Monetary Policy Report Update

– July 2005 –

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 11 July 2005.

Introduction

The update on global and Canadian economic developments presented in this *Report* highlights three issues. First, the balance of information on capacity pressures indicates that the Canadian economy is operating close to its production limits. Second, over the past several months, further progress has been made across sectors of the Canadian economy in adjusting to global developments. Third, while the risks to the outlook through 2006 appear balanced, the medium-term risks related to global imbalances are increasing.

On the whole, the Bank's outlook for output and inflation in Canada through to the end of 2006 is little changed from the scenario outlined in the April *Monetary Policy Report*.

The global economy has been unfolding broadly as expected, and prospects remain favourable for growth of about 4 per cent this year and next. However, growth has been less balanced than expected across economic zones, with the momentum stronger in Asia but weaker in Europe.

In Canada, strong growth in final domestic demand continues to offset the drag from net exports. The Bank's base-case projection calls for growth of real GDP to be 2.7 per cent in 2005 and to rise to 3.3 per cent in 2006. The Canadian economy is thus expected to remain near its production capacity through the period, and inflation is projected to return to 2 per cent by the end of next year.

Highlights

- The economy is operating close to its production capacity.
- The Bank's outlook is little changed from the April *Monetary Policy Report*, with growth projected to be 2.7 per cent in 2005 and 3.3 per cent in 2006.
- With the economy thus projected to continue to operate near its production capacity, inflation is expected to return to 2 per cent by the end of next year.
- In line with this outlook, some reduction of monetary stimulus will be required in the near term.
- Risks to the outlook through 2006 appear balanced, but over the medium term, risks related to global imbalances are increasing.

Chart 1
Target for the Overnight Rate and Target for the U.S. Federal Funds Rate
Daily

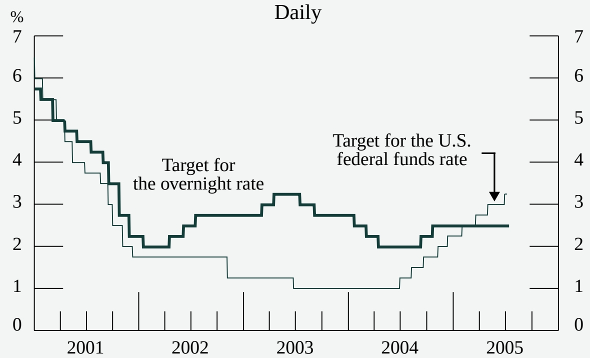
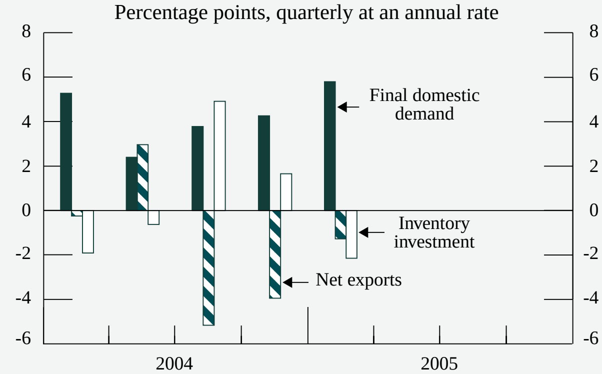


Chart 2
Contribution to Real GDP Growth
Percentage points, quarterly at an annual rate



To support aggregate demand, the Bank has held the target for the overnight rate unchanged at 2 1/2 per cent since October 2004 (Chart 1). However, in line with the Bank's outlook, some reduction in the amount of monetary stimulus will be required in the near term to keep aggregate demand and supply in balance and inflation on target.

Risks to the outlook over the next four to six quarters relate primarily to the future path of oil and non-energy commodity prices, the pace of growth in China, and the ongoing adjustment of the Canadian economy to global developments. These risks appear balanced.

Over the medium term, there is increasing risk that the correction of global current account imbalances could involve a period of weakness in world aggregate demand. Medium-term risks will be more fully addressed in the October *Monetary Policy Report*, when the Bank's projection horizon is extended to include 2007.

Overview of Recent Economic and Financial Developments

Canada's real GDP rose at an annual rate of 2.3 per cent in the first quarter of 2005, very close to the 2.5 per cent rate expected at the time of the April *Report*. However, at 5.8 per cent, the expansion of final domestic demand was stronger than anticipated in the April *Report*, while reductions in both net exports and inventory investment weighed more negatively on growth than expected (Chart 2).

