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Monetary Policy Report Update

January 2008

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 22 January 2008.

Overview

The Canadian economy grew broadly in line with the Bank's expectations in the second half of 2007. Despite some slowing in growth in the fourth quarter, the economy continues to operate above its production capacity. Both total and core inflation have been lower than was projected in the October *Monetary Policy Report*, largely reflecting a price-level adjustment related to increased competitive pressures in the retail sector stemming from the level of the Canadian dollar.

Financial conditions have deteriorated since October, leading to a tightening of credit conditions in industrialized countries. Given this, and a deeper and more prolonged decline in the U.S. housing sector, the outlook for the U.S. economy in 2008 is now significantly weaker than it was in October. Growth is expected to be particularly weak in the first half of the year before recovering later in 2008 and 2009.

For Canada, the effects of the slowing U.S. economy will lead to additional downward pressure on export growth. However, despite tighter credit conditions, domestic demand in Canada is expected to remain strong, supported by continued income growth associated with the increase in commodity prices seen since October, which has led to further gains in Canada's terms of trade. The Bank now projects that economic growth in 2008 will be weaker than was expected in October, averaging a little over 1 per cent in the first half of the year and a little over 2 per cent in the second half. On an average annual basis, the economy is projected to expand by 1.8 per cent in 2008 and by 2.8 per cent in 2009. This growth profile implies that the economy will move into modest excess supply in the second quarter of this year, and then return to balance in early 2010.

Highlights

- The Canadian economy continues to operate above its production capacity, despite a slowing of growth in the fourth quarter of 2007.
- The Bank projects average annual economic growth of 1.8 per cent in 2008 and 2.8 per cent in 2009.
- Both core and total CPI inflation are projected to fall below 1.5 per cent by mid-2008 before returning to 2 per cent by the end of 2009.
- Further monetary stimulus is likely to be required in the near term.

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The inflation projection has also been revised down, particularly for 2008, primarily reflecting the price-level adjustment noted above and the recent one-percentage-point reduction in the GST. Both core and total CPI inflation are projected to fall below 1 1/2 per cent by the middle of this year before returning to the 2 per cent target by the end of 2009. Excluding the impact of the recent GST reduction, total CPI inflation is projected to average close to 2 per cent throughout 2008 and 2009.

Risks and Policy Outlook

There are a number of important risks to this base-case projection.

On the downside, the tightening in credit conditions globally and in Canada could be greater and more protracted than assumed, and there could be a more prolonged slowdown in the U.S. economy, exerting a greater drag on Canadian GDP growth and inflation. As well, competitive pressures in Canada's retail sector could put more downward pressure on prices than assumed.

On the upside, there are risks posed by the continued strong momentum in domestic demand growth, underpinned by firm commodity prices, improved terms of trade, and strong credit growth. Capacity pressures could be stronger than judged, especially if weak productivity growth were to persist, which would put upward pressure on costs and inflation.

The Governing Council judges that, overall, the risks to the base-case projection for Canadian inflation are roughly balanced.

On 4 December and on 22 January, the Bank lowered its target for the overnight rate by one-quarter of one percentage point, bringing it to 4 per cent. In line with the Bank's outlook, further monetary stimulus is likely to be required in the near term to keep aggregate supply and demand in balance and to return inflation to target over the medium term.

Recent Economic and Financial Developments

Global Developments

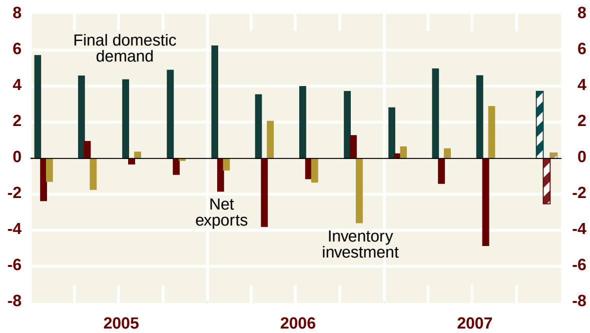
Global economic growth remained strong through the third quarter of 2007. During the fourth quarter, however, there was a slowing in the global economy, most notably in the United States. The ongoing repricing of risk and tightening of credit conditions in industrialized countries, largely stemming from problems in the U.S. subprime-mortgage market, contributed to the slowdown. Upward pressure on global inflation continued, exacerbated by large increases in the prices of energy and food.

Economic strength through the third quarter was broadly based across all major regions and was generally greater than expected. In the United States, economic growth in the third quarter was driven by unexpectedly high business spending and inventory accumulation, and by the rapid expansion of net exports in response to strong global demand and the depreciation of the U.S. dollar. Available information on the U.S. economy suggests that activity slowed in the fourth quarter as a result of the continued weakness in the housing sector, lower production to reduce inventory levels (particularly in the automobile sector), and the adverse effects of tighter credit conditions.

