TD Bank Financial Group

TD Economics

Commentary

April 25, 2006

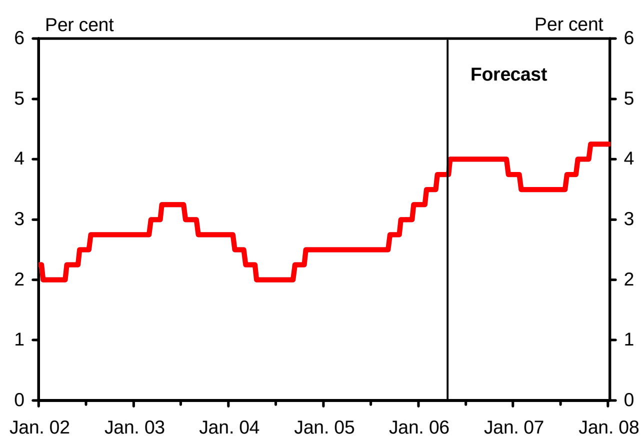
BANK OF CANADA HIKES AGAIN, SITS ON FENCE OVER FUTURE DIRECTION OF RATES

- **Overnight rated hiked 25bps to 4.00%**
- **Bank provides mixed message on future direction of policy**

The Bank of Canada fulfilled financial market expectations by delivering a quarter point rate hike today that lifted the overnight rate up to 4.00%. However, the accompanying communiqué is bound to provide considerable speculation about the future path of interest rates. In fact, the Bank provided a remarkable "on the one hand" and "on the other hand" statement that argues both for further rate hikes and also a pause in the monetary policy tightening cycle.

In support of further hikes, the Bank noted that "the Canadian economy is judged to be operating at, or just above, its production capacity". This is more hawkish than its prior comments that suggested that the economic slack had been eliminated, but did not suggest that the economy might be operating above capacity. Furthermore, the Bank remarks that global economy has proven a little stronger than anticipated, which has boosted commodity prices. And, the Bank's forecast for the Canadian economy points to continued strength, with real GDP rising 3.1% in 2006 (no change from the last projection), 3.0% in 2007 (upwardly revised by 0.1 percentage point) and 2.9% in 2008 (first time this has been reported). Of course, the Bank does not tell us the interest rate assumptions used in the forecast. Based on the Bank's outlook, the monetary authority reiterated that "some modest further increase in the policy interest rate may be required to keep aggregate supply and demand in balance and inflation on target over the medium term."

Conversely, the Bank takes note of a number of factors that might warrant moving to the sidelines and leaving rates on hold in the coming months. First, "...the past appreciation of the Canadian dollar continue to pose challenges for a number of sectors of the economy", suggesting a downside risk to the Bank's economic forecast if the fallout from the currency shock is greater than anticipated. Second, the Bank once again noted that there is a "small tilt to the downside later in the projection period", reflecting concerns about the possibility that an unwinding of global economic imbalances might lead to a slowdown in world economic activity that would dampen economic conditions in Canada. Third, inflation is expected to remain underwraps, averaging close to 2 per cent in 2007 and 2008 (after removing the impact of any change in the GST). And, there could be a downside risk to inflation. For example, the Bank notes that recently "core inflation has remained below 2 per cent owing to persistent downward



Actual data to Apr. 25, 2006; Forecast by TD Economics as at Mar. 2006
Source: Bank of Canada

pressure from prices of imported consumer goods", a trend which in our opinion is unlikely to abate in the near future. Finally, and perhaps most importantly, the central bank stated that it "will closely monitor evolving developments in the Canadian economy in light of the cumulative increase in the policy interest rate since last September. In other words, the Bank knows that the full impact of changes in interest rates takes time to be felt, and given that rates have been hiked six times, it might be prudent to pause to assess the response of the economy to the past tightening in monetary policy.

So, the outlook for interest rates is as clear as mud. And, financial markets will keenly await the April 27th Monetary Policy Report (MPR) for further guidance about the Bank's assessment of the economy and risks. Today's communiqué suggests that the Bank may be still leaning towards hiking rates again at its next decision on May 24th, but it is also signaling that it will be extremely reactive to forthcoming economic data. In our opinion, there are clear signs that the U.S. housing market is losing momentum, which is likely to lead to significantly slower U.S. economic growth ahead and we expect that upcoming Canadian economic reports will show a bit less strength. So, we will stick with the view that the Bank is done raising rates. We could be wrong, but if we are, there is little doubt that the peak in interest rates is close at hand.

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