BANK OF CANADA
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Monetary Policy Report

Summary

April 2008

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 22 April 2008.*

Overview

Growth in the global economy began to slow in the fourth quarter of 2007 and the first quarter of 2008. This reflected the effects of the slowdown in the U.S. economy and ongoing dislocations in global financial markets.

Growth in the Canadian economy has also moderated. Strong domestic demand has been largely offset by sharply reduced net exports. Both total and core CPI inflation were running at about 1.5 per cent at the end of the first quarter, but the underlying trend of inflation is judged to be about 2 per cent, consistent with an economy that was operating just above its production capacity.

The Bank is projecting a deeper and more protracted slowdown for the U.S. economy than in the January *Monetary Policy Report Update*. This projection reflects a more pronounced impact on consumer spending from the contraction in the U.S. housing market and significantly tighter credit conditions. While a housing-market correction of the size now under way in the United States would typically produce a severe slowdown in GDP growth, several factors are providing some offset. First, the recently legislated fiscal-stimulus package will support the U.S. economy in the third and fourth quarters. Second, the depreciation of the U.S. dollar will help spur exports. Third, substantial easing in U.S. monetary policy should continue to boost GDP growth in 2009 and beyond, particularly as financial market dislocations are worked out.

Highlights

- The U.S. economic slowdown is deeper and more protracted than previously anticipated.
- Slowing global economic growth and ongoing financial market turbulence will have direct consequences for the Canadian economy.
- Canadian GDP is projected to grow by 1.4 per cent in 2008, 2.4 per cent in 2009, and 3.3 per cent in 2010.
- Both core and total CPI inflation are projected to be slightly below 2 per cent in 2009 and to return to 2 per cent in 2010.
- The risks around the Bank's base-case projection for inflation appear balanced.
- Some further monetary stimulus will likely be required to achieve the inflation target.

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The deterioration in economic and financial conditions in the United States will have significant spillover effects globally, particularly in the industrial economies. Emerging-market economies should be less affected by the financial turbulence, and their growing domestic demand should help to offset the effect of weaker exports.

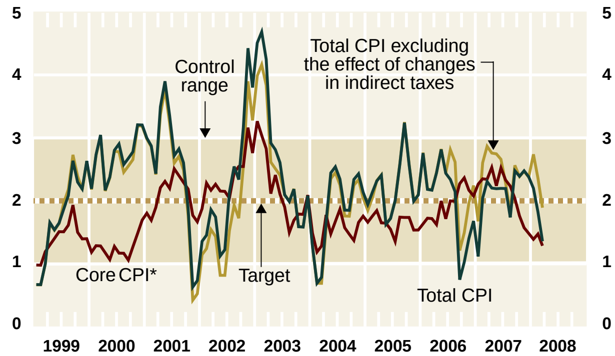
These global developments will have consequences for the Canadian economy. First, exports are projected to decline this year, exerting a significant drag on GDP growth through the first half, before picking up gradually in the second half of 2008 and in 2009. Second, turbulence in global financial markets will continue to make financing in capital markets more costly and difficult for Canadian businesses and banks. The increased bank funding spreads are expected to be further passed on to businesses and households, creating tighter credit conditions through the rest of 2008 that then begin to dissipate in 2009. Credit conditions are assumed to return to more normal levels in 2010. The relatively strong capitalization of Canadian financial institutions should mean that credit availability will remain more robust in Canada than in other major markets. Third, business and consumer sentiment in Canada is expected to soften somewhat.

Slowing U.S. domestic demand would be expected to place downward pressure on the prices of many commodities. This effect will, however, likely be offset to some extent by the combination of continued strong demand from commodity-intensive emerging-market economies and tight supply conditions in many commodity markets. Financial investors may also reinforce momentum in commodity prices at the margin. On balance, the prices of non-energy commodities are expected to ease over the projection period from their current very high levels.