With continuing strong global demand for oil and little significant supply adjustment, crude oil prices have moved higher. Prices for grains and oilseeds have also continued to rise, reflecting both strong growth in demand from major emerging economies and unfavourable supply developments. Many other commodity prices have also remained high.

Chart 1 Contribution to Real GDP Growth

Percentage points, quarterly at an annual rate



Note: GDP estimates for the fourth quarter of 2007 are based on the Bank's monitoring of current data.

Canadian Economic Activity

In the second half of 2007, the Canadian economy grew broadly in line with the Bank's expectations. Economic growth in Canada eased in the third quarter, with real GDP growing at an annual rate of 2.9 per cent, slightly stronger than the 2.5 per cent projected in the October *Report*. Inventory investment was higher than expected, contributing importantly to overall growth, and, once again, there was a considerable rise in final domestic demand (Chart 1).

Both business investment and government spending on goods and services were boosted in the third quarter by large purchases of machinery and equipment from abroad. Real personal disposable income increased moderately, while household net worth rose further, and household credit continued to record substantial increases. As a result, household spending rose solidly, after a very strong gain in the second quarter.

Net exports decreased markedly in the third quarter. Import volumes increased substantially in response to strong domestic demand and the past appreciation of the Canadian dollar. Export volumes rose modestly, however, as the exchange rate appreciation moderated the strong global demand for Canadian goods and services.

Current data for the fourth quarter point to another substantial gain in final domestic demand, supported by the rise in real incomes from a boost in the terms of trade that reflected strong commodity prices and the further appreciation of the Canadian dollar. However, there is likely to be a drag on GDP growth from net exports. Overall, real GDP is likely to have increased by 1.5 per cent in the fourth quarter.

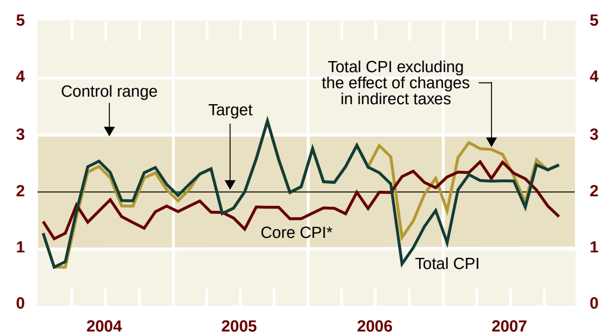
Inflation and the 2 Per Cent Target

Inflation in October and November was lower than projected in the October *Report*. This appears to largely reflect a price-level adjustment related to increased competitive pressures stemming from the high level of the Canadian dollar.

The core rate of inflation averaged 1.7 per cent in October and November, 0.6 percentage points lower than projected for the fourth quarter in the October *Report* (Chart 2). It appears that the Canadian dollar's rise to close to parity with the U.S. dollar raised consumers' awareness of the considerable differences between Canadian and U.S. prices and led to a greater-than-projected downward adjustment of the prices of some goods, particularly automobiles. Additionally, increases in meat prices were lower than expected, driven by increased supply. The prices of core services also rose somewhat less than expected.

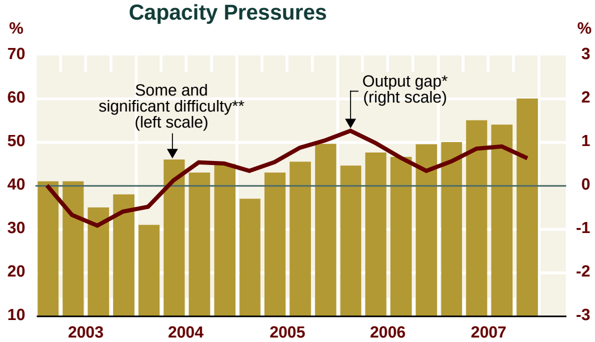
Chart 2 Consumer Price Index

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

Chart 3 Estimated Output Gap and the Response to *Business Outlook Survey* Question on Capacity Pressures



* Difference between actual output and estimated potential output. The estimate for the fourth quarter of 2007 is based on a projected rise in output of 1.5 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 back up from 1.7 per cent in August 2007 to an average of about 2.5 per cent in October and November, reflecting the temporary reduction in gasoline prices in September and October 2006.[1] Nevertheless, the growth in total CPI inflation was significantly lower than the 3.0 per cent expected in the October *Report*, owing to the downward adjustment in core inflation.

