BANK OF CANADA
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Monetary Policy Report Summary

January 2011

This text is a commentary of the Governing Council of the Bank of Canada. It presents the Bank's outlook based on data received up to 14 January 2011.

Highlights

- The global recovery is proceeding at a somewhat faster pace than previously anticipated.
- The Canadian economy is in a period of more modest growth, and the expected rebalancing of demand is beginning. Real GDP is projected to grow by 2.4 per cent in 2011 and 2.8 per cent in 2012.
- The Canadian economy is expected to return to full capacity and inflation to the 2 per cent target by the end of 2012.
- On 18 January 2011, the Bank maintained the target for the overnight rate at 1 per cent.
- The Bank judges that the risks to the inflation outlook are roughly balanced.

The global economic recovery is proceeding at a somewhat faster pace than the Bank had anticipated, although risks remain elevated. Private domestic demand in the United States has picked up and will be reinforced by recently announced monetary and fiscal stimulus. European growth has also been slightly stronger than anticipated. Ongoing challenges associated with sovereign and bank balance sheets will limit the pace of the European recovery and are a significant source of uncertainty to the global outlook. In response to overheating, some emerging markets have begun to implement more restrictive policy measures. Their effectiveness will influence the path of commodity prices, which have increased significantly since the October *Monetary Policy Report* (MPR), largely reflecting stronger global growth.

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 contribution of government spending is expected to wind down this year, consistent with announced fiscal plans. Stretched household balance sheets are expected to restrain the pace of consumption growth and residential investment. In contrast, business investment will likely continue to rebound strongly, owing to stimulative financial conditions and competitive imperatives. Net exports are projected to contribute more to growth going forward, supported by stronger U.S. activity and global demand for commodities. However, the 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.

Overall, the Bank projects the economy will expand by 2.4 per cent in 2011 and 2.8 per cent in 2012—a slightly firmer profile than had been anticipated in October. With a little more excess supply in the near term, the Bank continues to expect that the economy will return to full capacity by the end of 2012.

Underlying pressures affecting prices remain subdued, reflecting the considerable slack in the

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Canadian economy. Core inflation is projected to edge gradually up to 2 per cent by the end of 2012, as excess supply in the economy is slowly absorbed. Inflation expectations remain well anchored. Total CPI inflation is being boosted temporarily by the effects of provincial indirect taxes, but is expected to converge to the 2 per cent target by the end of 2012.

Despite improvements in the outlook for the global and Canadian economies, risks to inflation remain elevated. There are two main upside risks to inflation, relating to higher commodity prices and the possibility of greater-than-projected momentum in the Canadian household sector.

There are two main downside risks to inflation, relating to Canadian competitiveness and the possibility of weaker-than-projected household expenditures in Canada.

In addition, challenges in Europe continue to be a significant source of uncertainty for the global outlook. A comprehensive solution to the sovereign debt

Projection for global economic growth

	Share of real global GDP[a] (per cent)	Projected growth (per cent)[b]		
		2010	2011	2012
United States	20	2.9 *(2.7)*	3.3 *(2.3)*	3.2 *(3.3)*
Euro area	15	1.7 *(1.7)*	1.5 *(1.1)*	1.5 *(1.7)*
Japan[c]	6	4.3 *(2.9)*	1.4 *(1.3)*	2.1 *(2.3)*
China	13	10.4 *(10.3)*	9.3 *(9.0)*	8.8 *(8.9)*
Rest of the world	46	5.7 *(5.2)*	4.0 *(3.6)*	3.8 *(3.5)*
World	**100**	**5.0 *(4.7)***	**4.0 *(3.5)***	**3.9 *(3.8)***

a. GDP shares are based on IMF estimates of the purchasing-power-parity (PPP) valuation of country GDPs for 2009.

Source: IMF, WEO, October 2010

b. Numbers in parentheses are projections used for the October 2010 *Monetary Policy Report*.

c. Real GDP growth in Japan in 2010 was higher than was expected in the October *Report*, reflecting historical revisions to the national accounts data and stronger-than-projected growth in the third quarter.

Source: Bank of Canada

Summary of the base-case projection for Canada[a]

