



# Monetary Policy Report Update

July 2008

*This text is a commentary of the Governing Council of the Bank of Canada. It presents the Bank's updated outlook based on information received up to 15 July 2008.*

## Overview

Three major developments are affecting the Canadian economy: the protracted weakness in the U.S. economy; ongoing turbulence in global financial markets; and sharp increases in the prices of certain commodities—particularly energy. The first two developments are evolving roughly in line with expectations outlined in the April *Monetary Policy Report*. However, many commodity prices continue to outstrip earlier expectations, and this has altered the outlook for global and domestic inflation.

Although global economic growth is slowing, the momentum in the first half of the year has been stronger than earlier expected. Growth is becoming increasingly weighted towards emerging-market economies. This has contributed to rising demand for commodities in an environment where the supply response for many commodities has been muted and inventories are low. The resulting price increases have led not only to higher global inflation but also to continued improvements in Canada's terms of trade and increases in real national income.

Economic growth in Canada in the first quarter of 2008 was weaker than expected, mainly reflecting a sharp decline in inventory accumulation. However, final domestic demand continues to expand at a solid pace. Strong income gains from high commodity prices and high levels of employment, as well as an expected improvement in financial conditions, should support the growth of domestic demand through 2009 and 2010.

The drag from net exports diminishes over the projection horizon as the U.S. economy recovers and the effects of the past appreciation of the Canadian dollar dissipate.

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

## Highlights

- Commodity prices have moved sharply higher since April, particularly energy prices.
- Canadian GDP is projected to grow by 1.0 per cent in 2008, 2.3 per cent in 2009, and 3.3 per cent in 2010.
- Higher energy prices will push total CPI inflation temporarily above target, peaking in the first quarter of 2009, but core inflation will remain well contained.
- Total CPI inflation is projected to converge to the core rate of inflation at the 2 per cent target in the second half of 2009.
- There are significant risks to the base-case projection. These are viewed to be balanced.
- The Bank judges that the current level of the policy rate remains appropriate.

the U.S. economy are expected to generate above-potential economic growth starting in the first half of 2009, bringing the economy back to full capacity around mid-2010.

Total CPI inflation over the next year is expected to be much higher than projected at the time of the *April Report*. 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 then 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 and broadly in line with earlier expectations, averaging close to 1.5 per cent through the third quarter of this year and rising to 2 per cent in the second half of 2009.

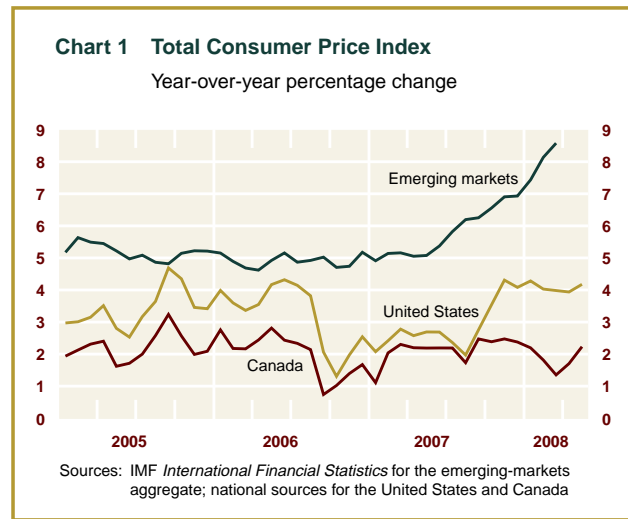
The three major developments affecting the Canadian economy pose significant upside and downside risks to the base-case projection. Weighing the implications of these developments, the Bank views the risks to its base-case projection for inflation as balanced.

Against this backdrop, the Bank of Canada kept its key policy rate unchanged at 3 per cent on 10 June and on 15 July, and judges that the current level of the target for the overnight rate 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 inflation target over the medium term.

