Tough rate call ahead for Carney

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OTTAWA — With the world economy stuck in between a recession that's over and a sustained recovery that has yet to arrive, Mark Carney has some hard choices to make this fall.

There is near unanimity that the Bank of Canada Governor will lift the benchmark interest rate tomorrow for a third consecutive time, to 1 per cent. There's also a growing consensus that the bank will then pause at its Oct. 19 decision while Mr. Carney spends more time assessing the durability of the rebound. But the market is already looking – with great uncertainty – at what comes after that.

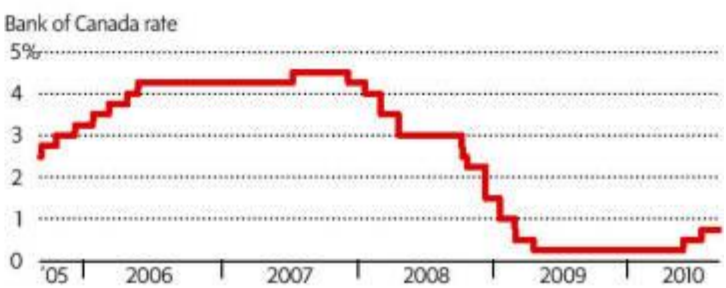
The question is how long that pause will be, and if last week's economic data are any guide, it is nearly impossible to answer with confidence. Some of the numbers have given Mr. Carney – the only Group of Seven central banker to raise rates this year – plenty of reasons to hold his fire tomorrow. Others seemed to give him a green light to keep raising rates.

A report last Tuesday from Statistics Canada showed the economy slowed sharply in the second quarter, with exports losing momentum as a result of sluggish overseas demand as companies, households and governments repair their balance sheets and spend cautiously. Meanwhile, inflation in Canada is tame, and the main drivers of growth – housing, government stimulus and consumer purchases – are giving the economy less of a boost.

On Friday, though, the picture in the vital U.S. market seemed a shade less fragile. American companies hired more workers than anticipated in August, data from the Labour Department showed, sending stocks higher and leaving analysts to hurriedly push aside any talk of a "double-dip" recession.

On the rise

The Bank of Canada, which slashed borrowing costs to fight the recession, was the first in the G7 to raise them again.



CARRIE COCKBURN / THE GLOBE AND MAIL ■ SOURCE: BLOOMBERG

The case for Mr. Carney to plow ahead with another step away from emergency-low rates was already decent. A Canadian slowdown was always expected, even if the second quarter's 2-per-cent annual growth rate was worse than the most pessimistic estimates. Business investment picked up, meaning the private sector – which has helped the economy recoup most of the jobs lost during the slump – is starting to fill the void left by the fading impact of stimulus and the cooling real estate market.

The bank's main rate is still a long way from the 3.5 to 4 per cent that most consider "neutral." And unlike the U.S., much of Europe and Japan, low interest rates and healthy banks have worked to re-ignite spending – so much so that many Canadians' debt loads have risen even as de-leveraging takes hold in the rest of the developed world.

"The risk of keeping rates too low for too long is probably a little more pressing in Canada," said Michael Gregory, a senior economist with BMO Nesbitt Burns. "You've got jobs, you've got a healthy banking system, and you've got consumers that do still have some capacity to take on more debt. That's why Canada has to be a little bit more careful, a little bit more pre-emptive, in dealing with interest rates than the other central banks."

For Mr. Gregory, that means the "onus of evidence," for now, is on those who would stop tightening.

Still, because the U.S. economy is far from healthy, Mr. Gregory predicts the Bank of Canada will put the rate hikes on hold next month and may need to stay in that mode until at least mid-2011.

Most economists agree that Mr. Carney will pause next month, a move he would explain in detail two days later, on Oct. 21, when he releases a quarterly forecast. But there's much less certainty about how long he will, or should, stay on the sidelines.

The C.D. Howe Institute's Monetary Policy Council, for instance, says the central bank should bring rates up to 1.5 per cent by March, a more aggressive timeline than Mr. Gregory's.

Stewart Hall of HSBC Securities is one of a handful of Bay Street economists still predicting the central bank will raise rates in October, and again on Dec. 7, arguing that Canada's fundamentals are too strong to justify leaving so much stimulus in the economy.

Nevertheless, the fits and starts of the U.S. economy, and Canada's own slowdown, give Mr. Carney the luxury of being able to take a lengthy pause after tomorrow without "shocking" even the financial market players who are pushing for him to keep on hiking, Mr. Hall said.

"They could pause for a quarter, just to see how the numbers play out, and nobody would hold their feet to the fire for it," Mr. Hall said.