Estimated Pressures on Capacity

Notwithstanding the easing in core inflation, the Canadian economy continues to operate above its production capacity.

The Bank's winter *Business Outlook Survey*, the conventional measure of the output gap,[2] and most labour market and wage indicators continue to suggest considerable tightness (Chart 3).

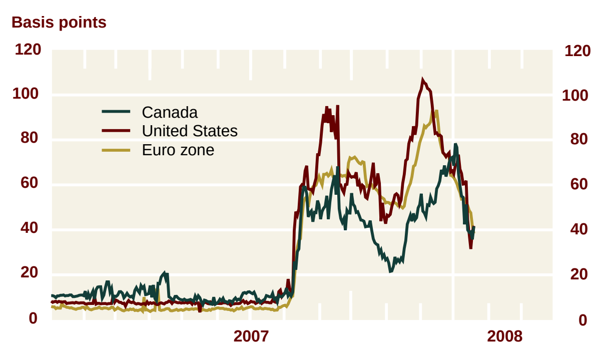
After reviewing all the indicators of capacity pressures, the Governing Council judges that, overall, the economy was operating about one-half of a per cent above its production capacity in the last quarter of 2007.

Credit Conditions

Global financial markets remain volatile as difficulties related to the valuation of structured products and expected losses stemming from the U.S. subprime-mortgage market persist and, more generally, as concerns about the economic outlook have increased. Canada has been affected by these global developments, but to a lesser extent than the United States and Europe. While household and business credit have continued to grow robustly in Canada, there has been some tightening in the prices, terms, and availability of credit.

Since late July, *financial institutions* in Canada and other countries have been facing increased spreads between their money market borrowing rates and expected overnight policy rates. Although money market conditions worsened after the October *Report*, partly because of concerns about year-end funding pressures, they have now returned to their October levels (Chart 4).

Chart 4 Spreads between 3-Month Interbank Offered Rates and Overnight Index Swaps*



* For the United States and the euro zone, LIBOR (London Interbank Offered Rate) is published by the British Bankers' Association. For Canada, CDOR (Canadian Dollar Offered Rate) is published by Reuters.

1. The upward pressure on gasoline prices coming from the recent rise in spot prices for crude oil was largely offset by the effect of the exchange rate appreciation and narrower margins.

2. The Bank's conventional measure indicates that the economy was operating about 0.6 per cent above its production potential in the fourth quarter of 2007. The estimated level of excess demand in the fourth quarter of 2007 is about 0.1 percentage points higher than was projected in the October *Report*. This rise is mainly the result of a marginal decrease in the estimated level of production capacity.

At the same time, however, there has been a considerable widening in credit spreads in Canadian and global bond markets for financial and non-financial institutions. For example, for 10-year bonds, the spreads for "A"-rated Canadian borrowers over yields on Government of Canada bonds have widened from about 100 basis points to around 140 basis points since the October *Report*.

The spread between the effective *household* borrowing rate and the expected target overnight rate is estimated to have increased by about 20 to 25 basis points since October.

The spread between the rate at which *non-financial firms* can borrow from financial institutions and the expected overnight rate has increased by about 15 to 20 basis points since October. Given the increase in spreads in bond markets, and a tightening in the terms and conditions for bank loans and market debt, there has been a significant tightening in credit conditions faced by firms.

Policy Rates

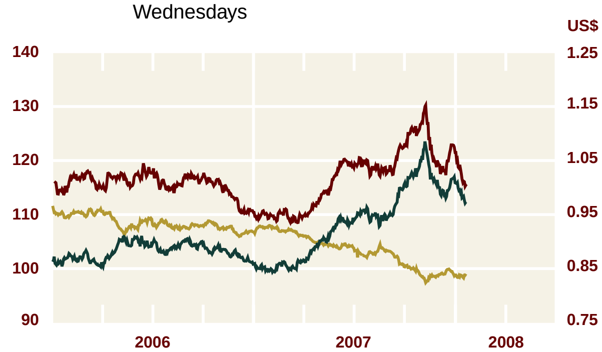
Since the October *Report*, policy rates have been reduced in both the United States and Canada. With the weaker economic outlook and further tightening of credit conditions, market expectations in a number of industrialized countries, including Canada and the United States, now reflect significantly lower policy rates for 2008 than at the time of the October *Report*.

Exchange Rates

Against a background of significant volatility in currencies, commodity prices, and interest rates since the October *Report*, and a generally weakening U.S. dollar, the Canadian dollar has exhibited exceptional volatility. After spiking sharply early in November, the dollar has since declined to trade around the level of 98 cents U.S. assumed in the October *Report* (Chart 5). This level is not inconsistent with fundamental factors.

