MONETARY POLICY REPORT

– October 2006 –

Summary

Overview

The Canadian economy continues to operate just above its full production capacity, and the near-term outlook for core inflation has moved slightly higher. However, with the U.S. economy slowing more quickly than expected, the base-case projection for Canadian economic growth has been revised down slightly from that in the July *Monetary Policy Report Update*. Lower energy prices have led to a downward revision of the projection for total consumer price inflation. They have also contributed to moving the Canadian dollar into a somewhat lower trading range.

Although domestic demand in Canada has continued to grow at a robust pace, GDP growth in the second and third quarters of 2006 has been slower than expected, largely because of weaker net exports. A weaker near-term outlook for the U.S. economy has curbed the near-term prospects for Canadian exports and growth. As well, the Bank has lowered its assumption for potential growth to 2.8 per cent for the 2006–08 period, given recent developments in labour productivity. As a result of these factors, the Bank's base-case projection for Canadian GDP growth has been lowered to 2.8 per cent this year and 2.5 per cent in 2007. But with the U.S. economy projected to recover by the end of 2007, growth should pick up to 2.8 per cent in 2008. Such a profile implies that the small amount of excess demand now in the economy will be eliminated by the second half of 2007 and that the economy

Highlights

- **The Canadian economy is judged to be operating just above its production capacity.**
- **The projection for Canadian growth has been lowered to 2.8 per cent for 2006 and 2.5 per cent for 2007, owing to a weaker near-term U.S. outlook.**
- **The Bank has lowered its assumption for potential growth to 2.8 per cent for 2006–08.**
- **Total CPI inflation is projected to average about 1 1/2 per cent until mid-2007 and then return to the 2 per cent target.**
- **The risks around the Bank's inflation projection are judged to be roughly balanced.**
- **The current level of the policy interest rate is judged, at this time, to be consistent with achieving the inflation target.**

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 17 October 2006.*

will then remain roughly in balance through to the end of the projection period.

With the economy currently in slight excess demand and with strong momentum in housing prices, core inflation is expected to move slightly above 2 per cent in the coming months. As the economy returns to potential and pressures from housing prices ease, core inflation should return to 2 per cent by the middle of 2007 and stay there through to the end of 2008.

Total CPI inflation will continue to be affected by the cut in the Goods and Services Tax (GST) and by developments in energy markets. Based on prices embedded in markets for energy futures, total inflation will likely average about 1 1/2 per cent through to the second quarter of 2007, before returning to the 2 per cent target and remaining there through to the end of the projection period.

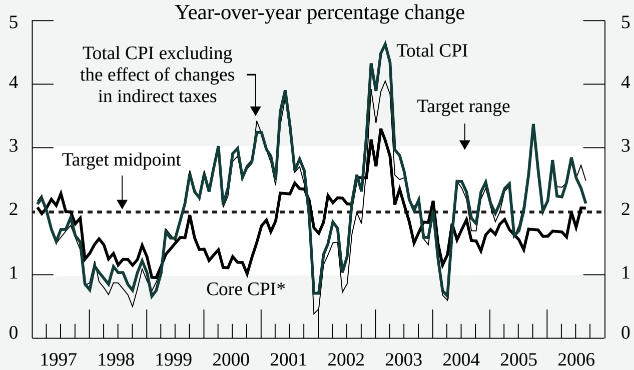
The Bank of Canada left the target for the overnight rate unchanged at 4.25 per cent on 6 September and 17 October. The current level of the policy rate is judged, at this time, to be consistent with achieving the inflation target over the medium term.

As noted in the press release of 6 September, the risks around the base-case projection are judged to be a little greater than at the time of the July *Update*. The main upside risk relates to the momentum in household spending and housing prices. The main downside risk is that the U.S. economy could slow more sharply than expected, leading to lower Canadian exports. The Bank judges that the upside and downside risks to its inflation projection are roughly balanced.

The correction of global imbalances is unfolding in a benign, albeit slow, manner. However, in the absence of further appropriate policy actions, there remains a possibility of a disorderly resolution of these imbalances. Consequently, the balance of risks for global and Canadian growth is tilted slightly to the downside late in the projection period.

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

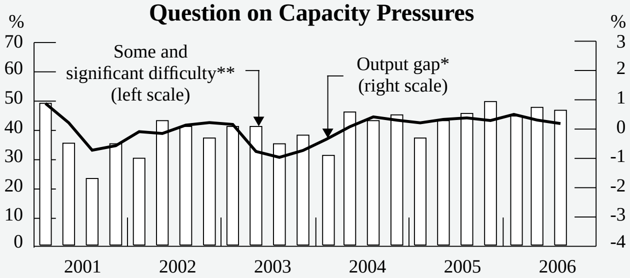
Recent Developments

Total CPI inflation has stayed above the 2 per cent target in recent months. Although total inflation was 2.1 per cent in August, down from 2.8 per cent in May, much of that decline represented the temporary impact of the reduction in the GST. Without the effect of changes in indirect taxes, inflation would have been 2.6 per cent in August. Higher prices for gasoline, housing, and some services have put upward pressure on inflation. But this has been partially offset by lower prices for many imported goods. Core inflation moved up to 2.0 per cent in July, which was earlier than had been expected, and remained there in August.

Economic growth slowed in the second quarter to a 2.0 per cent annual rate, down from 3.6 per cent in the first quarter, and lower than the 3.2 per cent rate projected in the July *Update*. Current information suggests that third-quarter growth was also about 2 per cent.

Final domestic demand continued to be the main driver of growth in the first half of the year. Gains in incomes and net worth led to strong household spending, while high profit levels helped support capital spending by business. Exports contracted in the first half of 2006 after growing at a rapid

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



* Difference between actual output and estimated potential output. Note that the estimate for the third quarter of 2006 is based on a projected rise in output of 2 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

pace in late 2005, but there are signs that export growth resumed in the third quarter.

