

The Bank of Canada Raises Rates but Softens its Stance

In brief:

The overnight rate and the discount rate rise by 25 basis points each—to 2.50% and 2.75% respectively. Caisse centrale Desjardins' prime rate will thus move to 4.25% as of tomorrow.

- 1) The economy is operating near the limits of its capacity and will stay close to its full potential until 2006.
- 2) World oil prices have greatly outstripped the Bank's previous forecasts, and the Canadian dollar has appreciated again.
- 3) The core inflation rate should climb to 2% by the end of 2005. The total index will be hit by the major fluctuation in oil prices.
- 4) The level of monetary stimulus must be reduced again, but the pace of action will depend on the Bank's assessment of the outlooks for inflation and demand.

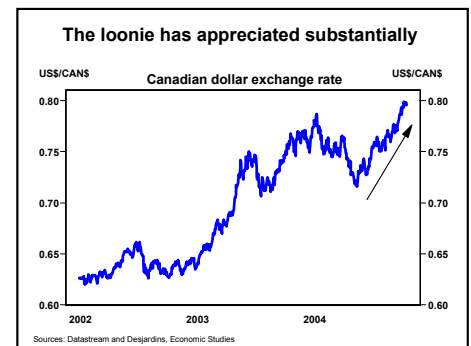
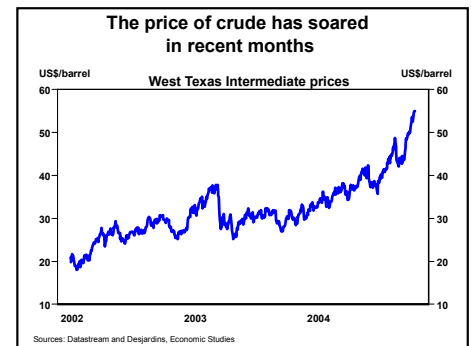


Excerpts from the BoC Press Release:

[...] The Canadian economy is operating near its production capacity and continues to adjust to global economic developments. Recently, world oil prices have risen well above the Bank's earlier assumptions and the Canadian dollar has appreciated further.

Looking ahead over the period to the end of 2006, the Bank's base-case projection calls for aggregate demand for Canadian goods and services to expand, on average, at about the same rate as potential output. Given the effects of higher oil prices and the past appreciation of the Canadian dollar, the Bank projects growth to be slightly less than 3 per cent in 2005, and slightly more than 3 per cent in 2006. With the economy expected to remain near its production capacity throughout this period, core inflation is projected to move back to the 2 per cent target by the end of 2005. Reflecting higher world oil prices, total CPI inflation is projected to move well above core inflation in the first half of 2005 and fall slightly below core inflation in 2006.

Against this background, the Bank decided to raise its target for the overnight rate. Further reduction of monetary stimulus will be required over time to keep inflation on target, with the pace depending on the Bank's continuing assessment of the prospects for factors that affect pressures on capacity and, hence, inflation. The details of the Bank's outlook for output and inflation and an analysis of the significant risks and uncertainties associated with this outlook will be discussed in the Monetary Policy Report, to be released on 21 October 2004. [...]



Conclusion: As expected, monetary authorities took an initial step this morning towards a softer stance. Although today's Bank of Canada press release reiterates that the Canadian economy is operating at close to output capacity, it also states that the economy should remain close to its full potential until the end of 2005. While the total CPI could undergo some short-term flip-flops, there is no real threat from inflation since, according to the Bank current assessment, core inflation should near 2% at most by the end of next year.

Canadian monetary authorities are unequivocal: further key rate hikes will be announced by the end of 2005. On the other hand, world oil prices have risen more than forecast, and the Canadian dollar has appreciated substantially in recent months. The loonie's ascent has also contributed extensively to recent tightening of monetary conditions and introduced downward pressures on the prices of imported goods. The Bank of Canada will have to carefully weigh the development of its risk factors in managing and implementing monetary policy in the quarters to come. Consequently, the Bank of Canada is not committed to systematically increasing its key interest rates with each decision. Thursday, Canadian monetary authorities will release the Monetary Policy Report, which will provide further details on the Bank's recent projections for economic growth and inflation. Note that we will be commenting on the report's contents in an issue of Economic Viewpoint Thursday afternoon.