BANK OF CANADA
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Monetary Policy Report

Summary

October 2008

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 21 October 2008.*

Overview

Three major interrelated global developments are having a profound impact on the Canadian economy and making the outlook more uncertain than it was at the time of the July *Monetary Policy Report Update*. First and foremost, the intensification of the global financial crisis in recent weeks has been reflected in severe strains in global money and credit markets and sharp falls and extreme volatility in global equity markets. The associated need for the global banking sector to continue to reduce leverage will restrain growth for some time. Second, there is growing evidence that the global economy is heading into a mild recession, led by a U.S. economy that is already in recession and expected to pick up only modestly through 2009. Third, there have been sharp declines in the prices of many commodities since the July *Update*. These developments have reduced inflationary pressures globally.

In response to the global financial crisis, policy-makers in major economies have taken several extraordinary actions to provide liquidity to markets, recapitalize their banking sectors, and restore credit flows. In line with the G7 Plan of Action, these initiatives have reduced the risk of a significantly worse outcome for the global financial system, and Canada's

Highlights

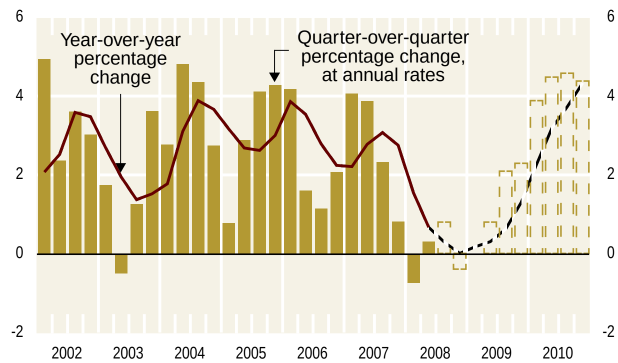
- Tighter credit conditions, weaker external demand, and sharply weaker commodity prices have lowered the outlook for Canadian growth and inflation.
- Growth in Canada will be sluggish through the first quarter of next year, then pick up over the rest of 2009 and accelerate to above-potential growth in 2010.
- Total CPI inflation is projected to fall below 1 per cent in mid-2009 before rising to 2 per cent by the end of 2010. Core inflation will remain below 2 per cent until the end of 2010.
- Policy-makers in major countries have taken bold actions to address the financial crisis and its effects on the economy. Canada's economy and strong financial system will benefit directly from these actions.
- The policy rate has been lowered by a total of 75 basis points this month, 225 basis points since the beginning of December 2007. Some further monetary stimulus will likely be required to achieve the 2 per cent inflation target over the medium term.
- The risks around the revised base-case projection for inflation are judged to be roughly balanced, but the outlook is subject to greater uncertainty than usual.

economy and strong financial system will benefit directly. Nonetheless, the deleveraging of the global financial system will take some time to complete, and will involve a larger and more persistent tightening of credit conditions than was assumed in July.

Given these developments, the projection for the Canadian economy has been revised down considerably for 2008 and 2009. However, uncertainty around the Bank's base-case projection for growth and inflation in Canada is much greater than normal, given the unsettled conditions in global financial markets and the rapid deceleration of global growth. The weaker outlook for global demand will increase the drag on the Canadian economy coming from exports. Lower commodity prices will also dampen the outlook, working through a deterioration in Canada's terms of trade to moderate domestic demand growth. The marked tightening in Canadian credit conditions in recent weeks will restrain business and housing investment. As a result, economic activity in Canada is projected to remain sluggish through the first quarter of next year, then to pick up over the rest of 2009 and to accelerate to above-potential growth in 2010, supported by improving credit conditions, the lagged effects of monetary policy actions, and stronger global growth. The recent sizeable depreciation of the Canadian dollar will also provide an important offset to the effects of weaker global demand and lower commodity prices. Overall, the Bank projects average annual growth in real GDP of 0.6 per cent in 2008 and 2009, rising to 3.4 per cent in 2010.

The growth of potential output has been slower than previously anticipated, owing to anemic productivity growth that has been only partially offset by a larger-than-expected increase in the supply of labour. The Bank has lowered its estimate for the growth of potential output to 2.3 per cent in 2008, and assumes a gradual rise to 2.5 per cent by 2010.