Firm commodity prices, high employment levels, and the effect of cumulative

Consumer Price Index

Year-over-year percentage change



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

easing in monetary policy will continue to support Canada's domestic demand, which is expected to be the key source of economic growth over the projection period.

Overall, the Canadian economy is projected to move into excess supply in the second quarter of this year, and spare capacity will continue to increase through early 2009. A return to growth rates above that of potential output, supported by a gradual strengthening in the U.S. economy, accommodative monetary policy, and a return to more normal credit conditions bring the economy back into balance around mid-2010. In the Bank's base-case projection, average annual real GDP growth is projected to be 1.4 per cent in 2008, 2.4 per cent in 2009, and 3.3 per cent in 2010.

The recent price-level adjustments for automobiles and the effect of past changes in indirect taxes will keep measured inflation below target through 2008. The emergence of excess supply in the economy should keep downward pressure on inflation through 2009. Both core and total inflation are projected to move up to 2 per cent in 2010, as the economy moves back into balance.

The risks around the projection for the U.S. and global economies, as well as for inflation in Canada, appear to be balanced. Still, there are a number of upside and downside risks around the Bank's new base-case projection for inflation in Canada.

On the upside, stronger domestic demand than incorporated in the base-case projection, possibly due to higher commodity prices, could lead to higher inflation in Canada, especially if the growth in potential output is lower than assumed. As well, global inflationary pressures could spill over to Canada through higher import costs.

On the downside, the projected weakness in the United States and other industrialized economies could put greater downward pressure on commodity prices. There are risks from the evolution of financial market dislocations and their effect on the cost and availability of credit. There could also be greater direct downward pressure on the prices of core goods related to the past appreciation of the Canadian dollar.

Against this backdrop, the Bank of Canada lowered its target for the overnight rate by 50 basis points on both 4 March and 22 April, bringing it to 3 per cent. In line with the new outlook, some further monetary stimulus will likely be required to achieve the inflation target over the medium term. Given the cumulative reduction of 150 basis points in the target for the overnight rate since December, the timing of any further monetary stimulus will depend on the evolution of the global economy and domestic demand, and their impact on inflation in Canada.

Recent Developments

Economic growth in Canada slowed in the fourth quarter of 2007 as the drag exerted by net exports intensified. Real GDP grew at an annual rate of 0.8 per cent in the fourth quarter, below the 1.5 per cent projected in the January *Update*. Both the slowdown in the U.S. economy and the past appreciation of the Canadian dollar led to a reduction in export volumes. At the same time, imports grew strongly, in response to robust domestic demand and the past appreciation of the currency. Available data suggest that GDP growth will be about 1 per cent in the first quarter of 2008, with reductions in inventory investment and net exports offsetting most of the growth in domestic demand.

While some labour market and wage indicators point to pressures on production capacity, other indicators suggest that capacity pressures have eased since the third quarter of 2007, including the Bank's conventional measure of the output gap and responses to the Bank's spring *Business Outlook Survey*. Overall, the Governing Council judges that the economy was operating just above its production capacity in the first quarter of 2008 and will move into excess supply in the second quarter.

Inflation pressures seen elsewhere in the world have been less evident in Canada. Total consumer price inflation, on a year-over-year basis, averaged 1.8 per cent in the first quarter of 2008, down from 2.4 per cent in the fourth quarter of 2007. However, this decrease was mainly due to the reduction in the Goods and Services Tax that took place in January. Owing to competitive pressures on automobile prices associated with the rise of the Canadian dollar to near parity with the U.S. currency, the core rate of inflation has moved down to average 1.4 per cent in the first quarter. In contrast, the pace of increase in the prices of some core services has remained high, given ongoing strength in domestic demand. The underlying trend of inflation is judged to be about 2 per cent.

