B A N K O F C A N A D A

MONETARY POLICY REPORT

– April 2005 –

Summary

Overview

The global economy has been unfolding largely as expected, and prospects for continued robust growth are quite favourable, especially over the near term. Against this backdrop, the outlook for the Canadian economy through to the end of 2006 is essentially unchanged from that in the January *Monetary Policy Report Update*.

The Canadian economy continues to adjust to major global developments. These include the realignment of currencies in response to global imbalances, the higher prices of both energy and non-energy commodities, and growing competition from emerging-market economies.

The sectoral adjustments to these developments are becoming more evident. Many Canadian commodity-producing sectors are expanding. However, firms in a number of other sectors exposed to international trade are facing pressure from the appreciation of the Canadian dollar and from foreign competition. On balance, net exports have been a drag on the economy. But with robust domestic demand, some sectors—such as retail, wholesale, and housing—have been growing strongly. Canadian monetary policy continues to facilitate the adjustment process by aiming to keep inflation at the 2 per cent target and the economy operating near its production capacity. The Bank continues to judge that the economy is operating slightly below its full production capacity.

Highlights

- **There is increasing evidence that the Canadian economy is adjusting to global developments, which include the realignment of currencies and higher commodity prices.**
- **The Bank's outlook for the Canadian economy is similar to that in the January *Update*, with growth projected to be about 2 1/2 per cent in 2005 and 3 1/4 per cent in 2006.**
- **With the economy moving back to its production capacity in the second half of 2006, core inflation should return to the 2 per cent target around the end of next year.**
- **In line with this outlook, a reduction of monetary stimulus will be required over time.**
- **There are both upside and downside risks to this outlook, which continue to relate largely to global developments and to the associated relative price changes.**

This is a summary of the Monetary Policy Report *of the Governing Council of the Bank of Canada. The* Report *is based on information received up to the fixed announcement date on 12 April 2005.*

After appreciating sharply in 2003 and 2004, the Canadian dollar has been fluctuating in a range of around 80 to 83 cents U.S. since the beginning of the year.

The Bank's base-case projection calls for annualized growth of about 2 1/2 per cent in the first half of 2005 and 3 per cent in the second half. Growth of about 3 1/2 per cent is expected over the four quarters of 2006, consistent with returning the economy to full production capacity in the second half of that year.

Expressed on an annual average basis, growth in 2005 is projected to be about 2 1/2 per cent, down slightly from the January *Update*, while the projection for 2006 is little changed at about 3 1/4 per cent.

We continue to expect core inflation to move back to the 2 per cent target around the end of 2006. Based on the scenario implied by oil-price futures, total CPI inflation is projected to remain slightly above 2 per cent this year and to move slightly below 2 per cent in the second half of 2006.

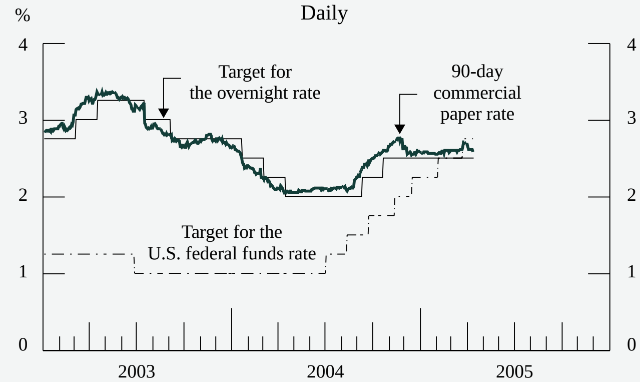
Growth in the Canadian economy this year and next is anticipated to come primarily from domestic demand, as net exports are expected to exert a drag on the economy. To continue to support aggregate demand, the Bank decided to leave the target for the overnight rate unchanged at 2.5 per cent on 1 March and 12 April. In line with the Bank's outlook, a reduction of monetary stimulus will be required over time.

The global and Canadian economic outlooks remain subject to both upside and downside risks and to uncertainties. These risks include the pace of expansion in Asia, and the prices of oil and non-energy commodities. A further risk relates to the resolution of current account imbalances, with the risk of a disorderly correction growing over time, should these imbalances persist.

