BANK OF CANADA

MONETARY POLICY REPORT UPDATE

– January 2006 –

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 24 January 2006.

Overview

The Canadian and global economies are evolving essentially in line with the Bank's expectations. The outlook for growth and inflation in Canada is similar to that in the October *Monetary Policy Report*.

Canada's real gross domestic product (GDP) is expected to have grown at an annual rate of about 3 per cent in the second half of 2005. The Canadian economy continues to adjust to global developments and to the associated changes in relative prices. Prices of energy commodities surged in the second half of 2005. The Canadian dollar has appreciated modestly against the U.S. dollar to a slightly higher range of 85 to 87 cents U.S.

Reflecting large swings in gasoline prices, total CPI inflation has been volatile, spiking above 3 per cent, as expected, but then reversing more quickly than anticipated. Core inflation has been quite stable at 1.6 per cent as expected.

While various indicators suggest different degrees of pressure, the Bank continues to judge that the economy is operating at its production capacity.

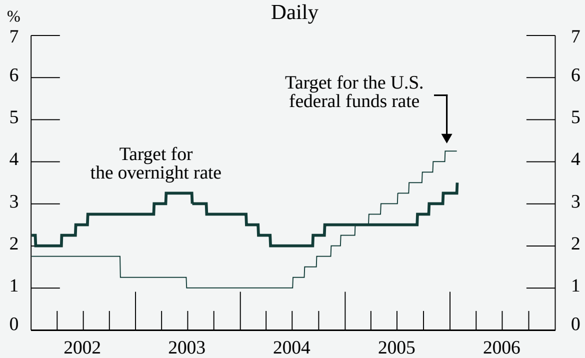
A solid rate of economic expansion is expected to continue in the United States and in the global economy more broadly. Against this backdrop, the Bank's base-case projection for Canada calls for strong growth in domestic demand and further gains in exports. Nevertheless, net exports will likely exert a small drag on growth through 2006 and 2007. Annual GDP growth is expected to be 3.1 per cent this year and 2.9 per cent in 2007, keeping the economy close to its production capacity.

Total CPI inflation will continue to be affected by the prices of crude oil and natural gas. The Bank is projecting total inflation of about 2.5 per cent in the first half of

Highlights

- The Canadian economy is operating at its production capacity.
- The Bank continues to project that the Canadian economy will grow roughly in line with its production potential through 2007.
- CPI and core inflation should return to the 2 per cent target by the first half of 2007.
- Risks to the Bank's projection remain balanced for 2006 and tilted to the downside through 2007 and beyond.
- In line with the Bank's outlook, some modest further increase in the policy interest rate would be required.

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



2006, easing to 2 per cent by the first half of 2007. Core inflation should also return to 2 per cent by the first half of 2007, somewhat later than projected in the October *Report*, owing largely to more persistent downward pressure from import prices.

The risks to the base-case projection remain balanced for 2006 and tilted to the downside through 2007 and beyond.

The Bank raised its key policy interest rate by 25 basis points at each of the last four fixed announcement dates, bringing the target for the overnight rate to 3.5 per cent (Chart 1). In line with the Bank's base-case projection and the current assessment of risks, some modest further increase in the policy interest rate would be required to keep aggregate supply and demand in balance and inflation on target over the medium term.

Recent Economic and Financial Developments

In 2005, the global economy continued to exhibit robust growth. In the United States, recent indicators suggest that real GDP growth was 3.6 per cent in 2005, just above the 3.5 per cent projected in the October *Report*. When combined with continued strong economic growth in China and some pickup in domestic demand in Japan, global GDP growth for 2005 is likely to have averaged just over 4 per cent.

In the second half of 2005, the Canadian economy continued to make significant adjustments to global developments and to the associated changes in relative prices. These include strong world economic growth, the high level of commodity prices, declining prices for many manufactured goods, and the appreciation of the Canadian dollar.

Particularly noteworthy was a substantial rise in Canada's terms of trade (the price of exports relative to the price of imports), chiefly reflecting the surge in the prices of energy commodities and products. On a year-over-year basis, the terms of trade were up 4.4 per cent in the third quarter of 2005, and recent indicators suggest that they continued to rise in the fourth quarter. As a result, real income increased more rapidly than real output (measured by real GDP). This showed up in gains in corporate profits, labour income, and government revenues, and in a surge in the equity values of energy and mining companies.

