BANK OF CANADA
BANQUE DU CANADA

Monetary Policy Report

Summary

April 2007

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 24 April 2007.*

Overview

Growth of the Canadian economy has been essentially in line with the expectations set out in the Bank's January *Monetary Policy Report Update*. But inflation has been higher than expected because pressures on capacity over the past year have been stronger than previously judged, and the prices of food and gasoline have recently risen more than expected. After considering the full range of indicators, the Bank now judges that the Canadian economy was operating just above its production capacity in the first quarter of this year.

Robust domestic demand continues to support Canada's economic growth, and there has also been stronger-than-expected growth outside North America, which has led to rising demand for, and prices of, many commodities. However, the slowing U.S. economy has had a moderating effect on economic growth in Canada.

Over the projection horizon, domestic demand should remain robust, although not as strong as in recent years. With the U.S. slowdown now expected to be somewhat more prolonged than previously projected, net exports should exert a slightly greater drag on growth in 2007. All told, the Canadian economy is expected to expand at a rate slower than potential through 2007, and in line with potential through 2008 and 2009.

With the excess demand in the economy expected to disappear in the second half of this year, and with pressures on housing prices expected to continue to ease, core inflation is projected to decline to 2 per cent by the end of 2007 and remain there through the projection period. If energy prices evolve in line with those currently reflected in futures markets, total inflation should average just below 2 per cent in the second quarter of 2007 before moving above the 2 per cent target and peaking below 3 per cent near the end of 2007. Total inflation should then return to target by mid-2008.

Highlights

- Inflation in Canada has been higher than expected, largely because pressures on capacity have been stronger over the past year than previously judged.
- The Canadian economy is projected to grow by 2.2 per cent in 2007 and 2.7 per cent in 2008 and 2009. The level of output in the economy is projected to return to potential in the second half of 2007.
- Total CPI inflation is projected to return to the 2 per cent target by the middle of 2008, and core inflation is projected to return to 2 per cent by the end of 2007.
- The Bank continues to judge that the risks to its inflation projection are roughly balanced, although there is now a slight tilt to the upside.
- The current level of the target for the overnight rate is judged, at this time, to be consistent with achieving the inflation target over the medium term.

The upside risk to the Bank's inflation projection is that the recent strength of inflation could be more persistent than projected. Pressures on capacity could be greater and more prolonged than currently judged. The strong growth in household credit and broad money continues to point to this upside risk. As well, the downward pressure on inflation from the prices of imported goods could diminish more quickly than expected, and global food and energy prices could put more upward pressure on inflation.

The downside risk to inflation continues to come from the possibility of a slowdown in the U.S. economy that is more pronounced than that already incorporated in the Bank's base-case projection.

The Bank continues to judge that the risks to its inflation projection are roughly balanced, although there is now a slight tilt to the upside.

The Bank left its key policy interest rate unchanged at 4.25 per cent on 6 March and 24 April. The current level of the target for the overnight rate is judged, at this time, to be consistent with achieving the inflation target over the medium term.

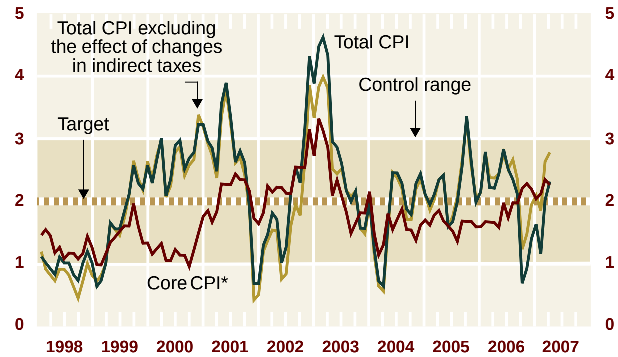
Recent Developments

The annual rate of increase for the total consumer price index rose from 1.3 per cent in the fourth quarter of 2006 to 1.9 per cent in the first quarter of this year. Without the July 2006 reduction in the GST, and the effect of other changes in indirect taxes, total CPI inflation would have been 2.4 per cent in the first quarter. Core inflation was 2.3 per cent in the first quarter. Both core and total inflation were somewhat higher than had been expected.

