Monetary Policy Report Update

– *July 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 11 July 2006.

Overview

Overall, the outlook for economic growth and inflation in Canada is largely unchanged from that set out in the April *Monetary Policy Report*. Growth in the first half of 2006 appears to have been a little stronger, and the Canadian dollar has traded in a higher range than envisaged in the last *Report*. As well, there was a further shift in the composition of demand towards consumption and away from exports. This additional strength in domestic demand is expected to persist into next year, but it should be more than offset by a weaker outlook for net exports, owing primarily to the recent strength in the Canadian dollar. Hence, in aggregate, growth in 2007–08 is expected to be a little weaker than projected in April.

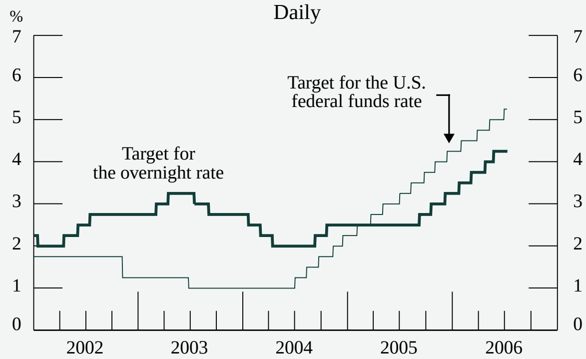
The economy is currently judged to be operating just above its production capacity. With some anticipated moderation in U.S. economic growth, combined with past interest rate and exchange rate increases, the Canadian economy is projected to return to its production capacity by the end of 2008. The Bank projects real GDP growth of 3.2 per cent in 2006, 2.9 per cent in 2007, and 2.8 per cent in 2008.

Total CPI inflation is expected to average just over 1 1/2 per cent from mid-2006 to mid-2007, with the reduction in the Goods and Services Tax (GST) lowering the inflation rate by 0.6 percentage points over this period. Inflation should then return to the 2 per cent target and remain there. Upward pressure on inflation from excess demand in the economy is offset by downward pressure from the declining prices of many imported consumer goods.

Highlights

- Overall, the outlook for growth and inflation in Canada is largely unchanged from April.
- While growth in the first half of 2006 appears to have been a little stronger, growth in 2007–08 is expected to be a little weaker, owing primarily to the lagged effects of the higher dollar.
- Total CPI inflation should average just over 1 1/2 per cent until mid-2007 and then return to the 2 per cent target.
- Risks to the Bank's projection remain roughly balanced, with a small tilt to the downside later in the projection period.
- The current level of the policy interest rate is judged at this time to be consistent with achieving the inflation target.

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



Core inflation (which excludes the effect of changes in indirect taxes, as well as eight of the most volatile CPI components) should remain at about 2 per cent throughout the projection period.

Since the April *Report*, world economic developments have generally been in line with our base-case assumption of an orderly resolution of global imbalances. Some rotation in global demand is becoming evident, with stronger domestic demand in Europe and Japan, weaker consumption in the United States, and some further real effective depreciation of the U.S. dollar.

There are important upside and downside risks to the projection, but the Bank continues to judge that these risks are roughly balanced. The upside risks to Canadian output and inflation relate primarily to the momentum in household spending and housing prices. The main downside risk for Canada is that the U.S. economy could slow more rapidly than expected, reducing demand for Canadian exports. Because of the possibility of a disorderly resolution of global current account imbalances, the balance of risks is tilted slightly to the downside later in the projection period.

The Bank of Canada raised the target for the overnight rate by 25 basis points to 4.25 per cent in late May. On 11 July, the target rate was left unchanged (Chart 1). The current level of the policy rate is judged, at this time, to be consistent with achieving the inflation target over the medium term. The Bank will monitor global and domestic economic and financial developments, including adjustments in the Canadian economy, relative to its projection.

Recent Economic and Financial Developments

Global Developments

The global economic expansion remains robust, with growth in China and the euro zone over the past few months slightly stronger than expected.

Economic activity in the United States is unfolding largely as anticipated. Real GDP growth has been strong over the past year, growing faster than potential output on average. The U.S. economy appears to be operating close to its potential, and recent indicators suggest that real GDP growth is moderating, particularly growth in residential investment and consumer spending.

Measures of inflation in the United States have moved slightly higher than expected, apparently reflecting a stronger response to continued strong growth, the cumulative increase in commodity prices, and the sizable real effective depreciation of the U.S. dollar since 2002.