Continued strong growth in the global economy, combined with higher export prices, appears to have supported substantial gains in capital spending by businesses and in export volumes. While the pace of household consumption eased somewhat in the second half of 2005, it remained an important contributor to the considerable growth in domestic demand over the period (Chart 2).

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

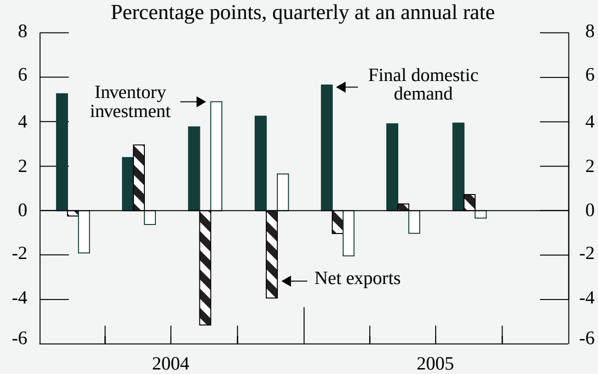
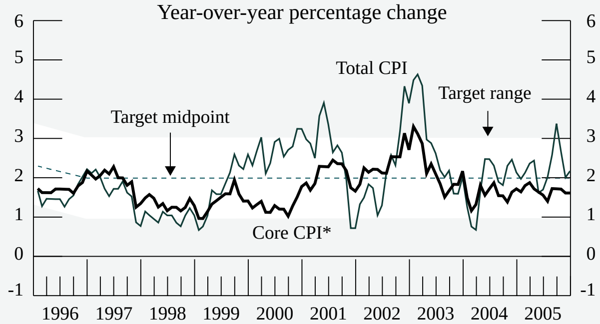


Chart 3
Consumer Price Index
Year-over-year percentage change



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

Overall, Canada's real GDP is expected to have grown at an annual rate of about 3 per cent in the second half of 2005. This implies that the level of activity at year-end was close to that projected in the October *Report*.

The 12-month rate of increase in the total CPI continued to exhibit marked volatility in the last four months of 2005 (Chart 3). As expected, total CPI inflation spiked above 3 per cent in September with the temporary surge in gasoline prices that followed disruptions to U.S. production from hurricane damage. In the fourth quarter of 2005, total CPI inflation, at 2.3 per cent, was lower than expected in the October *Report*. This chiefly reflected a quicker-than-expected reversal of the earlier spike in gasoline prices caused by somewhat lower prices for crude oil and a faster return of profit margins to more normal levels.

In contrast, the core rate of inflation remained quite stable. Even as the economy appeared to be operating at its production capacity in the fourth quarter, the core CPI was up 1.6 per cent from a year earlier, unchanged from its rate in the previous two quarters. Decreases in the prices of many import-intensive goods continued to exert downward pressure on the core rate, reflecting the combined effect of declines in the world prices of many manufactured goods and the past appreciation of the Canadian dollar. There has been no evidence that higher energy prices have fed through broadly to core inflation.

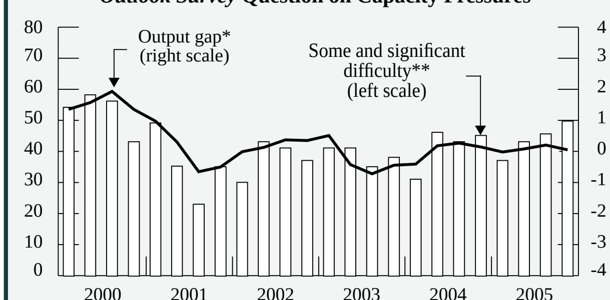
The underlying rate of increase in wages appears to have moved up to a range between 3 1/2 and 4 per cent since mid-2005. Unit labour costs in the business sector in the third quarter of 2005 were 2.6 per cent higher than year-earlier levels.

Pressures on Capacity

Various indicators suggest somewhat different degrees of pressure on production capacity. Statistics Canada's measure of capacity utilization in the non-farm, goods-producing sector continues to suggest marked pressure on production capacity. In the Bank's winter *Business Outlook Survey*, the percentage of firms reporting pressures on production capacity or labour shortages remained well above average. While capacity constraints are most apparent in Western Canada, a number of firms in the rest of the country report that they are more fully utilizing their existing capacity.