Prospects for Growth and Inflation

Global economic growth is projected to slow considerably to 3.7 per cent in 2008 and 3.5 per cent in 2009, before moving back close to the growth rate of potential output in 2010. This largely reflects a weaker outlook for growth in the U.S. economy owing to the impact of the pronounced slowdown in housing and the increased spreads and decreased availability of credit. Several factors, however, should work to stimulate demand in the United States, including the considerable easing in monetary policy and the cumulative effect of the depreciation in the real effective U.S. exchange rate. Real GDP growth in the United States is projected to be 1.0 per cent on an average annual basis in 2008, rising gradually to 1.7 per cent in 2009, and 3.4 per cent in 2010.

Growth in China and the newly industrialized Asian economies should remain strong, but will likely moderate over the projection horizon.

The prices of non-energy commodities are expected to ease by about 15 per cent by the end of 2010, owing to the combination of new supplies and slowing global demand. Energy commodity prices are assumed to decline by about 10 per cent over the projection period, consistent with prices in futures markets.

The weaker outlook for the U.S. economy and the further tightening in global credit conditions seen since the *Update* have direct consequences for the Canadian economy. The outlook for Canadian exports has been revised down, particularly for 2008, and the tightening in domestic credit conditions is expected to moderate growth in domestic demand through the end of next year. Nonetheless, domestic demand is still projected to be the main source of economic growth. In particular, consumer spending is expected to remain strong, supported by continued growth in incomes and household net worth, together with the reduction in policy interest rates. Growth in business investment is expected to ease somewhat over the projection horizon, reflecting the more subdued outlook for the U.S. and global economies.

Real quarterly GDP growth averages about 1/2 per cent at annual rates in the first half of this year, moving up to 1.8 per cent in the second half, 3 per cent in 2009, and 3.4 per cent in 2010. The economy moves into excess supply in the second quarter of 2008, and spare capacity continues to increase

Summary of the Base-Case Projection*

	2007	2008			2009		2010
	Q4	Q1	Q2	H2	H1	H2	
Real GDP (quarterly growth or average quarterly growth at annual rates)**	**0.8** (1.5)	**1.0** (0.6)	**0.3** (2.0)	**1.8** (2.3)	**2.7** (3.1)	**3.3** (3.2)	**3.4**
Real GDP (year-over-year percentage change)	**2.9** (2.9)	**2.1** (2.2)	**1.3** (1.7)	**1.1** (1.7)	**1.9** (2.5)	**2.8** (3.1)	**3.3**
Core inflation (year-over-year percentage change)	**1.6** (1.6)	**1.4** (1.4)	**1.3** (1.3)	**1.5** (1.6)	**1.7** (1.9)	**1.8** (2.0)	**2.0**
Total CPI (year-over-year percentage change)	**2.4** (2.4)	**1.8** (1.7)	**1.7** (1.4)	**1.9** (1.5)	**1.8** (1.9)	**1.8** (2.0)	**2.0**
WTI *** (level)	**91** (91)	**98** (93)	**111** (92)	**109** (90)	**106** (89)	**104** (87)	**102**

* Figures in parentheses are from the January *Monetary Policy Report Update*.
** For half and full years, the number reported is the average of the respective quarter-to-quarter percentage growth at annual rates.
*** Assumption for the price of West Texas Intermediate crude oil (US$ per barrel), based on an average of futures contracts over the 10 days ending 18 April 2008.

through early 2009. The economy returns to balance around mid-2010.

The core rate of inflation is projected to remain at about 1.3 per cent through the third quarter of 2008, with recent price-level adjustments for automobiles and the emergence of excess supply in the economy keeping downward pressure on inflation. As the economy returns to full capacity, core inflation is projected to rise to 2 per cent in 2010.

Total CPI inflation will continue to be affected by the evolution of energy prices, which have risen substantially since the *Update*, and the one-time effect of the latest reduction in the GST. Total inflation is projected to stay just below the 2 per cent target for most of the projection period and to return to 2 per cent in 2010.

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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