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Monetary Policy Report Summary

October 2010

This text is a commentary of the Governing Council of the Bank of Canada. It presents the Bank's outlook based on data received up to 15 October 2010.

The global economic recovery is entering a new phase. In advanced economies, temporary factors supporting growth in 2010—such as the inventory cycle and pent-up demand—have largely run their course and fiscal stimulus will shift to fiscal consolidation over the projection horizon. While the Bank expects that private demand in advanced economies will become sufficiently entrenched to sustain the recovery, the combination of difficult labour market dynamics and ongoing deleveraging in many advanced economies is expected to moderate the pace of growth relative to prior expectations. These factors will contribute to a weaker-than-projected recovery in the United States in particular. Growth in emerging-market economies is expected to ease to a more sustainable pace as fiscal and monetary policies are tightened. Heightened tensions in currency markets and related risks associated with global imbalances could result in a more protracted and difficult global recovery.

The economic outlook for Canada has changed. The Bank expects the economic recovery to be more gradual than it had projected in its July *Monetary Policy Report*, with growth of 3.0 per cent in 2010, 2.3 per cent in 2011, and 2.6 per cent in 2012. This more modest growth profile reflects a more gradual global recovery and a more subdued profile for household spending. With housing activity declining markedly as anticipated and household debt considerations becoming more important, the Bank expects household expenditures to decelerate to a pace closer to the rate of income growth over the projection horizon. Overall, the composition of demand in Canada is expected to shift away from government and household expenditures towards

Highlights

- The global recovery is expected to proceed at a more gradual pace than previously anticipated.
- The Canadian economy is entering a period of more modest growth, with real GDP projected to grow by 3.0 per cent in 2010, 2.3 per cent in 2011, and 2.6 per cent in 2012.
- The Canadian economy is expected to return to full capacity and inflation to the 2 per cent target by the end of 2012.
- On 19 October 2010, the Bank maintained the target for the overnight rate at 1 per cent.
- The Bank judges that the risks to the inflation outlook are roughly balanced.

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business investment and net exports. The strength of net exports will be sensitive to currency movements, the expected recovery in productivity growth, and the prospects for external demand.

Inflation in Canada has been slightly below the Bank's July projection. The recent moderation in core inflation is consistent with the persistence of significant excess supply and a deceleration in the growth of unit labour costs. The Bank judges that the output gap is slightly larger and that the economy will return to full capacity by the end of 2012 rather than the beginning of that year, as had been anticipated in July. The inflation outlook has been revised down and both total CPI and core inflation are now expected to converge to 2 per cent by the end of 2012, as excess supply in the economy is gradually absorbed and inflation expectations remain well anchored.

Important risks remain around this outlook and the Bank judges that the risks to the inflation outlook are roughly balanced. The three main upside risks are higher commodity prices, a stronger-than-anticipated recovery in the U.S. economy and the possibility of greater-than-projected momentum in the Canadian household sector. These upside risks are balanced by three downside risks relating to Canada's international competitiveness, global growth prospects,

Projection for global economic growth

	Share of real global GDP[a] (per cent)	Projected growth (per cent)[b]		
		2010	2011	2012
United States	20	2.7 *(2.9)*	2.3 *(3.0)*	3.3 *(3.5)*
Euro area	15	1.7 *(1.0)*	1.1 *(1.2)*	1.7 *(2.3)*
Japan	6	2.9 *(3.3)*	1.3 *(1.5)*	2.3 *(2.5)*
China	13	10.3 *(10.3)*	9.0 *(9.2)*	8.9 *(8.7)*
Rest of the world	46	5.2 *(5.1)*	3.6 *(3.8)*	3.5 *(3.6)*
World	**100**	**4.7 *(4.6)***	**3.5 *(3.8)***	**3.8 *(4.0)***

a. GDP shares are based on IMF estimates of the purchasing-power-parity (PPP) valuation of country GDPs for 2009.

Source: IMF, WEO, October 2010

b. Numbers in parentheses are projections used for the July 2010 *Monetary Policy Report*.

Source: Bank of Canada

Summary of the base-case projection for Canada[a]

