Market View
Economics and Strategy

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Paltry policy rate pass-through

By Taylor Schleich and Noah Black

To date, the Bank of Canada's easing cycle has brought the policy rate 225 basis points below last year's peak of 5%. That's much more substantial rate relief than markets expected when the easing cycle began in June 2024 (Chart 1). Despite this, the 10-year yield today trades at 3.43%, only a handful of basis points below the levels prevailing in the months leading up to the easing cycle. At first glance, this doesn't appear to be very efficient monetary policy transmission as not even 10% of BoC easing is reflected in longer-term borrowing costs. In this *Market View*, we examine this issue to determine how abnormal (or normal) this is.

One method of quantifying monetary policy transmission is to calculate the ratio of yield changes to the cumulative change in the policy rate. As one would expect, pass-through is relatively more efficient at the shorter end of the curve with 2-year yields down nearly 150 bps since the lead-up to the easing cycle. The further out the curve you go, the less of an impact you'll see. Counterintuitively, 30-year yields are *up* significantly relative to the pre-easing period (Chart 2).

Comparisons to historical periods aren't perfect as no two easing cycles are created equal. Moreover, pass-through calculations are sensitive to you where you put the pin in (i.e., at the start of the easing cycle, months before, or some average of the period leading up to easing). Often, easing is discounted well ahead of the first cut but there are times (e.g., the pandemic) when rate cuts are unexpected and the yield curve fails to pre-emptively price them in. Nonetheless, when we try to make objective comparisons to the past, this cycle stands out in recent history. The last three BoC cutting cycles delivered much more relief out the curve than we've seen this time around. Instead, this cycle more closely resembles those of the pre-GFC period, when yields were higher, contained more of a term premium and the curve was much steeper (Charts 3-5).

This cycle is similar to others in another important way. With the exception of the COVID-induced cutting cycle, yields tend to bottom right around or before the last cut is registered. 3 months *after* the final cut, yields are often materially higher than they were 3 months *before* the final cut or at the time of the final cut. There's still uncertainty over when this easing cycle will officially end but we see a low probability that longer-term yields will register a new trough anytime this year. And if the March cut does turn out to be the final one, this finding would've held true again (Chart 6).

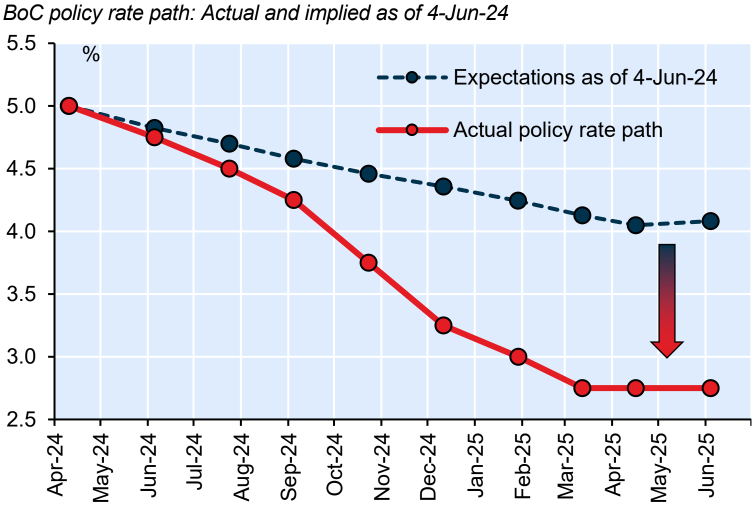
We'd note that the loonie's behaviour this cycle has also been consistent with the empirical record. On average (but not always), the C$ depreciates during the easing cycle and appreciates afterwards. That's been the 2024-25 experience, though the effect is more pronounced this cycle.

Muted rate cut pass-through has real economy consequences. In addition to making borrowing for governments more expensive, rates for consumers (e.g., via mortgages) are also higher. Were this easing cycle to resemble either of the last two (i.e., those for which we have data), five-year mortgage rates 'should' be some 40 basis points lower than they were in April (Chart 8). Of course, those on variable rates have enjoyed and will continue to enjoy relief proportional to the change in the policy rate. We've already started to see variable rate mortgages gain popularity this year and with 5-year yields on the rise in recent months, that shift may be ongoing (Chart 9).

