



Bank of Canada unexpectedly holds rates on inflation

Reuters

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OTTAWA (Reuters) - The Bank of Canada surprised the markets on Tuesday by holding its key interest rate steady at 3 percent and signaling an end to its rate-cutting cycle because of the threat of higher inflation.

Taking his cue from the U.S. Federal Reserve and the European Central Bank, Governor Mark Carney adopted a more hawkish tone and said price hikes now outweighed weak economic growth as the top risk to the economy.

Primary dealers had unanimously expected a quarter-point rate cut, and the BoC's unexpected decision brought to an abrupt end five months of policy easing which had lopped a collective 150 basis points off the overnight rate.

The Canadian dollar immediately shot up to around C\$1.0222 to the U.S. dollar, or 97.83 U.S. cents, from C\$1.0306, or 97.03 U.S. cents, just before the announcement.

"The bank now judges that the current stance of monetary policy is appropriately accommodative to bring aggregate demand and supply into balance and to achieve the 2 percent inflation target," the central bank said in a statement.

Economists said the BoC's decision reflected a concerted shift by developed countries, spooked by a sudden spike in oil prices, toward fighting inflation rather than worrying about stimulating economies battered by the global credit crisis.

"The new issue facing central banks, not just in Canada, but around the world is reflation," said Jeff Rubin, chief economist at CIBC World Markets.

In April, the bank had signaled another rate cut was in the pipeline but was vague on its timing. On Tuesday, it made no such reference.

"This is as close to a pause with the bias on the inflation tilting upward, that we now have to entertain the thought of the next story, which is the rate hike story," said Stewart Hall, markets strategist at HSBC Canada.

Carney had been unfettered thus far by pressure from rising global food prices because Canada's strong currency has kept prices low for imports and specific items like cars.

However, policymakers acknowledged recently that soaring gasoline prices were hurting businesses and consumers.

The central bank said it was now more likely that inflation would be greater than it projected in April, rising above 3 percent later this year, compared with its previous estimate of a rate below 2 percent all year.

"The balance of risks to the bank's April projection for inflation in Canada has shifted slightly to the upside," it said.

Core inflation, which strips out volatile items like gasoline, will stay below 2 percent through 2009. Both inflation measures are seen converging at 2 percent in 2010.

"Where people got caught off guard was the extent to which the bank is putting emphasis in terms of the inflationary pressures," said Paul Ferley, assistant chief economist at the Royal Bank of Canada.

At the same time, the Canadian economy has slowed more than the central bank had anticipated.

The economy moved into excess supply in the first quarter and the gap will grow this year, it said. In April, the bank expected the economy to move into excess supply only in the second quarter.

Last Monday, Fed Chairman Ben Bernanke made it clear the Fed's mission was to prevent a spike in world inflation.

And ECB President Jean-Claude Trichet surprised markets last Thursday by signaling a likely rate hike in July to

counter inflation.

Other policymakers on both sides of the Atlantic have reinforced that message over the past week.

(Reporting by Louise Egan; Editing by Bernadette Baum)

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