	2009	2010				2011				2012			
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Real GDP (quarter-over-quarter percentage change at annual rates)	4.9 *(4.9)*	5.8 *(6.1)*	2.0 *(3.0)*	1.6 *(2.8)*	2.6 *(3.2)*	2.6 *(3.0)*	2.3 *(3.0)*	2.3 *(2.5)*	2.6 *(2.4)*	2.7 *(2.0)*	2.8 *(1.9)*	2.8 *(1.9)*	2.8 *(1.9)*
Real GDP (year-over-year percentage change)	-1.1 *(-1.1)*	2.2 *(2.2)*	3.4 *(3.7)*	3.6 *(4.2)*	3.0 *(3.8)*	2.2 *(3.0)*	2.3 *(3.0)*	2.4 *(2.9)*	2.4 *(2.7)*	2.5 *(2.5)*	2.6 *(2.2)*	2.7 *(2.1)*	2.8 *(2.0)*
Core inflation (year-over-year percentage change)	1.6 *(1.6)*	2.0 *(2.0)*	1.8 *(1.9)*	1.6 *(1.8)*	1.6 *(1.8)*	1.5 *(1.8)*	1.6 *(1.7)*	1.7 *(1.8)*	1.7 *(1.9)*	1.8 *(2.0)*	1.9 *(2.0)*	1.9 *(2.0)*	2.0 *(2.0)*
Total CPI (year-over-year percentage change)	0.8 *(0.8)*	1.6 *(1.6)*	1.4 *(1.4)*	1.8 *(2.1)*	2.1 *(2.1)*	2.0 *(2.2)*	2.2 *(2.2)*	1.8 *(1.8)*	1.9 *(2.0)*	1.8 *(2.0)*	1.9 *(2.0)*	1.9 *(2.0)*	2.0 *(2.0)*
Total CPI excluding the effect of the HST and changes in other indirect taxes (year-over-year percentage change)	0.8 *(0.8)*	1.6 *(1.6)*	1.4 *(1.4)*	1.3 *(1.7)*	1.7 *(1.8)*	1.5 *(1.8)*	1.7 *(1.8)*	1.8 *(1.8)*	1.8 *(1.9)*	1.8 *(2.0)*	1.9 *(2.0)*	1.9 *(2.0)*	2.0 *(2.0)*
WTI[b] (level)	76 *(76)*	79 *(79)*	78 *(78)*	76 *(75)*	82 *(77)*	84 *(78)*	86 *(80)*	87 *(80)*	87 *(81)*	88 *(81)*	88 *(81)*	88 *(82)*	89 *(82)*

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

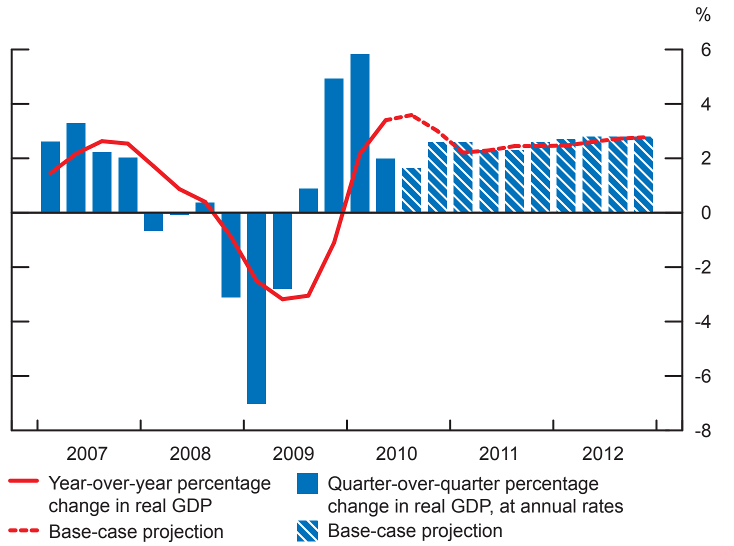
b. Assumptions for the price of West Texas Intermediate crude oil (US$ per barrel), based on an average of futures contracts over the two weeks ending 15 October 2010.

and the possibility of a more pronounced correction in the Canadian housing market.

On 8 September 2010, the Bank raised its target for the overnight rate by one-quarter of one percentage point to 1 per cent. On 19 October 2010, the Bank maintained the target for the overnight rate at 1 per cent. The Bank Rate is correspondingly 1 1/4 per cent and the deposit rate is 3/4 per cent. This leaves considerable monetary stimulus in place, consistent with achieving the 2 per cent inflation target in an environment of significant excess supply in Canada.

At this time of transition in the global recovery, with a weaker U.S. outlook, constraints beginning to moderate growth in emerging-market economies, and domestic considerations that are expected to slow consumption and housing activity in Canada, any further reduction in monetary policy stimulus would need to be carefully considered.

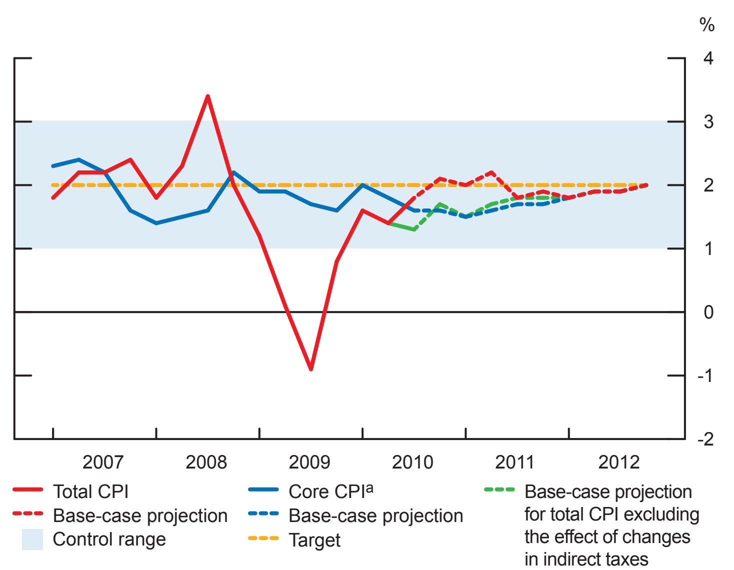
Real GDP is expected to grow at rates consistent with the gradual absorption of excess supply



Sources: Statistics Canada and Bank of Canada projections Last observation: 2010Q2

Total CPI and core inflation in Canada are projected to converge to 2 per cent over the projection horizon

Year-over-year percentage change, quarterly data



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

Sources: Statistics Canada and Bank of Canada projections

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