A number of factors have put upward pressure on both measures of inflation in recent months. In particular, capacity pressures have contributed to upward pressure on core inflation, especially for services. Core food prices have also been higher than expected, partly reflecting the rapid pass-through of higher prices for grains and oilseeds. As well, the downward pressure on inflation coming from lower prices for imported goods has lessened somewhat. Partly offsetting these factors was some easing in the rate of increase of housing prices. The higher rate of total inflation reflects these same factors, together with strong prices for fruit and vegetables, and higher-than-expected gasoline prices that stem from both temporary refining disruptions and higher prices for crude oil.

Consumer Price Index

Year-over-year percentage change

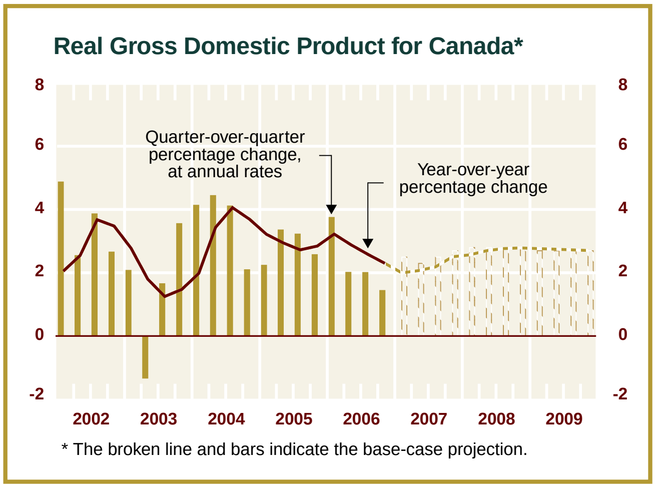


* CPI excluding eight of the most volatile components and the effect of changes in indirect taxes on the remaining components

Growth in the Canadian economy slowed modestly in the second half of 2006. In the fourth quarter, real GDP growth fell to 1.4 per cent at annual rates, owing partly to a sharp correction in inventories. But currently available information suggests that real GDP grew by about 2.5 per cent in the first quarter of 2007.

Since the middle of 2006, final domestic demand has remained the main driver of growth, supported by robust employment growth, gains in real personal disposable income, and additional gains in household net worth and credit. Strong capital spending by businesses also contributed to domestic demand. However, spending by governments slowed, as did spending on residential construction. Canadian exports recovered, led by exports of machinery and equipment and some primary commodities. This occurred despite weak U.S. demand for automobiles and building materials.

Several indicators suggest that the Canadian economy has been operating slightly above its production potential in recent months. These include very high levels of employment, core inflation remaining slightly above 2 per cent, and responses to questions



in the Bank's *Business Outlook Survey* about firms' ability to meet unanticipated increases in demand. In addition, with historical revisions to data, the Bank's conventional measure of the output gap indicates that the economy was operating 0.2 per cent above its production potential in the first quarter of 2007. But some indicators suggest that the economy was operating either in balance or with a slight amount of excess supply. These include responses by firms to questions in the Bank's *Survey* about labour shortages, as well as capacity utilization data, and the relatively modest pace of wage increases. All told, the Bank judges that the economy was operating just above its production capacity in the first quarter of 2007.

With strong growth in the global economy and delays in some projects that were designed to increase supply, the prices of many commodities have increased. Prices for non-energy commodities have been particularly strong since January, while crude oil prices rose in response to stronger demand and the return of normal weather patterns in North America, as well as renewed geopolitical uncertainty. While Canada's terms of trade deteriorated somewhat in the second half of 2006, the recent strength of commodity prices implies an improvement in the terms of trade and a pickup in nominal GDP growth in early 2007, which should support corporate profits and government revenues in the near term.

