The Bank of Canada increases the cost of money in the country and opens the door to at least one more hike in September

According to the Bank of Canada:

- The overnight rate target was raised by 25 basis points, to 4.50%.
- Economic growth and inflation were stronger than expected in the first half of the year, and the economy is now operating further above its production potential.
- The higher interest rates across the yield curve and the strong appreciation of the loonie should moderate growth to an average rate of 2.5% in 2008 and 2009.
- Inflation should decline to the target of 2.0% at the beginning of 2009.
- A modest further rate increase may be necessary in order to bring inflation back to the target, in the medium term.

Commentary:

No surprise: the Bank of Canada raised its key rate to 4.50% today. This is the first rate increase since May 2006. Economic growth and inflation were higher than expected in the first half of the year, and the Bank feels that the economy is now operating further above its production potential. Therefore, it upped its growth forecasts to 2.5% for 2007.

However, the higher interest rates across the yield curve and the strong appreciation of the loonie will put the brakes on economic growth, and the Bank now believes that prospects will be more modest than previously thought, i.e., in the neighbourhood of 2.5% in 2008 and in 2009. Right now, inflation is still at a level slightly higher than April’s forecasts, but the Bank expects it to slow down to 2.0% at the beginning of 2009, as excess demand diminishes.

The Bank believes that “some modest further increase in the overnight rate may be required to bring inflation back to the target over the medium term”. In these circumstances, it seems clear that the Bank does not intend to take its monetary policy to excessively restrictive levels. This reassures us with respect to our scenario of a final 25 basis-point increase in September, to be followed by an extended status quo. Canadian domestic demand may remain resilient, but the downside of a strong loonie will continue to make itself felt in the export sector, and regional disparities will persist.

Note that the loonie’s recent gains reflect anticipations of interest rate hikes and numerous mergers and acquisitions of Canadian companies, and are thus in part a “type 2” appreciation. Therefore, the Bank will take care to avoid the export sector offsetting domestic demand any more than necessary.
Excerpt from the Bank of Canada press release
July 10, 2007

[...] Economic growth and inflation in Canada in the first half of this year have been stronger than expected in the April Monetary Policy Report (MPR). Final domestic demand has remained the key driver of economic growth in Canada, bolstered by firm commodity prices. The Bank judges that the economy is now operating further above its production potential than was projected at the time of the April MPR. [...] 

The Canadian economy is now projected to grow by 2.5 per cent in 2007, somewhat stronger than was expected in April, and to grow somewhat more slowly in 2008 and 2009 than previously projected. In this new projection, higher interest rates across the yield curve and a higher assumed range for the Canadian dollar of 93 to 95.5 cents U.S. act to moderate growth in 2008 and 2009 to an average of about 2 1/2 per cent. [...] 

Inflation is projected to be slightly higher and more persistent than in the April MPR. However, as excess demand diminishes, total CPI and core inflation should decline to 2 per cent by early 2009.

There are both upside and downside risks to the Bank’s inflation projection. The main upside risk is that household demand in Canada could be stronger than expected. The main downside risks are related to the higher Canadian dollar and the ongoing adjustment in the U.S. housing sector. In the context of the Bank’s new projection, these risks appear to be roughly balanced.

In line with this outlook, the Bank is raising the target for the overnight rate to 4 1/2 per cent. Some modest further increase in the overnight rate may be required to bring inflation back to the target over the medium term. [...]