BANK OF CANADA
BANQUE DU CANADA

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CONTACT: Media Relations
613 782-8782

Bank of Canada lowers overnight rate target to 3/4 per cent

OTTAWA – The Bank of Canada today announced that it is lowering its target for the overnight rate by one-quarter of one percentage point to 3/4 per cent. The Bank Rate is correspondingly 1 per cent and the deposit rate is 1/2 per cent. This decision is in response to the recent sharp drop in oil prices, which will be negative for growth and underlying inflation in Canada.

Inflation has remained close to the 2 per cent target in recent quarters. Core inflation has been temporarily boosted by sector-specific factors and the pass-through effects of the lower Canadian dollar, which are offsetting disinflationary pressures from slack in the economy and competition in the retail sector. Total CPI inflation is starting to reflect the fall in oil prices.

Oil's sharp decline in the past six months is expected to boost global economic growth, especially in the United States, while widening the divergences among economies. Persistent headwinds from deleveraging and lingering uncertainty will influence the extent to which some oil-importing countries benefit from lower prices. The Bank's base-case projection assumes oil prices around US$60 per barrel. Prices are currently lower but our belief is that prices over the medium term are likely to be higher.

The oil price shock is occurring against a backdrop of solid and more broadly-based growth in Canada in recent quarters. Outside the energy sector, we are beginning to see the anticipated sequence of increased foreign demand, stronger exports, improved business confidence and investment, and employment growth. However, there is considerable uncertainty about the speed with which this sequence will evolve and how it will be affected by the drop in oil prices. Business investment in the energy-producing sector will decline. Canada's weaker terms of trade will have an adverse impact on incomes and wealth, reducing domestic demand growth.

Although there is considerable uncertainty around the outlook, the Bank is projecting real GDP growth will slow to about 1 1/2 per cent and the output gap to widen in the first half of 2015. The negative impact of lower oil prices will gradually be mitigated by a stronger U.S. economy, a weaker Canadian dollar, and the Bank's monetary policy response. The Bank expects Canada's economy to gradually strengthen in the second half of this year, with real GDP growth averaging 2.1 per cent in 2015 and 2.4 per cent in 2016. The economy is expected to return to full capacity around the end of 2016, a little later than was expected in October.

Weaker oil prices will pull down the inflation profile. Total CPI inflation is projected to be temporarily below the inflation-control range during 2015, moving back up to target the following year. Underlying inflation will ease in the near term but then return gradually to 2 per cent over the projection horizon.

The oil price shock increases both downside risks to the inflation profile and financial stability risks. The Bank's policy action is intended to provide insurance against these risks, support the sectoral adjustment needed to strengthen investment and growth, and bring the Canadian economy back to full capacity and inflation to target within the projection horizon.

Information note:

The next scheduled date for announcing the overnight rate target is 4 March 2015. The next full update of the Bank's outlook for the economy and inflation, including risks to the projection, will be published in the *Monetary Policy Report* on 15 April 2015.