BANK OF CANADA
BANQUE DU CANADA

Monetary Policy Report Update

July 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 10 July 2007.

Overview

Economic growth and inflation in Canada in the first half of this year have been stronger than expected in the April *Monetary Policy Report*. Final domestic demand has remained the key driver of economic growth in Canada, bolstered by firm commodity prices. The Bank judges that the economy is now operating further above its production potential than was projected at the time of the April *Report*. Both total CPI and core inflation have been higher than projected in April and are above the 2 per cent inflation target. Longer-term interest rates have increased, and the Canadian dollar has appreciated sharply, moving well above the trading range assumed in the last *Report*.

The Canadian economy is now projected to grow by 2.5 per cent in 2007, somewhat stronger than was expected in April, and to grow somewhat more slowly in 2008 and 2009 than previously projected. In this new projection, higher interest rates across the yield curve and a higher assumed range for the Canadian dollar of 93 to 95.5 cents U.S. act to moderate growth in 2008 and 2009 to an average of about 2 1/2 per cent. This brings aggregate demand and supply back into balance in 2009.

Inflation is projected to be slightly higher and more persistent than in the April *Report*. However, as excess demand diminishes, total CPI and core inflation should decline to 2 per cent by early 2009. Also contributing to the decline in inflation are greater downward pressure on import prices related to the stronger Canadian dollar, and continued deceleration in the pace of price increases for new houses. With the direct effect of the GST cut ending and the impact of the temporary easing in gasoline prices in late 2006, total

Highlights

- The Canadian economy is operating further above its potential than was projected in the April *Report*.
- The Bank projects average annual economic growth of about 2 1/2 per cent through 2009, with the economy returning to its production potential in 2009.
- Inflation is projected to be slightly higher than in the April *Report*, returning to the 2 per cent target by early 2009.
- There are both upside and downside risks to the projection for inflation, and these appear to be roughly balanced.
- In line with the Bank's outlook, some modest further increase in the policy rate may be required.

www.bankofcanada.ca

inflation is projected to peak at about 3 per cent in the fourth quarter of this year.

The Bank's new projection for inflation is subject to both upside and downside risks. The main upside risk is that household demand in Canada could be stronger than projected, which could attenuate the downward pressure on inflation from lower import prices and from the deceleration in the pace of price increases for new houses. Higher levels of household borrowing and broad money growth point to this risk. On the downside, the adjustment in the Canadian economy to the rapid appreciation of the Canadian dollar may dampen demand for Canadian goods and services and reduce inflationary pressures more than projected. As well, the ongoing adjustment in the U.S. housing sector could be more prolonged, and this could spill over to the U.S. economy more broadly, further dampening Canadian exports. Overall, the upside and downside risks to the Bank's projection for inflation appear to be roughly balanced.

In line with this outlook, the Bank of Canada raised its key policy interest rate to 4.5 per cent on 10 July. Some modest further increase in the overnight rate may be required to bring inflation back to target over the medium term.

Recent Economic Developments

Global Developments

Economic growth outside North America has generally been more robust than expected at the time of the April *Report*. Emerging-market economies, particularly China and India, continue to outperform expectations. Over the past few months, the economic expansion in Europe and Japan has also been stronger than anticipated, with further strengthening in domestic demand.

The U.S. economy has evolved essentially in line with expectations. Following a weaker-than-anticipated first quarter, growth looks to have rebounded in the second quarter. Activity in the housing sector continues to decrease, but business investment appears to be regaining momentum. Moreover, growth in household consumption has remained firm, suggesting that there has been no significant spillover from the ongoing adjustment in the housing sector. In general, most of the recent data have been consistent with a return of the economy to near potential growth, while U.S. inflation has moderated somewhat.

With ongoing strength in global demand and concerns about supplies, oil prices have moved higher. Other commodity prices have generally remained high, largely in line with the assumptions in the April *Report*.

Canadian Economic Activity

In Canada, economic growth picked up markedly in the first quarter of 2007, with real GDP increasing at an annual rate of 3.7 per cent. This was stronger than the 2.5 per cent growth projected in the April *Report*. In spite of the weak growth in the U.S. economy in the first quarter of 2007, Canada's export volumes were higher than expected. Inventory investment was also higher than projected.

Final domestic demand continued to be the key driver of economic growth in Canada in the first quarter. Real personal disposable income rose substantially, owing mainly to strong growth in employment. The net worth of households also continued to rise, partly reflecting the impact of the strength in Canada's terms of trade. This was accompanied by further strong growth in household credit. These developments underpinned a considerable increase in household spending. Furthermore, the inventory correction that had been a significant drag on growth in the last half of 2006 was completed by early 2007.