Chart 5 Canadian Dollar Exchange Rate and U.S. Trade-Weighted Index

Wednesdays



Closing spot exchange rate vis-à-vis U.S. dollar (right scale)
CERI excluding U.S. dollar (left scale, 1992=100)
U.S. broad dollar trade-weighted index (left scale, 1997=100)

Note: CERI: Canadian-dollar trade-weighted index (against U.S. dollar, euro, yen, U.K. pound, Mexican peso, and Chinese renminbi)
Sources: Bank of Canada and Federal Reserve Bank of St. Louis

The Economic Outlook

The Bank's base-case projection incorporates the following key assumptions: energy prices evolving in line with current futures prices; as in the October *Report*, a Canada/U.S. exchange rate averaging 98 cents U.S.; and a gradual and orderly resolution of global imbalances.

The robust expansion of the global economy experienced over the past several years is expected to moderate over 2008–09. The adverse impact of the tightening of credit conditions in industrialized countries should be partially offset by more accommodative monetary policy than previously expected and by continued strength in emerging-market economies. Nevertheless, global economic growth is expected to slow somewhat faster than projected in the October *Report* (Table 1).

Table 1
Projection for Global Economic Growth

	Share of real global GDP[a] (per cent)	Expected growth (per cent)[b]			
		Projection			
		2006	2007	2008	2009
United States	**20**	**2.9** *(2.9)*	**2.2** *(1.9)*	**1.5** *(2.1)*	**2.5** *(3.0)*
European Union	**19**	**2.9** *(2.9)*	**2.7** *(2.6)*	**1.8** *(2.0)*	**1.9** *(2.2)*
Japan	**6**	**2.4** *(2.2)*	**1.9** *(2.0)*	**1.6** *(1.7)*	**1.8** *(1.8)*
China and Asian NIEs[c]	**18**	**10.0** *(10.0)*	**10.1** *(10.0)*	**9.3** *(9.4)*	**7.9** *(8.0)*
Others	**37**	**6.3** *(6.3)*	**6.3** *(6.3)*	**5.7** *(5.8)*	**5.0** *(5.1)*
World	**100**	**5.4** *(5.4)*	**5.3** *(5.2)*	**4.6** *(4.8)*	**4.3** *(4.5)*

a. GDP shares are based on IMF estimates of the purchasing-power-parity (PPP) valuation of country GDPs for 2006. Source: IMF, WEO Database, April 2007. The World Bank recently published comprehensive revised estimates of purchasing-power parities, which will be reflected in the April 2008 *Monetary Policy Report*.
b. Numbers in parentheses are projections used for the October 2007 *Report*.
c. NIEs are newly industrialized economies.These include Hong Kong (Special Administrative Region), South Korea, Taiwan (Province of China), and Singapore.
Source: Bank of Canada

Futures prices for crude oil are higher than those in the October *Report*, but futures prices for natural gas are largely unchanged. The price index for non-energy commodities is expected to remain firm, easing somewhat as global growth moderates.

The U.S. Outlook

The projection for U.S. GDP growth has been revised down significantly from that in the October *Report*. Declining activity in the U.S. housing sector suggests a deeper and more prolonged adjustment in U.S. residential investment and a reduction in home equity values. Credit conditions are expected to tighten further, reflecting continuing financial market concerns and the weaker economic outlook. These factors, together with declines in the value of household wealth, are expected to reduce the growth of domestic demand relative to earlier projections. In this *Update*, which incorporates the effect of a significant easing in U.S. monetary policy (including some reduction in the policy rate beyond that announced on 22 January), the U.S. economy is projected to grow at a rate below that of potential output in 2008, before recovering gradually in 2009. Growth in 2008 is expected to be particularly weak in the first half of the year, averaging 0.5 per cent at an annual rate, because of weakness in household spending and residential investment. Annual U.S. GDP growth is projected to be 1.5 per cent in 2008 and 2.5 per cent in 2009.

The Canadian Outlook

For Canada, the Bank's base-case projection is weaker for 2008 but somewhat stronger for 2009 than in the October *Report*. Quarterly growth at annual rates is expected to average 1.3 per cent in the first half of 2008 and then move up to 2.3 per cent in the second half of this year, and to just over 3 per cent through 2009 (Table 2).

Final domestic demand is expected to remain the key driver of economic growth over the projection period, supported by high commodity prices, further robust growth in real incomes, and lower policy rates (Table 3). Growth of final domestic demand is a little stronger than in the last *Report*. But the major change is much weaker net exports. While import growth is expected to stay robust over the projection period, the outlook for Canadian exports has been marked down, reflecting the weaker U.S. economic outlook. With the pickup in U.S. GDP growth in 2009, the drag on Canadian economic activity coming from net exports diminishes.