International comparisons are also informative. Here, the takeaway is two-fold. First, muted rate cut pass-through is not a unique-to-Canada phenomenon as bond yields have been on the rise globally thanks in part to growing fiscal pressures/anxieties. Second, Canada's pass-through is far from the least 'efficient'. Indeed, many countries have enjoyed even less yield relief. For perhaps the most extreme example consider the U.K., where 100 bps of BoE cuts have coincided with 10-year yields *rising* 50 bps. For Canada, a *relatively* better contained fiscal outlook and more benign inflation/expectations are likely helping here. However, relative fiscal strength should not distract from the fact that deficits and debt loads are rising in Canada too. That isn't conducive to absolute yield relief, leaving governments, businesses and consumers facing higher borrowing costs than they otherwise might. For the Bank of Canada then, it may require additional policy rate relief to bring down rates and spur a needed rebound in economic activity. Here's hoping inflation data will co-operate and allow them to do so.

Chart 1: This cycle delivered more cuts than expected…

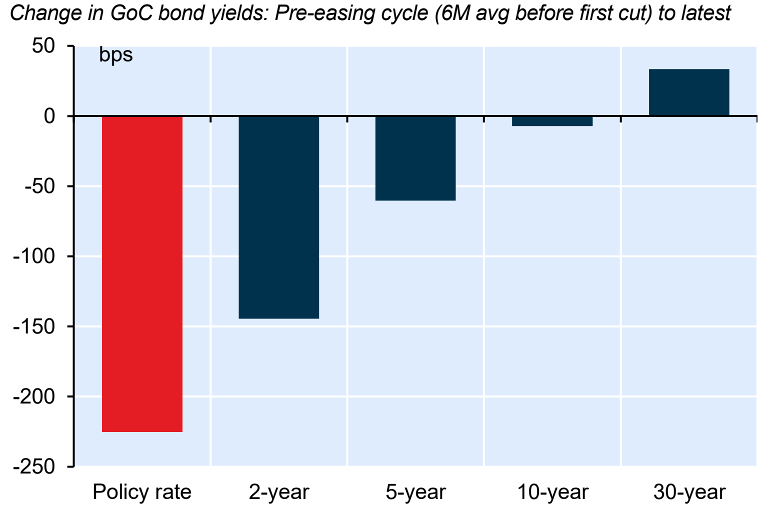
BoC policy rate path: Actual and implied as of 4-Jun-24



Source: NBC, Bloomberg

Chart 2: …yet longer-term yields are little changed (or up)

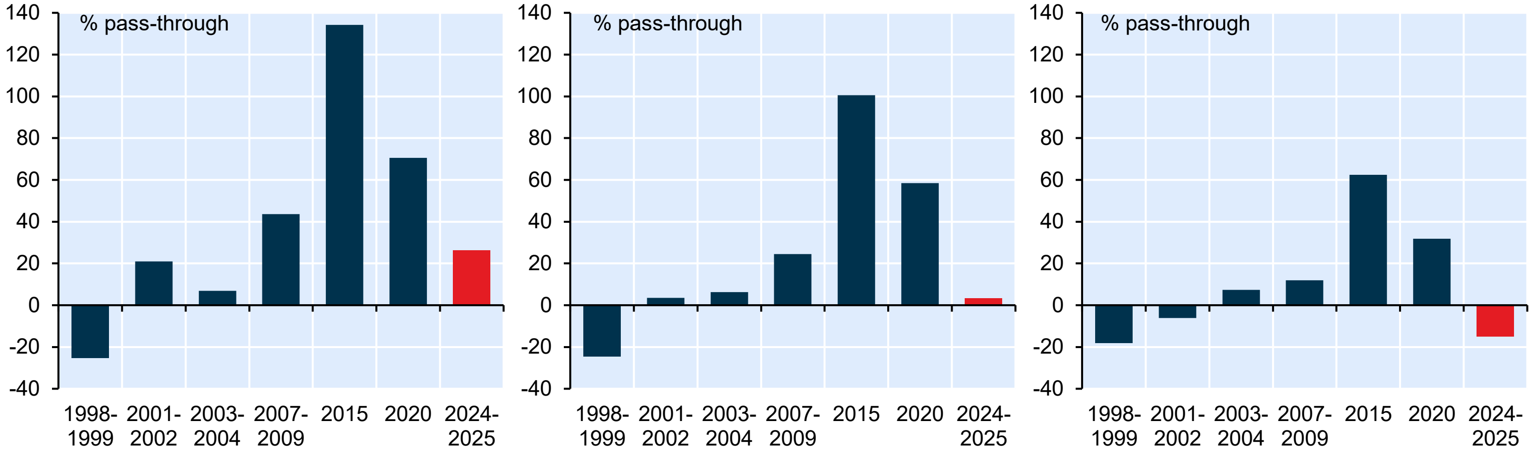
Change in GoC bond yields: Pre-easing cycle (6M avg before first cut) to latest