Based on available information, real GDP appears to have increased at an annual rate of 2.8 per cent in the second quarter of 2007, higher than the 2.3 per cent rate projected in the April *Report*. In particular, both consumer spending and exports showed strong momentum early in the quarter.

Estimated Pressures on Capacity

Several indicators suggest that the amount of excess demand in the Canadian economy increased in the second quarter of 2007 relative to that expected at the time of the April *Report*. In the Bank's latest *Business Outlook Survey*, the percentage of companies reporting that they would have difficulty in meeting an unanticipated increase in demand rose to the highest level since mid-2000 (Chart 1). The Bank's conventional measure of the output gap indicates that the economy was operating about 0.6 per cent above its production capacity in the second quarter of 2007, noticeably higher than projected in the April *Report*.[1]

A number of indicators continue to suggest tightness in labour markets, and measures of underlying labour costs have increased somewhat. The employment-to-population ratio is at a record high, and the unemployment rate is at a 33-year low. However, the percentage of firms reporting labour shortages in the recent *Business Outlook Survey* declined.

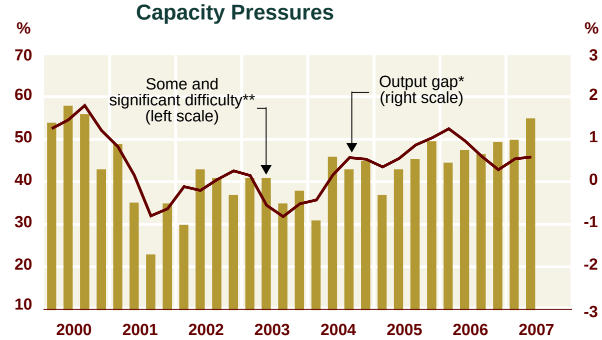
After reviewing all the indicators of capacity pressures, the Governing Council judges that, overall, the economy was operating about half a per cent above its production capacity in the second quarter of 2007.

Inflation and the 2 Per Cent Target

Inflation has been higher than projected in the April *Report* and the January *Update*. This is consistent with evidence of greater excess demand in the Canadian economy. It also reflects some relative price movements.

1. The estimated level of excess demand in the second quarter of 2007 is close to 0.5 percentage points higher than projected in the April *Report*. This increase reflects a rise in the projected level of real GDP in the second quarter of about 0.25 per cent and a decrease in the estimated level of production capacity of about 0.2 per cent, largely reflecting ongoing weakness in labour productivity.

Chart 1 Estimated Output Gap and the Response to *Business Outlook Survey* Question on Capacity Pressures

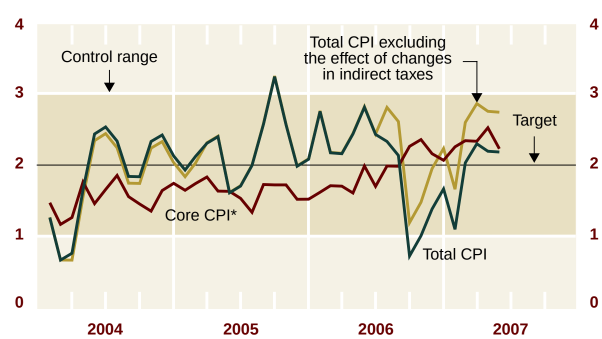


* Difference between actual output and estimated potential output based on the Bank's conventional measure. The estimate for the second quarter of 2007 is based on a projected rise in output of 2.8 per cent (at annual rates) for the quarter.
** Percentage of firms indicating that they would have either some or significant difficulty meeting an unanticipated increase in demand/sales

The 12-month rate of increase in the total CPI moved up from 1.8 per cent in the first quarter of 2007 to 2.2 per cent in April and May (Chart 2). This higher-than-projected rise in the total CPI resulted from the higher-than-expected core rate of inflation and from further increases in the prices of some of the volatile components. Gasoline prices were higher, chiefly because of refinery closures and unexpected strength in demand. Fruit and vegetable prices were also higher.

Chart 2 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

The core rate of inflation averaged 2.4 per cent in April and May, 0.2 percentage points higher than projected for the second quarter in the April *Report*. The rate of increase in the prices for core services excluding shelter has risen, reflecting strong demand pressures. Prices and markups for clothing and other semi-durable goods have also been higher than expected. Increases in shelter costs, while remaining relatively high, have continued to ease, largely as expected, reflecting a deceleration in price increases for new houses.

Financial Markets and Credit Conditions

Since the April *Report*, longer-term interest rates have increased in many economies (Chart 3). The increase largely reflects expectations of higher real interest rates, consistent with the outlook for continued strong global economic growth. Expectations for policy rates have also generally moved up.

