

Monetary Policy Report Summary

July 2012

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 13 July 2012.

Global growth prospects have weakened since April. While the economic expansion in the United States continues at a gradual but somewhat slower pace, developments in Europe point to a renewed contraction. In China and other emerging economies, the deceleration in growth has been greater than anticipated, reflecting past policy tightening and weaker external demand. This slowdown in global activity has led to a sizable reduction in commodity prices, although they remain elevated. The combination of increasing global excess capacity over the projection horizon and reduced commodity prices is expected to moderate global inflationary pressures. Global financial conditions have also deteriorated since April, with periods of considerable volatility. The Bank's base-case projection assumes that the European crisis will continue to be contained, although this assumption is subject to downside risks.

While global headwinds are restraining Canadian economic activity, domestic factors are expected to support moderate growth in Canada. The Bank expects the economy to grow at a pace roughly in line with its production potential in the near term, before picking up through 2013. Consumption and business investment are expected to be the primary drivers of growth, reflecting very stimulative domestic financial conditions. However, their pace will be influenced by external headwinds, notably the effects of lower commodity prices on Canadian incomes and wealth, as well as by record-high household debt. Housing activity is expected to slow from record levels. Government spending is not projected to contribute to growth in 2012 and to contribute only modestly thereafter, in line with plans to consolidate spending by federal and provincial governments. Canadian exports are projected to remain below their pre-recession peak until the beginning of 2014, reflecting the dynamics of foreign demand and ongoing competitiveness challenges, including the persistent strength of the Canadian dollar.

Highlights

- Global growth prospects have weakened since April.
- The Canadian economy is expected to grow at a pace roughly in line with its production potential in the near term, before picking up through 2013.
- The Bank projects that the economy will grow by 2.1 per cent in 2012, 2.3 per cent in 2013 and 2.5 per cent in 2014. The economy is expected to reach full capacity in the second half of 2013.
- Core inflation is forecast to remain around 2 per cent over the projection horizon, while total CPI inflation is expected to remain noticeably below the 2 per cent target over the coming year before returning to target around mid-2013.
- On 5 June and 17 July, the Bank maintained the target for the overnight rate at 1 per cent.

The Bank projects that the economy will grow by 2.1 per cent in 2012, 2.3 per cent in 2013 and 2.5 per cent in 2014. The economy is expected to reach full capacity in the second half of 2013, thus operating with a small amount of slack for somewhat longer than previously anticipated.

Core inflation is forecast to remain around 2 per cent over the projection horizon as the economy operates near its production potential, growth in labour compensation stays moderate and inflation expectations remain well anchored. Given the recent drop in gasoline prices and with futures prices suggesting persistently lower

oil prices, the Bank expects total CPI inflation to remain noticeably below the 2 per cent target over the coming year before returning to target around mid-2013.

The inflation outlook in Canada is subject to significant risks.

The three main upside risks to inflation in Canada relate to the possibility of higher global inflationary pressures, stronger Canadian exports and stronger momentum in Canadian household spending.

The three main downside risks to inflation in Canada relate to the European crisis, weaker global momentum and the possibility that growth in Canadian household spending could be weaker.

Overall, the Bank judges that the risks to the inflation outlook in Canada are roughly balanced over the projection period.

Projection for global economic growth

	Share of real global GDP ^a (per cent)	Projected growth ^b (per cent)			
		2011	2012	2013	2014
United States	19	1.7 (1.7)	1.9 (2.3)	2.1 (2.5)	3.0 (3.6)
Euro area	14	1.5 (1.5)	-0.6 (-0.6)	0.3 (0.8)	1.3 (1.4)
Japan	6	-0.7 (-0.7)	2.5 (1.9)	1.3 (1.6)	0.9 (1.6)
China	14	9.3 (9.2)	7.8 (8.1)	7.8 (8.0)	7.8 (8.0)
Rest of the world	47	4.3 (4.3)	3.2 (3.4)	3.2 (3.5)	3.3 (3.7)
World	100	3.8 (3.8)	3.1 (3.2)	3.1 (3.4)	3.5 (3.8)

a. GDP shares are based on International Monetary Fund (IMF) estimates of the purchasing-power-parity (PPP) valuation of country GDPs for 2011. Source: IMF, *World Economic Outlook*, April 2012

b. Numbers in parentheses are projections used for the April 2012 *Monetary Policy Report*.