## Recent Economic Developments

### *Global Developments*

Global economic growth, while slowing, appears to have been stronger in the first half of 2008 than expected at the time of the *April Report*. Global inflation has risen significantly, reflecting sharp increases in energy and food prices (Chart 1).



The main factor behind the recent surge in world energy and food prices appears to be the strong trend growth in many emerging-market economies and the resulting rise in their demand for commodities. Overly accommodative monetary policies have fed domestic demand and further exacerbated inflationary pressures in several emerging Asian economies. Limited growth in world oil supplies has also been a factor in pushing crude oil prices to record levels.

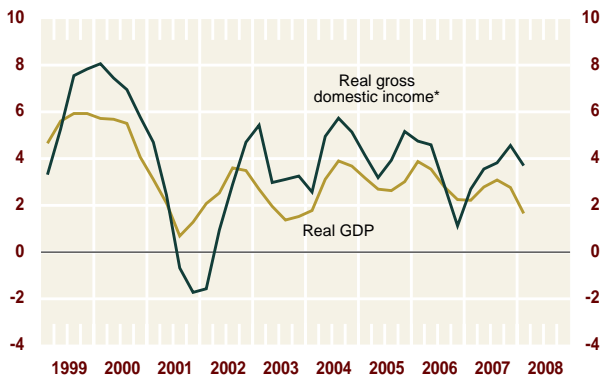
The U.S. economy grew at a modest pace in the first half of 2008, owing to further sharp declines in residential investment and weak household spending on durable goods, especially automobiles. However, consumption was somewhat more resilient than expected, supported by the early arrival of fiscal rebate cheques. Overall, the combined effect of a large overhang in the supply of housing, rising energy prices, declining employment, and continuing disruptions in financial markets has weighed heavily on U.S. domestic demand. Net exports remained the main source of strength in the U.S. economy.

While GDP growth in both Europe and Japan was stronger than anticipated in the first quarter of 2008, reflecting temporary factors, recent data indicate that growth in the second quarter will likely be weaker owing to spillover effects from the U.S. slowdown and ongoing unsettled conditions in global financial markets.

### Canadian Economic Activity

In Canada, real GDP growth was weaker than expected in the first quarter, with the economy contracting at an annual rate of 0.3 per cent, compared with the 1.0 per cent growth that had been projected in the April Report.<sup>1</sup> In contrast, real gross domestic income (GDI) increased at an annual rate of 2.4 per cent in the quarter, owing to a further 8.1 per cent (at an annual rate) improvement in Canada's terms of trade.<sup>2</sup> On a year-over-year basis, this real income measure is up nearly 4 per cent as a result of the significant rise in the prices of many commodities that Canada produces (Chart 2). The growth of household spending in Canada, nevertheless, fell short of expectations in the first quarter, and the decrease in inventory investment was considerably larger than expected.

**Chart 2 Real Gross Domestic Income and Real GDP**  
Year-over-year percentage change



\* Real gross domestic income is current-dollar gross domestic product deflated by the price index for final domestic demand.

Net exports made a surprising positive contribution to GDP growth in the first quarter, as the decline in exports was more than offset by a significant contraction in

1. Statistics Canada revised GDP growth up slightly for 2006 and 2007. Combined with the negative surprise to growth in the first quarter of 2008, this change implied that the level of real GDP in that quarter was about 0.1 per cent lower than previously projected.

2. Real GDI is nominal GDP deflated by an index of the prices of goods and services purchased by Canadians rather than the prices of goods and services produced by Canadians. It differs from real GDP because the goods and services purchased by Canadians differ from the goods and services produced domestically, and changes in the terms of trade thereby affect the purchasing power of the income generated in production.