Real Gross Domestic Product for Canada*



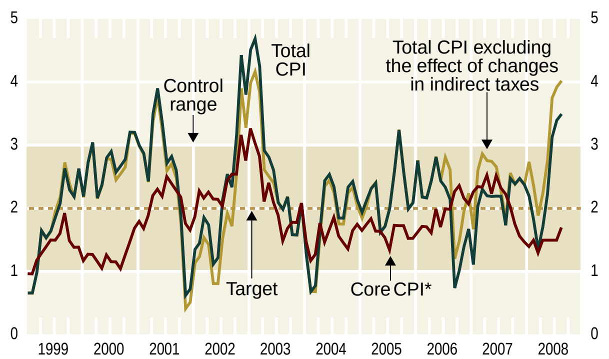
* The broken line and bars indicate the base-case projection.

The Canadian economy is judged to have moved into slight excess supply in the third quarter of 2008. This excess supply is expected to build through to the end of 2009, and is not projected to be fully eliminated until the start of 2011. With growing slack in the economy, and a lower assumed path for commodity prices, inflation pressures in Canada are projected to ease significantly relative to the July *Update*. Core inflation is projected to remain below 2 per cent until the end of 2010. Assuming oil prices in a range of US$81 to US$88 per barrel, consistent with recent futures prices, total CPI inflation should peak in the third quarter of 2008, and is projected to fall below 1 per cent in mid-2009 before returning to the 2 per cent target by the end of 2010.

In light of diminished inflationary pressures, the Bank of Canada lowered its policy interest rate by 50 basis points on 8 October, acting in concert with other major central banks. This extraordinary action, together with a 25-basis-point reduction on 21 October, brings the cumulative reduction in the target for the overnight rate to 75 basis points since the Bank's last fixed announcement date. These actions provide timely and significant support to the Canadian economy. The cumulative reduction in the Bank's policy rate since the beginning of

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

December 2007 is now 225 basis points. In line with the new outlook, some further monetary stimulus will likely be required to achieve the 2 per cent inflation target over the medium term.

The Bank judges that the risks are roughly balanced around its revised base-case projection for inflation in Canada—a base case that now incorporates the recent intensification of the global financial crisis, a mild global recession, and the measures that have been taken to resolve the crisis. The evolution of the financial crisis, its impact on the global economy, and the timing of the effect of the various extraordinary measures being taken to address it pose significant risks to the inflation projection on both the upside and the downside.

Recent Developments

The global economy is entering into a mild recession, owing largely to tighter credit conditions related to ongoing dislocations in global financial markets and the lagged effect of past increases in commodity prices. The slowdown which originated in the United States is now being felt across industrial countries and, to a lesser extent, in emerging markets. While U.S. economic growth was stronger than expected in the first half of the year, more recently the economy has decelerated much more rapidly than expected, and is now judged to be in recession. The slowing global growth has led to a sharp decline in the prices of many commodities, especially energy products, and these prices remain volatile.

Canadian economic growth has slowed abruptly this year as export volumes fell and final domestic demand decelerated noticeably. Spending related to pent-up demand for houses and some durables appears to have been largely completed. The level of real GDP declined over the first half of 2008, and available data suggest that real GDP grew at an annual rate of 0.8 per cent in the third quarter.

Indicators of capacity pressures are mixed. Overall, the Governing Council judges that the economy moved into slight excess supply in the third quarter of 2008.

The core rate of inflation edged up to 1.7 per cent in August, due mainly to the effect of higher food prices. Total inflation rose to 3.5 per cent in August, reflecting the additional impact of higher crude oil prices. The Bank judges that inflation expectations over the policy horizon are well anchored on the 2 per cent inflation target.

Financial Developments

The global financial turmoil that began in the summer of 2007 has become the deepest, broadest, and most persistent financial crisis in decades. Liquidity has contracted sharply as risk aversion has risen abruptly, and credit spreads have reached unprecedented levels. The growing difficulty of raising capital and credit, the increased cost of borrowing, and the related effects on confidence are all contributing to the global economic slowdown. In response, governments and central banks in major countries have taken extraordinary steps to stabilize the financial system and limit further negative feedback into the real economy. The G7 Plan of Action, announced on 10 October, provides an important foundation for stabilizing markets and restoring credit flows.

