The Bank of Canada maintains its key interest rates and indicates that the next move should be upward

According to the Bank of Canada:

- The overnight rate and the Bank Rate are unchanged at 4.25% and 4.50% respectively.
- Growth in the Canadian economy has been essentially in line with the Bank’s expectations as set out in January’s Monetary Policy Report Update.
- The Canadian economy will return to production capacity in the second half of 2007.
- The recent increase in food and gasoline prices has exceeded the Bank’s projections. Total CPI inflation is projected to rise above 2% in the second half of 2007. However, core inflation is projected to decline to 2% by the end of 2007.
- Upside and downside risks to inflation are still roughly balanced, although there is now a slight tilt to the upside.

Commentary:

As expected, the Bank of Canada’s projections regarding Canadian economic growth do not seem to have been modified much. It should be said that recent developments in the country’s economic situation have been in line with forecasts established by the Bank in its January Update. However, we will know more next Thursday, when the Monetary Policy Report comes out with more details on the Canadian monetary authorities’ economic scenario.

Recent growth in food and gas prices has thwarted the Bank’s projections for inflation. We now expect total inflation to rise above the 2% target in the second half of 2007. Information published last week by Statistics Canada already indicated total inflation of 2.3% in March. Inflation is clearly rising more quickly than the Bank had predicted. It had thought that core inflation “should average just above 1% in the first half of 2007”.

Despite the growth in total inflation, monetary authorities still consider the risks surrounding its projection for prices to be balanced. The main downside risk involves the possibility of a more pronounced slowdown in the American economy. The upside risk is related to the fact that inflation’s recent strength is more persistent than expected. This seems to be a risk of somewhat more extensive inflation pressure than the Bank had set out this winter regarding movement on prices for housing.

Under the circumstances, the Bank of Canada today said that “there is now a slight tilt to the upside”. In our opinion, this could be interpreted as a sign that the next move by Canadian key interest rates will likely be an increase. However, the persistent balance in risks should have the status quo prevailing for a few more months before any change is seen. Our scenario is thus for overnight rates to stay at 4.25% over the coming months. This status quo period should eventually be followed by a few hikes in key rates.

Here, the current situation mirrors the situation in the spring of 2006, when monetary authorities deemed the risks to be balanced, although there was a slight tilt to the downside. Monetary authorities had also ended monetary tightening a few months later and key rates have remained unchanged since that time.
Excerpt from the Bank of Canada press release
April 24, 2007

[...] Growth of the Canadian economy has been essentially in line with the Bank’s expectations as set out in the January Monetary Policy Report Update. But inflation has been higher than expected. Pressures on capacity over the past year have been stronger than previously judged. Also, food and gasoline prices have recently risen more than expected. After considering the full range of indicators, the Bank now judges that the Canadian economy was operating just above its production capacity in the first quarter of this year.

Robust domestic demand continues to support Canada’s economic growth. Stronger-than-expected growth outside North America has led to rising demand for, and prices of, many commodities. However, the slowing U.S. economy has had a moderating effect on growth in Canada.

Over the projection horizon, domestic demand is the main driver of growth in Canada. With the U.S. slowdown now expected to be somewhat more prolonged than previously projected, net exports should exert a slightly greater drag on growth in 2007. The Canadian economy is projected to grow by 2.2 per cent in 2007 and 2.7 per cent in both 2008 and 2009, returning to its production capacity in the second half of 2007 and remaining there through 2008 and 2009. Core inflation is projected to decline to 2 per cent by the end of 2007. Total CPI inflation is projected to rise above the 2 per cent inflation target in the second half of this year, before returning to the target by mid-2008.

The upside risk to the Bank’s inflation projection is that the recent strength of inflation could be more persistent than projected. The downside risk continues to come from the possibility of a more pronounced slowdown in the U.S. economy. The Bank continues to judge that the risks to its inflation projection are roughly balanced, although there is now a slight tilt to the upside. [...]