There is further evidence that the Canadian economy is continuing to adjust to global developments. The strong gains in final domestic demand generated further solid output growth in sectors with a low exposure to foreign competition. In contrast, since the end of 2004, there has been a small reduction in the overall level of activity in non-commodity-producing industries highly exposed to international competition.

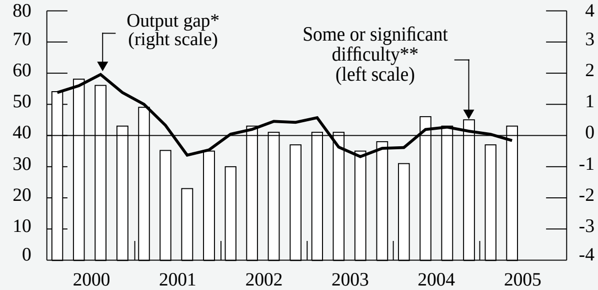
While production also declined in commodity-producing industries during the first quarter, this largely reflected temporary production disruptions at an oil sands facility, the impact of adverse weather conditions on oil and gas drilling, and reduced foreign demand for lumber. These industries staged a partial recovery in April.

The results from the Bank's summer *Business Outlook Survey* also show that the Canadian economy is adjusting to global developments. For example, capital spending is expected to increase particularly strongly in commodity-producing industries and in many areas of the services sector. The *Survey* also suggests that employment growth will continue to be concentrated in service and commodity-producing industries.

Based on available information, it appears that the Canadian economy grew by about 2.3 per cent in the second quarter. Current indicators suggest that final domestic demand continued to rise solidly. Moreover, several developments point to the prospect of a pickup in the pace of activity in the second half of the year. A further decrease in the rate of inventory accumulation in the second quarter should leave inventory levels and sales better aligned. Momentum appears to be building in capital spending, and employment growth has picked up.

Chart 3

Conventional Estimate of the Output Gap and 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 2005 is based on a projected rise in output of 2.3 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

The Bank's conventional estimate of the output gap indicates that the economy was operating with a slight amount of excess supply in the second quarter of 2005 (Chart 3). Based on its assessment of all indicators, it is the Governing Council's

Pressures on Capacity

The Bank's conventional measure of potential output was revised down slightly from the estimate used in the April *Report*, reflecting the downward revision to Statistics Canada's estimates of real GDP over the period from 2002 to mid-2004. With GDP growth in the last three quarters of 2004 revised upwards, however, the level of real GDP at the end of 2004 was left unchanged. Consequently, the Bank's conventional measure of the output gap suggests that the economy was operating at its capacity limits in the first quarter of 2005, instead of very slightly below its production capacity as projected in the last *Report*. With economic growth likely to have been 2.3 per cent in the second quarter, a slight amount of economic slack is expected to have emerged by mid-2005.

Statistics Canada's measure of capacity utilization in the non-farm, goods-producing sector[1] suggests greater pressure on production capacity than the Bank's conventional estimate of the output gap.

Other indicators, however, point to less pressure. For instance, wage increases have remained quite moderate, and core inflation, on average, has been below 2 per cent since mid-2003.

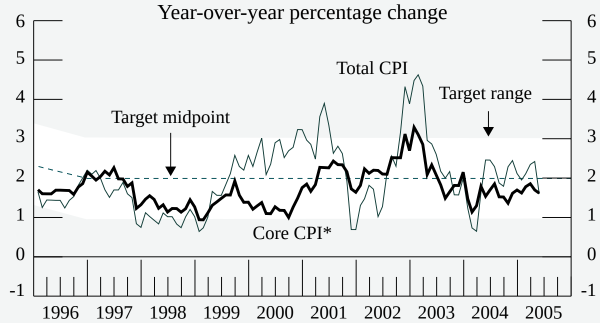
Similarly, the proportion of companies reporting labour shortages in the summer *Business Outlook Survey* remained lower than average, while the percentage of firms reporting difficulties meeting an unanticipated increase in demand was slightly higher than average.

Capacity constraints are felt most strongly in the construction and commodity-producing sectors, as well as in transportation services.

Evaluating the level and growth of potential output is complicated by the sectoral shifts associated with the adjustment of the Canadian economy to higher commodity prices and the appreciation of the Canadian dollar.