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

	2007		2008			2009
	Q3	Q4	Q1	Q2	H2	
Real GDP (quarter-over-quarter percentage change)[b]	**2.9** (2.5)	**1.5** (1.8)	**0.6** (2.0)	**2.0** (2.2)	**2.3** (2.5)	**3.2** (2.6)
Real GDP (year-over-year percentage change)	**2.9** (2.8)	**2.9** (2.9)	**2.2** (2.4)	**1.7** (2.1)	**1.7** (2.2)	**2.8** (2.5)
Core inflation (year-over-year percentage change)	**2.2** (2.2)	**1.6** (2.3)	**1.4** (2.2)	**1.3** (2.1)	**1.6** (2.0)	**1.9** (2.0)
Total CPI (year-over-year percentage change)	**2.2** (2.2)	**2.4** (3.0)	**1.7** (2.9)	**1.4** (2.4)	**1.5** (1.9)	**1.9** (2.0)
Total CPI (excluding effect of changes in indirect taxes)[c] (year-over-year percentage change)	**2.3** (2.3)	**2.4** (3.0)	**2.2** (2.9)	**1.9** (2.4)	**2.0** (1.9)	**1.9** (2.0)
WTI[d] (level)	**75** (75)	**91** (81)	**93** (78)	**92** (77)	**90** (76)	**88** (74)

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. The combined effect of the 1 per cent GST reduction on 1 January 2008 and some other small changes in indirect taxes is estimated to reduce total CPI by about 0.5 per cent for a year.
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 18 January 2008

With the weak near-term U.S. outlook and the tighter credit conditions in Canada, the economy moves into modest excess supply in the second quarter of this year. In this base-case projection, the subsequent strengthening of U.S. economic growth and further near-term reduction in policy interest rates in Canada bring aggregate supply and demand back into balance in early 2010.[3]

The projection for core inflation is lower than in the October *Report*. In 2008, this reflects the modest excess supply in the economy for much of the year and continued pressures from lower-than-expected prices for selected tradable goods. These lower prices are driven by the increased competition related to the high Canadian dollar. However, with the impact on measured inflation from price-level adjustments dissipating, with well-anchored inflation expectations, and with the economy moving back towards balance, core inflation should move up to 2 per cent by the end of 2009.

Table 3
Contributions to Average Annual Growth of Real Canadian GDP[a]
Percentage points

	2006	2007	2008	2009
Consumption	2.3 (2.3)	2.2 (2.1)	2.2 (2.1)	2.4 (2.0)
Housing	0.1 (0.1)	0.2 (0.2)	-0.1 (-0.1)	0 (0)
Government	0.8 (0.8)	0.6 (0.6)	0.7 (0.7)	0.6 (0.6)
Business fixed investment	1.2 (1.2)	0.6 (0.5)	0.5 (0.5)	0.5 (0.5)
Subtotal: Final domestic demand	4.4 (4.4)	3.6 (3.4)	3.3 (3.2)	3.5 (3.1)
Exports	0.3 (0.3)	0.6 (0.5)	- 0.1 (0.2)	0.4 (0.4)
Imports	-1.6 (-1.6)	-1.7 (-1.2)	-1.3 (-1.2)	-1.1 (-1.0)
Subtotal: Net exports	-1.3 (-1.3)	-1.1 (-0.7)	-1.4 (-1.0)	-0.7 (-0.6)
Inventories	-0.3 (-0.3)	0.1 (-0.1)	-0.1 (0.1)	0 (0)
GDP	2.8 (2.8)	2.6 (2.6)	1.8 (2.3)	2.8 (2.5)

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

3. The assumption for potential output growth is 2.8 per cent in 2008 and 2.7 per cent in 2009, the same as in the last *Report*.

The path for the 12-month rate of increase in the total CPI over the projection period reflects the revised outlook for core inflation, expectations for energy prices, and the effect of changes in indirect taxes. The projection for total CPI inflation in 2008 is lower than in the last *Report*, because of the reduced outlook for core inflation and the estimated direct effect of the one-percentage-point GST reduction (and small changes in other indirect taxes). This is partly offset by the effect of higher futures prices for crude oil. Total CPI inflation is expected to fall below the 2 per cent target in early 2008 and remain below the target for the rest of the year, before moving back to 2 per cent by the end of 2009. Total CPI inflation, excluding the impact of the recent GST reduction, is projected to average close to 2 per cent throughout 2008 and 2009.

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