

Rate hike likely as prices rise higher than forecast

Inflation rate jumps to 2.8% in May, from April's 2.4%

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CanWest News Service

Wednesday, June 21, 2006

Canadian consumers were hit by higher-than-expected price increases last month, and as a result, face the threat of a double whammy with higher interest rates possible next month.

The annual inflation rate jumped to 2.8 per cent last month, up from 2.4 in April, and above the central bank's two-per-cent inflation target, Statistics Canada reported Tuesday.

It was the 11th straight month that the annual inflation rate has been at or above the Bank of Canada's two-per-cent target, suggesting the central bank may rethink its plan to stop raising interest rates.

"The significantly above consensus May inflation readings increase the likelihood that the Bank of Canada will need to continue to raise the policy rate, despite its strong suggestion on May 24 that the current 4.25 per cent policy rate is at a level expected to keep the economy on track to meet its growth and inflation forecasts," said J.P. Morgan Canada economist Ted Carmichael.

"After a stronger-than-expected GDP report in the first quarter and a blockbuster jobs report, this latest reading on inflation certainly opens the door for a Bank of Canada rate hike this summer," economists at National Bank of Canada added in an analysis.

Further, core inflation, which excludes volatile prices such as gasoline and food, and which the central bank monitors for evidence of underlying inflation, jumped to two per cent from 1.6 the month before, the steepest core inflation rate in more than two years. The surge in core inflation reflected what was also a hefty 0.5 per cent increase in core prices during the month itself.

The report, and the ensuing increased expectation that the Bank of Canada will raise interest rates further next month, gave the Canadian dollar a modest boost Tuesday, when it went to 89.48 cents US from 89.30 cents the day before. Analysts say the strong dollar is a major reason why inflation, in a hot economy, hasn't moved higher than it has.

While gasoline prices, which were 18.6 per cent higher than a year earlier, remained the main culprit in the increase in the overall annual inflation rate, the 0.5 per cent increase in prices during May was largely due to an 11-per-cent surge in electricity prices in Ontario, and a 17-per-cent jump in hotel prices as operators applied their higher summer rates.

Helping keep a lid on the inflation rate, meanwhile, were lower prices for computer equipment and supplies, and video equipment, reflecting the impact of a number of factors, including a higher Canadian dollar, which made it possible to purchase imported products at a lower cost, and technological progress, which has reduced manufacturing costs for such products.

And there should be further inflation relief next month, thanks to the drop in the GST to six per cent from seven per cent, which should knock 0.6 per cent off July's consumer price index, Statistics Canada noted.

However, continued strong consumer spending will likely keep upward pressure on inflation, and in turn likely trigger a resumption of interest rate increases by the Bank of Canada, according to a separate analysis by Action Economics, an online think tank.

"Canadian consumption started the year on a healthy tack, accelerating to a robust 4.6 per cent growth rate in the first quarter," it noted. "Spending should remain solid through the fourth quarter, due to healthy income and job growth, impending fiscal stimulus, and a solid fundamental backdrop," it said.

"Combined with a growing threat to the inflation backdrop, the Bank of Canada will be compelled to resume rate hikes."

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