Daily Economic Update

July 12, 2017

Bank of Canada raises rates for the first time since 2010

The Bank of Canada announced their first rate hike in nearly seven years, a move that seemed a long shot just a few months ago given the central bank's dovish rhetoric. But the potential for an increase was clearly telegraphed by members of the Governing Council over the last month in what is surely their most concerted effort at forward guidance under Governor Poloz's tenure. Today's rate statement and Monetary Policy Report reflect many of the themes policymakers have touched on in their recent, more hawkish comments. The bank sees growth broadening across industries and regions and thinks the energy sector's adjustment to lower oil prices is largely complete. With above-trend growth looking more sustainable and excess capacity being absorbed, the economy needs less help from ultra-low interest rates.

The statement provided little guidance on when we might expect another rate hike, but it is worth noting that today's move was not necessarily framed as simply walking back some of the stimulus provided in 2015. Rather, we think the bank's projection that economic slack will be fully absorbed by the end of 2017 raises the risk that policymakers do more than withdraw those 50 basis points of 'insurance cuts' over the next year. But to do so, we think the Governing Council will want to see at least some evidence of tighter economic conditions putting upward pressure on inflation. Our expectation is the bank will raise rates again in October before hitting pause on their tightening cycle until they have greater confidence that inflation is heading to their 2% target on a sustained basis. Also arguing for such a pause is Governor Poloz's comment that the economy may be more sensitive to higher interest rates than in the past and thus policymakers will have to carefully gauge the effect of rate hikes on the economy.

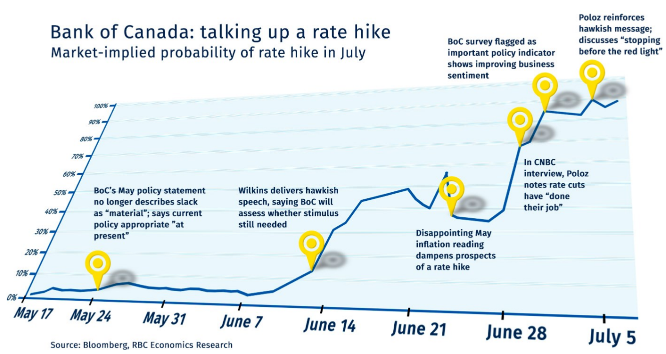
Highlights:

- The Bank of Canada raised their trend-setting overnight rate to 0.75% from 0.50%. Rates were previously lowered by 50 basis points in 2015 in response to the oil price shock.
- The bank's 2017 GDP growth forecast was revised up to 2.8% thanks to a larger increase in consumer spending. Growth is seen slowing to 2.0% next year as a more moderate add from consumers is only partially offset by stronger business investment and another solid increase in exports.
- Excess capacity in the economy is expected to be fully absorbed around the end of this year. That is earlier than April's assumption that the economy would reach potential in the first half of 2018.
- Slower inflation was mostly attributed to temporary factors including food price competition and electricity rebates in Ontario. The bank also noted a lag between monetary policy actions and future inflation.

GDP and inflation projections

	Q2/17	Q3/17	Q4/17	Q4/18	Q4/19
Bank of Canada					
Real GDP q/q	3.0	2.0			
Real GDP y/y	3.4	2.8	2.7	1.8	1.5
CPI y/y	1.4	1.3	1.6	2.0	2.1
RBC Economics					
Real GDP q/q	2.7	2.1	2.0	1.7	
Real GDP y/y	3.3	2.8	2.6	1.9	
CPI y/y	1.4	1.7	1.7	2.5	

Source: Bank of Canada, RBC Economics



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