Financial and Commodity Markets

In response to the evolving global situation, a number of major central banks have continued to tighten their monetary policy since the April *Report*. The U.S. Federal Reserve and the European Central Bank, among others, have raised their respective policy rates. The Bank of Japan has continued to gradually exit its quantitative easing policy.

Partly associated with the global rise in interest rates, equity markets in many countries declined in the past few months. However, the largest declines in prices occurred in markets that had experienced significant gains in the first four months of 2006. Volatility in markets rose but has since subsided.

Despite the substantial swings in the prices of metals and other commodities, the overall level of commodity prices at mid-2006 remained at about the level expected at the time of the last *Report*. Since that *Report*, the Canadian dollar has moved up against the U.S. dollar into a range of about 88.5 to 91.5 cents U.S. from a range of about 85.5 to 88.5 cents U.S.

Canadian Economic Activity

Canada's real GDP appears to have grown a little faster than expected in the first half of 2006. The economy continued to adjust to global developments that included continuing high prices for many of the commodities that Canada exports and a strong Canadian dollar.

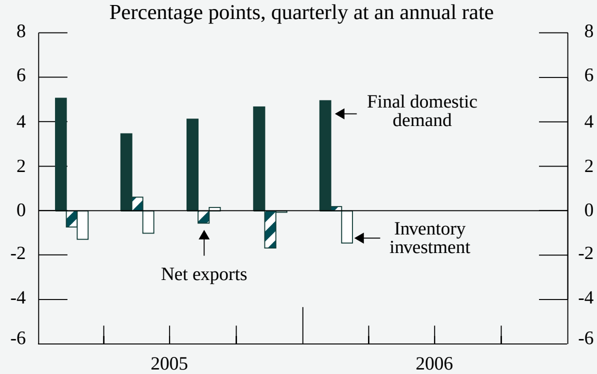
Real GDP rose at an annual rate of 3.8 per cent in the first quarter of 2006, higher than the 3.2 per cent expected in the April *Report*. Final domestic demand remained the major contributor to GDP growth (Chart 2).

The Bank's monitoring of available information points to real GDP growth of about 3.2 per cent in the second quarter, as previously anticipated. Monthly information indicates that consumer spending has been growing faster than expected as a result of further substantial increases in employment, real personal disposable income, and household net worth. This development is also consistent with continued strong growth in household credit. This additional strength in consumer spending appears to have been offset by greater-than-projected weakness in merchandise export volumes during the same period.

Chart 2

Contribution to Real GDP Growth

Percentage points, quarterly at an annual rate



Pressures on Capacity

The stronger economic growth in the first half of the year means that, at mid-year, the level of activity and the estimated degree of pressure on production capacity are marginally higher than projected in the April *Report*.

The Bank's conventional measure of the output gap, which is surrounded by a wide confidence interval, suggests that the economy was operating about 0.4 per cent above its production potential in the second quarter. In the Bank's summer *Business Outlook Survey*, the percentage of companies reporting difficulties in meeting an unanticipated increase in demand remained above average (Chart 3).

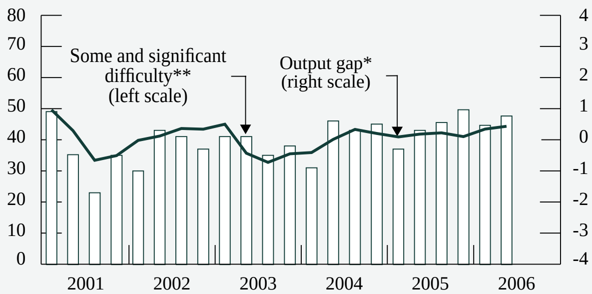
The employment-to-population ratio reached a record high in May 2006, and the unemployment rate fell to its lowest level since the mid-1970s. This tightness in labour markets is, however, less evident in wage developments. The underlying trend in wage increases has fluctuated between 3 per cent and 4 per cent over the past year and, with trend productivity growth close to 1 3/4 per cent, underlying increases in unit labour costs appear to be about 2 per cent.

