BANK OF CANADA

MONETARY POLICY REPORT

– October 2005 –

Summary

Overview

The global economy has continued to grow at a robust pace since the July *Monetary Policy Report Update*. Canada's economic growth in the first half of the year was somewhat stronger than had been expected. Overall, the economy now appears to be operating at full production capacity.

At the same time, the global and Canadian economies have continued to experience significant movements in energy prices. While the spikes in crude oil and gasoline prices caused by hurricanes in the Gulf of Mexico have already reversed, prices for natural gas and heating oil, as well as gasoline, are substantially higher than they were at the time of the July *Update*.

As well, the Canadian dollar has been trading in a higher range against the U.S. dollar since late summer, and has strengthened even further against other major currencies. This recent strength appears to be underpinned by fundamental factors, including high prices for crude oil and natural gas and Canada's generally solid economic performance.

Past and recent movements in energy prices and in the exchange rate for the Canadian dollar, along with competitive pressures from China and other newly industrialized economies, are giving rise to significant ongoing adjustments in the Canadian economy. This has resulted in considerable variation in the growth patterns of sectors and regions, making an

Highlights

- **The Canadian economy appears to be operating at full capacity.**
- **The Bank projects that the Canadian economy will grow in line with production potential through 2007.**
- **CPI and core inflation are expected to be 2 per cent in the second half of 2006. But CPI inflation will average near 3 per cent until then, boosted by high energy prices.**
- **The risks to the Bank's outlook appear balanced over the next four to six quarters, but are tilted to the downside through 2007 and beyond.**
- **In line with the Bank's outlook, some further reduction of monetary stimulus will be required.**

This is a summary of the Monetary Policy Report *of the Governing Council of the Bank of Canada. The* Report *is based on information received up to the fixed announcement date on 18 October 2005.*

assessment of overall capacity pressures and of the future growth of potential output particularly complex. Given these adjustments and the slow growth of productivity in recent years, the Bank has slightly reduced its estimate of potential output growth for 2005 and 2006.

The Bank's base-case projection sees the Canadian economy remaining at capacity through 2007. Real GDP is expected to grow at about the same pace as potential output over the projection period, averaging 2.8 per cent in 2005, 2.9 per cent in 2006, and 3 per cent the following year.

With the economy operating at capacity and with the increase in energy prices, pressures on consumer prices are somewhat stronger than they were at the time of the July *Update*. The annual rate of increase in the consumer price index (CPI) probably spiked above 3 per cent in September. On the assumption that energy prices evolve in line with currently prevailing futures prices, CPI inflation is projected to average near 3 per cent for the rest of 2005 and for the first half of 2006 before returning to the 2 per cent target in the second half. In contrast, core inflation should remain below 2 per cent in coming months. But with the economy operating at capacity and longer-term inflation expectations appearing to be well anchored, the Bank expects core inflation to return to 2 per cent by mid-2006.

The Bank's base-case outlook for output and inflation is subject to a number of risks and uncertainties. Over the next four to six quarters, these risks include the adjustment of the Canadian economy to global developments, uncertainty about the current level and future growth of potential output, and the evolution of energy prices. These short-term risks appear to be balanced. But looking further out to 2007 and beyond, there are increasing risks that the unwinding of global economic imbalances could involve a period of weak global growth.

90-Day Commercial Paper Rate, Target for the Overnight Rate, and Target for the Federal Funds Rate

The Bank raised its key policy interest rate by 25 basis points on 7 September and again on 18 October, bringing it to 3 per cent.

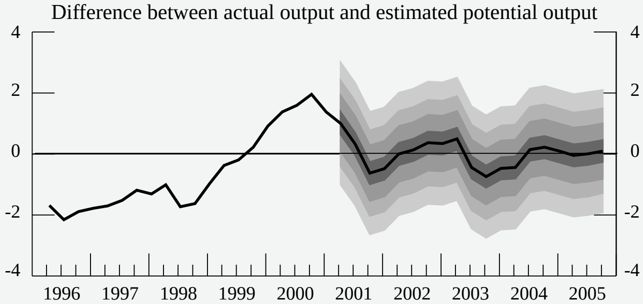
In line with the Bank's outlook, and given that the Canadian economy now appears to be operating at capacity, some further reduction of monetary stimulus will be required to maintain a balance between aggregate supply and demand over the next four to six quarters, and to keep inflation on target. However, with risks to the global outlook tilted to the downside as we look to 2007 and beyond, the Bank will monitor international developments particularly closely. More generally, the Bank will continue to assess the adjustments and underlying trends in the Canadian economy, as well as the balance of risks, as it conducts monetary policy to keep inflation on target over the medium term.

Recent Developments

CPI inflation was quite volatile over the first eight months of 2005, owing to fluctuations in energy prices —particularly gasoline prices. It averaged slightly above the Bank's 2 per

Estimated Output Gap*

Difference between actual output and estimated potential output



* The shading around the values of the estimated output gap shows (from darkest to lightest) confidence intervals of 25 per cent, 50 per cent, 75 per cent, and 95 per cent.

Note: The estimate for the third quarter of 2005 is based on a projected rise in output of 3 per cent (at annual rates) for the quarter.

cent target during this time, while core inflation averaged 1.6 per cent.

Real GDP grew at an annual rate of 2.7 per cent in the first half of 2005—somewhat stronger than projected. Final domestic demand continued to expand strongly.

At the time of the July *Update*, the Bank said that it expected the Canadian economy to have a slight amount of unused capacity at mid-year. The Governing Council now judges that the economy was operating at full capacity in the second quarter of 2005.