Source: NBC, Bloomberg

Charts 3-5: Rate cut pass-through to yield curve is muted compared to more recent easing cycles

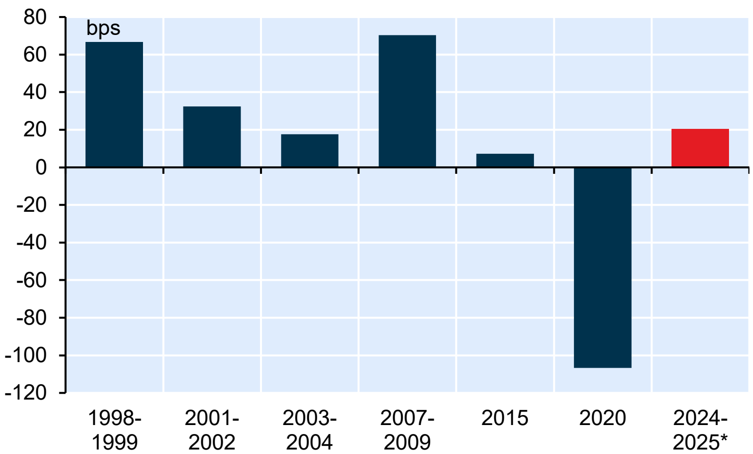
Rate cut pass-through in historical BoC easing cycles: Change in yields divided by change in overnight target. From left to right: 5-year | 10-year | 30-year*



Source: NBC, Bloomberg | *Note: For historical easing cycles, change in yield compares the 6-month average before first cut to the 6-month average after last cut. Different specifications yield broadly similar results. For 2024-25, we compare today's prevailing yields to the 6-month average before the first cut in June 2024.* Axis label refers to the years of easing cycle. *Negative pass-through means yields are up.*

Chart 6: Yields often higher after last cut vs. before last cut

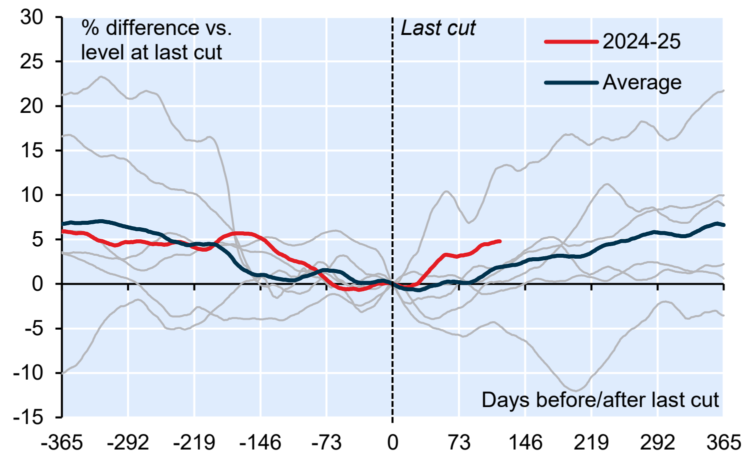
Change in 10-year yield: 3M before last cut to 3M after last cut



Source: NBC, Bloomberg | Note: For 2024-25, the chart treats March's cut as the final one. Axis label refers to the years of easing cycle.

Chart 7: On average, C$ sells off during easing, rallies after

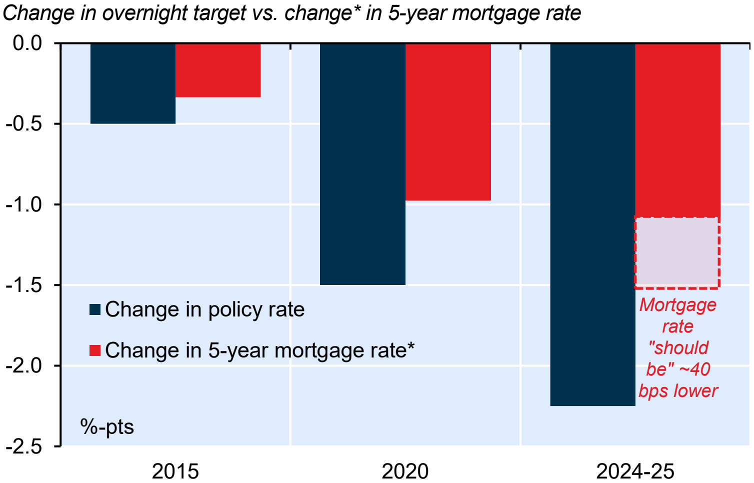
CAD/USD relative to level on date of last cut: 2024-25, past 6 cycles & average



Source: NBC, Bloomberg | Note: For current cycle, we treat March 2025 as the last cut. Based on the 1-month moving average of CAD/USD. Average refers to past 6 easing cycles. Grey lines are individual easing cycles.

