The Bank of Canada Raises Its Key Rates

The overnight rate and the discount rate increase by 25 basis points each-to 2.25% and 2.5% respectively. The prime rate of Caisse centrale Desjardins’ will therefore rise to 4.00% starting tomorrow.

1) The economy is operating near the limits of its capacity.

2) Global demand should increase at a pace equal to or slightly higher than the growth rate of production capacity. Therefore, the slight negative gap that persists between production and full potential will gradually be resorbed over the coming months.

3) Numerous uncertainties continue to surround the economic forecasts: future progress of the Canadian foreign trade sector, the impact of oil price fluctuations on our economy and inaccuracy in estimating production potential.

Excerpts from the BoC Press Release:

[...] Data received since the July Monetary Policy Report Update indicate that Canada’s economic growth in the first half of this year was somewhat stronger than the Bank had been expecting, largely as a result of more robust external demand for Canadian goods and services. The Bank judges that the economy is now operating close to its production capacity. Core inflation, which was 1.9 per cent in July, is consistent with this assessment. Total CPI inflation, at 2.3 per cent in July, has remained above expectations, primarily because oil prices have been persistently higher than the Bank had assumed.

Looking forward, the Bank expects aggregate demand to grow at, or marginally above, the rate of growth of production capacity. With the economy operating close to its capacity, monetary stimulus needs to be reduced to avoid a buildup of inflationary pressures. In this context, the Bank decided to raise its target for the overnight rate.

Uncertainties around the economic outlook continue to relate primarily to three factors: the estimated size of the output gap, the future growth of Canadian exports and imports, and the overall effect on the Canadian economy of current and future movements in the world prices of oil and non-energy commodities. In conducting monetary policy, the Bank will continue to pay attention to these factors as it assesses the evolving prospects for pressures on capacity and inflation. […]

Conclusion: There are several risks still affecting the Canadian economy. We point primarily to the effect of the ups and downs of energy prices on our economy and inflation, to the effect of less rapid than forecast US growth on our foreign trade sector and to internal demand that increased only 1.7%, annualized, in the second quarter of 2004. In spite of all this, the Bank of Canada decided this morning to begin its monetary tightening with an increase of 25 basis points in its key rates. It must be noted that this increase was largely anticipated by market players and that it follows on two consecutive increases in the US federal funds rates. That said, Canadian monetary authorities did not want to disappoint financial markets by getting too far away from US monetary policy. On the other hand, in light of the recent developments in the US economic indicators, many analysts (including ourselves) have revised downward their forecasts for the growth of Uncle Sam’s economy. In these circumstances, it is not impossible that the Federal Reserve might opt, between now and the winter, to pause its process of monetary tightening. The Bank of Canada might then find itself faced with a difficult choice to make: continue unilaterally to increase its key rates or keep in step with the Federal Reserve and also declare a pause scarcely after beginning its own monetary tightening.