At the same time, the Bank's conventional measure of the output gap indicates that the economy was operating at its production capacity at the end of 2005 (Chart 4).

Chart 4
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 2005 is based on a projected rise in output of 2.5 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

A number of labour market indicators suggest that the economy has been operating close to potential. In particular, increases in labour costs now appear to be more consistent with the economy being close to its production capacity than was the case at the time of the last *Report*.

The core rate of inflation points to less pressure on capacity. It has continued to stay below 2 per cent since the end of 2003.

It is the Governing Council's judgment, after reviewing all the indicators of capacity pressures, that the economy was operating at its production capacity at the end of 2005.

Financial Conditions

The Canadian dollar has appreciated modestly against the U.S. dollar since the October *Report* and has moved from the range of 84 to 86 cents U.S., which had been in place since September 2005, to a slightly higher range of 85 to 87 cents U.S. The Canadian dollar was essentially unchanged against most other major currencies over this period. Robust commodity prices continue to contribute to the strength of the Canadian dollar.

Financial conditions in Canada remain favourable. Yields on corporate bonds remain low, equity markets have improved over recent months, and market volatility is low.

The Economic Outlook

The Bank's base-case projection continues to incorporate the following key assumptions: energy prices consistent with current futures prices; a smooth and orderly resolution of global imbalances over the medium term, including a modest and gradual further real effective depreciation of the U.S. dollar; and a Canada/U.S. exchange rate in its current range of 85 to 87 cents U.S.

Growth in the global economy is expected to remain robust at just over 4 per cent in 2006 and about 4 per cent in 2007. This reflects continued economic strength in Asia, a gradual pickup in Europe, and solid growth in the United States. The outlook for the U.S. economy is similar to that in the October *Report*. With post-hurricane rebuilding and the recovery in consumer confidence, real GDP growth is expected to be 3.6 and 3.1 per cent in 2006 and 2007, respectively.

Prices for both crude oil and natural gas have been quite volatile since mid-October. Futures prices suggest that oil will average just above US$65 per barrel over the projection period and that natural gas prices will average close to US$10 per MMBtu.

Real prices for non-energy commodities are expected to remain near current levels through 2006 and 2007. Together

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

	2005	2006	2007
Consumption	2.2 *(2.2)*	1.7 *(1.6)*	1.6 *(1.7)*
Housing	0.2 *(0.3)*	-0.2 *(-0.2)*	0 *(0)*
Government	0.7 *(0.7)*	1.0 *(1.0)*	0.9 *(0.9)*
Business fixed investment	1.0 *(0.9)*	0.9 *(0.8)*	0.7 *(0.6)*
Subtotal: Final domestic demand	4.1 *(4.1)*	3.4 *(3.2)*	3.2 *(3.2)*
Exports	1.3 *(1.3)*	2.1 *(2.1)*	1.6 *(1.6)*
Imports	-2.6 *(-2.7)*	-2.4 *(-2.3)*	-1.9 *(-1.8)*
Subtotal: Net exports	-1.3 *(-1.4)*	-0.3 *(-0.2)*	-0.3 *(-0.2)*
Inventories	0.1 *(0.1)*	0 *(-0.1)*	0 *(0)*
GDP	2.9 *(2.8)*	3.1 *(2.9)*	2.9 *(3.0)*

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

with the assumptions for the prices of energy commodities, this implies that Canada's terms of trade will stay close to the high level reached in the second half of 2005.

Against this backdrop, the base-case projection for Canada calls for solid growth in final domestic demand to continue to contribute importantly to economic expansion through 2006 and 2007 (Table 1). In particular, business investment is projected to grow strongly, owing to a number of factors including the global economic expansion and expectations of persistently high commodity prices.

Following a substantial increase in 2005, consumer spending is also expected to rise solidly over the projection period. This would chiefly reflect relatively robust gains in real incomes. In contrast, investment in housing is expected to ease slightly, after strong increases in recent years.

Growth in spending on goods and services by all levels of government combined is assumed to be strong, with overall expenditures on goods, services, and transfers increasing broadly in line with revenues.

Exports are projected to rise further as a result of the continued expansion of the U.S. economy, while further marked gains in investment in machinery and equipment should continue to stimulate imports. Although the adjustment of net exports to the rise of the Canadian dollar through 2003 and 2004 seems to be well advanced, the subsequent strengthening of the Canadian exchange rate is expected to result in net exports exerting a modest drag on overall growth through 2006 and 2007.