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

Inflation and the 2 Per Cent Target

The 12-month rate of increase in the total CPI continued to be above the Bank's 2 per cent inflation-control target, averaging 2.6 per cent in April and May of 2006

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

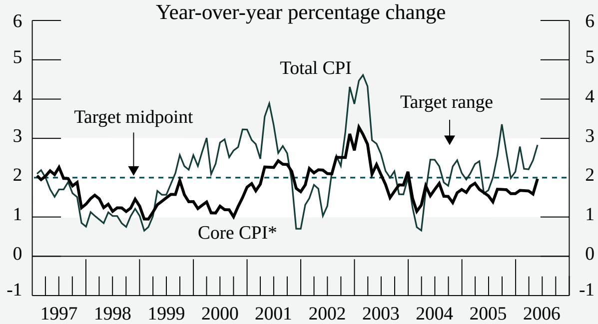


* Difference between actual output and estimated potential output based on the Bank's conventional measure. The estimate for the second quarter of 2006 is based on a projected rise in output of 3.2 per cent (at annual rates).
** Percentage of firms indicating that they would have either some or significant difficulty meeting an unanticipated increase in demand/sales

(Chart 4). Once again, this resulted mainly from substantial increases in energy prices at the consumer level.

In contrast, the core rate of inflation remained below 2 per cent in the first four months of 2006, before moving up to 2 per cent in May—slightly sooner than expected. The rate of increase in the price of shelter for homeowners has picked up since early this year because of higher prices for new housing. The rate of increase in the prices of other services has also strengthened. At the same time, the prices of many import-intensive goods have continued to come under downward pressure from decreases in the world prices of many manufactured goods and from the past appreciation of the Canadian dollar.

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

The Economic Outlook

The Bank's base-case projection assumes energy prices consistent with current futures prices, as well as a smooth and orderly resolution of global imbalances, resulting from supportive policy actions to rebalance global demand combined with a gradual real effective depreciation of the U.S. dollar.

Global economic growth in 2006 is now expected to be 4.9 per cent, slightly stronger than the 4.8 per cent anticipated at the time of the last *Report*. The current momentum in global economic activity is projected to ease gradually, with global economic growth slowing to 4.6 per cent in 2007 and 4.4 per cent in 2008, more in line with growth in world production potential.

Consistent with the April *Report*, real GDP growth in the United States is expected to average 3.5 per cent in 2006, before moderating to a rate close to potential growth of about 3.2 per cent in 2007 and 2008. Housing activity and growth in consumption are projected to slow as part of a rotation in the source of growth away from domestic demand and towards exports.

Prices for crude oil futures over the projection period are slightly higher than those in the April *Report*, averaging just over US$74 per barrel, while those for natural gas are somewhat lower.

The price index for non-energy commodities is expected to ease over the projection period from the high levels reached in the second quarter of 2006, largely as a result of declines in metals prices as increases in world supply become more evident. Nevertheless, the projected level of non-energy commodity prices remains high relative to historical experience.

The Bank's base-case projection for economic growth in Canada is 3.2 per cent in 2006, 2.9 per cent in 2007, and 2.8 per cent in 2008 (Chart 5, Table 1). While this overall outlook for growth is largely unchanged from that in the April *Report*, it is a little stronger in 2006 and a little lower in 2007 and 2008. The slower growth stems from the assumption that the Canada-U.S. exchange rate will stay in its recent higher range over the projection period. In addition, the projected composition of growth has changed somewhat since April (Table 1). Stronger growth in consumption spending is offset by a weaker outlook for net exports.

Strong domestic demand in Canada, supported by robust global growth, remains a key feature of the base-case projection. Business investment and consumer spending are expected to remain strong, while spending on housing, after rising considerably in 2006, is expected to decline slightly in 2007 and 2008. Government expenditures on goods, services, and transfers are assumed to increase broadly in line with revenues over the projection period, adding to the strength of domestic demand.

While exports are expected to continue to increase, reflecting the strength in global demand, export growth is now projected to make a more modest contribution to growth owing to the assumption that the exchange rate remains in its current range. At the same time, further marked gains in investment in machinery and equipment, combined with the strength in the Canadian dollar, should stimulate imports. Thus, net exports are expected to exert a drag on overall growth for some time, though this effect should diminish over the projection period.

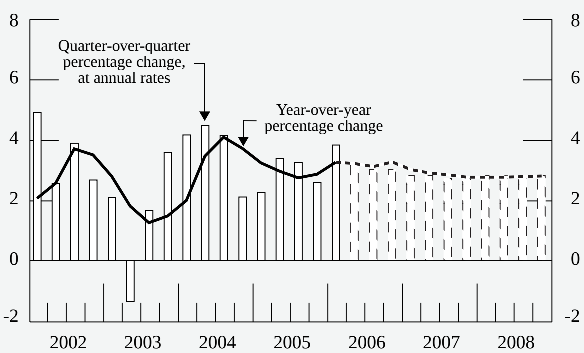
The assumption for potential output growth continues to be 2.9 per cent in 2006 and 3.0 per cent in 2007 and 2008.[1] This growth profile implies that the economy would remain in slight excess demand over the remainder of 2006, before returning to its production capacity by the end of 2008.