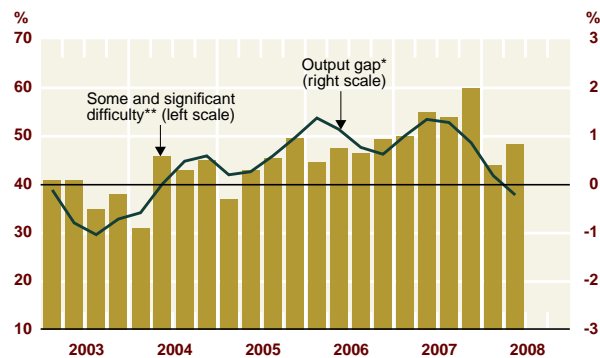
imports. Spending on imported goods and services, which had surged in the last half of 2007, in line with the sharp appreciation of the Canadian dollar, fell back significantly. The contraction in merchandise imports was related to the large negative inventory swing. Exports decreased for a third consecutive quarter as a result of declining U.S. spending on housing and automobiles, and the effects of the past appreciation of the Canadian dollar.

Available data for the second quarter of 2008 suggest that annualized real GDP growth was about 0.8 per cent. The growth of final domestic demand likely remained solid, while net exports exerted a dampening effect. However, inventory investment is not expected to have been the major drag on growth that it was in the first quarter.

### Estimated Pressures on Capacity

After three quarters of below-trend growth, the Canadian economy is judged to have moved into excess supply in the second quarter of 2008. The Bank's conventional measure of the output gap suggests that the economy is currently operating about 0.2 per cent below its production potential, although respondents to the *Business Outlook Survey* still reported some pressures on capacity, particularly in Western Canada (Chart 3).

**Chart 3 Estimated Output Gap and the Response to Business Outlook Survey Question on Capacity Pressures**



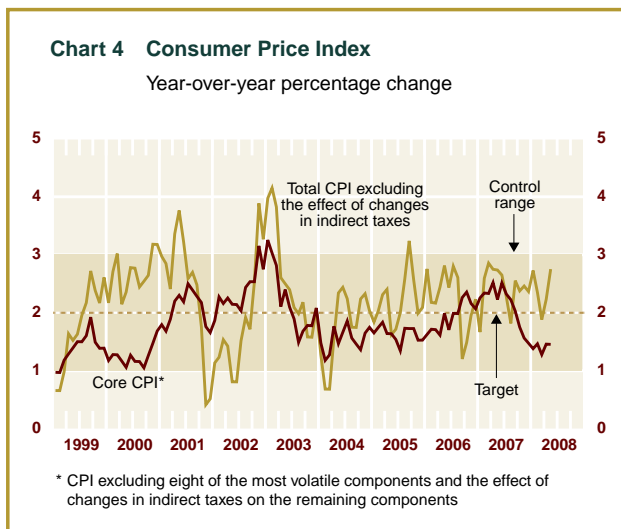
\* Difference between actual output and estimated potential output. The estimate for the second quarter of 2008 is based on a projected rise in output of 0.8 per cent (at annual rates) for the quarter.

\*\* Percentage of firms indicating that they would have either some or significant difficulty meeting an unanticipated increase in demand/sales.

### ***Inflation and the 2 Per Cent Target***

Total CPI inflation has been higher than expected in the April *Report*, reflecting the impact of higher prices for crude oil on gasoline prices, as well as a marginally higher core rate of inflation. The 12-month rate of increase in the total CPI rose from 1.4 per cent in March to 2.2 per cent in May (or from 1.9 to 2.8 per cent, respectively, if the effect of changes in indirect taxes is excluded).

The core rate of inflation averaged 1.5 per cent in April and May, up from a low of 1.3 per cent in March (Chart 4). The downward pressure exerted on certain goods prices (especially automobile prices), as a result of the rise in the Canadian dollar to near parity with the U.S. dollar, continued to hold the core rate down.



