How Much North American Monetary Policy Divergence Could We See?

The Federal Reserve (Fed) and Bank of Canada (BoC) continued to gradually tighten their monetary policies in the first quarter. However, the two central banks’ stances moved in different directions. In the United States, the monetary authorities upgraded their economic and interest rate forecasts. Conversely, while maintaining a generally positive tone in its last statement, the BoC noted several reasons for waiting longer before continuing with monetary tightening. Our interest rate scenarios (graph 1) are therefore calling for slightly faster key rate hikes in the United States than in Canada.

Based on the recent remarks from the central banks, we could imagine a scenario involving greater divergence, with the Fed raising its rates 0.25% every quarter, and the BoC only taking action every six months (graph 2). In that case, the spread between U.S. and Canadian key rates would jump 100 basis points by the end of 2019, instead of increasing by 25 basis points like in our baseline scenario.

This kind of increase in the spread between North American short-term rates would, however, put substantial downside pressure on the Canadian dollar. As Canadian inflation should be above the 2% target throughout 2018, we can assume that the BoC would be uncomfortable with a sharp drop in the loonie that would magnify inflation pressures. The Fed could also hesitate to go it alone with a faster monetary tightening, as everything suggests other central banks will remain quite cautious.

**IMPLICATIONS**

The divergence between North American monetary policies will be curbed by the inflation pressure it would generate in Canada through a weaker loonie. Justifying a scenario of sharply diverging monetary policies would take a major shock to Canada’s economy, or the emergence of much stronger inflation pressure in the United States.

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