

Economy picks up but risks remain, Carney says as he holds line on rate

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Ottawa — Bank of Canada Governor Mark Carney left his benchmark interest rate [at 1 per cent](#) Tuesday, warning that uncertainty overseas, the strong Canadian dollar and the poor corporate productivity performance will hold back exports even as he upgraded his forecasts for the next two years.

In explaining the decision to leave borrowing costs alone for the third time in a row, as expected by the markets, the Bank of Canada said the global recovery is “proceeding at a somewhat faster pace” than policy makers had anticipated last fall, though “risks remain elevated.”

The Canadian economy will grow 2.4 per cent this year and 2.8 per cent in 2012, the central bank said, in a teaser to a full quarterly forecast it will release Wednesday. That compares with an October forecast of 2.3 per cent growth for this year and 2.6 per cent in 2012.

Those adjustments were not enough for the central bank to tweak its October projection for inflation to return to policy makers’ 2-per-cent target by the end of 2012, or for the “considerable slack” left over in the economy from the recession to be absorbed by the end of that year.

Although business investment is rebounding strongly and net exports are poised to start contributing more to economic growth as the impact of government stimulus fades and debt-strapped consumers spend less, companies and the goods and services they sell abroad still face headwinds, the bank said.

The strength of the loonie is among those, because it makes Canadian exports more expensive to foreign buyers. The currency dipped from the highest level against the U.S. dollar in more than two-and-a-half years after Mr. Carney’s decision, which dampened investors’ expectations that the central bank might raise rates by spring, but has hovered around parity for months, buoyed in recent weeks by commodity prices and renewed optimism about the American economy.

“The recovery in Canada is proceeding broadly as anticipated, with a period of more modest growth and the beginning of the expected rebalancing of demand,” the central bank said Tuesday in the statement accompanying its decision. “However, cumulative effects of the persistent strength in the Canadian dollar and Canada’s poor relative productivity performance are restraining this recovery in net exports and contributing to a widening of Canada’s current account deficit to a 20-year high.”

Without saying just how much of a kick Mr. Carney believes the crucial U.S. economy could get from the tax-cut package President Barack Obama and Republicans in Congress agreed to late last year, or the U.S. Federal Reserve’s controversial attempt to keep long-term interest rates low by buying \$600-billion (U.S.) in bonds, the central bank said private demand in the United States has picked up and will be “reinforced” by both measures.

The Bank of Canada’s new forecast due Wednesday will probably boost projections for the U.S. economy, but Fed policy makers including Chairman Ben Bernanke have given no sign that they’re ready to pull back any of their extraordinary stimulus measures.

That suggests Mr. Carney could be on hold for longer than he’d like to be, since he has noted there are “limits to the divergence that there can be” between Canadian and American interest rates. Indeed, there is a risk that further interest rate increases while the Fed is still on the sidelines and flushing hundreds of billions of dollars into the financial system

would cause more investors to flock to the Canadian dollar, causing further grief for exports.

The European recovery, meanwhile, has been a bit stronger than central bankers anticipated, they said, but will be curbed by ongoing sovereign and bank debt problems in several countries, fuelling "a significant source of uncertainty" for the worldwide outlook. And as emerging markets like China take steps to keep their economies from overheating, the commodity prices that have soared since the central bank's last quarterly forecast in October, benefiting producing nations like Canada, could start to drop as demand slows.

Taken together, all of these factors mean further rate hikes "would need to be carefully considered," the central bank said, repeating language it has used since October when Mr. Carney decided to pause his tightening campaign after three increases.

Most economists say the central bank will be on hold until May 31 or July 19, although minorities in both directions predict increases as soon as March or April, or as late as October. The next decision for Mr. Carney is scheduled for March 1, and Wednesday's forecast could provide more clues about whether there's any chance he might move that soon.

"We don't get the sense that the (Bank of Canada) is inclined to hike rates any time soon," said Stewart Hall, an economist at HSBC Securities in Toronto, "although we will await the full fleshing out of the Bank's economic base case in tomorrow's release of its monetary policy report before making a decision on whether or not we need to alter our view."

The central bank also repeated language from past statements saying its decision to stand firm leaves "considerable monetary stimulus" in place - a hint that Mr. Carney would be raising rates if he felt he could.

At the same time, measures introduced Monday by Finance Minister Jim Flaherty to clamp down on household debt, by making it harder for people to take on more obligations than they can afford, will likely give the central bank more flexibility to wait until it makes sense to raise rates throughout the economy rather than doing so to discourage a small subset of borrowers.

The mortgage rules, the strong currency, the lack of inflationary pressures, and the potentially fleeting nature of any jolt to the U.S. economy from the tax cuts and the Fed's bond-buying, mean Mr. Carney may keep his policy rate below 2 per cent through the end of the year, according to Michael Gregory, a senior economist at BMO Capital Markets in Toronto.