

Bank of Canada urged to hike rates after June

Paul Vieira, *Financial Post* Published: Tuesday, February 23, 2010

OTTAWA -- The Bank of Canada should uphold its conditional pledge to keep its key policy rate at 0.25% until July but should then embark on sharp rate hikes of 50 basis points at every announcement date until mid-2011, says an analysis prepared for the C.D. Howe Institute.

The call for sharp rate increases after June emerged Tuesday, one week before the Bank of Canada releases its latest interest-rate statement. Further, recent data indicate the Canadian economy likely expanded in the final quarter of 2009 at a faster pace than the central bank expected (4% vs 3.3%), and inflation is now closer to the central bank's 2% preferred target than it previously envisaged.

The report suggested the central bank, in response to the great recession, cut rates at a pace faster than the drop in inflation. As a result, the central bank should follow a similar pattern in increasing borrowing costs at a rate faster than inflation once the recovery takes hold, argued Michael Parkin, an economics professor at the University of Western Ontario.

Based on a number of assumptions, Mr. Parkin calculates that increases of 50 basis points from now until mid-2011 are appropriate, leading to a central bank benchmark rate of roughly 4.25% (assuming eight scheduled rate announcements from July to the middle of next year).

"While the bank might want to raise the overnight rate more slowly than 50 basis points at every announcement date, doing so would keep the real overnight rate negative through a period in which the economy is returning to normal and run a serious risk of leading to excess demand and rising inflation expectations in 2012 and 2013," Mr. Parkin wrote.

The paper added the current rapid growth rates of the monetary base and monetary aggregates must be slowed, and this could only occur if the policy rate follows a sharply rising path.

Still, the Bank should keep its conditional commitment to leave the benchmark rate unchanged until July or risk damaging its credibility, Mr. Parkin said. Other conclusions from his analysis include:

- The Bank should publish conditional statements about the future path of the policy rate to help shape market expectations and avoid surprises that disrupt financial markets, output, and employment.
- And measures aimed at easing credit conditions should be unwound but "with care," he added, to ensure a gradual return to normalcy in credit markets.