

Bank of Canada hints rate hikes ahead

'A question of when, not if'

Reuters

Tuesday, May 29, 2007

OTTAWA -- The Bank of Canada may raise interest rates soon to quell inflation, it signaled on Tuesday after holding its key overnight rate at 4.25%, raising expectations of a hike as early as July.

The clear bias toward higher rates in a statement from the central bank was a marked departure from its neutral preference since May 2006, the longest period of rate stability in Canada since the early 1970s.

"On balance, the bank judges that there is an increased risk that future inflation will persist above the 2 percent inflation target," the bank said in a statement. "And some increase in the target for the overnight rate may be required in the near term to bring inflation back to target."

The hawkish statement triggered a sharp jump in the Canadian dollar to a fresh 29-1/2 year high at C\$1.0715 to the U.S. dollar, or 93.33 U.S. cents.

In a frank assessment of its own projections made in April, the bank acknowledged that it had underestimated both inflation and growth in the first part of this year.

The result? Demand for goods and services has outpaced the economy's capacity to produce them, it said. It also suggested that the sharp rise in the Canadian dollar would not necessarily impede a rate hike.

"This is much more hawkish than what people were expecting," said Marc Levesque, chief strategist at TD Securities in Toronto, the only bank to have predicted a July rate hike in a Reuters survey last week.

"Core inflation is running meaningfully above their target, it's accelerating, the economy is growing faster than they were expecting, they are in a situation of greater excess demand... That's the stuff of rate hikes."



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Bank of Canada Governor David Dodge prepares to testify before the House of Commons Finance Committee on Parliament Hill in Ottawa February 1, 2007.

The bank's next rate announcements will be on July 10 and September 5.

"A QUESTION OF WHEN, NOT IF"

"The main point now, though, is that bank tightening is almost entirely a question of when, not if," Doug Porter, deputy chief economist at BMO Capital Markets, said in a note.

Wells Fargo currency strategist Nick Bennenbroek is betting on a hike in July, unless there is a raft of softer economic data before then.

A hike would narrow the gap between Canada's benchmark rate and that of the U. S. Federal Reserve, which is now at 5.25%. The Fed is expected to ease rates later this year.

Bank of Canada Governor David Dodge is juggling a very different set of challenges than his U.S. colleagues, however.

While the United States must cope with sluggish growth as inflation pressures abate, Canada's commodity exports are thriving and the core inflation rate watched by the bank came in above target at 2.5% in April, exceeding the equivalent U.S. measure for the first time in three years.

The bank said first-quarter growth was likely to be 3.5%, a full percentage point higher than its April estimate. It dropped any reference to the impact of the U.S. slowdown, saying only that U.S. activity was "largely as expected."

In past statements it had said that slowdown risk from the United States was balanced by the risks of inflation or high household spending.

It also doused speculation among some economists that it might rely on the strong appreciation of the Canadian dollar to keep the economy in check.

It linked the currency's rise, which has led to massive layoffs in the manufacturing sector, to strong global demand for Canadian commodities.

That message could cause more "job carnage" as the dollar goes even higher, the Canadian Labour Congress said.

"The Bank of Canada sees an economy at risk of overheating. But the reality is a major ongoing loss of good jobs, poor quality new jobs, and stagnant wages," it said in a statement.

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