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Carney rate pause expected, but cut could follow

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OTTAWA — Will a cut follow the pause? The question of how long Mark Carney will wait before he raises interest rates has shifted to include the possibility he could reduce borrowing costs in the face of a global slowdown.

As warning signs for the recovery flash red, Mr. Carney is expected to keep Canadian interest rates on hold this week and could indicate that his year-long pause will continue for several months.

“Lower-for-longer” is becoming the slogan for central bankers everywhere. Just weeks ago, many economists argued Mr. Carney would need to lift borrowing costs at least once by the end of 2011 or risk losing his grip on inflation. The Bank of Canada Governor, who has left his benchmark rate at 1 per cent for seven consecutive meetings starting last October, is expected to use his decision this Wednesday to underscore he has no intention of tightening policy until the global economic picture has improved.

There has been such a steady stream of discouraging economic news since Mr. Carney’s last decision on July 19 that trading in securities tied to future interest rate levels suggests investors believe the central bank’s next move is more likely to be a rate cut – the first since April of 2009. Many economists, however, still anticipate that the bank will move to tighten – but will take more time to do so.

At a minimum, the latest U.S. employment figures put an exclamation point on a long list of reasons for Mr. Carney to remain on hold on Wednesday, and possibly well into 2012. Two years into the U.S. recovery, job growth has stalled, re-igniting fears that the world’s biggest economy and Canada’s No. 1 customer is slipping back into recession. A solution to Europe’s debt crisis is nowhere in sight, raising the spectre of a continent-wide banking meltdown that cripples global finance. Demand in several of Canada’s biggest export markets remain sluggish even after the temporary effects of Japan’s natural disasters have dissipated.

`”[Mr. Carney] will use the line, which he’s been consistent with and which is what the analysis shows, that recoveries that follow financially induced recessions tend to be long and slow,’’ said Don Drummond, the former chief economist at Toronto-Dominion Bank who is leading a spending review for the Ontario government. “We’re certainly seeing that.”

Moreover, Federal Reserve policy makers have committed to keeping U.S. rates at rock-bottom levels “at least through mid-2013,” and odds are going up that the Fed will launch another round of unconventional easing after a two-day meeting in Washington next month.

Fed Chairman Ben Bernanke could hint at this in a speech to the Economics Club of Minnesota Thursday, hours before President Barack Obama speaks to the U.S. Congress to unveil his plan for kick-starting American hiring. Also on Thursday, the European Central Bank holds a policy meeting, at which President Jean-Claude Trichet is expected to acknowledge he has more reason to be concerned about growth in the euro zone than inflation. Mr. Trichet has come under fire for raising interest rates earlier this year to stem price gains, especially as evidence mounts that those moves were too much for the region's fragile economy to handle.

Mr. Carney may be likely to keep rates steady this week, but that doesn’t mean there’s been a huge shift in his view of the economic outlook. Only two weeks ago, he told the House of Commons finance committee that Canadian growth will be slower than expected but he doesn’t see a recession. He also said neither the U.S. nor Europe would see another downturn.

Since he made those comments, a few Canadian and foreign indicators have heightened fears the slowdown that lasted through the summer could deepen. Statistics Canada reported last week that the domestic economy shrank at an annualized rate of 0.4 per cent in the second quarter, as exports fell the most in two years.

But the growth number may not change Mr. Carney’s outlook for Canada. Much of the contraction in the second quarter was a result of temporary, one-time setbacks, namely supply-chain disruptions linked to the Japanese earthquake, as well as wildfires in northern Alberta that curbed energy sales. However, business investment – which Mr. Carney has been

counting on to lead the recovery in the second half – continued to surge as companies remained upbeat, and consumer spending kept chugging along. And for the month of June, the economy eked out 0.2-per-cent growth, suggesting the worst may have been over by the end of the quarter.

Despite investor bets that a rate cut could be on the horizon, analysts said that even if Mr. Carney sounds a more “dovish” tone this week, as long as he is confident that growth will persist he’ll avoid any hint that he would contemplate a rate cut if proven wrong.

An important reason to steer clear of such talk is because Mr. Carney and his policy team have repeatedly stressed the financial risks of leaving borrowing costs too low for too long, such as record levels of household debt and rising real estate prices.

The central bank will need to be up-front about any shift in its thinking on the rebound’s durability, but without undermining its longstanding argument that borrowers should be careful about taking on debt because, eventually, interest rates will be much higher than they are today.

“I would be surprised if they even hinted at [the possibility of rate cuts] as long as they still see growth,” said Benjamin Reitzes, a senior economist at BMO Nesbitt Burns. “The bank is still very concerned about household debt. What’s the point of cutting rates? To spur borrowing. So, why would you want to suggest that if you don’t need to? It would just exacerbate one of the concerns that you have about the economy.”

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