Source: Bank of Canada

Summary of the base-case projection for Canada^a

	2011	2012				2013				2014			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (quarter-over-quarter percentage change at annual rates)	1.9 (1.8)	1.9 (2.5)	1.8 (2.5)	2.0 (2.4)	2.3 (2.5)	2.3 (2.5)	2.4 (2.2)	2.6 (2.3)	2.7 (2.2)	2.5 (2.2)	2.3 (2.2)	2.2 (2.2)	2.2 (2.2)
Real GDP (year-over-year percentage change)	2.2 (2.2)	1.8 (2.0)	2.5 (2.7)	1.9 (2.3)	2.0 (2.5)	2.1 (2.5)	2.3 (2.4)	2.4 (2.4)	2.5 (2.3)	2.6 (2.2)	2.6 (2.2)	2.4 (2.2)	2.3 (2.2)
Core inflation (year-over-year percentage change)	2.1 (2.1)	2.1 (2.1)	2.0 (1.9)	1.9 (1.8)	1.9 (1.8)	1.9 (1.8)	2.0 (2.1)	2.0 (2.1)	2.1 (2.1)	2.1 (2.1)	2.0 (2.0)	2.0 (2.0)	2.0 (2.0)
Total CPI (year-over-year percentage change)	2.6 (2.6)	2.4 (2.4)	1.7 (2.0)	1.2 (2.2)	1.6 (2.2)	1.5 (2.1)	1.5 (1.9)	2.0 (1.9)	2.0 (1.9)	2.0 (1.9)	2.0 (2.0)	2.0 (2.0)	2.0 (2.0)
Total CPI excluding the effect of the HST and changes in other indirect taxes (year-over-year percentage change)	2.5 (2.5)	2.2 (2.3)	1.6 (1.9)	1.1 (2.1)	1.5 (2.1)	1.5 (2.1)	1.6 (2.0)	2.1 (2.0)	2.1 (2.0)	2.1 (2.0)	2.0 (2.0)	2.0 (2.0)	2.0 (2.0)
WTI ^b (level)	94 (94)	103 (103)	93 (103)	86 (104)	87 (105)	88 (105)	89 (105)	89 (104)	89 (103)	88 (102)	88 (101)	87 (99)	87 (99)
Brent ^b (level)	109 (109)	118 (118)	109 (122)	100 (121)	99 (119)	98 (117)	98 (115)	98 (113)	97 (112)	96 (110)	96 (108)	95 (106)	94 (104)

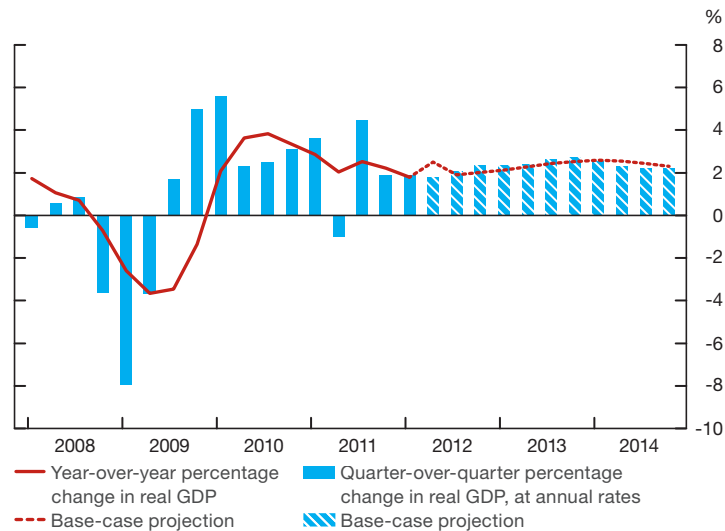
a. Figures in parentheses are from the base-case projection in the April 2012 *Monetary Policy Report*.

b. Assumptions for the prices of West Texas Intermediate and Brent crude oil (US\$ per barrel), based on an average of futures contracts over the two weeks ending 13 July 2012

Reflecting all of these factors, on 17 July, the Bank decided to maintain the target for the overnight rate at 1 per cent. To the extent that the economic expansion continues and the current excess supply in the economy is gradually absorbed, some modest withdrawal of the present considerable monetary policy stimulus may

become appropriate, consistent with achieving the 2 per cent inflation target over the medium term. The timing and degree of any such withdrawal will be weighed carefully against domestic and global economic developments.

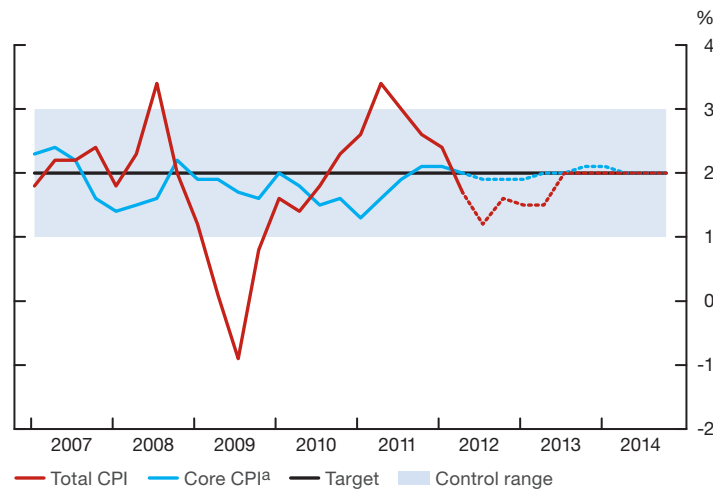
Real GDP is expected to grow at a moderate pace



Sources: Statistics Canada and Bank of Canada calculations and projections

Core CPI inflation is expected to be steady, while total CPI inflation in Canada is projected to remain noticeably below 2 per cent over the coming year

Year-over-year percentage change, quarterly data



Note: Dotted lines indicate projections.

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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