In Canada, growth in household credit remains robust, and growth in business credit has moved above its historical average since the April *Report*. Monetary aggregates have also grown robustly.

The Canadian dollar has appreciated sharply, trading between 93 and 95.5 cents U.S. since the May policy announcement (Chart 4). The current value of the Canadian dollar is well above the range of 86.5 to 89.5 cents U.S. assumed in the projection in the April *Report*. Much of this appreciation reflects the strength of demand for Canadian goods and services and continuing firm commodity prices. However, the currency appears to have moved more strongly in response to these factors than historical experience would suggest.

Chart 3 Term Structure of Interest Rates in Canada and the United States

Yields on government bonds and treasury bills

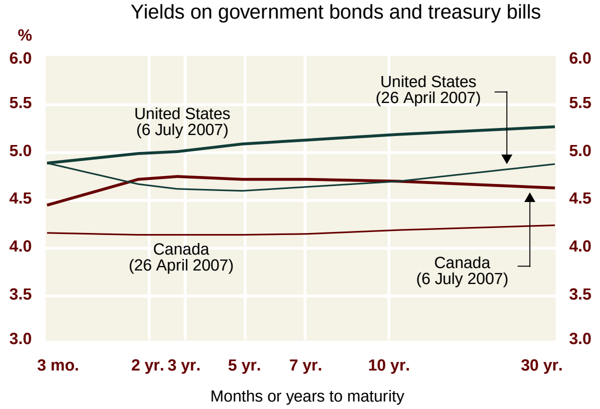
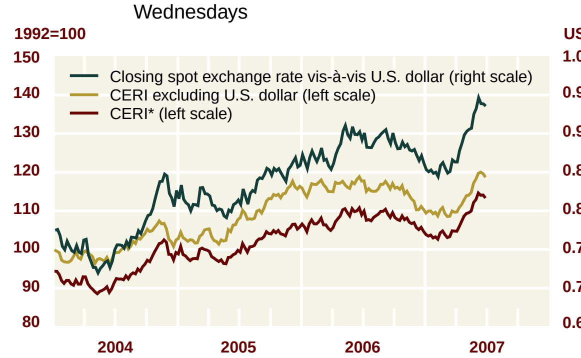


Chart 4 Canadian Dollar Exchange Rate

Wednesdays



* CERI: U.S. dollar, euro, yen, U.K. pound, Mexican peso, and Chinese renminbi

The Economic Outlook

The Bank's base-case projection incorporates the following key assumptions: a gradual and orderly resolution of global imbalances, energy prices evolving in line with current futures prices, and a Canada / U.S. exchange rate in the range of 93 to 95.5 cents U.S. observed since the May policy announcement.

The outlook for the global economy is slightly stronger than in the April *Report*, with growth expected to remain robust over the next three years. Some deceleration is still expected, as global excess supply is reduced and as the impact of ongoing monetary policy tightening is felt. Global economic growth is projected to ease from 5.0 per cent in 2007 to 4.8 per cent in 2008, and to 4.6 per cent in 2009.

The projection for the U.S. economy is little changed from that in the April *Report*. GDP growth is expected to slow from about 3.3 per cent in 2006 to about 2.1 per cent in

2007. Lower residential investment is likely to continue to reduce GDP growth over the coming quarters. However, U.S. exports should be supported by stronger growth in domestic demand in other countries and by a depreciating U.S. dollar, and business investment is picking up. GDP growth is projected to be about 3 per cent in 2008 and 2009.

Futures prices for crude oil have increased relative to those in the April *Report*. The price index for non-energy commodities is at a high level and is still expected to ease gradually over the projection period.

In the Bank's projection for Canada, GDP growth is somewhat stronger in 2007 and somewhat weaker in 2008 and 2009 than was projected in the April *Report*. Quarterly growth is expected to average about 2 3/4 per cent at annual rates for the final three quarters of this year and about 2 1/2 per cent through 2008 and 2009 (Table 1).

Final domestic demand in Canada is expected to remain the key driver of economic growth over the projection period, supported by the strength of Canada's terms of trade and high levels of employment (Table 2). Growth in investment in machinery and equipment should continue to boost imports. Although the gradual strengthening of the U.S. economy over the projection period is supportive of Canadian exports, export growth is expected to be weaker than previously projected owing to the higher Canadian dollar. On balance, net exports are expected to subtract from growth in 2008 and 2009.