1. While that measure has been revised upwards, the revision chiefly reflected a change in Statistics Canada's methodology for estimating potential output in the oil and gas extraction industry.

Chart 4
Consumer Price Index
Year-over-year percentage change



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

judgment that the economy was operating with slightly more excess supply at mid-year than the conventional measure suggests, but was still close to its capacity limits. (See box on page 3.)

The 12-month rate of increase in the consumer price index has continued to exhibit considerable volatility, rising to 2.4 per cent in April and falling to 1.6 per cent in May (Chart 4). This is largely due to fluctuations in gasoline prices.

In contrast, the core rate of inflation has remained relatively stable, fluctuating in a range between 1.6 and 1.9 per cent since the beginning of the year.

Since late May, world oil prices have strengthened further. Current oil futures contracts indicate that the West Texas Intermediate (WTI) price of oil will average around US$60 per barrel over the projection period. This scenario for oil prices is somewhat higher than that used in the last *Report*, especially for 2006.

The External Environment

On balance, the global economy has been unfolding largely as expected at the time of the April *Report*, with prospects for growth essentially unchanged at about 4 per cent in both 2005 and 2006.

U.S. real GDP grew by 3.8 per cent at annual rates in the first quarter of 2005, in line with expectations. Monthly indicators for the second quarter point to solid growth in domestic demand. As a result, the base-case outlook for U.S. economic growth in 2005 is essentially the same as in the April *Report*, which called for robust growth in 2005. Output growth is projected to remain strong in the United States in 2006. The projection assumes a gradual slowing in household spending and a rise in net exports.

Growth has been less balanced than anticipated across other economic zones, with momentum stronger than expected in Asia but weaker in Europe. In this regard, growth in China's real GDP has remained very strong, and the first-quarter rebound in Japan's real GDP was larger than expected. In contrast, in the euro area, evidence suggests slightly slower growth than that incorporated in the April *Report*.

Financial Conditions

The Canadian dollar has traded in a range of about 79 to 83 cents U.S. since the time of the April *Report*, as it has since the beginning of the year. However, with the U.S. dollar appreciating against other major currencies, the Canadian dollar has risen modestly on a trade-weighted basis.

Yields on short-term government bonds in Canada have remained relatively stable since the April *Report*, while comparable yields in the United States have moved somewhat higher, reflecting actual and anticipated increases in the federal funds rate.

Long-term government bond yields in both countries have fallen by between 20 and 30 basis points. This decline has been part of a global phenomenon, with longer-term yields in most industrial countries at very low levels. While this may partly reflect several technical factors, the low yields would be consistent with strong desired global savings relative to business investment. Risk premiums on corporate bonds are also very low.

Domestic Economic Prospects

In Canada, solid growth in final domestic demand is expected to continue to contribute importantly to economic activity over the remainder of this year and through 2006 (Table 1). Various factors suggest further substantial gains in business investment. These include the high rate of capacity utilization in a number of industries, the global economic expansion and the associated relatively high level of commodity prices, continued favourable financial conditions, buoyant profit levels, and earlier reductions in the prices of imported machinery and equipment.

Following a strong advance in the first quarter of 2005, consumer spending is expected to rise solidly over the projection period. This reflects further gains in real incomes, the continued effects of past monetary stimulus, and a relatively high level of consumer confidence. In contrast, investment in housing is expected to be little changed, on balance, over this period. The current outlook incorporates somewhat higher growth in government spending than in the April *Report*. Nevertheless, expenditures by all levels of government are still projected to rise broadly in line with revenues, as governments continue to strive to maintain fiscal balance.

Ongoing solid global economic growth, particularly in the United States, is expected to boost the demand for Canadian exports, while imports will be bolstered by strong investment in machinery and equipment. The earlier appreciation of the Canadian dollar is expected to continue to dampen Canada's export growth and to stimulate imports, but this effect should lessen considerably next year. The negative contribution of net exports to real GDP growth appears to have peaked and is expected to fall to zero in 2006 (Table 1).

The Bank's base-case projection calls for economic growth, on an average annual basis, to be 2.7 per cent in 2005 and to rise to 3.3 per cent in 2006. This outlook for both 2005 and 2006 is essentially the same as in the April *Report*.

