



Economic Flash!

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Bank of Canada Thinks It Needs Rate Hikes

- The Bank of Canada *thinks* it knows what the Canadian economy needs—higher interest rates—but isn't so arrogant to assume that financial and commodity markets have it wrong in their recent concerns about global growth. Hence today's odd split decision, with Governor Carney delivering the anticipated quarter-point hike, but in a rare move, admitting that even he isn't so sure about what comes next. Instead of the typical concluding comment that would have said that further reductions in monetary stimulus would be required to meet the inflation targets, the Bank left the door open, saying that such moves would have to be "weighed carefully against domestic and global economic developments."
- Clearly, no central bank would raise rates a quarter point and imagine that a single, trivial nudge was all that was necessary. The Bank's economic model would project virtually the same growth and inflation trajectory whether overnight was 25 bps or 50 bps. Indeed, the Bank's last full forecast, published in April, showed robust growth ahead and the elimination of the output gap by the second quarter of 2011, a path that would be inconsistent with holding real interest rates in such deeply negative territory. Today's statement describes recent growth and inflation figures as "in line" with its April MPR, notes that its April call already cited global fiscal tightening as a downside risk, and minimizes the impact of developments in Europe thus far on Canada.
- As a result, both the Bank's base case and our forecast, include further hikes in upcoming rate setting dates. So why the hesitation by Carney's team to spell that out? Because at this point, the Bank can't be too sure that it isn't hiking in the early stages of a crash in financial and commodity markets, a sovereign debt crisis, or even the start of a renewed global downturn. Carney's own background in capital markets likely has him giving some respect to the predictive power of markets, or the ability of market fears to be a self-fulfilling prophesy.
- As a result, one can translate today's statement as follows: the economy is improving, we no longer need such aggressively stimulative interest rates, and we will tighten further. Unless, that is, financial and commodity markets are so badly hit in the next six weeks that we have to go back to the drawing board on our April Monetary Policy Report forecast.

Implications & Actions

- **Re: Economic Forecast** — Today's rate hike was in line with our forecast, and we look for the Bank to take overnight rates up to 1% by October. But, in line with recent market developments, our view is not as rosy as the Bank of Canada's in terms of growth late this year and for 2011 as a whole, with fiscal tightening at home and abroad turning into a significant drag. We look for the Bank of Canada to pause in December, and for the next round of hikes to be no sooner than Q2 2011, by which time the Fed will also be moving rates higher.

- **Re: Markets** — Markets hadn't fully priced in this quarter-point move, but were expecting that if it came, it would include a decisive call about further action. Instead, this most dovish of rate hikes left the 2-year Canadian rates actually falling, and took the C\$ a bit weaker. Don't look for these reactions to hold up if, as we expect, financial and commodity markets are calm enough in the next six weeks to put a rate hike firmly on the calendar for July.

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