The Bank closely monitors a number of indicators of inflation expectations. The measure of near-term inflation expectations reported in the Bank's latest *Business Outlook Survey* increased sharply, with about one-third of firms expecting CPI inflation to be above 3 per cent over the next two years. However, this measure is highly influenced by swings in energy prices and tends to reverse as total CPI inflation falls in response to stabilizing or declining energy prices. The mean private sector forecast for total CPI inflation in 2009 remains at 2 per cent, and Consensus Economics' forecasts of inflation for two years and beyond have also stayed

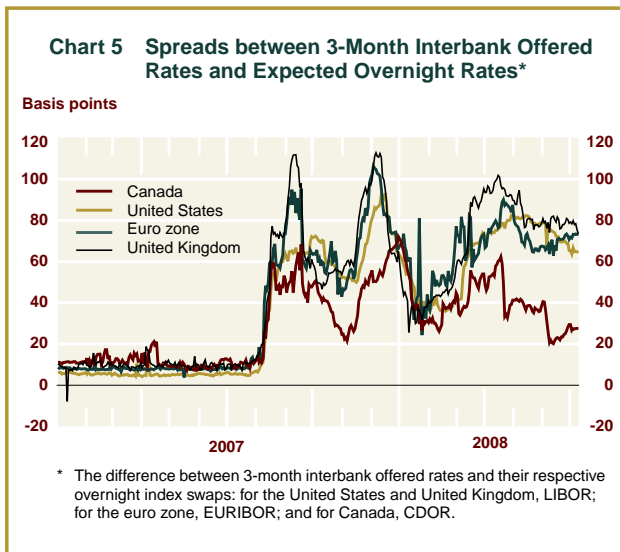
close to 2 per cent. Inflation expectations, as measured by the spread between 30-year conventional and Real Return bonds, have increased in recent months, although they remain well within the range experienced over the past several years. Liquidity and technical factors suggest that this measure should be interpreted with caution. Considering all measures, the Bank judges that expectations of inflation over the policy horizon remain well anchored to the 2 per cent inflation target.

### **Financial Developments**

Conditions in global financial markets continue to be unsettled. Volatility in bond and equity markets has remained high since the April *Report*, and credit spreads on corporate debt, particularly for financial institutions, have widened. In the United States and Europe, spreads on short-term bank funding remain well above historical averages. At the same time, the issuance of corporate debt has improved, and financial institutions have made progress with regard to disclosing their balance sheet exposures and strengthening their capital positions. Nonetheless, the ongoing re-intermediation of assets onto bank balance sheets and the deleveraging of the financial system are expected to weigh on global credit markets for some time.

### **Canadian Credit Conditions**

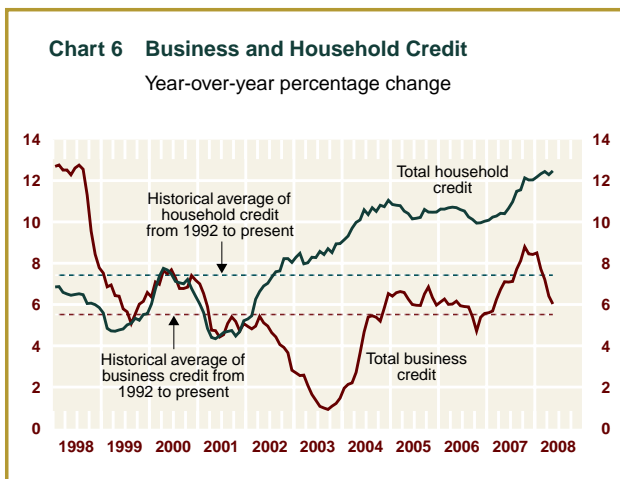
Although credit conditions in Canada remain challenging, they are better in many respects than those in other major markets. For example, short-term credit spreads, as measured by the spread between short-term lending rates and the expected overnight rate, have narrowed significantly in recent months (Chart 5). Reflecting these improved conditions, the Bank of Canada was the first G-7 central bank to withdraw the provision of extraordinary liquidity. While the average effective borrowing spreads faced by banks, non-financial businesses, and households have increased by about 75 basis points vis-à-vis the overnight rate since the onset of turbulence in financial markets last summer, this increase has been more than offset by the cumulative



150-basis-point reduction in the target overnight rate. As a result, the effective borrowing costs faced by banks, businesses, and households are estimated to have fallen by about 75 basis points over the past year.

