The USMCA Will Not Necessarily Cause Key Rates to Rise Faster

After many months of uncertainty, Canadian and U.S. negotiators finally concluded an agreement in the eleventh hour. If everything goes as planned, the United States-Mexico-Canada Agreement (USMCA) will eventually replace the North American Free Trade Agreement (NAFTA). The new agreement does not settle everything, as tariffs on steel, aluminum and lumber have not been lifted. However, the risk of an actual trade war between the United States and Canada, particularly the fear that the automotive sector will be affected by punitive tariffs, has nearly disappeared.

The financial markets reacted immediately. The Canadian dollar and bond yields jumped as soon as the agreement was announced. This can be explained, in part, by the fact that the agreement appears to confirm that Canadian key rates will be hiked once again at the meeting on October 24.

At first glance, the trade agreement could even justify raising Canadian key rates faster than previously anticipated after October. The governor of the Bank of Canada (BoC) has often stated that monetary policy is an exercise in risk management. Fewer risks may therefore justify slightly higher key rates. Furthermore, less uncertainty surrounding trade relations may somewhat improve the outlook for the Canadian economy by stimulating business investment, among other things.

The reduced risk is, however, accompanied by higher bond yields. Five-year Canadian federal bond yields, which barely exceeded 2.15% in early September, recently jumped to nearly 2.50%. The increase in Canadian yields partly reflects an overall upward adjustment in bond yields among advanced countries. Higher interest rates could put the brakes on the Canadian economic in addition to drawing attention back to the risks linked to household debt. This increase in bond yields therefore reduces the need for the BoC to raise key rates faster now that trade tensions have eased.

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**IMPLICATIONS**

All things being equal, a new trade deal could have justified hiking Canadian key rates faster. Given higher bond yields, however, we expect the BoC to continue to act very cautiously and gradually. After rates are raised 0.25% on October 24, we still expect that the BoC will increase its key rates only twice next year.

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