According to the Bank of Canada:

- The overnight rate and the Bank Rate rise 0.25% to 3.00% and 3.25% respectively.
- Canada’s economy is operating at full production potential and this situation should continue until the end of 2007.
- Total inflation should be about 3% on average during the first half of 2006, driven by high energy prices. The total and core inflation rates should, however, be at about 2% in the second half of 2006.
- The Bank believes that further reduction of monetary stimulus will be required over the next four to six quarters.

Commentary:

This morning, as almost all analysts predicted, the Bank of Canada opted for another 25 basis point increase in its key interest rates. On September 7, monetary authorities had decreed the first increase in the target for the overnight rate after a break of 11 straight months.

Once again, the Bank of Canada is maintaining a pragmatic approach, reiterating that Canada’s economy is currently operating at production capacity. Moreover, according to its projections, “the Canadian economy will continue to operate at about its production potential through 2007.”

With respect to inflation, monetary authorities expect the total and core annual inflation rates to be about 2% for the second half of 2006. In the meantime, high energy prices should put the annual variation in the total CPI at about 3% on average.

Under these circumstances, a gradual increase in Canada’s key interest rates to less expansionist levels is to be expected in the quarters to come. The Bank also believes that “some further reduction of monetary stimulus will be required to maintain a balance between aggregate supply and demand over the next four to six quarters.”

It is therefore clear that further key rate hikes will be decreed in the months to come. In the shorter term, a 25 basis point increase is almost guaranteed for December and probably for the start of 2006 unless Canada’s economy is hit harder than expected by the adverse effects of increasing energy prices and the loonie’s appreciation. The Bank of Canada’s monetary tightening could also be interrupted by a pause of a few months in the first half of 2006 if the economy shows clear signs of a downturn in the last few months of 2005 and early 2006.

On Thursday, the Bank of Canada will release its Monetary Policy Report. This should give us a few more details on the outlook for inflation and the evolution of the Canadian and global economies.

Sources: Bank of Canada, Statistics Canada and Desjardins, Economic Studies
BoC Press Release:

[...] The global and Canadian economies have continued to grow at a solid pace. At the same time, there have been significant movements in energy prices and the Canadian dollar has traded in a higher range against the U.S. dollar and other major currencies. Overall, the Canadian economy now appears to be operating at its full production capacity.

The Bank projects that the Canadian economy will continue to operate at about its production potential through 2007. CPI and core inflation are projected to be 2 per cent in the second half of 2006, although CPI inflation is expected to average near 3 per cent until then, boosted by high energy prices. Short-term risks to this projection appear to be balanced. But as we look further out to 2007 and beyond, there are increasing risks that the unwinding of global economic imbalances could involve a period of weak global growth.

In line with the Bank’s outlook, and given that the Canadian economy now appears to be operating at capacity, some further reduction of monetary stimulus will be required to maintain a balance between aggregate supply and demand over the next four to six quarters, and to keep inflation on target. However, with the risks to the global outlook tilted to the downside as we look to 2007 and beyond, the Bank will monitor international developments particularly closely. More generally, the Bank will continue to assess the adjustments and underlying trends in the Canadian economy, as well as the balance of risks, as it conducts monetary policy to keep inflation on target over the medium term. [...]