Bank of Canada hikes rates as economy roars

By Barrie McKenna
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The Bank of Canada has hiked its key interest rate for the second time in less than two months amid surprisingly resurgent growth across the country.

The central bank raised its overnight lending rate by a quarter of a percentage point to 1 per cent Wednesday, surprising many analysts who had not expected another rate increase until at least October.

"Recent economic data have been stronger than expected, supporting the bank's view that growth in Canada is becoming more broadly based and self-sustaining," the bank said in a statement.

The bank also cited "robust" consumer spending, "solid" job and income growth, "cooling" housing markets as well as "more widespread strength" in exports and business investment.

The loonie surged after the announcement, jumping more than a cent to top 82 cents (U.S.). The dollar is now up about 3 per cent in the past month and 14 per cent since it hit a low this year of roughly 73 cents in April.

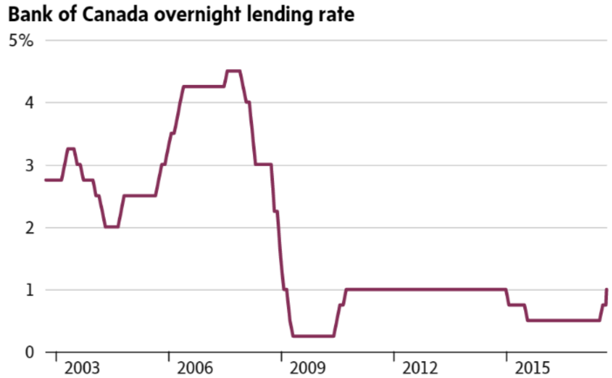
Bank of Montreal chief economist Douglas Porter said the central bank appears to have a new and "seeming care-free stance on the soaring Canadian dollar," suggesting it may be willing to continue aggressively raising rates.

Inflation, on the other hand, still remains below the bank's 2-per-cent target. The statement highlighted a recent "slight increase" in key measures of inflation in Canada, but noted that wage and price pressures are more subdued than normal in all developed countries.

Wednesday's decision reinforces the message that the era of easy money and low rates is coming to an end in Canada. The central bank's overnight rate generally sets the pattern for mortgages, bonds and deposits.

And the Bank of Canada may not be done. Economists are already bracing for more hikes this year if the economy continues to show strength.

"Absent a significant shock, [Wednesday's] rate increase will be part of a larger and longer march towards rate normalization," Toronto-Dominion Bank economist Brian DePratto said in a research note.



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National Bank of Canada economists are also calling for another rate hike this year.

The bank offered few clues about what it will do next or when. Future rate hikes are not "predetermined and will be guided by incoming economic data and financial market developments," according to the statement.

The Bank of Canada made it clear that it is keeping a close eye on how higher lending rates will affect heavily indebted Canadians.

"Given elevated household indebtedness, close attention will be paid to the sensitivity of the economy to higher interest rates," the bank said.

Central bank officials have worried in recent years about risky borrowing by some

Canadians, and what might happen if borrowing costs rise sharply or house prices fall. The bank has repeatedly warned about the overheated housing markets in Southern Ontario and B.C.

The bank's next scheduled rate-setting is Oct. 25, when the bank is also due to release its quarterly forecast.

Financial markets had priced in a roughly 50-50 chance of a rate hike Wednesday, but the vast majority of economists surveyed by Bloomberg still believed the Bank of Canada would wait.

Bank of Canada Governor Stephen Poloz and his central bank colleagues have badly underestimated how fast the economy was growing early this year.

"The level of GDP growth is now higher than the bank expected," the bank acknowledged.

Canada's surging economy, coupled with the sudden shift in thinking at the Bank of Canada, has given a lift to the Canadian dollar, which was trading at more than 80 cents (U.S.) before Wednesday's rate announcement.

The final piece of surprising news came last week, when Statistics Canada reported that the economy surged ahead at a 4.5-per-cent annual clip in the second quarter – best among Group of Seven countries and nearly twice as fast as the bank had projected in July.

That followed a very strong 3.7-per-cent pace in the first three months of the year.

At 1 per cent, the bank's key interest rate is now exactly where it was in January, 2015 – before the central bank made two emergency rate cuts to deal with the aftershocks of the oil price collapse.

Back in July, the Bank of Canada increased its key interest rate for the first time in seven years, saying the economy was now strong enough for it to unwind that rate relief.