BANK OF CANADA
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Monetary Policy Report Summary

January 2015

This text is a commentary of the Governing Council of the Bank of Canada.

Highlights

- The sharp drop in global crude oil prices will be negative for Canadian growth and underlying inflation.
- Global economic growth is expected to pick up to 3 1/2 per cent over the next two years.
- Growth in Canada is expected to slow to about 1 1/2 per cent and the output gap to widen in the first half of 2015.
- Canada's economy is expected to gradually strengthen in the second half of this year, with real GDP growth averaging 2.1 per cent in 2015 and 2.4 per cent in 2016, with a return to full capacity around the end of 2016, a little later than was expected in October.
- Total CPI inflation is projected to be temporarily below the inflation-control range during 2015 because of weaker energy prices, and to move back up to target the following year. Underlying inflation will ease in the near term but then return gradually to 2 per cent over the projection horizon.
- On 21 January 2015, the Bank announced that it is lowering its target for the overnight rate by one-quarter of one percentage point to 3/4 per cent.

Inflation has remained close to the 2 per cent target in recent quarters. Core inflation has been temporarily boosted by sector-specific factors and the pass-through effects of the lower Canadian dollar, which are offsetting disinflationary pressures from slack in the economy and competition in the retail sector. Total CPI inflation is starting to reflect the fall in oil prices.

Oil's sharp decline in the past six months is expected to boost global economic growth, especially in the United States, while widening the divergences among economies. Persistent headwinds from deleveraging and lingering uncertainty will influence the extent to which some oil-importing countries benefit from lower prices. The Bank's base-case projection assumes oil prices around US$60 per barrel. Prices are currently lower but our belief is that prices over the medium term are likely to be higher.

The oil price shock is occurring against a backdrop of solid and more broadly-based growth in Canada in recent quarters. Outside the energy sector, we are beginning to see the anticipated sequence of increased foreign demand, stronger exports, improved business confidence and investment, and employment growth. However, there is considerable uncertainty about the speed with which this sequence will evolve and how it will be affected by the drop in oil prices.

Business investment in the energy-producing sector will decline. Canada's weaker terms of trade will have an adverse impact on incomes and wealth, reducing domestic demand growth.

Although there is considerable uncertainty around the outlook, the Bank is projecting real GDP growth will slow to about 1 1/2 per cent and the output gap to widen in the first half of 2015. The negative impact of lower oil prices will gradually be mitigated by a stronger U.S. economy, a weaker Canadian dollar, and the Bank's monetary policy response. The Bank expects Canada's economy to gradually strengthen in the second half of this year, with real GDP growth averaging 2.1 per cent in 2015 and 2.4 per cent in 2016. The economy is expected to return to full capacity around the end of 2016, a little later than was expected in October.

Weaker oil prices will pull down the inflation profile. Total CPI inflation is projected to be temporarily below the inflation-control range during 2015, moving back up to target the following year. Underlying inflation will ease in the near term but then return gradually to 2 per cent over the projection horizon.

The outlook for inflation is subject to several risks emanating from both the external environment and the domestic economy. The most important risks to inflation are: stronger U.S. private demand, oil prices lower or higher than assumed, slower growth in emerging-market economies, weaker Canadian exports and business investment, and imbalances in the Canadian household sector.

From a policy perspective, the oil price shock increases both downside risks to the inflation profile and financial stability risks.

Weighing all these factors, on 21 January the Bank of Canada announced that it is lowering its target for the overnight rate by one-quarter of one percentage point to 3/4 per cent. The Bank's action is intended to provide insurance against these policy risks, support the sectoral adjustment needed to strengthen investment and growth, and bring the Canadian economy back to full capacity and inflation to target within the projection horizon.

Projection for global economic growth

	Share of real global GDP[a] (per cent)	Projected growth[b] (per cent)			
		2013	2014	2015	2016
United States	16	2.2 (2.2)	2.4 (2.2)	3.2 (2.9)	2.8 (2.7)
Euro area	12	-0.4 (-0.4)	0.8 (0.8)	0.9 (0.8)	1.2 (1.0)
Japan	5	1.6 (1.5)	0.1 (0.8)	0.6 (0.7)	1.6 (0.8)
China	16	7.7 (7.7)	7.4 (7.4)	7.2 (7.0)	7.0 (6.9)
Rest of the world	51	3.0 (2.9)	2.9 (2.9)	3.1 (3.2)	3.4 (3.4)
World	100	3.0 (3.0)	3.1 (3.1)	3.4 (3.4)	3.5 (3.5)

a. GDP shares are based on International Monetary Fund (IMF) estimates of the purchasing-power-parity (PPP) valuation of country GDPs for 2013 from the IMF's October 2014 *World Economic Outlook*.

b. Numbers in parentheses are projections used for the Bank's October 2014 *Monetary Policy Report.*

Summary of the projection for Canada[a]

	2013	2014				2015				2016			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (quarter-over-quarter percentage change at annual rates)	2.9 (2.7)	1.0 (0.9)	3.6 (3.1)	2.8 (2.3)	2.5 (2.5)	1.5 (2.4)	1.5 (2.4)	2.0 (2.4)	2.5 (2.4)	2.6 (2.3)	2.6 (2.3)	2.6 (2.2)	2.3 (2.0)
Real GDP (year-over-year percentage change)	2.7 (2.7)	2.1 (2.1)	2.5 (2.5)	2.6 (2.3)	2.5 (2.2)	2.6 (2.6)	2.1 (2.4)	1.9 (2.4)	1.9 (2.4)	2.1 (2.4)	2.4 (2.4)	2.6 (2.3)	2.5 (2.2)
Core inflation (year-over-year percentage change)	1.2 (1.2)	1.3 (1.3)	1.7 (1.7)	2.0 (2.0)	2.2 (2.1)	2.0 (1.9)	1.9 (1.8)	1.8 (1.7)	1.9 (1.8)	1.9 (1.9)	1.9 (1.9)	1.9 (1.9)	2.0 (2.0)
Total CPI (year-over-year percentage change)	0.9 (0.9)	1.4 (1.4)	2.2 (2.2)	2.0 (2.0)	2.0 (2.2)	0.5 (1.6)	0.3 (1.4)	0.5 (1.5)	1.2 (1.8)	1.9 (1.9)	1.9 (1.9)	1.9 (1.9)	2.0 (2.0)

a. Numbers in parentheses are from the projection in the October 2014 *Monetary Policy Report*. Assumptions for the price for crude oil are based on the average of spot prices since early December.

The Bank of Canada's *Monetary Policy Report* is published quarterly in January, April, July and October.

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