The Bank of Canada’s “Cautious” Tone Wiped Out Some of the Loonie’s Gains

The Canadian key rate hike announced in July, followed by another increase in September, prompted the markets to upgrade their expectations on monetary tightening in Canada. This propelled the loonie higher, which flirted with US$0.83 temporarily.

The economic data had to remain solid to maintain the lofty expectations regarding rate increases and the Bank of Canada (BoC) had to keep sending signals in this direction. However, this is not what happened. In his September 18 speech, Deputy Governor Timothy Lane mentioned that the BoC would monitor the effects of a rising Canadian dollar, suggesting that monetary firming could be slower than what the markets are expecting. On September 27, it was BoC Governor Stephen Poloz’s turn to keep expectations in check by mentioning that the BoC will raise its rates in a “cautious” manner. At the same time, the Governor indicated that future decisions on monetary policy will rely almost exclusively on incoming data. Yet two days later, the real GDP by industry data showed that economic advances paused in July, casting a shadow on the economy’s excellent performance in previous months.

Within just two weeks, expectations on another key rate increase at the end of October slid from close to 60% to about 20%. The interest rate spreads with the United States adjusted accordingly and today the loonie is hovering at around US$0.80. Increased expectations of monetary tightening in the United States steepened the unfavourable slope in interest rate spreads and the impact on the exchange rate. In contrast, oil prices that were a tad higher than in mid-September helped contain the loonie’s losses.

**IMPLICATIONS**

The strategy adopted by the BoC could keep the Canadian exchange rate in fairly volatile territory. Some good economic data would be enough to encourage the markets to raise their expectations on monetary firming and see the loonie fly back to its recent cyclical peak. That said, a rapid rise in the Canadian dollar could also spur the markets to expect the BoC’s more prudent tone.

Forecasting in this environment is more difficult. We recently called for the Canadian dollar to reach almost US$0.85 by year-end. This target may seem ambitious today, but we can still expect the loonie to regain some altitude in the short term.

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**Graph**

Following interest rate spreads, the loonie falls back to US$0.80

Sources: Datastream and Desjardins, Economic Studies