Most of the uncertainties with respect to the Canadian outlook continue to relate to how the economy is adjusting to the relative price changes associated with major global developments.

90-Day Commercial Paper Rate, Target for the Overnight Rate, and Target for the Federal Funds Rate

Daily

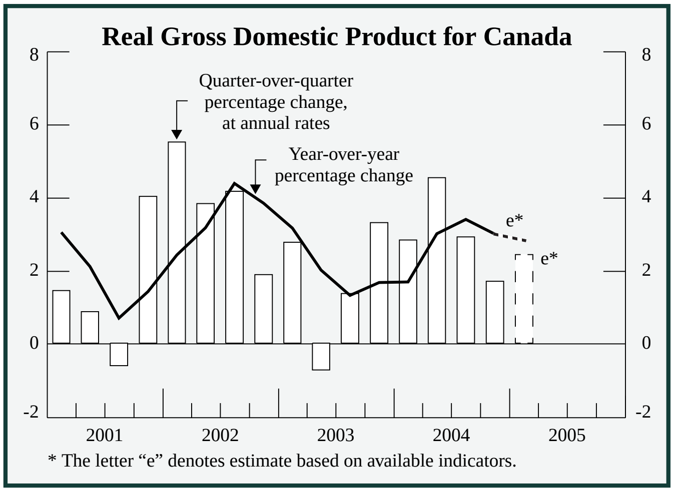


Recent Developments

After growing at an annualized rate of 2.9 per cent in the third quarter of 2004, the Canadian economy grew by only 1.7 per cent in the fourth quarter. This was weaker than the projections in both the October *Report* and the January *Update*.

The major factor behind this slower growth was a decline in exports in the second half of 2004. Although part of this drop represented a fall from unexpectedly high levels in the second quarter, it more fundamentally reflected the ongoing adjustment to the past appreciation of the Canadian dollar. In contrast, final domestic demand continued to grow robustly in 2004. Household spending increased, supported by monetary stimulus and ongoing gains in real incomes. The pace of business investment rose sharply towards the end of the year, and businesses accumulated inventories in the second half.

The weaker-than-projected growth in the fourth quarter was largely offset by upward revisions to GDP estimates for earlier quarters. The level of economic activity at the end of 2004 was therefore broadly in line with the



Bank's expectations in the January *Update*, and slightly below the Bank's estimate of potential output. So it remains the Bank's judgment that the economy was operating with a small output gap at year-end. This view is broadly supported by the responses of firms to questions about pressures on production capacity in the Bank's spring *Business Outlook Survey*.

Core inflation has been broadly stable over the past year, fluctuating in a range of 1.5 to 1.8 per cent. Other measures of the trend of inflation have also remained below the Bank's 2 per cent target. The modest amount of slack in the economy and lower prices for import-intensive goods have worked to keep core inflation below 2 per cent, but higher energy prices have pushed total CPI inflation to an average of just over 2 per cent since last August.

Prospects for Growth and Inflation

Overall, the global economy has performed as anticipated, and growth is projected to remain relatively strong at around 4 per cent in both 2005 and 2006. While oil prices have moved sharply higher, other factors are helping to underpin the growth of the global economy in the near term, including favourable financial conditions. As well, the continued strong economic performance of non-Japan Asia is expected to make a relatively larger contribution to global growth than previously expected.

The underlying momentum of the U.S. economy remains robust. Continued strength in business investment is expected, and exports should be helped by the past depreciation of the U.S. dollar. However, the impact of higher interest rates and higher oil prices will likely dampen household spending.

For Canada, despite strong external demand, especially from the United States and Asia, net exports are expected to continue to subtract from growth during 2005 and 2006. This reflects both the influence of the past appreciation of the Canadian dollar—which is restraining export growth and encouraging imports—as well as strong growth in investment, which has a high import content.

Economic growth this year and next is expected to be supported primarily by continued strength in domestic demand. We expect business capital spending to increase even more strongly than last year, because of high commodity prices, favourable financial conditions, high profits, and further declines in the prices for imported machinery and equipment. Consumer spending is also likely to continue to grow strongly owing to projected gains in real incomes, the effect of monetary stimulus, and high levels of consumer confidence. Housing investment is not projected to grow but should remain at a high level. Government spending should grow in line with revenues, since we expect that governments at all levels will continue to work to maintain fiscal balance.

