BANK OF CANADA
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Monetary Policy Report Update

January 2007

This text is a commentary of the Governing Council of the Bank of Canada. It presents the Bank's updated outlook based on information received up to 16 January 2007.

Overview

The global economy has continued to expand robustly. However, U.S. economic growth slowed in 2006, with the weakness concentrated in the automotive and housing sectors. This weakness does not appear to have spread to the rest of the U.S. economy and, with signs that a significant amount of the adjustment in these sectors has already taken place, U.S. economic growth is expected to pick up.

With reduced demand for Canadian exports and the need to adjust inventories, output growth in Canada decelerated more than had been expected in the October *Report*, likely averaging about 1.6 per cent in the second half of last year. The Bank judges that at the end of 2006, the Canadian economy was operating at, or just above, its production capacity.

Looking ahead, real GDP growth should average about 2 1/2 per cent in the first half of 2007, rising to about 2 3/4 per cent in the second half. In 2008, growth is projected to stay in line with the growth of potential output (estimated at 2.8 per cent), keeping the economy operating near its capacity throughout the projection period. With the weakness seen in the second half of 2006, this growth profile implies average annual growth of 2.3 per cent in 2007 and 2.8 per cent in 2008.

Total consumer price inflation will continue to be affected by movements in energy prices and, during the first half of 2007, by last year's reduction in the Goods and Services

Highlights

- The Canadian economy is judged to have been operating at, or just above, its production capacity at the end of 2006, following weaker-than-expected growth in the second half of the year.
- The Bank projects that the Canadian economy should continue to operate near its production capacity throughout 2007 and 2008.
- Total CPI inflation should average just above 1 per cent in the first half of 2007, returning to the 2 per cent target in 2008, while core inflation should return to 2 per cent in the first half of 2007 and remain there.
- Risks to the Bank's inflation projection continue to be roughly balanced but have diminished somewhat since the October *Report*.
- The current level of the policy interest rate is judged, at this time, to be consistent with achieving the inflation target.

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Tax (GST). If energy prices unfold in line with current futures prices, total CPI inflation should fall to about 1 per cent in the first half of 2007, returning to the 2 per cent target early in 2008. With the economy operating near its production potential, and with slightly less upward pressure from housing prices, core inflation should return to 2 per cent in the first half of 2007 and stay there throughout the projection period.

The Bank judges that the risks to its inflation projection are roughly balanced. The main downside risk continues to be that growth in the U.S. economy could be lower than expected. The main upside risk comes from rising house prices and increased spending related to borrowing against home equity. Both these upside and downside risks have diminished somewhat since the October *Report*.

There remains a small possibility of a disorderly resolution of global imbalances, in the absence of further appropriate policy actions internationally.

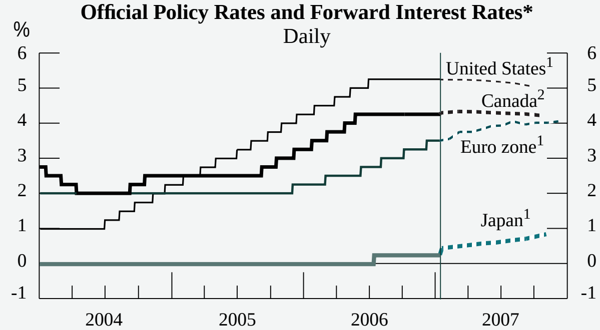
There also continues to be considerable uncertainty about Canadian trend productivity growth. Recent productivity data have been weak, and it is unclear how much of that weakness is due to cyclical factors.

The Bank of Canada left the target rate for the overnight rate unchanged at 4.25 per cent on 5 December 2006 and 16 January 2007 (Chart 1). In line with the Bank's outlook, the current level of the policy rate is judged, at this time, to be consistent with achieving the 2 per cent inflation target over the medium term.

Chart 1

Official Policy Rates and Forward Interest Rates*

Daily



* Solid lines are official interest rates, and dotted lines are forward overnight interest rates. No adjustments are made for term premiums.

