

# Monetary Policy Report Summary

July 2009

*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 21 July 2009.*

The global economy has suffered an intense, synchronous recession and considerable excess supply has opened up. There are now increasing signs that economic activity has begun to expand in many countries in response to monetary and fiscal policy stimulus and measures to stabilize the global financial system. However, the recovery is nascent. Effective and resolute policy implementation remains critical to sustained global growth.

The dynamics of the recovery in Canada remain broadly consistent with the Bank's medium-term outlook in its April *Monetary Policy Report*. Stimulative monetary and fiscal policies, improved financial conditions, firmer commodity prices, and a rebound in business and consumer confidence are spurring domestic demand growth. However, the higher Canadian dollar, as well as ongoing restructuring in key industrial sectors, is significantly moderating the pace of overall growth.

Some of the early strength in domestic demand represents a bringing forward of household expenditures, which modestly alters the profile of growth over the projection period relative to the April *Report*. The Bank projects that the economy will contract by 2.3 per cent in 2009 and then grow by 3.0 per cent in 2010 and 3.5 per cent in 2011, reaching production capacity in the middle of 2011.

Total CPI inflation declined to -0.3 per cent in June and should trough in the third quarter of this year before returning to the 2 per cent target in the second quarter of 2011 as aggregate supply and demand return to balance. Core inflation held up at

## Highlights

- The global economic recovery is nascent. Effective and resolute policy implementation remains critical to sustained global growth.
- The dynamics of the recovery in Canada remain broadly consistent with the Bank's medium-term outlook in April, although the growth profile is slightly altered by a faster rebound in domestic demand.
- Economic growth in Canada is expected to turn positive in the third quarter. Real GDP is projected to decline by 2.3 per cent this year and to grow by 3.0 per cent in 2010 and by 3.5 per cent in 2011.
- Both total CPI and core inflation should trough in the second half of this year and return to 2 per cent in the second quarter of 2011.
- The Bank maintained its policy rate at 1/4 per cent and reaffirmed its conditional commitment to hold its current policy rate until the end of the second quarter of 2010.
- As a consequence of conducting monetary policy at the effective lower bound, the Bank judges that the risks to its inflation projection are tilted slightly to the downside.

1.9 per cent in the second quarter of 2009. The Bank still expects core inflation to diminish in the second half of this year before gradually returning to 2 per cent in the second quarter of 2011.

Although the vigorous policy actions taken by monetary and fiscal authorities around the world appear to have reduced the probability of an extreme negative outcome for the global economy, significant upside and downside risks remain to the inflation projection for Canada.

The main upside risks to inflation relate to domestic factors, and the possibility that economic momentum will be stronger and more sustained than currently anticipated. Another upside risk to inflation is the possibility that potential output will be lower than the Bank's revised estimate, if the extensive restructuring in certain sectors is more protracted and the

investment response is more delayed than currently envisaged.

The principal downside risks to inflation relate mainly to the external sector. The restoration of normal financial conditions could be more gradual than expected, and further setbacks cannot be precluded. Such developments could have serious spillover effects in Canada through trade, financial, and confidence channels. Importantly, a stronger and more volatile Canadian dollar could act as a significant drag on growth and put additional downward pressure on inflation.

While the underlying macroeconomic risks to the projection are roughly balanced, the Bank judges that, as a consequence of operating at the effective lower bound, the overall risks to its inflation projection are tilted slightly to the downside.