Growth in business credit has slowed in recent quarters (Chart 6), reflecting the recent contraction in economic activity and generally challenging credit market conditions. Non-price-related terms and conditions for bank intermediated credit have tightened over the past year.

In contrast, growth in household credit remains robust. This likely reflects high employment and increases in wealth and real income. While banks appear to have fully



passed on their increased borrowing costs to households, they do not appear to have tightened non-price conditions. Nonetheless, the continued strength in household credit growth is somewhat surprising, given the moderation of activity in the housing market and the reported decline in consumer confidence. The growth of household credit is expected to moderate in the coming months.

### ***Policy and Interest Rates***

Financial market expectations, as reflected in asset prices, suggest that policy rates in all the major economies will remain unchanged or increase modestly by year-end. For Canada, current levels of short-term interest rates incorporate no change in the target overnight rate by year-end.

### ***Exchange Rate***

The Canadian dollar remains at about the same level as at the time of the April *Report*, having traded in a range of roughly 97.5 to 101.5 cents U.S. While stronger commodity prices are generally supportive of the Canadian dollar, concerns about the outlook for the U.S. economy and U.S. demand for Canadian goods and services appear to have weighed on the currency.

### **The Economic Outlook**

The Bank's base-case projection incorporates the following key assumptions: a Canada/U.S. exchange rate averaging 98 cents U.S.; energy prices evolving in line with current futures prices; prices for non-energy commodities decreasing by about 15 per cent over the projection horizon; tight global credit conditions persisting through 2008, before gradually improving in 2009; and an orderly resolution of global imbalances. Potential output growth in Canada is also assumed to be the same as in the April *Report* (that is, 2.8 per cent in the second half of 2008 and declining by 0.1 percentage point per year in 2009 and 2010).



## The Global Outlook

In the base-case projection, global economic growth slows in the second half of 2008 and in 2009, owing to weakness in the U.S. economy, ongoing financial market turbulence, sharply higher commodity prices, and more restrictive monetary policy in a number of overseas economies. With inflation at uncomfortably high levels in emerging markets, growth should be dampened by tighter monetary conditions—as monetary authorities raise policy rates and reserve requirements, and real exchange rates appreciate (Table 1).

The outlook for the U.S. economy is similar to that in the *April Report*. However, the average annual growth rates for 2008 and 2009 differ because of a stronger starting point in the first half of 2008 and weaker growth through the rest of the year. The stronger first half reflects the boost to retail sales coming from the early arrival of the temporary fiscal stimulus. Going forward, continuing turbulence in financial markets, the ongoing correction in the housing

market, and significantly higher energy prices lead to weaker consumption and investment. Purchases of durables, especially automobiles, are expected to be most affected. Growth in the economy begins to recover in 2009, led by net exports and firming domestic demand growth, as credit conditions improve, the housing market stabilizes, and the effect of past monetary policy easing gathers strength. Annual U.S. growth is now expected to average 1.6 per cent in 2008, 1.5 per cent in 2009, and 3.3 per cent in 2010. Core inflation is expected to be about 2.0 per cent throughout the projection horizon.

## The Canadian Outlook

Against this global backdrop and with the inventory adjustment completed, real GDP growth in Canada is projected to pick up in the second half of 2008, and to rise above 3.0 per cent from mid-2009 to the end of 2010. Compared with the *April Report*, average annual growth is projected to be slightly lower this year, owing to the weakness in the first quarter, while projected growth for 2009 and 2010 is essentially unchanged (Table 2).

Final domestic demand is projected to be the key driver of economic growth in Canada over the projection horizon. Recent increases in global commodity prices lead to higher wages and salaries, higher government revenues, higher corporate profits and equity valuations, and stronger investment growth, particularly in the energy sector. Net exports exert a significant drag on growth through the rest of 2008, but this drag diminishes through 2009 and 2010 as the U.S. economy gradually recovers.