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

	2006	2007	2008
Consumption	2.0 *(1.8)*	1.8 *(1.6)*	1.6 *(1.6)*
Housing	0.2 *(0.1)*	-0.1 *(-0.1)*	-0.1 *(-0.1)*
Government	0.8 *(0.9)*	0.8 *(0.9)*	0.7 *(0.6)*
Business fixed investment	1.0 *(1.0)*	0.9 *(0.8)*	0.6 *(0.7)*
Subtotal: Final domestic demand	4.0 *(3.8)*	3.4 *(3.2)*	2.8 *(2.8)*
Exports	1.1 *(1.7)*	1.2 *(1.4)*	1.2 *(1.2)*
Imports	-2.0 *(-2.1)*	-1.7 *(-1.6)*	-1.2 *(-1.1)*
Subtotal: Net exports	-0.9 *(-0.4)*	-0.5 *(-0.2)*	0 *(0.1)*
Inventories	0.1 *(-0.3)*	0 *(0)*	0 *(0)*
GDP	3.2 *(3.1)*	2.9 *(3.0)*	2.8 *(2.9)*

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

Chart 5
Real Gross Domestic Product for Canada*



* Dashed line/bar denotes projection.

1. Since the April *Report*, Statistics Canada has revised up its estimates of labour productivity growth for 2005, giving the Bank greater confidence in its assumption of 1 3/4 per cent for trend productivity growth and 3 per cent for potential output growth.

In this base-case projection, the anticipated moderation of U.S. growth, combined with the lagged effects of past interest rate and exchange rate increases, brings aggregate supply and demand back into balance. Hence, in this projection, the current level of the policy interest rate is consistent with achieving the 2 per cent inflation target.

Movements in the 12-month rate of increase in total CPI inflation will be importantly influenced by the cut in the GST from 7 per cent to 6 per cent on 1 July 2006 and by developments in the markets for crude oil and natural gas. The direct effect of the one-percentage-point cut in the GST on the total CPI is estimated to be 0.6 per cent. Total CPI inflation is expected to average just over 1 1/2 per cent in the second half of 2006 and the first half of 2007, before returning to the 2 per cent target (Table 2). Note that total CPI inflation is likely to fall temporarily to close to 1 per cent this September, reflecting the brief surge in energy prices last September.

Core inflation is expected to remain at about 2 per cent throughout the projection period. The upward pressure on inflation from excess demand in the economy should be offset by continued downward pressure from further reductions in the prices of manufactured goods. These two offsetting factors are projected to diminish in tandem over the projection period, with the result that the core rate should stay at 2 per cent.

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

	2006				2007		2008
	Q1	Q2	Q3	Q4	H1	H2	
Real GDP (quarter-to-quarter percentage change at annual rates)[b]	**3.8** *(3.2)*	**3.2** *(3.2)*	**3.0** *(3.0)*	**3.0** *(3.0)*	**2.8** *(2.9)*	**2.7** *(2.9)*	**2.8** *(2.9)*
Real GDP (year-over-year percentage change)	**3.2** *(3.2)*	**3.2** *(3.1)*	**3.1** *(3.0)*	**3.2** *(3.1)*	**2.9** *(3.0)*	**2.8** *(2.9)*	**2.8** *(2.9)*
Core inflation (year-over-year percentage change)	**1.7** *(1.7)*	**1.8** *(1.8)*	**2.0** *(2.0)*	**2.0** *(2.0)*	**2.0** *(2.0)*	**2.0** *(2.0)*	**2.0** *(2.0)*
Total CPI (year-over-year percentage change)	**2.4** *(2.4)*	**2.7** *(2.6)*	**1.5** *(1.9)*[c]	**1.8** *(2.3)*[c]	**1.6** *(2.1)*[c]	**2.0** *(2.0)*	**2.0** *(2.0)*
Total CPI excluding the effect of changes in indirect taxes (year-over-year percentage change)	**2.4** *(2.4)*	**2.7** *(2.6)*	**2.1** *(1.9)*	**2.4** *(2.3)*	**2.2** *(2.1)*	**2.0** *(2.0)*	**2.0** *(2.0)*
WTI[d] (level)	**63** *(63)*	**71** *(70)*	**73** *(73)*	**75** *(74)*	**76** *(74)*	**75** *(73)*	**73** *(71)*

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. Note that the base-case projection for total CPI in the April *Report* did not assume any reduction in the GST, an indirect tax.
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 7 July 2006.

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