Prospects for Growth and Inflation

The Bank's base-case economic projection has been developed using a number of assumptions, including a slow and orderly resolution of global imbalances predicated on further appropriate policy measures being taken internationally. The evolution of energy prices is assumed to conform with prices in energy futures markets, and the Canadian dollar is assumed to remain in the range of 86.5 to 89.5 cents U.S. seen since early April.

The global economy has continued to outperform expectations, with slowing U.S. growth more than offset by stronger-than-expected growth overseas.

The U.S. economy is now expected to slow slightly more than previously expected, owing primarily to a more prolonged slowdown in the housing sector and weaker business investment. Growth should slow to 2.1 per cent in 2007 from 3.3 per cent last year, before recovering to 2.8 per cent next year and to 3.1 per cent in 2009.

Growth in the overseas economies is projected to be slightly stronger than previously expected. As global capacity is absorbed, however, growth in the world economy is projected to moderate somewhat from 5.3 per cent in 2006 to 4.8 per cent this year and next, and to 4.6 per cent in 2009.

In Canada, domestic demand should continue to be the main driver of economic growth, but to be less vigorous than in recent years. Strong gains in consumer spending are expected to continue, supported by further increases in real disposable income and household net worth. Housing investment should decline slightly in 2007 and 2008 and then steady out in 2009. The Bank assumes that the government sector will run balanced budgets. Business investment should remain strong, underpinned by near-term capacity pressures, a strong outlook for global growth, high commodity prices, accommodative financial conditions, and strong profit levels and balance sheets. With the continuing weakness in U.S. demand, net exports should exert a slightly greater drag on growth in 2007 than previously projected, although this effect should diminish over the course of the year.

Overall, the Bank projects that real GDP growth in Canada will average just below 2 1/2 per cent in the first half of 2007 and just above 2 1/2 per cent in the second half. Annual average growth in 2007 is therefore projected to be 2.2 per cent. With the economy operating just above its production capacity in the first quarter, this growth profile implies that the economy would move back to its production capacity in the second half of 2007.

In both 2008 and 2009, annual average growth is projected to be 2.7 per cent. This would keep the economy operating at its production capacity for the remainder of the projection period. The Bank assumes the growth rate of potential will be 2.8 per cent in 2007 and 2008, and 2.7 per cent in 2009, with trend labour input assumed to decline in 2009 as demographic changes affect the workforce.

Core inflation should remain slightly above 2 per cent over the coming months, given pressures on capacity and the impact of higher core food prices. But with the economy projected to return to its production capacity in the second half, and with further easing of pressures from housing prices, upward pressure on core inflation is expected to moderate. At the same time, downward pressure on core inflation from lower import prices is also expected to diminish. Overall, core inflation is projected to return to 2 per cent by the end of 2007 and to remain there through the projection period.

Total inflation is projected to average just under 2 per cent in the second quarter of this year. Based on the higher near-term track for core inflation and the prices currently embedded in energy futures markets, and with the direct impact on inflation of the GST reduction ending in July, total inflation is then projected to move above the 2 per cent target, peaking below 3 per cent near the end of 2007, before returning to target by mid-2008.

