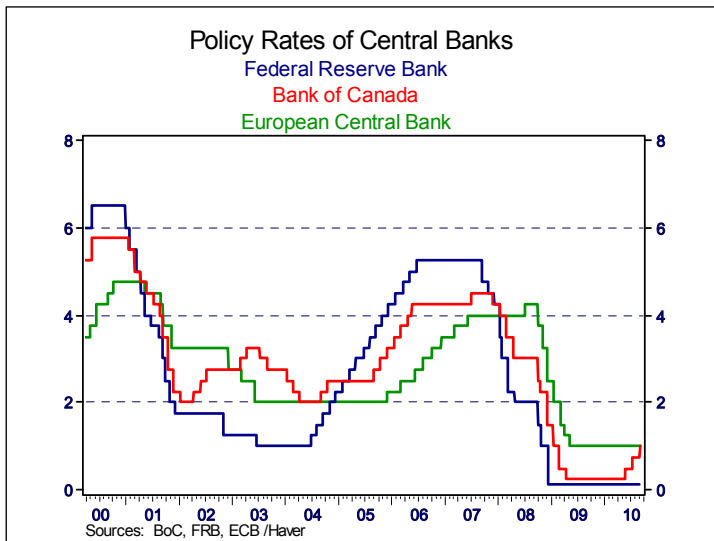




September 8, 2010

Once again, the BoC adopts a deliberately ambiguous tone



While we will never know if Bank of Canada's officials debated the issue as much as their U.S. Federal Reserve counterparts, they did end up agreeing to raise the policy rate by a quarter of a point. The overnight rate target has moved further away from zero for the third time in a little over three months, going from 0.75% to 1.00% this morning. With the overnight rate target still at a very low level and sidestepping last spring's conditional statement, "financial conditions in Canada have tightened modestly but remain exceptionally stimulative."

Our central bank could not disregard the fact that economic conditions in North America have deteriorated in the past few weeks. In addition, "the Bank now expects the economic recovery in Canada to be slightly more gradual than it had projected in its July Monetary Policy Report, largely reflecting a weaker profile for U.S. activity." In other words, we are seeing again an example that Canada's economy is not an island unto itself, separate from the rest of the world. The good news is that a double-dip in the U.S. is not in the cards. The BoC has

notably acknowledged that the recent drop in bond yields ease credit conditions of households and businesses.

That the BoC's officials deliberately maintained an ambiguous tone in its statement is no surprise. They've done it earlier this summer. "Any further reduction in monetary policy stimulus would need to be carefully considered in light of the unusual uncertainty surrounding the outlook." On July 20th, the term "considerable uncertainty" was used. This substitution reflects a somewhat higher level of uncertainty than invoked in the past. Put simply, the statement suggests that Governor Carney will not be counting any chickens before they hatch this fall.

In fact, this deliberately ambiguous statement contrasts with the guidance provided by the Reserve Bank of Australia (RBA) and the Riskbank – two other inflation targeting central banks. According to their last statements, it is quite clear the RBA plans to keep the cash rate at 4.50% and that further hikes are in the cards in Sweden:

- "With growth in the near term likely to be close to trend, inflation close to target and with the global outlook remaining somewhat uncertain, the Board judged this setting of monetary policy to be appropriate for the time being."
- "The repo rate needs to be raised gradually towards more normal levels to attain the inflation target of 2 per cent and create the right conditions for stable growth in the real economy. The Executive Board of the Riksbank has therefore decided to raise the repo rate by 0.25 percentage points to 0.75 per cent."

That said, we cannot accuse the BoC for a lack of guidance or miscommunication. Canada's economic ties with the US are after all much larger than in Australia or Sweden. And since there is "unusual uncertainty" as Fed Chairman Ben Bernanke phrased it, Governor Carney probably did not have too much choice but to adopt a similar tone. Therefore, *LBS Economic Research* is squarely behind this flexible strategy. Given a particularly elevated level of uncertainty – QE2, reforms, unemployment, etc. – the best bet is to remain noncommittal by not signalling that we may be due for a pause at least for the remainder of the year, or worse, even further into the beginning of 2011. While nothing is yet cast in stone, we do not expect rate hikes in October and December for the time being. We continue to anticipate 2010 to close with an overnight rate target of 1.00%, and 2011 to end at 1.50%. However, a few upbeat economic reports like the *Labour Force Survey* on Friday could quickly change the odds. In other words, we cannot brush aside hikes this upcoming fall or by next spring so easily. This would be too inflexible and a stark deviation from the manoeuvrability the BoC has left itself.

Sébastien Lavoie, Assistant Chief Economist