Economics

THE WEEK AHEAD

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Tweedledee and Tweedledon't

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The Fed had every reason to talk tough this week, perhaps even to the point of erring on the high side in terms of its forecasts for rate hikes ahead. Should the Fed press on to 4.5% or higher, does that force the Bank of Canada to follow suit? Or are there reasons why the two central banks are more like close cousins than identical twins?

Historically, overnight rates in the two countries do tend to move in the same direction, as do their two economies. But peaks and troughs in rates have had significant gaps in both directions, most recently in the last business cycle, when the Fed pressed on to mid-2% rates while the Bank paused at only a 1.75% peak.

Note that the Fed still estimates the long run neutral rate at 2.5%. That's important for the BoC outlook, since its models for the Canadian neutral rate put significant weight on where the US neutral rate lies.

The argument that aggressive Fed hikes force the Bank's hand is that failing to do so will weaken the Canadian dollar, and that acts as an easing in monetary conditions and a boost to import prices. But so far at least, that impact would be very modest, since the C$ is appreciating against other trading partners. That helps hold down prices for Japanese and European vehicles, for example.

The BoC's trade-weighted CAD index was 1% above the average in the first half of 2022 as of August, while the loonie is 6% weaker versus the US dollar alone as of today. Bank of Canada research suggests that even if the loonie was down that much against the full basket, that would add only a few decimal places to the CPI. There's reason to believe that, once the Fed goes on hold, major currencies, including the loonie, will recoup some of the lost ground against the US dollar.

While a cheaper Canadian dollar can stimulate exports, there's been an offset in the other determinant of export conditions: commodity prices. The BoC's index of commodity prices was down 10% in August from its first half average.

To some extent, the more other central banks hike rates, the less the Bank of Canada has to tighten to achieve its desired slowdown. The Fed's more aggressive stance this month reflects its willingness to sacrifice more US growth in order to get inflation down. The resulting downgrade of the US outlook, and similar shifts overseas as other central banks tighten, serves to weaken Canada's export prospects. Higher US target rates and quantitative tightening push up Treasury yields and weigh on equity markets, and some of that tightening in financial conditions spills over into Canadian stocks and bonds.

Canada has long rejected the idea of a common currency with the US, for the very reason that the right monetary policy for this country doesn't precisely mirror the Fed's path. Of late, the data are giving off several signals that the optimal peak rate will be lower north of the border. Hiring has softened more, core inflation hasn't been quite as ugly, and much of the squeeze from higher mortgage rates on Canada's household sector lies ahead, as more and more mortgages come up for renewal. That's not a factor in the US, given the preponderance of 30-year fixed rate mortgages stateside.

Of course, both central banks are still on a tightening path, and we still expect the Bank of Canada to deliver another 50 bp hike in October. But when it comes to picking the right peak for rates, one high enough to quell inflation in the coming year, we say "vive la différence".

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