1. Foreign forward overnight rates based on the implied forward rate derived from the overnight index swap market or federal funds futures for the respective country.
2. Canadian forward overnight rates based on yields on bankers' acceptances (BAs) and three-month futures for bankers' acceptances (BAX)

Recent Economic and Financial Developments

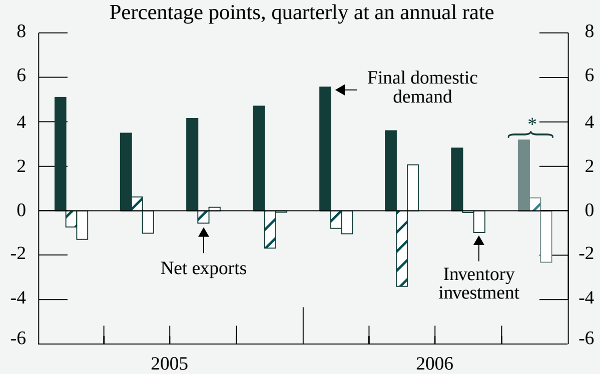
Global Developments

Since the October *Report*, the global economic expansion has remained robust. Economic growth in the euro area over the past few months has been slightly stronger than projected, and growth in China continues to outperform expectations. In Japan, business investment and exports remain vigorous despite relatively weak household consumption. The stronger overseas demand, particularly in business investment, along with a modest real effective depreciation of the U.S. dollar over the past year and a half, continues to support U.S. exports and is consistent with the Bank's assumption of an orderly resolution of global imbalances.

With this continuing strength in global demand, commodity prices have remained high since the October *Report*. Oil and natural gas prices have recently eased, however, owing to warmer-than-usual temperatures in North America.

After a strong start to 2006, real GDP growth in the United States moderated. This mainly reflected a substantial downturn in residential investment and reduced motor vehicle production. More broadly, the need to adjust inventory levels is also dampening manufacturing production, and business investment is somewhat less buoyant than previously expected. But adjustments in the housing and auto sectors have not led to significant spillover effects in the rest of the U.S. economy. Household consumption has remained firm, supported by steady employment gains in the services sector.

Chart 2
Contribution to Real GDP Growth
Percentage points, quarterly at an annual rate



* These are projections for the fourth quarter of 2006.

Canadian Economic Activity

With the slower growth in the U.S. economy, output growth in Canada has also decelerated. In the third quarter, real GDP grew at an annual rate of 1.7 per cent. While this was slightly less than projected in our October *Report*, the level of real GDP in the third quarter was as anticipated because of an upward revision to growth in the first quarter. Based on available information, real GDP is likely to have grown by about 1.5 per cent in the fourth quarter of 2006, weaker than the 2.8 per cent rate projected in the October *Report*.

This slowdown in growth in the second half of 2006 was largely due to reduced U.S. demand for building materials and motor vehicles—which has adversely affected Canada's exports—and to the need for Canadian businesses to adjust inventories. This inventory adjustment appears to have been related largely, but not entirely, to weaker U.S. demand for Canadian goods.

Final domestic demand remains the key contributor to growth in Canada (Chart 2). Strength in labour markets and real personal disposable income, together with increases in household net worth and household credit, has continued to support solid growth in consumer spending.

Estimated Pressures on Capacity

After reviewing all the indicators of capacity pressures, it is the Governing Council's judgment that the economy was operating at, or just above, its production capacity in the fourth quarter of 2006.

A number of indicators suggest that the economy was operating above its production capacity. In the Bank's winter *Business Outlook Survey*, the percentage of companies reporting that they would have difficulties in meeting an unanticipated increase in demand was still above average (Chart 3). The Bank's conventional measure of the output gap suggests that the economy was operating just above its production potential in the fourth quarter.[1] The employment-to-population ratio remained very high in December compared with historical experience, and the unemployment rate was at a 30-year low. The core rate of inflation has been slightly above 2 per cent in recent months.

On the other hand, the underlying trend increase in wages (based on average hourly earnings of permanent workers) has eased to a range of 2 1/2 to 3 1/2 per cent in recent months, after moving up earlier in 2006. As well, the percentage of firms reporting labour shortages in the Bank's winter survey was slightly below average.

Inflation and the 2 Per Cent Target

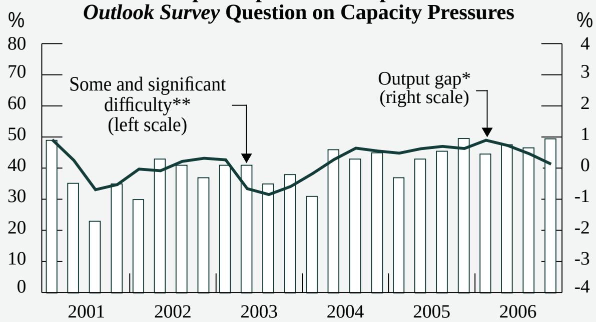
In recent months, total CPI inflation has been slightly lower than projected in the October *Report*. The 12-month rate of increase in the total CPI fell to just below 1 per cent in September and October 2006 (Chart 4).[2] This mainly reflected anticipated base-year effects associated with the hurricane-related

1. The conventional estimates of production capacity in recent years have been revised down slightly, partly because of the impact of weak observed labour productivity growth on the estimate of trend growth in labour productivity.