Prospects for Growth and Inflation

The Bank's base-case outlook for the global and Canadian economies incorporates a number of assumptions. These include energy prices consistent with current futures prices; a smooth and orderly resolution of global imbalances, involving a modest further depreciation of the U.S. dollar; and a relatively stable Canada-U.S. exchange rate in the recent range of 84 to 86 cents U.S. over the projection period.

The Bank's base-case outlook suggests that global economic growth will continue at about 4 per cent per year, since growth in China and other newly industrialized Asian economies should remain strong. The U.S. economy is expected to grow by 3.5 per cent in 2005, somewhat less than the 3.7 per cent forecast in the July *Update*, mainly because of higher energy prices and the disruptive economic effects of hurricanes. Growth should pick up in 2006, since the effect of higher energy prices should be more than offset by spending on reconstruction efforts. U.S. growth is forecast to ease modestly in 2007, as domestic demand begins to slow in the face of higher policy interest rates and increased net savings by households and governments.

In Canada, the Bank projects that robust final domestic demand will continue to support economic growth through 2007. Business investment is expected to continue to increase strongly. Consumer spending should also continue to rise but at a somewhat slower pace than forecast in the July *Update*, partly because of higher energy prices. Housing investment will likely be little changed, and total spending by all levels of government should grow in line with revenues.

Growth abroad should lead to gains in exports, while substantial investment in machinery and equipment should boost imports. The past and recent appreciation of the Canadian dollar will also affect exports and imports. On balance, net exports are expected to exert a small drag on overall growth through 2006 and 2007.

All told, the Bank's base-case projection calls for Canada's average annual GDP to grow by 2.8 per cent this year, 2.9 per cent in 2006, and 3.0 per cent in 2007. CPI inflation is projected to return to the 2 per cent target in the second half of 2006. With the economy operating at capacity throughout the projection period and with inflation expectations well anchored, core inflation is expected to rise to 2 per cent by mid-2006.

Risks to the Outlook

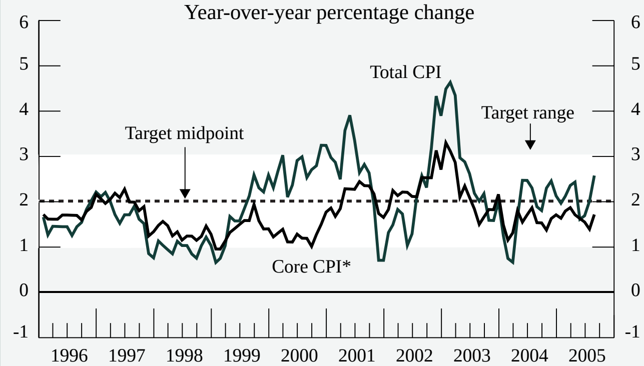
Over the next four to six quarters, the risks to the Canadian outlook appear to be balanced. There are both upside and downside risks to global economic activity, particularly related to future energy prices and the pace of growth in China. There are still upside and downside risks to exports and imports related to how the Canadian economy continues to adjust to the appreciation of the Canadian dollar, higher commodity prices, and increased competition from China and other newly industrialized economies.

The ongoing adjustments and large changes in relative prices also pose some risks to the outlook for inflation. The sectoral and regional shifts occurring in the Canadian economy make the overall assessment of capacity pressures particularly complex. There is also a risk that, with the Canadian economy operating at capacity, the rise in energy costs could feed through more broadly to other prices, putting upward pressure on inflation. The potential for this to affect longer-term inflation expectations should be mitigated, however, by monetary policy clearly focused on achieving the 2 per cent target.

For 2007 and beyond, the risks are tilted to the downside. The principal risk is that, as household and government savings rates begin to rise in the United States, domestic demand elsewhere in the world will fail to pick up sufficiently to sustain world demand. The longer these global imbalances persist without appropriate policy actions being taken, the greater is the risk of an abrupt and disorderly adjustment. This scenario would likely involve large movements in exchange rates and other asset prices and a sharp slowing in the world economy. The negative impact on the demand for Canadian-produced goods and services would have implications for the conduct of monetary policy.

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

Summary of the Base-Case Projection*

	2005		2006			2007	
	Q3	Q4	Q1	Q2	H2	H1	H2
Real GDP (quarter-to-quarter percentage change at annual rates)	**3.0** *(2.7)*	**2.7** *(3.3)*	**2.9** *(3.5)*	**2.9** *(3.5)*	**2.9** *(3.3)*	**3.0**	**3.0**
Real GDP (year-over-year percentage change)	**2.6** *(2.4)*	**2.8** *(2.6)*	**2.9** *(3.0)*	**2.9** *(3.2)*	**2.9** *(3.4)*	**2.9**	**3.0**
Core inflation (year-over-year percentage change)	**1.6** *(1.7)*	**1.6** *(1.7)*	**1.7** *(1.8)*	**1.9** *(1.8)*	**2.0** *(1.9)*	**2.0**	**2.0**
Total CPI (year-over-year percentage change)	**2.7** *(2.2)*	**2.9** *(2.4)*	**2.8** *(2.5)*	**2.8** *(2.5)*	**2.0** *(2.0)*	**1.9**	**1.9**
WTI ** (level)	**63** *(60)*	**63** *(61)*	**64** *(61)*	**64** *(61)*	**64** *(60)*	**63**	**62**

* Figures in parentheses are from the July *Monetary Policy Report Update*.
** 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 14 October 2005.

The Bank of Canada's *Monetary Policy Report* is published semi-annually in April and October. Regular *Updates* are published in July and January. Copies of the full *Report*, the *Summary*, and the *Update* may be obtained by contacting Publications Distribution, Communications Department, Bank of Canada, Ottawa, Ontario, Canada K1A 0G9.

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