Chart 8: Less pass through means less mortgage rate relief

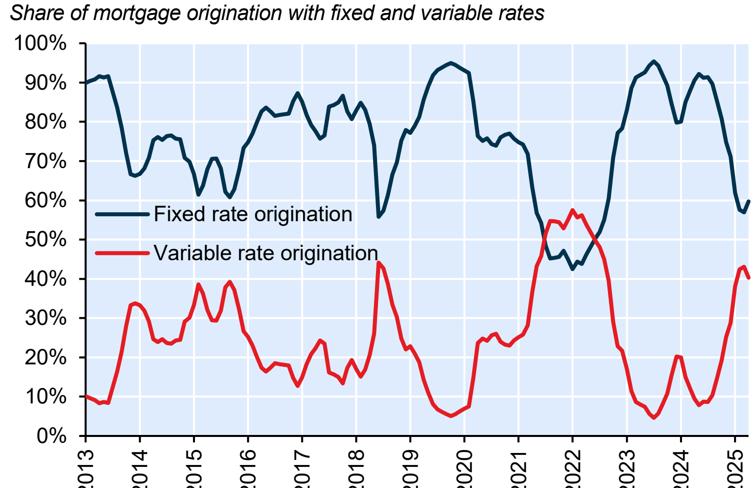
Change in overnight target vs. change in 5-year mortgage rate*



Source: NBC, BoC, Bloomberg | Note: We compare the average originated 5-year mortgage rate in the month before the first cut to the average 5-year mortgage rate originated 6-12 months after the last cut. Axis label refers to the years of easing cycle.

Chart 9: Canadian mortgage holders are going variable again

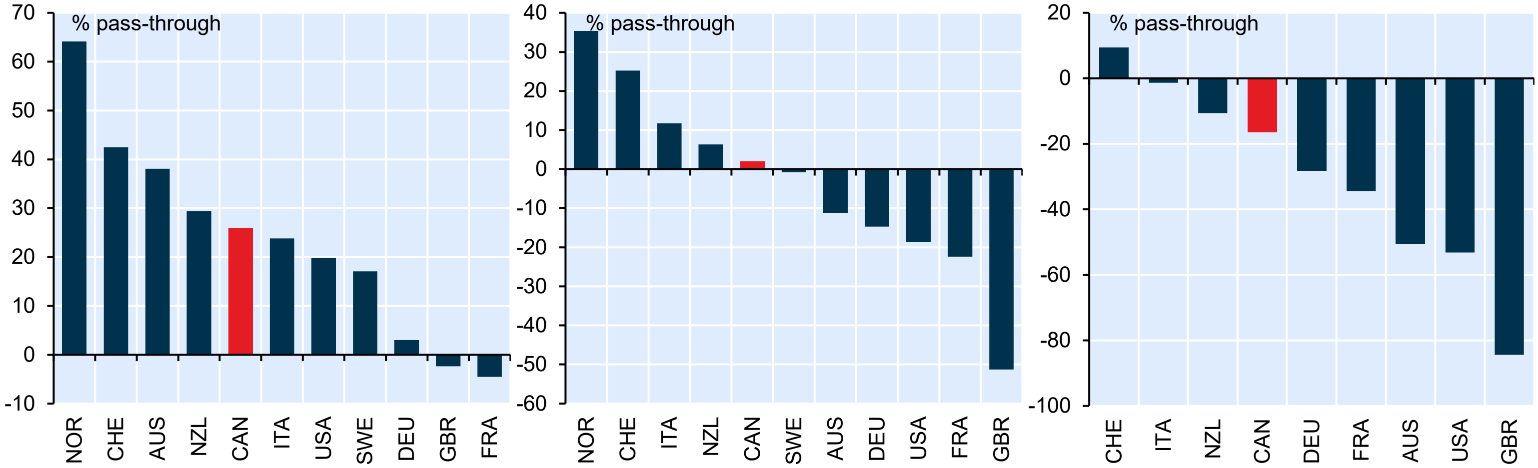
Share of mortgage origination with fixed and variable rates



Source: NBC, BoC

Chart 10-12: While low compared to historical cycles, Canada curve has enjoyed more pass through than other peer nations