Higher oil prices are still expected to have a modest adverse effect on aggregate demand in 2005. But an increase in investment and production in the energy sector should more than offset the negative effects by 2006.

With the expected slowing of inventory accumulation, we project annualized growth to average about 2 1/2 per cent in the first half of 2005, about 3 per cent in the second half, and about 3 1/2 per cent through 2006. This scenario, which includes a reduction of monetary stimulus over the projection period, implies that the economy will return to potential in the second half of 2006.

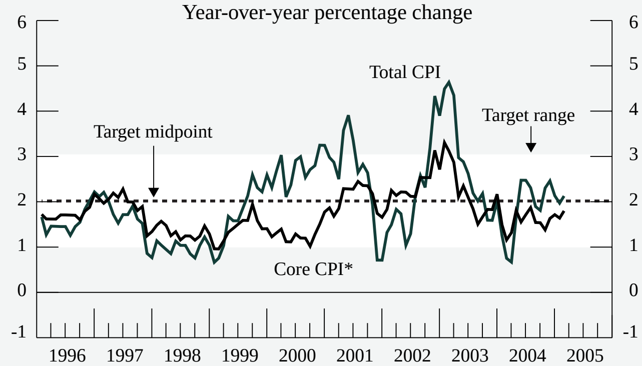
One uncertainty around the outlook relates to the trend rate of growth of potential output. Over the past two years, growth in labour productivity has been close to zero, and increases in production capacity have been largely maintained by rapid growth in labour inputs. For the economy's production capacity to expand at our assumed growth rate of 3 per cent, labour productivity growth will need to return to a trend growth rate of around 1 3/4 per cent going forward. The likelihood of such growth is supported by the recent and projected increases in business investment in Canada and by continued rapid growth in labour productivity in the United States.

Core inflation should remain below 2 per cent through 2005 and most of 2006, owing to the continued small amount of excess supply in the economy, the effect of the stronger Canadian dollar, and the lower prices of some consumer goods from countries such as China. There is a risk of some pass-through of higher energy and other commodity prices to consumers, but the risk looks to be small, and the effect will likely be spread out over time.

All told, we expect core inflation to stay near 1.7 per cent through the end of this year. With the economy returning to potential in the second half of 2006 and with expectations well anchored, core inflation should rise gradually to 2 per cent around the end of 2006. Based on the scenario implied by oil-price futures, total CPI inflation is projected to stay above 2 per cent for some time, before moving below 2 per cent in the second half of 2006.

Consumer Price Index

Year-over-year percentage change



* CPI excluding the eight most volatile components and the effect of changes in indirect taxes on the remaining components

Projection for Core and Total CPI Inflation

Year-over-year percentage change*

	2005				2006	
	Q1	Q2	Q3	Q4	H1	H2
Core inflation	**1.7** *(1.7)*	**1.6** *(1.6)*	**1.7** *(1.7)*	**1.7** *(1.7)*	**1.8** *(1.8)*	**1.9** *(1.9)*
Total CPI	**2.1** *(2.4)*	**2.1** *(2.0)*	**2.3** *(1.5)*	**2.3** *(1.5)*	**2.2** *(1.7)*	**1.8** *(1.8)*
WTI (level)**	**50** *(47)*	**56** *(47)*	**57** *(45)*	**57** *(45)*	**56** *(43)*	**54** *(42)*

* Figures in parentheses are from the January *Monetary Policy Report Update*.

** Assumption for the price of West Texas Intermediate crude oil (US$ per barrel), based on an average of futures contracts over the two weeks ending 7 April 2005.

The Bank of Canada's *Monetary Policy Report* is published semi-annually in April and October. Regular *Updates* are published in July and January. Copies of the full *Report*, the *Summary*, and the *Update* may be obtained by contacting: Publications Distribution, Communications Department, Bank of Canada, Ottawa, Ontario, Canada K1A 0G9.

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