2. Recall that the July 2006 reduction in the GST lowers total CPI inflation by about one-half of a percentage point for a year.

Chart 3

Estimated Output Gap and the Response to *Business Outlook Survey* Question on Capacity Pressures



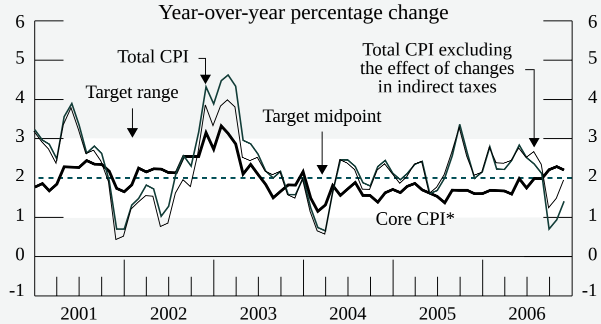
* Difference between actual output and estimated potential output based on the Bank's conventional measure. The estimate for the fourth quarter of 2006 is based on a projected rise in output of 1.5 per cent (at annual rates).

** Percentage of firms indicating that they would have either some or significant difficulty meeting an unanticipated increase in demand/sales

Chart 4

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

surge in energy prices in September of 2005, and unanticipated declines in the prices of gasoline and natural gas. Total CPI inflation moved up to 1.4 per cent in November as the base-year effects dissipated.

From September to November of 2006, the core rate of inflation averaged about 2.2 per cent, up from 2 per cent in July and August. This increase was largely because core prices for shelter and other services rose at a slightly faster rate, although more recently there are some indications of a moderation in the rate of increase in housing prices. Decreases in the prices of many import-intensive goods continued to put downward pressure on core inflation.

The four-quarter change in the chain price index for GDP eased from 3.0 per cent in the second quarter of 2006 to 1.4 per cent in the third quarter, reflecting a further reduction in Canada's terms of trade. This caused further moderation in the year-to-year increase in nominal GDP.

Financial Markets and Credit Conditions

Long-term interest rates, market volatility, and credit spreads have remained low in most countries. In addition, many equity indexes have recently recorded either multi-year or all-time highs.

Against this backdrop, financing conditions in Canada remain favourable. Financial institutions and markets continue to be willing to lend, since business profitability and overall financial health remain strong. Growth of business credit is near its historical average, and the modest decline experienced since early 2006 likely reflects a slight moderation in demand rather than a tightening in the supply of credit. The pace of growth in household credit remains well above its historical average, although it has declined somewhat since the last *Report*. This strong growth has been partly associated with borrowing against home equity. Growth rates of the narrow and broad monetary aggregates have continued to increase.

Over the past three months, the Canadian dollar has moved from a high of 89.5 cents U.S. to a low of close to 84.5 cents U.S. This reflects a number of factors, including the recent weakness in energy prices and an unwinding of support from cross-border currency flows related to mergers and acquisitions.

The Economic Outlook

The Bank's base-case projection incorporates the following key assumptions: energy prices evolving in line with current futures prices, a gradual real effective depreciation of the U.S. dollar, and a

Canada / U.S. exchange rate in the range of 84.5 to 87.5 cents U.S., evident since the December interest rate announcement.

The robust expansion of the global economy is still expected to decelerate to a more sustainable rate over 2007–08. As in the October *Report*, global economic growth is projected to ease from 5.1 per cent in 2006 to 4.7 per cent in 2007, and to 4.5 per cent in 2008.

In the base-case scenario for the U.S. economy, real GDP growth is expected to recover to the rate of growth in potential output in the second half of 2007 before moving slightly above potential growth through 2008. On an annual basis, growth is projected to be 2.5 per cent in 2007 and 3.2 per cent in 2008 (very close to the projection in the October *Report*).

Futures prices for crude oil and natural gas are lower than those in the October *Report*, with prices for crude oil moving up from current levels of about US$53 per barrel to about US$59 on average in 2007 and about US$63 in 2008. The price index for non-energy commodities is still expected to decrease modestly over the projection period from the very high levels reached towards the end of 2006.

