

ECONOMIC NEWS



If NAFTA Was Dropped, Where Would the Loonie Go?

While this is not the most probable scenario, we cannot completely overlook the possibility that the United States might drop the North American Free Trade Agreement (NAFTA). This type of announcement would have several impacts, especially on the value of the loonie which could depreciate sharply.

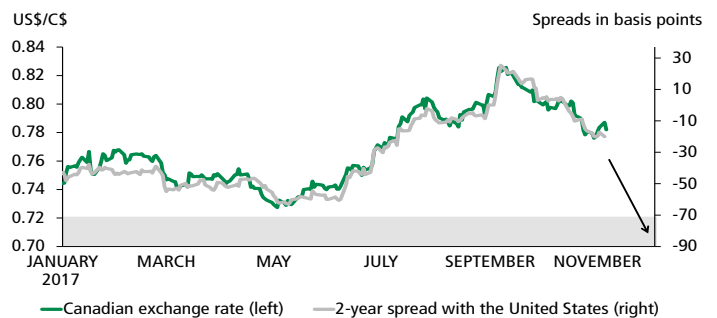
The main driver of the Canadian exchange rate in recent months has been movements in the interest rate spreads between Canada and the U.S. Expectations on monetary tightening in Canada pushed up market interest rates over the summer, thereby reducing the spreads with U.S. rates. The loonie edged closer to US\$0.83. Thereafter, moderating expectations on monetary firming wiped out part of the gains. If the U.S. were to drop NAFTA, we could easily imagine the Bank of Canada (BoC) ending its monetary tightening, perhaps even opting to cut interest rates instead. According to our estimates, the spreads for 2-year rates between Canada and the U.S. could swiftly fall to between -70 and -90, which would be consistent with a loonie at around US\$0.70.

This hypothetical scenario assumes that oil prices will remain relatively steady and that the U.S. continues its monetary firming. The addition of customs tariffs would be an incentive to increase production in the United States, and the resulting inflationary pressures would prompt the Federal Reserve to continue its monetary tightening, perhaps even accelerate the process.

We could also study exchange rate movements based on anticipated changes in trade balances. The customs tariffs imposed by the U.S. would probably lead to a deterioration of Canada's trade balance, which would exert downside pressures on the loonie. Making accurate assumptions on the tariffs that would be imposed if NAFTA was to be dropped and the scope of the deterioration in Canada's trade balance is therefore more difficult to do.

GRAPH

Sharp widening of interest rate spreads could plunge the loonie to about US\$0.70



Sources: Datastream and Desjardins, Economic Studies

IMPLICATIONS

If NAFTA were to be dropped, the loonie's significant depreciation would help mitigate the shock on Canada's economy. Making realistic assumptions on changes in interest rate spreads, we believe that the loonie could quickly depreciate to about US\$0.70.

The Canadian dollar could fall even further in the months following the NAFTA withdrawal. This would depend on the new disclosed informations, such as the details about customs tariffs. The higher the tariffs, the greater the depreciation could be. The BoC could also show itself to be more interventionist than expected, especially if the trade balance were to deteriorate significantly. That said, inflationary pressures could also surface in Canada through import prices, and rein in monetary easing—and the loonie's dive.

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