Given this growth profile, excess supply in the Canadian economy is projected to increase further through late 2008, but to gradually dissipate with the acceleration in aggregate demand. The economy is thus projected to return to balance around mid-2010.

Total CPI inflation for the remainder of 2008 is expected to be sharply higher than projected in the last *Report*, chiefly because of much higher prices for crude oil (Table 3). With the price of crude oil assumed to

**Table 1**  
**Projection for Global Economic Growth**

	Share of real global GDP <sup>a</sup> (per cent)	Expected growth (per cent) <sup>b</sup>			
		2007	Projection		
			2008	2009	2010
United States	22	2.2 (2.2)	1.6 (1.0)	1.5 (1.7)	3.3 (3.4)
European Union	20	2.7 (2.7)	1.7 (1.3)	1.5 (1.6)	2.3 (2.2)
Japan	7	2.0 (2.0)	1.7 (1.4)	1.5 (1.6)	1.7 (1.8)
China and Asian NIEs <sup>c</sup>	14	10.2 (10.2)	8.9 (8.4)	7.6 (7.2)	7.4 (7.3)
Others	37	6.3 (6.3)	5.4 (5.2)	4.6 (4.6)	5.5 (5.5)
World	100	4.9 (4.9)	4.1 (3.7)	3.4 (3.5)	4.4 (4.4)

a. GDP shares are based on IMF estimates of the purchasing-power-parity (PPP) valuation of country GDPs for 2006.

Source: IMF, WEO Update, January 2008.

b. Numbers in parentheses are projections from the April 2008 *Monetary Policy Report*.

c. NIEs are newly industrialized economies. These include Hong Kong (Special Administrative Region), South Korea, Taiwan (Province of China), and Singapore.

Source: Bank of Canada

	2007	2008	2009	2010
Consumption	2.5 (2.6)	2.1 (2.5)	2.3 (2.3)	2.4 (2.3)
Housing	0.2 (0.2)	-0.1 (0.1)	-0.1 (-0.1)	-0.1 (-0.1)
Government	0.9 (0.8)	0.9 (0.9)	0.7 (0.6)	0.6 (0.6)
Business fixed investment	0.5 (0.6)	0.5 (0.4)	0.5 (0.4)	0.5 (0.4)
<b>Subtotal: Final domestic demand</b>	<b>4.1</b> <b>(4.2)</b>	<b>3.4</b> <b>(3.9)</b>	<b>3.4</b> <b>(3.2)</b>	<b>3.4</b> <b>(3.2)</b>
Exports	0.4 (0.4)	-1.1 (-1.3)	0 (0.1)	1.2 (1.2)
Imports	-1.8 (-1.9)	-0.8 (-1.1)	-1.1 (-0.9)	-1.3 (-1.1)
<b>Subtotal: Net exports</b>	<b>-1.4</b> <b>(-1.5)</b>	<b>-1.9</b> <b>(-2.4)</b>	<b>-1.1</b> <b>(-0.8)</b>	<b>-0.1</b> <b>(0.1)</b>
Inventories	0 (0)	-0.5 (-0.1)	0 (0)	0 (0)
<b>Real GDP</b>	<b>2.7</b> <b>(2.7)</b>	<b>1.0</b> <b>(1.4)</b>	<b>2.3</b> <b>(2.4)</b>	<b>3.3</b> <b>(3.3)</b>
<b>Memorandum Item:</b> <b>Real GDI<sup>b</sup></b>	<b>3.7</b>	<b>4.0</b>	<b>4.4</b>	<b>3.3</b>

- a. Figures in parentheses are from the base-case projection in the April *Monetary Policy Report*.
- b. Real gross domestic income is current-dollar gross domestic product deflated by the price index for final domestic demand.

stabilize near its current level, core inflation well contained, and inflation expectations well anchored, the 12-month change in the total CPI is expected to converge to the core rate in the second half of 2009 at the 2 per cent target.