The weaker-than-expected activity in the second and third quarters implies that the economy is operating at a level slightly lower than previously expected. With recent weakness in labour productivity growth, however, the Bank's conventional estimate of potential output for 2005–06 has also been revised down slightly. Thus, the conventional measure of the output gap indicates that the economy was operating at a level 0.2 per cent above its production potential in the third quarter. While there is considerable uncertainty surrounding this estimate, a wide range of indicators are broadly consistent with the Governing Council's judgment that the economy is operating just above its production capacity.

The prices of many non-energy commodities have remained firm. However, crude oil prices have come down in recent weeks, reflecting reduced supply risk and some easing in the projected growth of demand. There has also been a marked reduction in natural gas prices since the end of 2005. These developments mean a reduction in Canada's terms of trade and slower growth in nominal GDP over the balance of 2006. This implies some downward pressure on the growth of corporate profits and government revenues in the future.

Prospects for growth and inflation

The Bank's base-case projection has been developed assuming a slow and orderly resolution of global imbalances. Energy prices are assumed to evolve along a path that is consistent with current futures prices, and the Canadian dollar is assumed to remain within the recent range of 87.5 to 90.5 cents U.S.

The global economy continues to expand at a solid pace. While growth has slowed in the United States, economies in Europe, Japan, and many emerging markets have been strengthening. These signs that growth in demand is rotating away from the United States and towards other economies are encouraging, as this is important for an orderly unwinding of global imbalances. Overall, the projection for global economic growth has been raised to 5.1 per cent in 2006, 4.7 per cent next year, and 4.5 per cent in 2008.

Growth in the U.S. economy is now projected at 3.3 per cent for 2006 as a whole, down slightly from the July *Update*. Given the pronounced slowdown in the housing sector, U.S. GDP growth in the second half of 2006 is likely to be in the range of 2 to 2 1/2 per cent. This is below the growth rate of potential output, which is now assumed to be 3 per cent. Growth should remain below potential into 2007, at 2.6 per cent, but recover by the end of the year and average 3.2 per cent in 2008. With slower near-term growth, U.S. core inflation should move gradually lower.

In Canada, domestic demand is projected to continue to support economic expansion through 2008. Consumer spending is expected to remain firm, owing to further gains in disposable income and household net worth. Business investment is projected to strengthen further, prompted by capacity constraints, relatively high commodity prices, favourable financing conditions, and strong cash flow. But housing investment is expected to decline slightly in 2007 and 2008. The Bank assumes that governments as a whole will act to bring spending and revenues into balance, consistent with commitments to run balanced budgets.

With the slowing in the U.S. economy, and given the lagged effects of the past appreciation of the Canadian dollar, near-term export growth is projected to be modest, while imports should continue to rise more strongly. Net exports are projected to subtract 1.3 percentage points from growth this year and 0.7 percentage points in 2007. By 2008, net exports are no longer projected to be a drag on growth.

The Bank's base-case projection calls for average annual real GDP growth of 2.8 per cent in 2006, 2.5 per cent in 2007, and 2.8 per cent in 2008. This projection reflects the weaker near-term outlook for the United States. The base case also takes into account a reduction in our assumption for potential output growth to 2.8 per cent through 2008, which is due to lower assumed trend growth in labour productivity. The implication is that the economy would remain in slight excess demand in the near term, before returning to potential in the second half of 2007. The economy would then continue to operate at about its production capacity through to the end of 2008.

Developments in energy markets, as well as the reduction in the GST, imply that total inflation will fall temporarily below 1 per cent in September. Total inflation will likely average about 1 1/2 per cent from the fourth quarter of 2006 through to the second quarter of 2007 (lower than projected in the *Update*) and then average about 2 per cent through to the end of 2008. Core inflation is projected to move slightly above 2 per cent through to mid-2007, given the small amount of excess demand in the economy and continued momentum in housing prices. The upward pressure coming from these factors should continue to be partly offset by further downward pressure coming from the lower prices of manufactured goods. As these pressures ease, core inflation should return to 2 per cent in the second half of next year and stay there for the remainder of the projection period.

Summary of the Base-Case Projection*

	2006			2007		2008
	Q2	Q3	Q4	H1	H2	
Real GDP (period-over-period percentage change at annual rates)**	**2.0** (3.2)	**2.0** (3.0)	**2.8** (3.0)	**2.5** (2.8)	**2.7** (2.7)	**2.8** (2.8)
Real GDP (year-over-year percentage change)	**2.9** (3.2)	**2.5** (3.1)	**2.6** (3.2)	**2.4** (2.9)	**2.6** (2.8)	**2.8** (2.8)
Core inflation (year-over-year percentage change)	**1.8** (1.8)	**2.0** (2.0)	**2.1** (2.0)	**2.2** (2.0)	**2.0** (2.0)	**2.0** (2.0)
Total CPI (year-over-year percentage change)	**2.6** (2.7)	**1.7** (1.5)	**1.5** (1.8)	**1.4** (1.6)	**2.0** (2.0)	**2.0** (2.0)
Total CPI excluding the effect of changes in indirect taxes (year-over-year percentage change)	**2.6** (2.7)	**2.2** (2.1)	**2.0** (2.4)	**1.9** (2.2)	**2.0** (2.0)	**2.0** (2.0)
WTI*** (level)	**71** (71)	**71** (73)	**60** (75)	**64** (76)	**66** (75)	**67** (73)

* Figures in parentheses are from the July *Update*.
** For half and full years, the number reported is the average of the respective quarter-to-quarter percentage growth at annual rates.
*** 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 13 October 2006

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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