Summary of the Base-Case Projection*

	2006	2007			2008	2009
	Q4	Q1	Q2	H2		
Real GDP (quarterly growth or quarterly growth at annual rates)**	**1.4** (1.5)	**2.5** (2.4)	**2.3** (2.6)	**2.6** (2.8)	**2.8** (2.9)	**2.7**
Real GDP (year-over-year percentage change)	**2.3** (2.3)	**2.0** (1.9)	**2.1** (2.1)	**2.4** (2.5)	**2.7** (2.8)	**2.7**
Core inflation (year-over-year percentage change)	**2.2** (2.2)	**2.3** (2.1)	**2.2** (2.0)	**2.1** (2.0)	**2.0** (2.0)	**2.0**
Total CPI (year-over-year percentage change)	**1.3** (1.3)	**1.9** (1.2)	**1.9** (1.0)	**2.6** (1.7)	**2.1** (2.0)	**2.0**
Total CPI (excluding the effect of changes in indirect taxes) (year-over-year percentage change)	**1.8** (1.8)	**2.4** (1.7)	**2.4** (1.5)	**2.6** (1.7)	**2.1** (2.0)	**2.0**
WTI *** (level)	**60** (60)	**58** (56)	**64** (58)	**68** (61)	**70** (63)	**70**

* Figures in parentheses are from the January *Monetary Policy Report 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 20 April 2007

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.
Telephone: 613 782-8248; toll free in North America: 1 877 782-8248;
email: publications@bankofcanada.ca; or visit our website: www.bankofcanada.ca

Bank of Canada Regional Offices

Atlantic Provinces
1583 Hollis Street, 5th Floor
Halifax, Nova Scotia B3J 1V4
David Amirault, *Senior Regional Representative (Economics)*
Monique LeBlanc, *Senior Regional Representative (Currency)*

Quebec
1501 McGill College Avenue,
Suite 2030
Montréal, Quebec H3A 3M8
Thérèse Laflèche, *Senior Regional Representative (Economics)*
Phuong Anh Ho Huu, *Senior Regional Representative (Currency)*

Ontario
150 King Street West, 20th Floor,
Suite 2000
Toronto, Ontario M5H 1J9
Hung-Hay Lau, *Senior Regional Representative (Economics)*
Paul de Swart, *Senior Regional Representative (Currency)*

Prairie Provinces, Nunavut, and Northwest Territories
404 – 6th Avenue SW, Suite 200
Calgary, Alberta T2P 0R9
Mark Illing, *Senior Regional Representative (Economics)*
Ted Mieszkalski, *Senior Regional Representative (Currency)*

British Columbia and Yukon
200 Granville Street, Suite 2710
Vancouver, British Columbia
V6C 1S4
Farid Novin, *Senior Regional Representative (Economics)*
Trevor Frers, *Senior Regional Representative (Currency)*

New York Office
Canadian Consulate General
1251 Avenue of the Americas
New York, NY 10020-1175
U.S.A.
Zahir Lalani, *Consul and Senior Representative for the Bank of Canada*

For Further Information about the Bank of Canada

Publications

Monetary Policy Report* and *Update
A detailed summary of the Bank's policies and strategies, as well as a look at the current economic climate and its implications for inflation. The *Report* is published in April and October; the *Update* is published in January and July. Without charge.

Business Outlook Survey
Published quarterly. Without charge.

Financial System Review
Brings together the Bank's research, analyses, and judgments on various issues and developments concerning the financial system. Published semi-annually. Without charge.

Bank of Canada Review
A quarterly publication that contains economic commentary and feature articles. By subscription.

Bank of Canada Banking and Financial Statistics
A comprehensive package of Canadian data. Published monthly. By subscription.

Weekly Financial Statistics
A 20-page package of banking and money market statistics. By subscription.

For information about these and other publications, contact:

Publications Distribution
234 Wellington Street, Ottawa K1A 0G9
Telephone: 613 782-8248
Toll free in North America: 1 877 782-8248
Fax: 613 782-8874
Email: publications@bankofcanada.ca

Internet

www.bankofcanada.ca

Provides timely access to press releases, speeches by the Governor, most of our major publications, and current financial data.

Public Information

For general information on the role and functions of the Bank, contact our Public Information Office.

Telephone: 1 800 303-1282
Fax: 613 782-7713
Email: info@bankofcanada.ca

For information on unclaimed balances:
Telephone: 1 888 891-6398
Fax: 613 782-7802
Email: ucbalances@bankofcanada.ca