Intelligence MEMOS

From: Steve Ambler and Jeremy M. Kronick

To: Bank of Canada Observers

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Re: **The Bank of Canada Didn't Follow the Fed Last Week: A Good Call**

Bank of Canada governor Tiff Macklem and the Bank's Governing Council held course last week, leaving their target for the overnight rate unchanged at 4.5 percent. The day before, US Federal Reserve chair Jerome Powell was considerably more hawkish, enough to convince markets that the 25-basis point increase in the federal funds rate that they were expecting from the Fed's next setting is probably too low. Of course, this was before the Silicon Valley Bank implosion is likely giving rise to second thoughts.

A question remains, however, would a more hawkish Fed mean the Bank of Canada will also have to hike further? We don't think so.

In large part, the argument in favour of following the Fed has to do with the Canada-US exchange rate, which has mainly depreciated since the tightening cycle began a year ago, and which matters for an inflation-targeting central bank like the Bank of Canada.

Some depreciations aren't a problem. Suppose the Canadian dollar falls relative to the US dollar because demand falls for Canadian goods. If that happens, foreigners require fewer Canadian dollars and our dollar depreciates – just as it would appreciate if the demand for Canadian goods rose. In such cases, the exchange rate acts as a shock absorber: a depreciation makes Canadian goods cheaper, causing a rebound in foreign demand. An appreciation does the opposite. Either way, there is no need for monetary policy to react, and it probably should not.

But suppose the Canadian dollar falls relative to the US dollar because investor preferences change – as, for example, when nervousness causes a flight to the US dollar. That kind of depreciation will make Canadian exports cheaper for foreign buyers and imports more expensive for Canadians. That increases inflation here at home, and, as a result the Bank may need to respond with tighter monetary policy.

In our view, even if the recent decline in the Canada-US exchange rate is mainly due to global rebalancing toward the US dollar – the so-called "safe haven effect" – and bumps inflation up a little, monetary conditions in Canada are still quite restrictive, which means the Bank need not mimic further hikes by the Fed.

Real policy interest rates – calculated by subtracting inflation from nominal rates – are rising in Canada, and at a faster pace than in the US. And they are what **matter** for monetary policy effectiveness.

The Bank is targeting 4.5 percent, while the Fed is aiming for 4.5 to 4.75 percent. But inflation is lower in Canada and is falling faster. Headline inflation in February was 6 percent in the US, compared to Canada's January 5.9 percent, which will be updated next Tuesday. Real rates are still negative in both countries but less negative here. Those inflation numbers are year-over-year, however, which is mostly old information. Looking at one-month or three-month annualized rates of inflation, real interest rates are now moving into positive territory. And, because inflation is continuing to fall, the Bank's real policy rate will continue to rise even without further rate hikes. In effect, monetary policy will continue to tighten in Canada.

Our other main reason for believing the Bank should not follow the Fed in lock step is that the Canadian economy is showing more signs of weakness than the American. Real growth in Canada was stagnant in the fourth quarter, compared to an annualized growth rate of 2.7 percent in the US. In part, this reflects the fact that the Bank began tightening before the Fed did. As the Bank notes, this tightening has already reined in the growth of spending. But since monetary policy operates with long and variable lags, it is prudent for the Bank to pause and allow its rate hikes to have their full effect before considering further increases. Following the Fed's policy rate upward could easily tip the Canadian economy into recession and make any downturn deeper and longer-lasting.

The trade-off governor Macklem and his group must make between further tightening monetary policy in response to the Fed and allowing a short-term depreciation of the Canadian dollar is a delicate juggling act. But in our view, with real policy rates continuing to tighten here at home and further signs of economic weakness emerging, we should set a different course than chairman Powell.

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