REUTERS

Bank of Canada hikes rate again, signals pause

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By Louise Egan

OTTAWA (Reuters) - The Bank of Canada raised its overnight interest rate on Wednesday by a quarter of a percentage point to 4.25 percent, as expected, but signaled an end to its nine-month tightening cycle.

For the first time since September, the central bank's announcement made no mention of the possible need for further rate hikes.

Instead, it suggested that monetary stimulus was now neutral and would help keep inflation on target and economic growth at roughly 3 percent this year and next, in line with the bank's forecasts.

"With today's increase, the target for the overnight rate is now at a level that is expected to keep the Canadian economy on the base-case path projected in the April Monetary Policy Report and to return inflation to the 2 percent target," the bank said in its statement.

There had been some uncertainty about whether the bank would raise rates for the seventh consecutive time on Wednesday for a cumulative increase of 175 basis points in the past year. Nine of Canada's 14 primary securities dealers surveyed by Reuters last week had called for a hike while four saw no move.

But the bank's new statement left little room for doubt about the next rate decision in July.

"I think you've got to say this is one of the clearest statements we've gotten from the Bank of Canada in quite some time," said Eric Lascelles, strategist at TD Securities in Toronto.

"We should not expect the overnight rate to go above 4.25 percent at future rate decisions; it's just astonishingly clear."

Mark Chandler, senior market economist at Scotia Capital, said the central bank's next move will depend heavily on specific economic data, putting it in the same boat as the U.S. Federal Reserve after it hiked rates to 5.0 percent on May 10.

"The market should be pricing in no move really at the next meeting ... it's just a question of how the data come in," he said.

The Canadian dollar weakened slightly to C$1.1236 to the U.S. dollar, or 89.00 U.S. cents, after the announcement, from C$1.1214 to the U.S. dollar, or 89.17 U.S. cents. Domestic bond prices were down in response to surprisingly strong U.S. new home sales data.

Commercial banks quickly followed suit, raising their prime lending rate to 6 percent.

STRONG DOMESTIC DEMAND

The central bank said recent data showed domestic demand is robust and that overall inflation and core inflation, which strips out the most volatile items, are "evolving largely in line with the bank's expectations."

However, its references to its April report -- which hawkishly warns that the economy is operating at, or slightly above, capacity -- could also be a hint that it has not entirely closed the door on more hikes this year.

"It may be construed that the Bank of Canada is explaining to the market that, while it sees policy now being neutral, there is still a tightening bias lurking in the background as upside data in the second half of 2006 is more likely than downside," said Peter

Frank, senior foreign exchange strategist at ABN Amro in Chicago.

Indeed, the bank left a tiny window for future rate changes, saying it will closely monitor risks to its forecasts for the Canadian economy.

But higher rates are the last thing manufacturers want as they struggle to cope with the pressures of a soaring Canadian dollar.

"The bank must take into consideration Canada's need for a robust manufacturing sector. This requires addressing the dollar's rise by undertaking an interest rate reduction," said Avrim Lazar, president and chief executive of the Forest Products Association of Canada.

The bank also noted continued strong economic momentum in the global and Canadian economies but warned of increased volatility in commodities markets as well as in foreign exchange and financial markets generally.

(Additional reporting by Toronto treasury desk)
