Intelligence MEMOS

From: Jeremy M. Kronick and Steve Ambler

To: Interest Rate Watchers

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Re: **Don't Fear Fed Inaction; Keep Those Rate Cuts Coming**

With CPI inflation slowing to 2.5 percent in July, last week's Bank of Canada rate cut surprised no one.

Given the dovish tone of the Bank's announcement, it would be reasonable to expect at least one and possibly two more 25-basis point cuts before the end of this year (a basis point is one-hundredth of a percentage point).

This cut widened the gap between the Bank of Canada's overnight rate target and the top of the US Federal Reserve's band for its equivalent, the federal funds rate, from 50 basis points at the end of May to 1.25 percent.

Should this gap worry the Bank of Canada – perhaps lead it not to cut the overnight rate again even if it otherwise wants to? We think the answer is no, for the following reasons.

First, the Fed is now poised to start a rate-cutting cycle of its own. In a late-August speech at Jackson Hole, Wyoming, Fed chair Jerome Powell said:

"The time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks. . . . With an appropriate dialing back of policy restraint, there is good reason to think that the economy will get back to 2 percent inflation while maintaining a strong labour market. The current level of our policy rate gives us ample room to respond to any risks we may face, including the risk of unwelcome further weakening in labour market conditions."

The Fed will probably cut at the same rate as the Bank of Canada, or even faster. A 50-basis point cut in September, though unlikely, is not beyond the realm of possibility.

Second, the consequences of a divergence between the two policy rates are not likely to be severe, and are likely less severe now than in the past.

One possible danger of a widening spread between the two policy rates is the possibility of a depreciation of our dollar. Depreciation would mean higher prices for imports of final and intermediate goods, fuelling inflation both directly and indirectly. This risk is probably lower now than it would have been a few years ago because of the increased importance of services in the Consumer Price Index. Services are largely non-tradable goods, so they are not subject to the effects of exchange rate depreciation.

Also, despite a divergence of a full percentage point during the time between the Bank's previous announcement on July 24 and its latest announcement, the Canadian dollar actually strengthened by close to 3 percent. The reasons for this are complex (as they are for any exchange rate movement) but can partly be explained by lower inflation in Canada. Inflation devalues currency, so more of it in the US relative to Canada strengthens the loonie.

Those considerations noted, the whole point of a flexible exchange rate regime is to allow a central bank to pursue an autonomous monetary policy including letting domestic and foreign interest rates diverge. Indeed, flexible exchange rates act as a shock absorber.

Setting last month aside, if we look at the previous six months of 2024, the Canadian dollar largely depreciated. Much of this happened before the two interest rates started diverging. The reason for the loonie's depreciation? A US economic slowdown would likely include lower US demand for Canadian goods – and the first quarter data we have for 2024 support this notion. Less demand for Canadian goods means less demand for the Canadian dollar.

As a result, the Canadian dollar depreciates, making Canadian goods cheaper and causing a rebound in US demand. This stabilizing effect makes any corrective monetary policy in this scenario unnecessary.

The story in the US is just one variable among many that the Bank of Canada needs to constantly be evaluating when setting its monetary policy. With headline inflation currently at 2.5 percent, the real policy rate (the difference between the Bank's policy rate and inflation) is 1.75 percent. Despite the Bank lowering the overnight rate 75 basis points since its peak, this real rate is actually higher than a year ago in September 2023 when it was 1.2 percent. In other words, monetary policy has become more restrictive despite these interest rate cuts. With unemployment at home increasing and economic growth weak, more cuts should be coming, whatever the Fed does.

Jeremy M. Kronick is Associate Vice President, and Director of the Centre on Financial and Monetary Policy at the C.D. Howe Institute, where Steve Ambler, a professor of economics, Université du Québec à Montréal, is the David Dodge Chair in Monetary Policy.

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