BANK OF CANADA
BANQUE DU CANADA

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Bank of Canada releases *Monetary Policy Report Update*

OTTAWA—The Bank of Canada today released its July *Monetary Policy Report Update*. In it, the Bank described three major developments affecting the Canadian economy: protracted weakness in the U.S. economy, ongoing turbulence in global financial markets, and sharp increases in the prices of certain commodities, particularly energy. While the first two developments are evolving roughly in line with expectations outlined in the April *Monetary Policy Report*, many commodity prices continue to outpace earlier expectations, which has altered the outlook for global and domestic inflation.

The *Update* noted that although economic growth in Canada in the first quarter of 2008 was weaker than expected, final domestic demand – supported by strong terms of trade – continued to expand at a solid pace. The Canadian economy is judged to have moved into slight excess supply in the second quarter of 2008. Excess supply is expected to increase through the balance of the year. High terms of trade, accommodative monetary policy, and a gradual recovery in the U.S. economy are expected to generate above-potential economic growth starting early next year, bringing the economy back to full capacity around mid-2010.

Assuming energy prices follow current futures prices, total CPI inflation is projected to rise temporarily above 4 per cent, peaking in the first quarter of 2009. As energy prices stabilize and with medium-term inflation expectations remaining well anchored, total inflation is projected to converge to the core rate of inflation at the 2 per cent target in the second half of 2009. Core inflation is projected to remain well contained.

The three major developments affecting the Canadian economy pose significant upside and downside risks to the projection. On the upside, domestic demand could be greater than projected, potential output growth could be lower than assumed, and global inflationary pressures could lead to higher-than-projected import costs for Canada. On the downside, commodity prices could be weaker than assumed, U.S. growth could be weaker than expected, and continued strains in global financial markets could have a greater-than-projected impact on global growth and the cost and availability of credit in Canada. Weighing the implications of these considerations, the Bank views the risks to its projection for inflation as balanced.

Against this backdrop, the Bank judges that the current level of the target for the overnight rate – 3 per cent – remains appropriate. The Bank will continue to monitor carefully the evolution of risks, together with economic and financial developments in the Canadian and global economies, and set monetary policy consistent with achieving the 2 per cent inflation target over the medium term.