BANK OF CANADA

Monetary Policy Report

– April 2006 –

Summary

Overview

The Canadian economy continues to grow at a solid pace, consistent with the Bank's outlook in the January *Monetary Policy Report Update*. The global economy has been robust, showing a little more momentum than had been anticipated. This has led to higher prices for many commodities which, along with strong domestic demand, have supported economic activity in Canada. At the same time, global competition and the past appreciation of the Canadian dollar continue to pose challenges for a number of sectors. All factors considered, the Canadian economy is judged to be operating at, or just above, its production capacity.

High and variable energy prices associated with the strength of global demand have kept total CPI inflation above the Bank's 2 per cent target. Core inflation has remained below 2 per cent, owing to persistent downward pressure from the prices of imported consumer goods.

Against this backdrop, the Bank raised its policy interest rate by one-quarter of one percentage point on 7 March and again on 25 April, bringing it to 4.0 per cent.

Canada's GDP is projected to grow by 3.1 per cent in 2006, in line with expectations in the January *Update*, and by 3.0 per cent in 2007, slightly stronger than previously expected. Growth in 2008 is expected to be 2.9 per cent. The Canadian economy is projected to operate slightly above its capacity through 2006 and to return to capacity by the end of 2008.

Total CPI inflation will continue to be volatile, affected by the evolution of

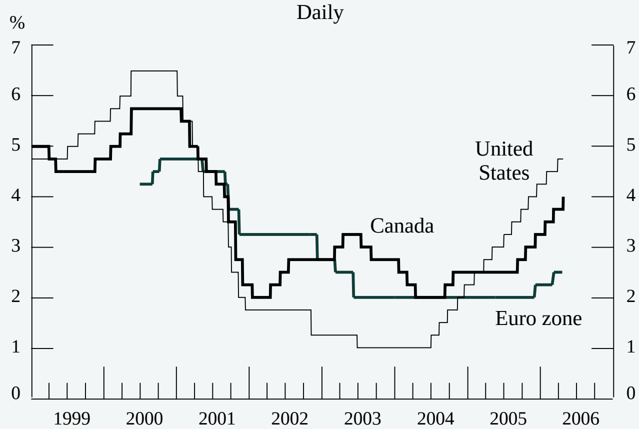
Highlights

- **The Canadian economy is judged to be operating at, or just above, its production capacity, supported by robust global growth, higher commodity prices, and strong domestic demand.**
- **The Bank projects economic growth of 3.1 per cent in 2006, 3.0 per cent in 2007, and 2.9 per cent in 2008.**
- **Total CPI inflation (excluding any changes in the GST) should average close to 2 per cent in 2007 and 2008.**
- **The Bank judges that the risks to the projection are roughly balanced, with a small tilt to the downside later in the projection period.**
- **In line with the Bank's outlook, some modest further increase in the policy interest rate may 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 25 April 2006.*

Policy Rates in Canada, the United States, and Europe

Daily



energy prices. Based on prices embedded in energy futures markets, the Bank projects total CPI inflation (excluding any changes in the Goods and Services Tax—GST) to average close to 2 per cent in 2007 and 2008. Upward pressure on inflation from excess demand in the economy is offset by downward pressure from the declining prices of many imported consumer goods. Core inflation is projected to rise to 2 per cent in the second half of this year and to remain there through the end of 2008.

There are both upside and downside risks to the Bank's projection for growth and inflation. In the Bank's view, these risks are roughly balanced, with a small tilt to the downside later in the projection period.

In line with the Bank's outlook for the Canadian economy, some modest further increase in the policy interest rate may be required to keep aggregate supply and demand in balance and inflation on target over the medium term. The Bank will closely monitor evolving developments in the Canadian economy in light of the cumulative increase in the policy interest rate since last September.

Recent Developments

Total CPI inflation has averaged 2.5 per cent since last September, owing mainly to increases in energy prices. Fluctuations in the inflation rate have been caused largely by swings in gasoline prices. But over the same period, core inflation has remained stable near 1.7 per cent. The declining world prices of many manufactured consumer goods and the past appreciation of the Canadian dollar have helped to keep core inflation low. There has been little evidence that higher energy costs are being passed through more generally to the prices of other goods and services.