#### Summary of the base-case projection<sup>a</sup>

	2008	2009				2010				2011			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (quarter-over-quarter percentage change)	-3.7 (-3.4)	-5.4 (-7.3)	-3.5 (-3.5)	1.3 (-1.0)	3.0 (2.4)	4.0 (3.4)	4.0 (3.6)	3.8 (4.4)	3.8 (4.8)	3.8 (5.0)	3.3 (5.0)	2.8 (4.7)	2.8 (4.3)
Real GDP (year-over-year percentage change)	-1.0 (-0.7)	-2.1 (-2.4)	-3.1 (-3.4)	-2.9 (-3.8)	-1.2 (-2.4)	1.2 (0.3)	3.1 (2.1)	3.7 (3.4)	3.9 (4.0)	3.8 (4.4)	3.7 (4.8)	3.4 (4.9)	3.2 (4.7)
Core inflation (year-over-year percentage change)	2.2 (2.2)	2.0 (1.9)	1.9 (1.6)	1.6 (1.3)	1.4 (0.9)	1.4 (1.0)	1.6 (1.1)	1.6 (1.3)	1.7 (1.5)	1.9 (1.7)	2.0 (1.9)	2.0 (2.0)	2.0 (2.0)
Total CPI (year-over-year percentage change)	2.0 (2.0)	1.2 (1.2)	0.1 (-0.1)	-0.7 (-0.8)	1.2 (1.0)	1.4 (1.6)	1.4 (1.6)	1.3 (1.6)	1.7 (1.7)	1.8 (1.8)	2.0 (1.9)	2.0 (2.0)	2.0 (2.0)
WTI <sup>b</sup> (level)	58 (58)	43 (43)	62 (51)	62 (57)	64 (60)	67 (62)	68 (64)	69 (66)	70 (67)	71 (68)	72 (69)	73 (70)	74 (71)

a. Figures in parentheses are from the base-case projection in the April *Monetary Policy Report*.

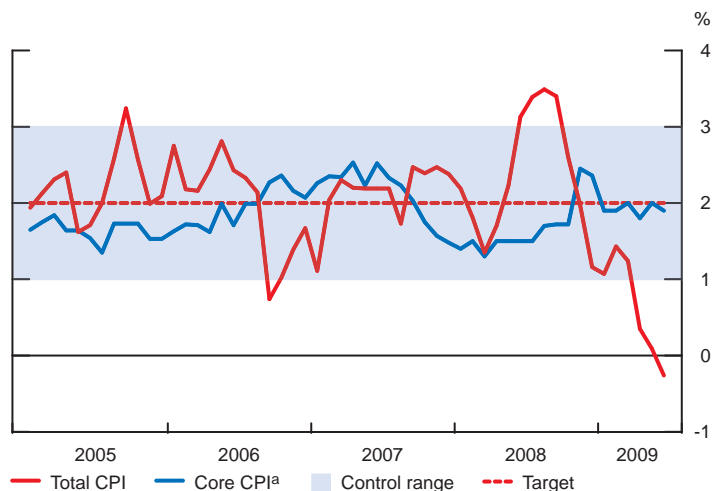
b. Assumptions for the price of West Texas Intermediate crude oil (US\$ per barrel), based on an average of futures contracts over the two weeks ending 17 July 2009.

On 4 June and 21 July, the Bank reaffirmed its conditional commitment to maintain its target for the overnight rate at the effective lower bound of 1/4 per cent until the end of the second quarter of 2010 in order to achieve the inflation target.

The Bank retains considerable flexibility in the conduct of monetary policy at low interest rates, consistent with the framework outlined in the *April Report*.

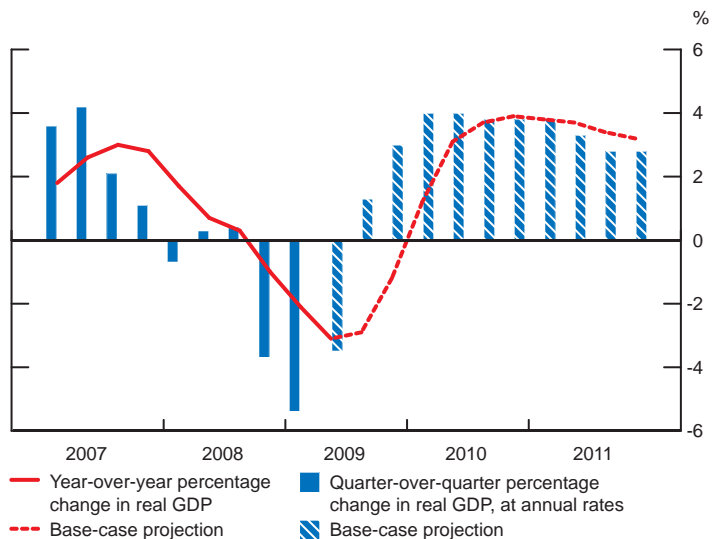
**Total CPI inflation has fallen, while core inflation has remained stable**

Year-over-year percentage change, monthly data



a. CPI excluding eight of the most volatile components and the effect of changes in indirect taxes on the remaining components  
Source: Statistics Canada

**Real GDP growth is expected to rebound in the second half of 2009**



Sources: Statistics Canada and Bank of Canada calculations