Why CAD Shouldn't Be A Barrier To BoC Hikes

A key issue that has emerged concerning the BoC outlook is whether the Canadian dollar (CAD) is too strong to justify a hike in the context of the 5% appreciation in the CAD versus the USD since it began moving after May 4th. Obviously there are limits to tolerating exchange rate movements—and a risk to the arguments below is that of sharply overshooting the arguments—but there are at least five reasons why one should not be so concerned about CAD movements to date—and arguably perhaps quite a bit further from here.

INFLATION PASS-THROUGH IS WHAT MATTERS MOST

What ultimately matters is how currency movements feed back upon the BoC's inflation mandate. Scotiabank's Global Macroeconomic Model estimates that a 10% depreciation in CAD relative to the USD would raise core CPI by 0.15% within about a two-year period of time. The percentage movements in the currency from its softest point in early May through to today are well under 5% when trade-weighted and, when mapped onto pass-through assumptions, represent negligible effects on core CPI. More importantly, a currency's movements for such purposes have to be long-lasting and not just judged from one particular point over a short interval of time. The level of USDCAD today versus a year ago has changed very little which may suggest no lasting effect of currency movements to date on core CPI.

CAD IS STILL ARGUABLY AT EMERGENCY LEVELS OF STIMULUS

Compared to mid-2014 after which commodities tanked, CAD remains 25 cents weaker against the USD. The fact it isn't 32 cents weaker—at it was in early May—is a difference amounting to small potatoes and just reflects the BoC's argument (and our own) that we're past the worst of the commodity effects on the economy. The level of USDCAD, however, still signals significant net stimulus to Canadian growth relative to where it was in mid-2014. The currency should be weaker given still-soft commodity prices, but if the worst effects of the commodity price plunge have worked through the economy, then CAD is still accommodative at the point when spare capacity is closed. Risks to trade should be evaluated in terms of net export volumes (net of imports) and the currency has been working favourably on net exports around present exchange rate levels (see chart).

IT'S WHY THE CURRENCY HAS APPRECIATED THAT MATTERS

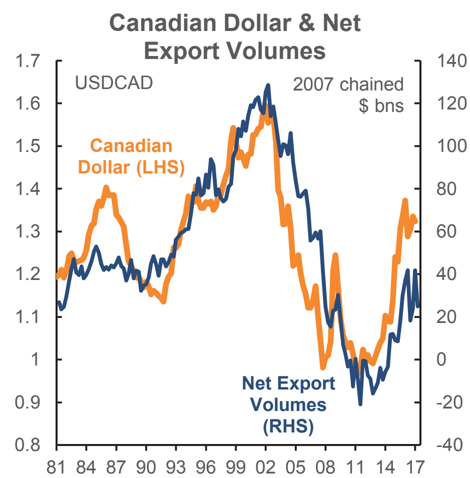
The BoC has long moved away from its old ways of looking at good versus bad types of currency moves through approaches like "type 1 and type 2" forms of currency movements or the even older monetary conditions index that attempted to crudely weight the equivalence of rate and currency movements without exploring why currencies were moving. Abandoning these approaches was therefore done for good reasons, but the notion that *why* a currency moves should be considered is still generally valid. On that, there are at least two points:

a) CAD appreciation is reflecting the underlying closure of spare capacity that we project to be carving out a bottom on inflation toward a moderately higher path in 2018 and the currency is moving accordingly in anticipation of policy tightening as one such consideration. The BoC may have been more concerned about CAD strength before excess capacity was being closed off than it is likely to be at this

CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707
Scotiabank Economics
derek.holt@scotiabank.com

Chart 1



Sources: Scotiabank Economics, Statistics Canada.

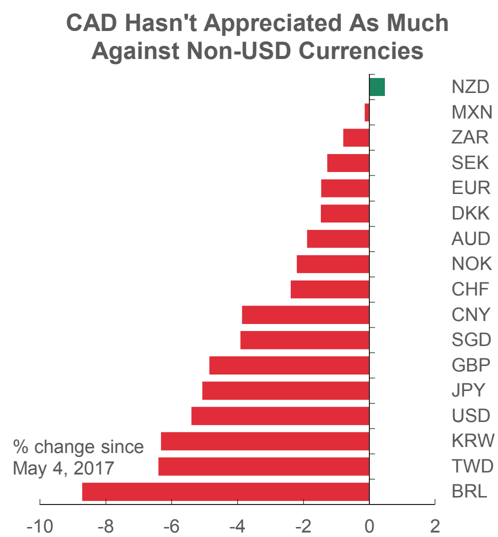
point. To not hike because of CAD worries when CAD and rates should be moving to firmer levels as capacity shuts would be to introduce an odd bifurcated bias to interpreting market movements as the economy moves into excess demand conditions next year.

b) The BoC was arguably uncomfortable with the accumulating short positions into CAD on housing worries and viewed the accompanying depreciation as representing excessive stimulus; it is therefore more likely to be comfortable with where the currency is now than several weeks ago. Right now, USDCAD is simply back to where it was before Home Capital worries and tightened housing rules in Ontario entered the picture. The bet that drove CAD weakness had been based upon excessive pessimism with respect to risks facing the financial system without fully understanding the variety of differences as to how housing finance markets operate in Canada. Unwinding that bet is rationally shaking out a depreciation that was backed by shaky beliefs.

THE BOC DOES NOT LOOK AT CURRENCY RISK JUST IN TERMS OF USDCAD

The nominal single-country exchange rate is a sub-optimal way of looking at the currency. In January 2016 the BoC moved to a different trade-weighted measure of the currency that broadened the basket to include more realistic weights for crosses that were either previously excluded or underweighted. See table 3 on page 10 here for the weights in the so-called Calculated Effective Exchange Rate (CEER) they now use. The USD does indeed have a high weight, but about half the basket is comprised of other currencies and therefore only half of the movement in the C$ versus the USD since early May would flow into the CEER which is a fairly modest currency move when weighted.

Chart 2



Sources: Scotiabank Economics, Bloomberg.

The biggest weights across the other half of the basket go to the yuan (12.9% weight, against which CAD has appreciated by 4% since early May), Euro (11.7% weight, against which CAD has appreciated by 1.6%), peso (7.8% weight, -0.1%) and yen (4.7% weight, +5%). In other words, the USD is among the biggest moving crosses versus CAD (chart 2) and I'd say for reasons the BoC should look through in that it's part of a broad unwinding of the reflation/Trump trades on a market overshoot from conditions before the US election.

Going forward, if markets are wrong in doubting the Fed's resolve to keep hiking, then that could limit further depreciation in CAD versus the USD. Further, it is not just how CAD relates to the USD that matters; it is also how it moves relative to a variety of other crosses in countries where several of the central banks are either guiding potential rate hikes (BoE), still hiking (Mexico) or approaching a more balanced outlook (ECB). In short, the BoC can have more comfort in hiking if other central banks are either stabilizing or moving with it on the bias going forward.

BROADER FINANCIAL CONDITIONS

The BoC stopped publishing its financial conditions index, but it is still a valid point to say that much more than just the currency affects broad financial market conditions. Bloomberg's high yield debt index is at an all-time high. Investment grade corporate spreads are favourable. While the TSX has fallen this year, it remains close to where it was by mid-2014 before commodities fell and 28% higher than the trough in early 2016.

WHAT, ME WORRY? NAH

If it's a worry, then Governor Poloz had several opportunities to flag it directly (unlikely, as the BoC may prefer a more opaque approach relative to, say, the RBA) or indirectly by adopting a more cautious tone, but he did not.

For a further elaboration on our Bank of Canada forecasts go here.