Monetary Policy Report: The Bank of Canada announces further hikes in key interest rates

As is customary in the spring, the Bank of Canada published this morning its latest version of the country’s semi-annual Monetary Policy Report. The report was much-awaited by analysts in this period of uncertainty as it expresses the most recent observations and outlook of our central bank, as well as giving us a glimpse into the upcoming trend of its monetary policy.

Highlights

- The inflation rate, as measured by the total CPI and the Benchmark Index (CPIX), has largely exceeded the Bank of Canada’s 2% target over the past few months. Even though the rise in inflation to a great extent is due to certain one-time factors (for instance, the boost in insurance premiums and soaring energy prices), domestic demand exerting price pressures has also contributed (specifically, in housing and certain services).

- Despite curbed economic growth in Canada since mid-2002, mostly attributable to the soft spot in the US economy, the Bank of Canada believes that our economy is still operating near its capacity limits.

- Given the very expansionary monetary policy currently in force in the United States, the anticipated return of confidence, the boost in military expenditures and the tax cuts, economic activity should pick up in the United States beginning in the fourth quarter of 2003. Thus, real US GDP growth could be as high at 4% next year.

- Even though the outlook for the global economy has declined over the short term, the underlying momentum of Canadian domestic demand and a quicker pace of US economic growth within a few quarters should allow Canada’s global demand to pick up speed near the end of 2003 and into 2004. Consequently, the Canadian economy should grow by a rate higher than its potential (evaluated to be 3%) in 2004.

- With the mitigation of the impact of short-lived factors, the drop in energy prices and economic growth that is a little softer for a major portion of 2003, inflation should return toward the midpoint of the target spread by early 2004.

- However, in order to ward off inflationary pressures that could resume in 2004 when the Canadian economy has exceeded its potential supply, the Bank of Canada should tighten its policy of monetary loosening with further increases in the key interest rates in 2003.

Conclusion

Finally, the discourse by the Bank of Canada has not really softened in today’s report. The monetary regulatory bodies remain optimistic still regarding the economic outlook over the medium term. One fact remains in the message conveyed by our central bank over the past several months: the Canadian economy ought to exceed its potential supply within a few quarters.

Furthermore, in anticipation of inflationary pressures that generally accompany such a situation, the Bank of Canada has already raised its key lending rates twice over the past few months. Today’s report is firm: more hikes will follow. In all likelihood, the path will stay open on June 3rd for another increase of 25 basis points of key interest rates. This obviously presupposes that US economic indicators will continue their restructuring and that SARS (or “severe acute respiratory syndrome”) will not have a major or lasting fallout on economic activity.