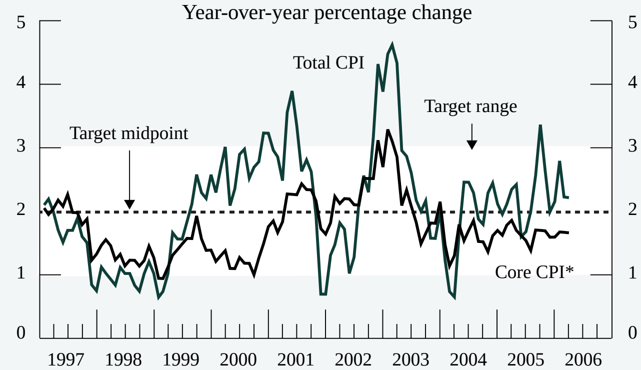
The Canadian economy has maintained steady growth, even as it continues to adjust to global developments. Canada's terms of trade rose sharply in the second half of 2005. This boosted corporate profits, labour income, and government revenues. Labour productivity grew at a higher rate in the second half of last year, bringing it closer to the Bank's assumption for trend productivity growth. The Canadian dollar has traded in a range of 85 1/2 to 88 1/2 cents U.S. since the January *Update*.

Real GDP grew at an annual rate of 3 per cent in the second half of 2005, as expected. The level of economic activity at the end of last year was very close to what the Bank had anticipated. Growth in the first quarter of 2006 is projected to be 3.2 per cent.

After weighing all the indicators of capacity pressures, the Bank's Governing Council judges that the economy was operating at, or just above, its production capacity in early 2006.

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

Prospects for Growth and Inflation

The global economy has remained robust, with most major overseas economies participating in the expansion. Global growth in 2005 was stronger than expected, and significant momentum is expected to carry forward into this year. Growth is projected to moderate slightly in 2007 and 2008.

The U.S. economy is expected to continue to expand strongly in 2006, with real GDP growth of 3.5 per cent, then moderate to 3.2 per cent in 2007 and to 3.1 per cent in 2008.

The Bank's base-case assumes an orderly unwinding of global imbalances, reflecting a shift in global demand stemming from market-based adjustments, including a gradual, real effective depreciation of the U.S. dollar. This shift of demand is also supported by policy-based adjustments, including a reduction of the U.S. fiscal deficit, structural reforms in Europe and Asia, and more flexibility in Asian exchange rates. It is assumed that only a small fraction of the U.S.-dollar depreciation will be against the Canadian dollar, and that it will occur late in the projection period.

In Canada, final domestic demand continues to be the main driver of growth. Business investment is projected to remain strong through 2008. This reflects a robust global economy, high commodity prices, and healthy profits and corporate balance sheets. Consumer spending should also remain firm through the period, reflecting further gains in real disposable income. Housing investment is projected to continue to contribute to growth in 2006 before easing in 2007 and 2008. Government spending at all levels should grow in line with revenues.

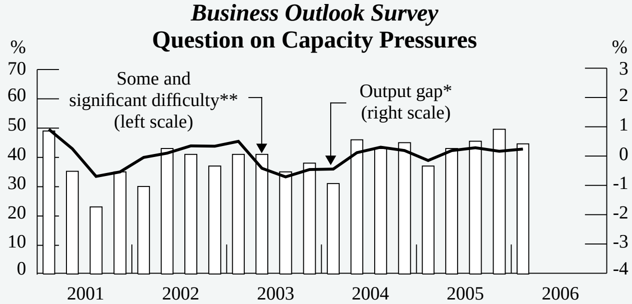
Both imports and exports are expected to rise through 2008. Net exports are still expected to be a slight drag on growth for some time, with this effect diminishing over the projection period.

Overall, the Bank projects GDP growth of 3.1 per cent in 2006, 3.0 per cent in 2007, and 2.9 per cent in 2008. This profile implies that the Canadian economy would be in slight excess demand this year and would return to potential by the end of the projection period. In the base-case projection, the slowing in U.S. economic growth, combined with the lagged effects of past interest rate increases, as well as some modest further increase in interest rates across the yield curve, will bring aggregate demand and supply back into balance.