Despite the healthy position of Canadian financial institutions, the global financial crisis has led to a substantial tightening of credit conditions in Canada. Borrowing spreads for financial and non-financial firms have risen sharply since the July *Update*, and access to credit has become severely impaired. Borrowing spreads are also higher for households, but there is little indication so far that non-price conditions are being tightened. Growth in household credit is expected to moderate as housing prices decline modestly and real income growth decelerates.

The Canadian dollar has depreciated sharply in recent weeks, reflecting a substantial pullback in commodity prices, the weaker outlook for the Canadian economy, and portfolio adjustments resulting from financial dislocations.

Summary of the Base-Case Projection[a]

	2008				2009		2010
	Q1	Q2	Q3	Q4	H1	H2	
Real GDP (quarter-over-quarter percentage change)[b]	-0.8 (-0.3)	0.3 (0.8)	0.8 (1.3)	-0.4 (1.8)	0.4 (2.8)	2.2 (3.2)	4.4 (3.4)
Real GDP (year-over-year percentage change)	1.6 (1.7)	0.7 (0.9)	0.3 (0.6)	0 (0.9)	0.2 (1.9)	1.0 (2.8)	3.4 (3.3)
Core inflation (year-over-year percentage change)	1.4 (1.4)	1.5 (1.5)	1.6 (1.5)	1.8 (1.8)	1.7 (1.9)	1.6 (2.0)	1.9 (2.0)
Total CPI (year-over-year percentage change)	1.8 (1.8)	2.3 (2.2)	3.4 (3.8)	2.6 (4.1)	1.7 (3.6)	1.0 (2.0)	1.9 (2.0)
WTI[c] (level)	98 (98)	124 (124)	119 (141)	82 (142)	82 (143)	84 (142)	87 (141)

a. Numbers in parentheses are from the July *Monetary Policy Report Update*.
b. For half and full years, the number reported is the average of the respective quarter-to-quarter percentage growth at annual rates.
c. 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 17 October 2008.

Prospects for Growth and Inflation

The Bank's base-case projection for Canadian growth and inflation assumes that the Canadian dollar will average 85 cents U.S., close to its current level, that energy prices will evolve in a manner consistent with recent prices in futures markets, that the G7 Plan of Action will stabilize global financial markets, and that credit conditions in Canada will gradually improve over time. The global economy is projected to grow by less than 3 per cent in 2009—a pace that most economists would term recessionary—owing largely to tighter credit conditions that are more persistent and more pervasive across countries than assumed earlier this year. The weaker outlook for global growth means that the assumed path for commodity prices is also lower than before.

These global developments have weakened the near-term outlook for the Canadian economy. As a result, the Bank's base-case projection for the Canadian economy is considerably lower in the second half of 2008 and through 2009 than the projection in the July *Update*. On an average annual basis, the economy is projected to grow by 0.6 per cent in both 2008 and 2009, and by 3.4 per cent in 2010. Export volumes are projected to fall further, but with imports expected to grow more slowly, the drag from net exports will be smaller than projected in July. Growth in final domestic demand is expected to be subdued until late 2009, reflecting lower projected real income growth related to the recent reversal in commodity prices and the slowdown in housing investment. Business investment is also expected to decrease on account of slowing global growth, tight credit conditions, and a high level of uncertainty.

Below-potential growth will result in increased excess supply in the economy through 2009. But with a return to more normal financial conditions and with the stimulus provided by accommodative monetary policy, business and household spending should strengthen further in 2010. Exports are also expected to increase in 2010 as the U.S. economy recovers. Economic slack is projected to start being absorbed in 2010, such that the economy returns to full capacity early in 2011.

Despite the earlier reductions in automobile prices falling out of the year-over-year calculations, there will be downward pressure on core inflation coming from the presence of excess supply in the economy and modest reductions in housing prices. Accordingly, core inflation is projected to decline from 1.8 per cent in the fourth quarter of this year to 1.5 per cent in mid-2009. As excess supply diminishes, and with some upward pressure expected from import prices, core inflation should return to 2 per cent by the end of 2010.

The outlook for total CPI inflation has been lowered, largely reflecting the decline in energy prices. With the price of crude oil assumed to follow the path indicated by recent futures prices, total inflation is projected to fall below 1 per cent in mid-2009. With inflation expectations well anchored and with aggregate supply and demand returning to balance, total inflation is expected to return to the 2 per cent target towards the end of 2010.

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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