The Bank's base-case projection calls for economic growth of 3.1 per cent in 2006 and 2.9 per cent in 2007, similar to that in the October *Report* (Chart 5, Table 2). Growth in potential output continues to be projected at 2.9 per cent in 2006 and 3.0 per cent in 2007.

This growth profile implies that the economy would be in slight excess demand in 2006, returning to its production capacity by the end of 2007. In this base-case projection, two factors contribute to bringing aggregate supply and demand back into balance next year: the effect of higher short-term interest rates and a projected slowing of the U.S. economy.

With the economy pressing against its production capacity and with inflation expectations well anchored, the core rate of

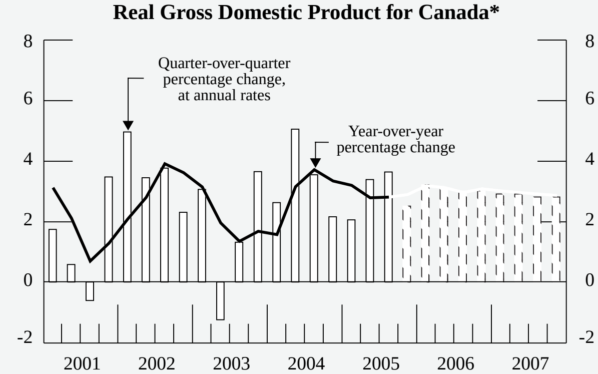
Table 2
Summary of the Base-Case Projection *

	2005	2006			2007	
	Q4	Q1	Q2	H2	H1	H2
Real GDP (quarter-to-quarter percentage change at annual rates)	**2.5** *(2.7)*	**3.2** *(2.9)*	**3.1** *(2.9)*	**3.0** *(2.9)*	**2.9** *(3.0)*	**2.8** *(3.0)*
Real GDP (year-over-year percentage change)	**2.9** *(2.8)*	**3.2** *(2.9)*	**3.1** *(2.9)*	**3.0** *(2.9)*	**3.0** *(2.9)*	**2.9** *(3.0)*
Core inflation (year-over-year percentage change)	**1.6** *(1.6)*	**1.7** *(1.7)*	**1.8** *(1.9)*	**1.9** *(2.0)*	**2.0** *(2.0)*	**2.0** *(2.0)*
Total CPI (year-over-year percentage change)	**2.3** *(2.9)*	**2.5** *(2.8)*	**2.4** *(2.8)*	**2.1** *(2.0)*	**2.0** *(1.9)*	**2.0** *(1.9)*
WTI** (level)	**60** *(63)*	**65** *(64)*	**66** *(64)*	**67** *(64)*	**67** *(63)*	**67** *(62)*

* Figures in parentheses are from the October *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 20 January 2006

Chart 5
Real Gross Domestic Product for Canada*



* Dashed line/bar denotes projection.

inflation is projected to increase to 2 per cent by the first half of 2007. This is somewhat later than projected in the October *Report*, reflecting the impact on consumer prices of more persistent declines than previously anticipated in the Canadian-dollar prices of many manufactured goods.

The outlook for the 12-month rate of increase in the total CPI will continue to be importantly affected by developments in the markets for crude oil and natural gas. Total CPI inflation is expected to be about 2.5 per cent in the first half of 2006 before returning to the 2 per cent target by the first half of 2007.

Risks to the Base-Case Projection

Risks to the base-case projection for Canada still appear to be balanced for 2006, with both upside and downside risks to global economic growth.

Through 2007 and beyond, risks are tilted to the downside. Should the unwinding of global imbalances involve a slowdown in world economic activity, it would imply lower net export volumes, lower commodity prices, and less growth in business investment for Canada than in the base-case projection. If there were also a pronounced depreciation of the U.S. dollar against the Canadian dollar as part of a broader adjustment in currencies, then the negative impact on the demand for Canadian products would be greater.

In addition to these risks, there continue to be uncertainties about the overall assessment of capacity pressures and their effect on inflation, owing to the large sectoral and regional shifts under way in the Canadian economy. The Bank is monitoring this closely.

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

Copies can also be obtained by contacting the Bank at:
Telephone: (613) 782-8248; email: publications@bankofcanada.ca