Compared with the April *Report*, this projection includes higher interest rates across the yield curve and a higher exchange rate, both of which act to moderate growth and bring aggregate demand and supply in Canada back into balance in 2009.[2]

Table 1
Summary of the Base-Case Projection[a]

	2007				2008		2009
	Q1	Q2	Q3	Q4	H1	H2	
Real GDP (quarterly growth or average quarterly growth, at annual rates)[b]	**3.7** (2.5)	**2.8** (2.3)	**2.7** (2.5)	**2.6** (2.7)	**2.6** (2.8)	**2.4** (2.8)	**2.5** (2.7)
Real GDP (year-over-year percentage change)	**2.0** (2.0)	**2.3** (2.1)	**2.6** (2.2)	**2.9** (2.5)	**2.6** (2.6)	**2.5** (2.8)	**2.4** (2.7)
Core inflation (year-over-year percentage change)	**2.3** (2.3)	**2.4** (2.2)	**2.3** (2.1)	**2.2** (2.0)	**2.2** (2.0)	**2.1** (2.0)	**2.0** (2.0)
Total CPI (year-over-year percentage change)	**1.8**[c] (1.9)	**2.3** (1.9)	**2.6** (2.3)	**3.0** (2.8)	**2.4** (2.2)	**2.1** (2.0)	**2.0** (2.0)
Total CPI (excluding the effect of changes in indirect taxes) (year-over-year percentage change)	**2.3**[c] (2.4)	**2.8** (2.4)	**2.7** (2.3)	**3.0** (2.8)	**2.4** (2.2)	**2.1** (2.0)	**2.0** (2.0)
WTI[d] (level)	**58** (58)	**65** (64)	**71** (67)	**71** (69)	**72** (70)	**73** (70)	**73** (70)

a. Figures in parentheses are from the April *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. Revisions to the year-over-year percentage change in the first quarter of 2007 for both the total CPI and the total CPI excluding the effect of changes in indirect taxes are the result of rounding effects associated with the change in the CPI base year from 1992 to 2002.
d. 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 6 July 2007

The projection for core inflation for 2007 and 2008 is slightly higher than in the April *Report* (Table 1). Greater excess demand than was expected in April is projected to keep core inflation above 2 per cent for a longer period. But three factors should bring core inflation back to 2 per cent by early 2009. First, with economic activity moderating somewhat in 2008 and 2009, excess demand pressures are slowly worked off. Second, with the stronger Canadian dollar, downward pressure on inflation from lower import prices is expected to be a little greater than earlier projected. And finally, the

2. The assumption for potential output growth remains unchanged from that used in the April *Report*, at 2.8 per cent in both 2007 and 2008 and at 2.7 per cent in 2009.

contribution to inflation coming from price increases for new houses is expected to continue to decline.

The projected path for the 12-month rate of increase in the total CPI reflects the revised outlook for the core rate, expectations for energy prices, and the effect of past changes in indirect taxes. With the higher futures prices for oil and the direct effect of the GST cut on inflation ending, total CPI inflation is projected to rise further in the second half of this year. Considerable year-over-year increases in gasoline prices, owing partly to the impact of the temporary easing in gasoline prices in late 2006, will cause total CPI inflation to peak in the fourth quarter at about 3 per cent. CPI inflation is then expected to decline, reaching the 2 per cent target by early 2009.

Table 2
Contributions to Average Annual Real GDP Growth[a]
Percentage points

	2006	2007	2008	2009
Consumption	2.3 *(2.2)*	2.1 *(1.8)*	1.9 *(1.6)*	1.8 *(1.7)*
Housing	0.1 *(0.2)*	0.1 *(-0.1)*	-0.1 *(-0.1)*	-0.1 *(0)*
Government	0.8 *(0.8)*	0.6 *(0.6)*	0.7 *(0.7)*	0.6 *(0.6)*
Business fixed investment	1.2 *(1.1)*	0.6 *(0.7)*	0.6 *(0.5)*	0.4 *(0.4)*
Subtotal: Final domestic demand	4.4 *(4.3)*	3.4 *(3.0)*	3.1 *(2.7)*	2.7 *(2.7)*
Exports	0.3 *(0.5)*	0.6 *(0.4)*	0.9 *(1.3)*	0.9 *(1.0)*
Imports	-1.6 *(-1.7)*	-1.4 *(-1.3)*	-1.5 *(-1.3)*	-1.2 *(-1.0)*
Subtotal: Net exports	-1.3 *(-1.2)*	-0.8 *(-0.9)*	-0.6 *(0)*	-0.3 *(0)*
Inventories	-0.3 *(-0.4)*	-0.1 *(0.1)*	0.1 *(0)*	0 *(0)*
GDP	2.8 *(2.7)*	2.5 *(2.2)*	2.6 *(2.7)*	2.4 *(2.7)*

a. Figures in parentheses are from the projection presented in the April *Report*.

The *Monetary Policy Report* and the *Update* are available on the Bank's website at: www.bankofcanada.ca

Copies can also be obtained by contacting the Bank at:
Telephone: 1 877 782-8248; email: publications@bankofcanada.ca