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Countdown begins to interest rate hikes

Paul Vieira, **Financial Post** Monday, March 01, 2010

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OTTAWA -- The Bank of Canada took its first steps Tuesday toward returning the country to more normal interest rate levels by signalling a more hawkish tone on inflation and acknowledging the economy is performing better than expected on "vigorous" consumer demand.

The messages were conveyed in the Bank of Canada's latest interest-rate statement, which kept its record-low benchmark rate of 0.25% as is and pledged to keep it there until July. But most bank watchers took note of subtle changes in the statement, compared with previous rate announcements, and there was enough there for them to begin the countdown to rate hikes.

"I suspect [governor] Mark Carney and company are starting to feel the urge to tighten -- not a strong urge now, but an urge nevertheless," said Michael Gregory, senior economist at BMO Capital Markets.

Among the key changes was a declaration from the bank that the risks to its inflation outlook are "roughly balanced," and no longer "tilted slightly to the downside" -- language that suggests deflation is no longer a concern and that price increases are creeping up to a level that may prompt a response. (The central bank sets its interest rates to ensure inflation remains at 2%.)

The wording change may appear trivial, "but it is nonetheless significant as it reflects an economic backdrop that continues to improve at a much faster pace than what the bank had envisaged," said Paul-André Pinsonnault, senior fixed-income economist at National Bank Financial.

The rate statement emerged a day after economic data indicated the Canadian economy grew at a robust 5% annualized pace in the final three months of 2009, blowing past market expectations for a 4% gain and the

central bank's original 3.3% forecast. Economists say the fourth-quarter performance has set the stage for another robust gain, of perhaps 4% or more, for the first three months of 2010.

Meanwhile, recent data indicate that both the headline and core inflation rates have moved much closer to the 2% level than the central bank had expected. Under the bank's forecast, the 2% level would not be reached until the third-quarter of next year.

In the statement, the central bank acknowledged economic activity has been "slightly higher" than its own projections, with the 5% gain in the fourth quarter powered by "vigorous domestic demand" and a recovery in exports.

Using the adjective "vigorous" caught the eye of some analysts, such as Mr. Gregory. "That implies a strong unleashing of demand pent-up during the recession, with the credit creation process critical to this unleashing.

"In other words," he added, "low interest rates are doing their job in stimulating demand -- perhaps, increasingly, too well."

Mr. Pinsonnault noted the bank also dropped any reference to "considerable" excess supply, an indication, he said, that the slack in the economy is being absorbed at a faster pace than the central bank anticipated.

The consensus remains that the central bank will wait until July to begin raising rates, but the bank used Tuesday's statement to begin building its case. There are two more scheduled rate decisions between now and then, with one April 20 and then June 1.

"What we saw [Tuesday] was one of many steps aiming at moving away from dovish statements to relatively more hawkish ones. This gradual movement comes naturally well before an actual tightening in monetary policy," said Sébastien Lavoie, economist with Laurentian Bank Securities.

His firm believes rate increases will begin in the third quarter, but he said the odds have increased that the first hike will be in July as opposed to September.

How much, and how rapidly, the central bank raises rates beginning in July is up for debate, with economists estimating increases of 100 to 150 basis points in the second half of 2010.

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Pvieira@nationalpsot.com

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