete, and they should not be relied upon as such. All estimates and opinions expressed herein constitute judgments as of the date of this report and are subject to change without notice. This report may provide addresses of, or contain hyperlinks to, Internet web sites. CIBC has not reviewed the linked Internet web site of any third party and takes no responsibility for the contents thereof. Each such address or hyperlink is provided solely for the recipient's convenience and information, and the content of linked third-party web sites is not in any way incorporated into this document. Recipients who choose to access such third-party web sites or follow such hyperlinks do so at their own risk.

© 2024 CIBC World Markets Inc. All rights reserved. Unauthorized use, distribution, duplication or disclosure without the prior written permission of CIBC World Markets Inc. is prohibited by law and may result in prosecution.

The CIBC logo and "CIBC Capital Markets" are trademarks of CIBC, used under license..