Bank of Canada raises interest rates again

According to the Bank of Canada:

- The overnight rate and the Bank Rate are up 0.25% to 3.50 and 3.75%, respectively.
- The growth of the Canadian and world economies is essentially in line with the Bank’s October projections.
- The Bank believes that the Canadian economy is still operating at production capacity and will continue to do so until the end of 2007.
- Although risks to the Bank’s projections remain balanced for 2006, they are tilted to the downside as of 2007.
- The monetary authorities believe that some modest further increases will be required.

Commentary:

As consensus expected, the Bank of Canada raised interest rates 25 basis points this morning, the fourth such increase since September.

Also as expected, there was not much new in this morning’s press release. In it the Bank reiterated that the economy is evolving in line with its October projections and stated that it will continue operating at full potential throughout 2007. However, the central bank also stated that although the risks are balanced for 2006, they will tilt to the downside as of 2007. It looks like we’ll have to wait until Thursday’s release of the Monetary Policy Report Update for more details on the Bank’s outlook for output and inflation, although we are not expecting any significant changes in this regard.

What was different in this morning’s press release was the change in the Bank’s language regarding the direction of interest rates. Whereas it stated in December that “some further reduction in monetary stimulus will be required to maintain a balance between aggregate supply and demand over the next four to six quarters,” it now states that “some modest further increase in the key interest rate will be required to keep aggregate supply and demand in balance.” This means that while we can expect more increases in the coming weeks, the Bank will stop its rate hikes in the near future.

The way we see it, the Bank of Canada will raise rates another 25 basis points at its March 7 and April 25 meetings. The overnight rate could therefore reach 4.00% in the spring, where it will likely remain for the rest of the year.

Sources: Datastream and Desjardins, Economic Studies
BoC Press Release:

[...] Information received since the last interest rate announcement on 6 December indicates that the Canadian and global economies are evolving essentially in line with the Bank’s expectations as set out in the October Monetary Policy Report (MPR). The Canadian economy continues to adjust to global developments and to the associated changes in relative prices. CPI inflation, at 2.3 per cent in the fourth quarter of 2005, was lower than expected primarily because of lower gasoline prices. As anticipated, core inflation remained stable at 1.6 per cent. The level of economic activity at year end was close to expectations.

The outlook for growth and inflation in Canada is similar to that in the October MPR. The Bank continues to judge that the Canadian economy is operating at its production capacity and will grow roughly in line with production potential through 2007. CPI and core inflation should return to the 2 per cent target by the first half of 2007. Risks to the Bank’s projection remain balanced for 2006 and tilted to the downside through 2007 and beyond. Further details of the Bank’s outlook for output and inflation will be discussed in the Monetary Policy Report Update, to be released on 26 January 2006.

In line with the Bank’s base-case projection and current assessment of risks, some modest further increase in the policy interest rate would be required to keep aggregate supply and demand in balance and inflation on target over the medium term. [...]