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

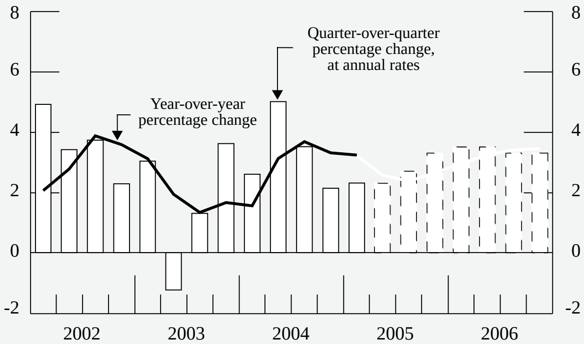
	2004	2005	2006
Consumption	1.9 *(1.9)*	2.2 *(2.0)*	1.8 *(1.9)*
Housing	0.5 *(0.5)*	0.2 *(0.1)*	-0.2 *(-0.1)*
Government	0.6 *(0.6)*	0.8 *(0.7)*	1.0 *(0.9)*
Business fixed investment	0.7 *(0.7)*	0.9 *(1.0)*	0.8 *(0.8)*
Subtotal: Final domestic demand	3.7 *(3.7)*	4.1 *(3.8)*	3.4 *(3.5)*
Exports	1.9 *(1.9)*	1.4 *(0.9)*	2.2 *(2.2)*
Imports	-2.7 *(-2.7)*	-2.8 *(-2.0)*	-2.2 *(-2.4)*
Subtotal: Net exports	-0.8 *(-0.8)*	-1.4 *(-1.1)*	0 *(-0.2)*
Inventories	0 *(-0.1)*	0 *(-0.1)*	-0.1 *(0)*
GDP	2.9 *(2.8)*	2.7 *(2.6)*	3.3 *(3.3)*

1. Figures in parentheses are estimates used for the scenario in the April *Report*.

The Bank projects that real GDP growth will increase to about 3 per cent, on average, in the second half of 2005 and 3.4 per cent over the four quarters of 2006 (Chart 5, Table 2). Based on an assumed rate of growth of potential output of 3 per cent, this outlook implies that the economy will be operating at capacity in the second half of 2006.

Labour productivity in the first quarter of 2005 was up 1 per cent from its year-earlier level, following two years of surprisingly low growth. While the rebound is encouraging, productivity growth remains below the Bank's assumption for trend growth in productivity of 1 3/4 per cent.

Chart 5
Real Gross Domestic Product for Canada*



* Dashed line/bar denotes projection.

The Bank will continue to assess productivity developments for indications of growth in potential output.

Table 2
Projection Summary*

	2005			2006	
	Q2	Q3	Q4	H1	H2
Real GDP (quarter-over-quarter percentage change)	**2.3** (2.5)	**2.7** (2.7)	**3.3** (3.3)	**3.5** (3.5)	**3.3** (3.4)
Real GDP (year-over-year percentage change)	**2.6** (2.4)	**2.4** (2.4)	**2.6** (2.7)	**3.1** (3.1)	**3.4** (3.4)
Core inflation (year-over-year percentage change)	**1.6** (1.6)	**1.7** (1.7)	**1.7** (1.7)	**1.8** (1.8)	**1.9** (1.9)
Total CPI (year-over-year percentage change)	**1.9** (2.1)	**2.2** (2.3)	**2.4** (2.3)	**2.5** (2.2)	**2.0** (1.8)
WTI** (level)	**53** (56)	**60** (57)	**61** (57)	**61** (56)	**60** (54)

* Figures in parentheses are from the April *Monetary Policy Report*.
** 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 7 July 2005

The Outlook for Inflation

The factors governing the outlook for inflation are the same as those described in the April *Report*.

The core rate of inflation is expected to remain close to 1.7 per cent over the remainder of this year. With the economy projected to operate near its full production capacity, and with inflation expectations remaining well anchored, the core rate is projected to rise gradually to 2 per cent by the end of next year (Table 2).

The outlook for the 12-month rate of increase in the total CPI will continue to be importantly affected by developments in the market for crude oil. Based on an average of recent oil-price futures, total CPI inflation is expected to move up to about 2.5 per cent in late 2005. By the end of 2006, total CPI inflation is expected to have moved back down to the target rate of 2 per cent.

Copies of the *Monetary Policy Report* and the *Update* can be obtained by contacting the Bank at:

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