CAPITAL MARKETS ECONOMICS

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Special Report: Fed Tapering: Another Reason For A Dovish BoC

- **Through adverse effects on the Canadian economy, Fed tapering would delay rate hikes by the BoC while potential resulting CAD depreciation would not be unwelcome.**

While there is a sound macroeconomic case for a prolonged BoC hold especially in the wake of this week's BoC statement, a reinforcing factor concerns the effects of eventual tapering of Fed bond purchases probably by late winter. To us, that means both central banks start hiking their policy rates by late 2015 or perhaps later. This view contrasts with the consensus opinion that is still counting on a Fed tapering decision to give the Bank of Canada the green light to hike borrowing costs ahead of the Fed.

Fed Taper Effects On Canada

Generally, we think that Fed tapering would hit the Canadian economy harder than the US economy, requiring prolonged monetary policy accommodation in Canada, for the following reasons:

- First, tapering would put **upward pressure upon global fixed rates at a time when the mature Canadian household cycle doesn't need a rate shock.** The US might be able to afford higher fixed rates as it unleashes pent-up demand in the household sector, but Canada cannot.

- Second, tapering would probably pull capital into the US and raise the cost of company financing on the margin in such a fashion as to **restrain the already disappointing investment cycle.**

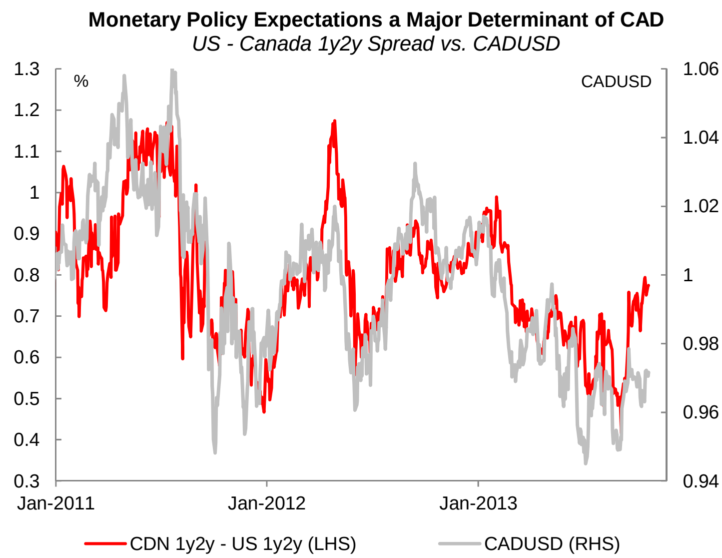
- Third, **Fed tapering could weaken commodity prices** in favour of USD-oriented flows and thus further restrain Canadian growth and investment.

- Fourth, while Fed tapering presumably requires improving US economic fundamentals, **the economic improvement in the US may well continue to fail to trickle over into Canada** by virtue of the fact that Canada has lost so much export competitiveness over time.

CAD Depreciation Would Not Be Unwelcome To The BoC

The second argument is that if Fed tapering prompted a stronger USD and by corollary weaker CAD, it's not at all clear that this would be unwelcome to the BoC as it expresses frustration over export growth. Thus, the consensus assumption that the BoC would hike its policy rate spread over the US when CAD provides room for doing so seems off-base to us.

Chart 1



Source: Bloomberg, Scotiabank Economics

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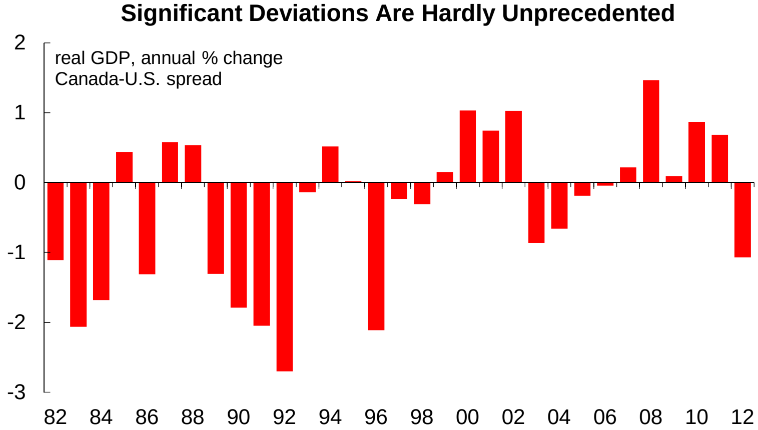
This argument also boils down to what rate spread consistently matters most for USDCAD. As chart 1 demonstrates, the post-crisis QE2-onward environment provides the best correlations between USDCAD and short-rate spreads in the two countries versus a longer-term bond yield spread. The implication is that Fed tapering further up the curve would have a less powerful depreciating influence upon CAD than the appreciating effects of policy rate increases and the BoC must be cognizant of this.

In all, we continue to forecast underperformance of Canadian economic growth relative to the US, and Fed tapering will not help in this regard. Canadian GDP growth underperformed the US by about a percentage point last year, has underperformed the US in seventeen of the past 31 years since 1982 and has done so by between about 1-3% in ten of those years (chart 2). Canada underperformance is therefore hardly unprecedented and is more likely going forward.

Chart 2



Source: Statistics Canada, BEA, BLS, Scotiabank Economics