Carney's big call

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Ottawa -- Bank of Canada governor Mark Carney has had a busy time of it since taking over as the country's central banker 27 months ago, mostly tackling the financial crisis, mapping out the road to recovery and reassuring Canadians that at the end of the day the bank's extraordinary policies would work.

The one thing he has yet to do during his term, however, is raise interest rates. That might be about to change on Tuesday. If he does pull the trigger - and that is what most analysts expect - it won't be after grappling with competing forces that convey two starkly different messages about the economic outlook.

"We are at point where it is a tug of war between structural issues that are facing the eurozone and a very strong economic cyclical backdrop," says Stéfane Marion, chief economist at National Bank Financial.

Weighing on the governor are the economic data, which call out for a rate hike - as much as 50 basis points, some reckon. The data have been consistently strong and surprising to the upside. Job creation is in full swing, with a record 109,000 workers added to payrolls in April; consumers are buying up goods at a healthy pace, tax credits or not; corporate profits are rebounding to pre-recession levels; and inflation is creeping closer to the central bank's preferred 2% target. The sterling fundamentals prompted the central bank last month to ditch its conditional commitment to keep its policy rate at a record low 0.25% until July, leading traders to price in a nearly 100% chance of a rate hike on June 1.

That was until sovereign debt worries exploded in Europe, once Greece formally asked for international help days after the last Bank of Canada rate decision. That sparked an across-the-board retreat in global equity markets, down 9.3% since the beginning of May, as traders sold stocks and poured into risk-averse U.S. treasuries and other government securities on fears that another credit crunch was at hand. Mr. Carney is likely aware of this better than most, given his capital markets background from Goldman Sachs.

The most worrying sign on Mr. Carney's radar screen might be the small but steady increases in the cost of borrowing among banks, a signal European lenders are finding it tough to access cash from their peers on concern over how much Greek, Portuguese and Spanish debt they hold.

In the end, the consensus is Mr. Carney is leaning toward a rate hike - a modest one, though, of 25 basis points. The thinking is, an ounce of prevention now is worth a pound of cure later.

"We can't look at things in a vacuum, because there are so many other factors besides Europe's issues" says Jonathan Basile, an economist with Credit Suisse in New York who closely watches Canadian markets. "The truth is the macroeconomic evidence is outweighing the financial risks right now."

The last time the Bank of Canada raised its benchmark rate was in July 2007, by 25 basis points to 4.5%. At the time, former governor David Dodge said the economy was operating above its production potential, and inflation was likely to stay above its 2% inflation target for longer than forecast.

Little did Mr. Dodge know that the U.S. subprime crisis would morph into the worst financial crisis since the Great Depression, roiling markets and economies around the world. This is why Europe's recent fiscal woes have triggered a case of nerves, and might prompt Mr. Carney to rethink any rate move.

"The Bank of Canada wants to raise rates, but it doesn't have a crystal ball," CIBC World Markets said in a note to clients. "It can't be certain that the recent financial market downturn isn't going to morph into something more severe that would make a rate hike look out of place."

There's another school of thought, though, that suggests markets have overreacted to a regional problem. In this context, it is key to remember the Bank of Canada didn't expect the eurozone to contribute much to global growth, envisaging only 1.2% expansion this year and 1.6% in 2011.

"The European picture will calm down and people will realize it is not as dramatic as being played out," says Carlos Leitao, chief economist at Laurentian Bank Securities.

Yes, he acknowledges, the debt-ridden southern European economies have tough years ahead. But other countries, led by Germany and France, are going to capitalize on the lower euro and boost their exports to emerging economies and North America, which will help offset the drag from the so-called Club Med nations.

Besides Europe, Mr. Carney has other factors to consider.

Canada's sovereign debt levels are indeed much better than the industrialized world, as our politicians like to remind us. But the amount of debt held by households, measured as a percentage of disposable income, stood at a historical high of 146% - of which 98% is mortgage related - at the end of 2009, rating agency DBRS estimates. That would put Canadian households ahead of the United States but behind Britain on this measure. A rate hike would signal it might be time to live more modestly and refrain from too much debt-financed consumption (which helped fuel those nasty asset bubbles that central banks may want to pay more attention to in the aftermath of the subprime debacle).

Mr. Carney's other challenge is to explain why, and what's ahead. He has come off a period where he provided extraordinary guidance to markets. Don't expect similar language from the governor.

If anything, Mr. Marion warns the central bank should refrain from using the type of guidance the U.S. Federal Reserve deployed in 2004, when it signalled a period of "moderate" rate hikes were in the offing.

In retrospect, the Fed's use of the word moderate "encouraged more financial excesses," leading to the subprime bust, Mr. Marion says. "Carney doesn't have to be brusque about it. He has the luxury to start slowly, and leave his options open," from pausing should Europe deteriorate to hiking aggressively, by 50 basis points, if conditions warrant.

Mr. Carney reminded us recently that "nothing is pre-ordained" at the Bank of Canada. He's likely to drive home that point on Tuesday, rate hike or not.

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