Bank of Canada raises interest rates for first time in 7 years

By Barrie McKenna
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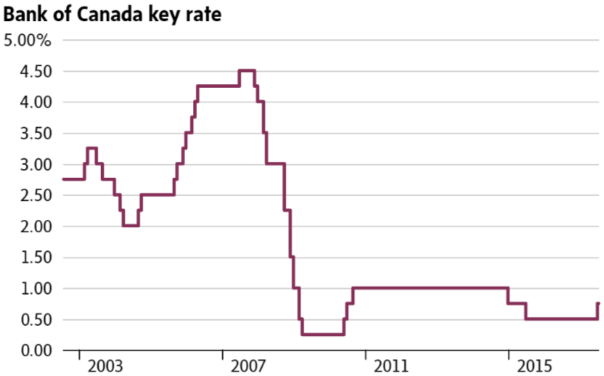
The Bank of Canada is hiking its key interest rate for the first time in seven years, joining the U.S. Federal Reserve in starting the process of undoing nearly a decade of easy money.

The bank raised its overnight lending rate to 0.75 per cent from 0.5 per cent Wednesday, citing "bolstered" confidence that the Canadian economy has finally turned the corner after years of sputtering growth.

Bank of Canada key rate



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"Growth is broadening across industries and regions and therefore becoming more sustainable," the bank said in a statement.

"The current outlook warrants [Wednesday's] withdrawal of some of the monetary stimulus in the economy."

Meanwhile, the bank dismissed the recent fall in inflation as mainly temporary, dragged down by lower gasoline prices, electricity rebates in Ontario, intense food price competition and unexpectedly weak car prices.

Bank of Canada Governor Stephen Poloz and his central bank colleagues aren't yet ready to pull the trigger on a second rate hike this year. The bank insisted that any future rate hikes would be guided by the effect of "incoming data" on inflation, according to the statement.

"Monetary policy is not on a predetermined path," Mr. Poloz told reporters in Ottawa after the rate announcement.

Many economists are expecting at least one more rate hike this year, most likely in October, when the bank releases its next quarterly forecast.

Bank of Montreal chief economist Douglas Porter said Wednesday's hike begins a process that could see the Bank of Canada's key rate bumped up to 1.5 per cent by mid-2018.

"And so the tide begins to turn," Mr. Porter said in a research note. "We would expect the next rate hike in October . . . and then a brief pause before some modest follow-up moves in 2018."

The bank said that the 3.5-per-cent annual pace of GDP growth in the first quarter will "moderate" over the rest of the year, but remain "above potential." Among other things, the bank expects consumer spending, exports and business investment to drive growth in the months ahead.

But Wednesday's quarter percentage-point rate increase could cool one of the key sectors that has been driving the economy – housing. Lenders have already started pushing some mortgage rates higher, which will discourage home buying.

The bank pointed out that housing activity has already abated, particularly in the Toronto area, where homes sales have fallen sharply.

The central bank also noted that while the global economy is getting stronger and spreading to new regions, "elevated geopolitical uncertainty still clouds the global outlook." For example, the bank has removed from its forecast an expected bump to the U.S. economic growth from future personal and corporate tax cuts, which now appear less likely.

Today's ultra-low interest rates have encouraged many Canadians to load up on mortgage debt, driving home prices and home construction, particularly in and around Toronto and Vancouver. But they have also penalized savers and made it tough for pension funds to generate healthy returns.

Inflation remains one of the puzzles facing central banks – not just in Canada, but globally. Canada's Consumer Price Index (CPI) currently sits well below the bank's 2 per cent target and continues to drift lower.

Economists will no doubt raise questions about why the central bank is raising rates while inflation is still falling.

But the Bank of Canada is apparently looking ahead to conditions that will likely prevail a year or two from now. Inflation may weaken further in the months ahead before getting back to the two per cent target by the middle of next year as excess capacity in the economy fades, according to the bank's Monetary Policy Report, released Wednesday.

"Reacting only to the latest inflation data would be akin to driving while looking in the rear-view mirror," Mr. Poloz told reporters.

The bank now estimates that the so-called output gap – a measure of excess labour, factory capacity and the like – will close "around the end of 2017." That's significantly sooner than its assessment in April that the gap would disappear in the first half of next year.

The Bank of Canada cut rates twice in 2015, taking out what Mr. Poloz called "insurance" against the fallout from the collapse in the price of oil and other commodities.

Recently, Mr. Poloz has said that those cuts "have largely done their work" as the effects of the oil shock receded in Canada's oil patch.

"Higher interest rates are what is needed to reduce the vulnerability of high household indebtedness and real estate price imbalances in parts of the country," Conference Board of Canada chief economist Craig Alexander said. "[Wednesday's] decision to raise rates is a positive development."

Overall, the bank's latest projection of where the economy is headed is little changed from its April forecast. It now expects the economy to grow 2.7 per cent this year, compared to its earlier estimate of 2.5 per cent. But its forecast for GDP growth in 2018 and 2019 remains virtually unchanged.

The bank did, however, significantly underestimate the strength of consumption this year – most notably the hot housing markets in Ontario and B.C.

Likewise on inflation, the bank said CPI inflation will average just 1.6 per cent this year, versus its April estimate of 2.1 per cent. But its forecasts for 2018 and 2019 (2 per cent and 2.1 per cent) remain roughly in line with earlier projections.

The central bank warned of a series of risks that could derail its latest forecast. These include rising trade protectionism, a house price correction in Toronto and Vancouver and weaker than expected exports and business investment. The bank likewise cited a number of factors that could cause the economy to grow faster than expected, including stronger U.S. growth and more debt-fueled consumption in Canada.