The core rate of inflation is projected to remain at about 1.5 per cent through the third quarter of 2008. With the earlier price-level adjustments of automobiles starting to fall out of the year-over-year calculation, the core rate should increase to 1.8 per cent in

	2008				2009		2010
	Q1	Q2	Q3	Q4	H1	H2	
Real GDP (quarter-over-quarter percentage change) <sup>b</sup>	<b>-0.3</b> (1.0)	<b>0.8</b> (0.3)	<b>1.3</b> (1.6)	<b>1.8</b> (2.0)	<b>2.8</b> (2.7)	<b>3.2</b> (3.3)	<b>3.4</b> (3.4)
Real GDP (year-over-year percentage change)	<b>1.7</b> (2.1)	<b>0.9</b> (1.3)	<b>0.6</b> (0.9)	<b>0.9</b> (1.2)	<b>1.9</b> (1.9)	<b>2.8</b> (2.8)	<b>3.3</b> (3.3)
Core inflation (year-over-year percentage change)	<b>1.4</b> (1.4)	<b>1.5</b> (1.3)	<b>1.5</b> (1.3)	<b>1.8</b> (1.7)	<b>1.9</b> (1.7)	<b>2.0</b> (1.8)	<b>2.0</b> (2.0)
Total CPI (year-over-year percentage change)	<b>1.8</b> (1.8)	<b>2.2</b> (1.7)	<b>3.8</b> (1.9)	<b>4.1</b> (1.9)	<b>3.6<sup>c</sup></b> (1.8)	<b>2.0</b> (1.8)	<b>2.0</b> (2.0)
Total CPI (excluding effect of changes in indirect taxes) (year-over-year percentage change)	<b>2.4</b> (2.4)	<b>2.8</b> (2.2)	<b>4.4</b> (2.4)	<b>4.7</b> (2.4)	<b>3.6</b> (1.8)	<b>2.0</b> (1.8)	<b>2.0</b> (2.0)
WTI <sup>d</sup> (level)	<b>98</b> (98)	<b>124</b> (111)	<b>141</b> (110)	<b>142</b> (108)	<b>143</b> (106)	<b>142</b> (104)	<b>141</b> (102)

- a. Figures in parentheses are from the April *Monetary Policy Report*.
- b. For half and full years, the number reported is the average of the respective quarter-to-quarter percentage growth at annual rates.
- c. In the first half of 2009, total CPI inflation is projected to be 4.3 per cent in the first quarter and 2.9 per cent in the second quarter.
- d. 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 11 July 2008.

the fourth quarter of this year. Downward pressure on core inflation from excess supply is expected to keep the core rate of inflation below 2.0 per cent through the first half of 2009 as the deceleration in the growth of housing prices largely offsets the expected acceleration of food prices. With the amount of excess supply diminishing and with some upward pressure from increases in labour and energy costs, the core rate is expected to move up to 2.0 per cent in the second half of 2009 and stay there over the projection horizon.

In this base-case projection, the momentum in domestic demand arising from improvements in the terms of trade, the normalization of credit conditions

through 2009, and the gradual recovery of the U.S. economy, act to bring the economy back to potential around mid-2010.

### ***Risks to the Outlook***

The three major developments affecting the Canadian economy pose significant upside and downside risks to the Bank's base-case projection.

On the upside, domestic demand could be greater than projected, given the strength in Canada's terms of trade and the momentum of household credit growth. In addition, potential output growth could be lower than assumed, given the ongoing weakness in labour productivity associated in part with the reallocation of resources across sectors. Global inflationary pressures could also lead to higher-than-projected import costs for Canada.

On the downside, commodity prices could be weaker than assumed. Growth in the United States could also be weaker than expected, particularly in those sectors that are most relevant for Canadian exports. In addition, continued strains in global financial markets could have a greater-than-projected impact on global growth and on the cost and availability of credit in Canada.

Weighing the implication of these considerations, the Bank views the risks to its base-case projection for inflation as balanced.

The *Monetary Policy Report* and the *Update* are available on the Bank's website at: <http://www.bankofcanada.ca>.

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ISSN: 1495-8473