Core inflation is expected to rise to 2 per cent in the second half of this year, earlier than expected in the January *Update*, owing to increases in electricity prices. Ongoing downward pressure on core inflation from reductions in the prices of manufactured goods should be offset by upward pressure coming from the economy operating with slight excess demand. These offsetting factors are projected to diminish in tandem over the projection period, leaving core inflation at 2 per cent.

Total CPI inflation will continue to be affected by developments in the markets for crude oil and natural gas. Total inflation should average about 2.5 per cent through the middle of 2006. But after a period of volatility exacerbated by the movements in energy prices a year earlier, total inflation is projected to return close to the 2 per cent target in the first half of 2007.

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 first quarter of 2006 is based on a projected rise in output of 3.2 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

This projection does not take into account the federal government's stated intention to reduce the GST from 7 per cent to 6 per cent in the near future, and to 5 per cent within five years. The Bank estimates that the direct effect of a reduction in the GST from 7 per cent to 6 per cent would be a reduction in the total CPI inflation rate of about 0.6 percentage points over a one-year period. The core rate of inflation would not be directly affected by the GST reduction. The Bank's approach is to look through any direct effects on total CPI inflation from changes in indirect taxes.

Risks to the Outlook

There are both upside and downside risks to the Bank's base-case projection. In the main, the Bank judges these risks to be roughly balanced. However, there remains a small risk of a disorderly correction to global imbalances, leading to significantly weaker global growth, which tilts the risks to the downside later in the projection period. This risk appears to be lower than previously judged, given the tentative signs of policy shifts and of rotation in global demand.

The upside risks for growth and inflation in Canada stem largely from the momentum of the global economy and the associated future path of commodity prices. Stronger global growth could also risk putting pressure on global production capacity. This could reduce the pace of price declines for many manufactured consumer goods, adding to upward pressure on inflation in Canada.

At the same time, there is an important downside risk that the U.S. economy could slow more quickly than anticipated. There is also a risk that adjustment to global imbalances could involve weaker global growth, which would have additional negative consequences for Canada. As well, the real effective depreciation of the U.S. dollar may affect the Canadian dollar more than is assumed, putting a renewed drag on net exports and dampening economic activity in Canada.

There continues to be uncertainty about the level and growth of potential output in Canada. Given the productivity-enhancing investments that are being made, productivity growth could be higher than assumed in the base-case projection. However, the large sectoral and regional shifts still under way continue to make it particularly difficult to assess the economy's production capacity.

Summary of the Base-Case Projection*

	2006				2007		2008
	Q1	Q2	Q3	Q4	H1	H2	
Real GDP (quarter-to-quarter percentage change at annual rates)	**3.2** *(3.2)*	**3.2** *(3.1)*	**3.0** *(3.0)*	**3.0** *(3.0)*	**2.9** *(2.9)*	**2.9** *(2.8)*	**2.9**
Real GDP (year-over-year percentage change)	**3.2** *(3.2)*	**3.1** *(3.1)*	**3.0** *(3.0)*	**3.1** *(3.1)*	**3.0** *(3.0)*	**2.9** *(2.9)*	**2.9**
Core inflation (year-over-year percentage change)	**1.7** *(1.7)*	**1.8** *(1.8)*	**2.0** *(1.9)*	**2.0** *(1.9)*	**2.0** *(2.0)*	**2.0** *(2.0)*	**2.0**
Total CPI** (year-over-year percentage change)	**2.4** *(2.5)*	**2.6** *(2.4)*	**1.9** *(1.9)*	**2.3** *(2.3)*	**2.1** *(2.0)*	**2.0** *(2.0)*	**2.0**
WTI† (level)	**63** *(65)*	**70** *(66)*	**73** *(67)*	**74** *(67)*	**74** *(67)*	**73** *(67)*	**71**

* Figures in parentheses are from the January *Monetary Policy Report Update*.
** Excluding the effect of any changes in the Goods and Services Tax
† 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 21 April 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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