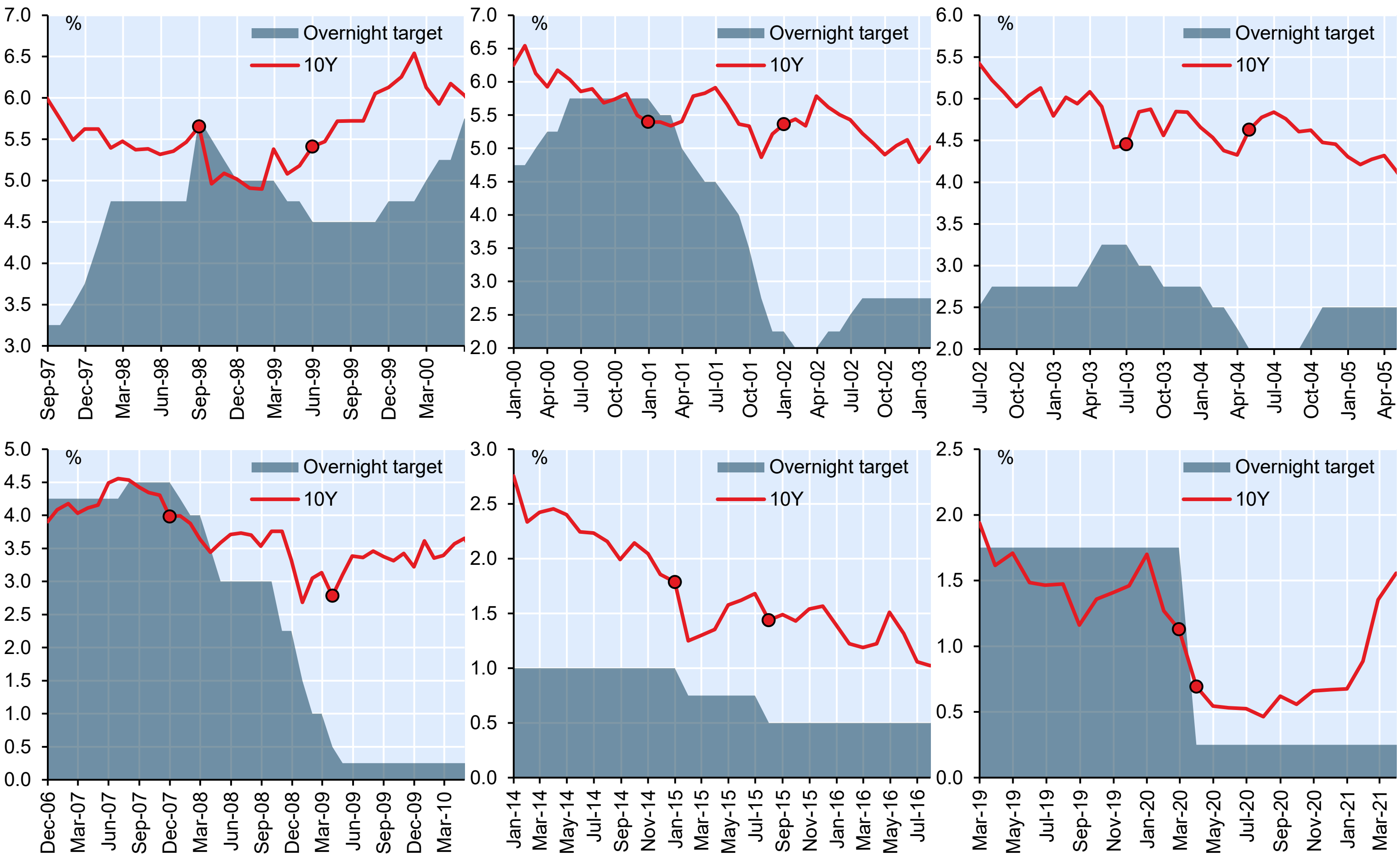
Rate cut pass-through in current easing cycles for peer countries: Change in yields divided by change in overnight target. From left to right: 5-year | 10-year | 30-year*



Source: NBC, Bloomberg | Note: For 2024-25, we compare today's prevailing yields to the 6-month average before each central bank's first cut. Negative pass-through means yields are up.

Chart 13-18: The 10-year yield's perspective on historical Bank of Canada easing cycle

Overnight target and 10-year yield during historical easing cycles, including 12 months before first cut and 12 months after last cut



Source: NBC, Bloomberg | Note: 10-year yields are monthly closes. Markers refer to month before first cut and month of last cut.

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