

Canada: Transitioning from the zero bound. BoC hikes rates 25bps.

...making Canada the first G7 nation to hike its central rate.

A not entirely unexpected event for Canada this morning. All primary dealers were looking for a rate hike out of the BoC this morning. Today's rate hike comes on the back of a course of action that began back in December 2007 that took overnight rates from 4.50% down to 0.25% in a seventeen month span. By the time the BoC had effectively reached the zero bound with rates at 0.25%, they provided a conditional pledge to leave rates at that level through to the end of the second quarter of 2010.

The BoC dropped that pledge to leave rates at 0.25% at the April rate meeting, setting up market participants for today's 25bps rate hike. The dropping of the conditional pledge was a clear signal to both the market and economists alike of the BoC's interest to begin raising rates at today's meeting. And while Governor Carney acknowledged that "nothing is pre-ordained" and to be certain there was some palpable nervousness surrounding today's decision, most of the interest beyond the initial pricing reaction to the rate hike, the bulk of the interest is focused on the language of the post meeting statement.

To be certain, as is always the case, the hope is for policy clarification and complete clairvoyance. For today, markets and economist alike get uncertainty. For market participants that had been pricing towards a view to a steady diet of 25bp rate hikes throughout the rest of 2010, there is some likely disappointment here. Instead of a clear expression of its interest to steadily march the overnight target higher, the language out of the BoC is more cautious, in keeping with the potential for a flatter rate escalation ladder for the BoC than was expected or forecast.

Uncertain times, uncertain responses.

In April when the BoC dropped its pledge to hold rates at 0.25% through to the end of the second quarter of 2010 and prior to the issues surrounding sovereign solvency in the EU, the market was prepared to price in a steady diet of rate hikes throughout the remaining meeting schedule for 2010, along with some deference to the potential for a 50bp rate hike tucked in there.

For today, the BoC statement provides us with less clarity than was probably hoped for by market participants that are tasked with pricing the future cost of money in the here and now. But in that there should be no surprise. The level of certainty in outlook that presided in April has diminished in keeping with the level of uncertainty expressed by market capital and concerns registered in European inter bank lending markets. On that basis, the BoC can be expected to play out the rate cycle on a meeting by meeting basis rather than lend itself to a post meeting statement read that suggests a steady march towards rate normalization. Instead, the market will have to contend itself with the rate cycle than is potentially more staccato like than steady. Alas, in the land of central banking, no central bank will endeavor to paint itself into a corner. Everything is conditional, always.

At this point however, despite the soft overtones of the policy statement, we will stick with our call for rate hikes at each of the remaining policy meetings with a year end target rate of 2010 of 1.50%.

An island unto ourselves.

Well not quite. Canada's main economic point of attachment is the US economy. Interbank lending rates in North America are not experiencing the tightening that followed the onset of the subprime crisis that cause havoc in the developed world's funding markets. And the BoC acknowledges as much, indicating that "thus far, the spillover into Canada from events in Europe has been limited to a modest fall in commodity prices and some tightening of financial conditions". While market uncertainty is high, we are not experiencing the break down in market capital or interbank lending to the extent that crippled markets and economies alike in 2008. In there however, perhaps lies the window in on monetary policy in Canada. At each and every meeting may need take consideration of the state of interbank lending and whether or not there is a systemic financial impact on Canada. The country can tolerate market volatility, unwanted as it may be. Economically, policy makers could not tolerate a breakdown in the dissemination of capital.

There is hesitancy here in today's post meeting statement in keeping with the sovereign event risk in Europe and the potential for global capital markets to transmit this event across the Atlantic. "Given the considerable uncertainty surrounding the outlook, any further reduction of monetary stimulus would have to be weighed carefully against domestic and global economic developments."

That said, rates policy is nowhere near to a level that could even be considered even remotely in keeping with rate neutrality. We would peg a level of rate neutrality in the area of where the Fed's Yellen has talked about for the US economy which is in the range of a real rate of 1-3%. For the Bank of Canada with a 2% inflation target this suggests a rate range of 3-5%. Which is to say with a quarter point rate hike and overnight rate target moving from 0.25% to 0.50%, the BoC is really not tightening policy so much as merely lessening the torrent of stimulus that continues to hit the economy and encourage continued consumer spending and leverage.

Disclosure appendix

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