	2009	2010				2011				2012			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (quarter-over-quarter percentage change at annual rates)	4.9 *(4.9)*	5.6 *(5.8)*	2.3 *(2.0)*	1.0 *(1.6)*	2.3 *(2.6)*	2.5 *(2.6)*	2.8 *(2.3)*	3.0 *(2.3)*	3.0 *(2.6)*	2.9 *(2.7)*	2.6 *(2.8)*	2.5 *(2.8)*	2.5 *(2.8)*
Real GDP (year-over-year percentage change)	-1.1 *(-1.1)*	2.1 *(2.2)*	3.4 *(3.4)*	3.4 *(3.6)*	2.8 *(3.0)*	2.0 *(2.2)*	2.2 *(2.3)*	2.6 *(2.4)*	2.8 *(2.4)*	2.9 *(2.5)*	2.9 *(2.6)*	2.7 *(2.7)*	2.6 *(2.8)*
Core inflation (year-over-year percentage change)	1.6 *(1.6)*	2.0 *(2.0)*	1.8 *(1.8)*	1.5 *(1.6)*	1.6 *(1.6)*	1.4 *(1.5)*	1.5 *(1.6)*	1.6 *(1.7)*	1.7 *(1.7)*	1.8 *(1.8)*	1.9 *(1.9)*	1.9 *(1.9)*	2.0 *(2.0)*
Total CPI (year-over-year percentage change)	0.8 *(0.8)*	1.6 *(1.6)*	1.4 *(1.4)*	1.8 *(1.8)*	2.3 *(2.1)*	2.2 *(2.0)*	2.3 *(2.2)*	1.9 *(1.8)*	2.0 *(1.9)*	1.8 *(1.8)*	1.9 *(1.9)*	1.9 *(1.9)*	2.0 *(2.0)*
Total CPI excluding the effect of the HST and changes in other indirect taxes (year-over-year percentage change)	0.8 *(0.8)*	1.6 *(1.6)*	1.4 *(1.4)*	1.3 *(1.3)*	1.9 *(1.7)*	1.7 *(1.5)*	1.8 *(1.7)*	1.9 *(1.8)*	1.9 *(1.8)*	1.8 *(1.8)*	1.9 *(1.9)*	1.9 *(1.9)*	2.0 *(2.0)*
WTI[b] (level)	76 *(76)*	79 *(79)*	78 *(78)*	76 *(76)*	85 *(82)*	91 *(84)*	93 *(86)*	95 *(87)*	95 *(87)*	95 *(88)*	95 *(88)*	95 *(88)*	95 *(89)*

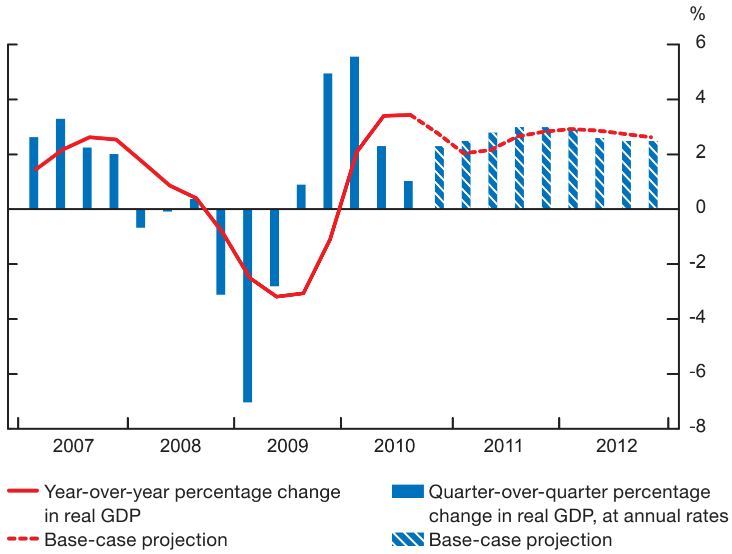
a. Figures in parentheses are from the base-case projection in the October *Monetary Policy Report*.

b. Assumptions for the price of West Texas Intermediate crude oil (US$ per barrel), based on an average of futures contracts over the two weeks ending 14 January 2011 and financial stability issues in a number of countries will be required.

The Bank judges that the risks to the inflation outlook are roughly balanced over the projection horizon.

Reflecting all of these factors, on 18 January 2011 the Bank decided to maintain the target for the overnight rate at 1 per cent. The Bank Rate is correspondingly 1 1/4 per cent and the deposit rate is 3/4 per cent. This leaves considerable monetary stimulus in place, consistent with achieving the 2 per cent inflation target in an environment of significant excess supply in Canada. Any further reduction in monetary policy stimulus would need to be carefully considered.

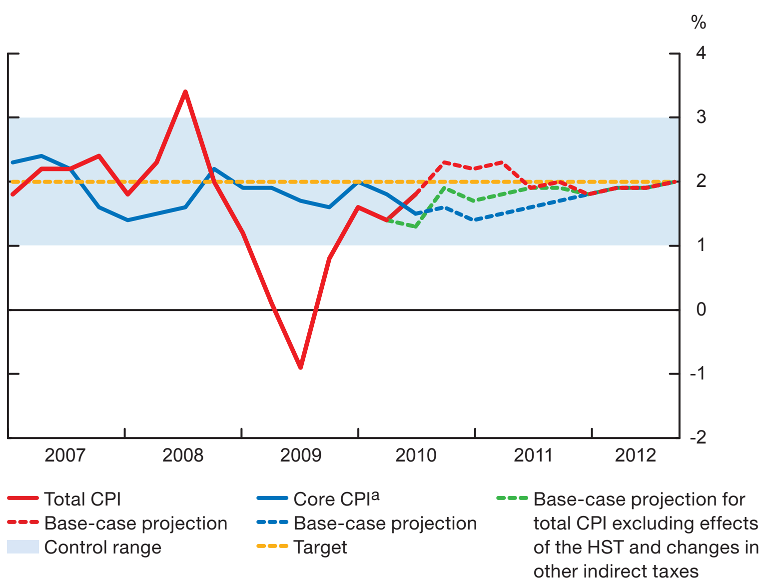
Real GDP is expected to grow at a rate consistent with the gradual absorption of excess supply



Sources: Statistics Canada and Bank of Canada projections

Total CPI and core inflation in Canada are projected to converge to 2 per cent over the projection horizon

Year-over-year percentage change, quarterly data



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

Sources: Statistics Canada and Bank of Canada calculations and projections

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