In the Bank's base-case projection for Canada, economic growth picks up through 2007, with quarterly growth averaging about 2 1/2 per cent at annual rates in the first half of the year and about 2 3/4 per cent in the second half. Together with the weaker growth experienced in the second half of 2006, this implies annual average growth for 2007 of 2.3 per cent. For 2008, growth is projected to continue at a pace of 2.8 per cent, in line with the growth of potential output. This implies that the economy would continue to operate near its production capacity throughout the entire projection period.

Strong domestic demand in Canada continues to be a key feature of the base-case projection (Table 1).

However, Canadian export growth is expected to remain weak in the near term, recovering gradually through 2007 and 2008. At the same time, pronounced gains in investment in machinery and equipment should boost imports further. Consequently, net exports should continue to exert a considerable drag on overall growth in 2007, with this effect diminishing over the projection period.

Table 1
Contributions to Average Annual Real GDP Growth[a]
Percentage points

	2006	2007	2008
Consumption	2.2 *(2.2)*	1.7 *(1.8)*	1.7 *(1.7)*
Housing	0.2 *(0.2)*	-0.1 *(-0.1)*	-0.1 *(-0.1)*
Government	0.8 *(0.8)*	0.7 *(0.8)*	0.7 *(0.7)*
Business fixed investment	0.9 *(1.0)*	0.7 *(0.7)*	0.5 *(0.5)*
Subtotal: Final domestic demand	4.1 *(4.2)*	3.0 *(3.2)*	2.8 *(2.8)*
Exports	0.4 *(0.6)*	0.5 *(0.7)*	1.1 *(1.1)*
Imports	-1.6 *(-1.9)*	-1.3 *(-1.4)*	-1.1 *(-1.1)*
Subtotal: Net exports	-1.2 *(-1.3)*	-0.8 *(-0.7)*	0 *(0)*
Inventories	-0.2 *(-0.1)*	0.1 *(0)*	0 *(0)*
GDP	2.7 *(2.8)*	2.3 *(2.5)*	2.8 *(2.8)*

a. Figures in parentheses are from the base case presented in the October *Report*.

The inventory adjustment evident in the second half of 2006 is expected to be largely completed early in 2007 and, therefore, would no longer subtract from growth.

The projection for core inflation is little changed from that in the October *Report*. With the economy expected to remain close to its production potential and with easing housing price pressures, core inflation is expected to return to 2 per cent in the first half of 2007 and remain there throughout the projection period.

In 2007, movements in the 12-month rate of increase in the total CPI will be importantly influenced by the GST cut in July 2006 and by developments in the markets for crude oil, gasoline, and natural gas. Total CPI inflation is expected to average just above 1 per cent in the first half of 2007, before returning to the 2 per cent target by early 2008 (Table 2).

The current level of the policy rate is consistent with achieving the 2 per cent inflation target in this base-case projection.

Table 2
Summary of the Base-Case Projection[a]

	2006		2007			2008
	Q3	Q4	Q1	Q2	H2	
Real GDP (quarter-to-quarter percentage change at annual rates)[b]	**1.7** *(2.0)*	**1.5** *(2.8)*	**2.4** *(2.4)*	**2.6** *(2.5)*	**2.8** *(2.7)*	**2.9** *(2.8)*
Real GDP (year-over-year percentage change)	**2.5** *(2.5)*	**2.3** *(2.6)*	**1.9** *(2.3)*	**2.1** *(2.4)*	**2.5** *(2.6)*	**2.8** *(2.8)*
Core inflation (year-over-year percentage change)	**2.1** *(2.0)*	**2.2** *(2.1)*	**2.1** *(2.2)*	**2.0** *(2.2)*	**2.0** *(2.0)*	**2.0** *(2.0)*
Total CPI (year-over-year percentage change)	**1.7** *(1.7)*	**1.3** *(1.5)*	**1.2** *(1.4)*	**1.0** *(1.4)*	**1.7** *(2.0)*	**2.0** *(2.0)*
Total CPI excluding the effect of changes in indirect taxes (year-over-year percentage change)	**2.2** *(2.2)*	**1.8** *(2.0)*	**1.7** *(1.9)*	**1.5** *(1.9)*	**1.7** *(2.0)*	**2.0** *(2.0)*
WTI[c] (level)	**71** *(71)*	**60** *(60)*	**56** *(63)*	**58** *(65)*	**61** *(66)*	**63** *(67)*

a. Figures in parentheses are from the October *Monetary Policy Report*.
b. For half and full years, the number reported is the average of the respective quarter-to-quarter percentage growth at annual rates.
c. 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 12 January 2007.

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