BANK OF CANADA
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Monetary Policy Report
Summary

October 2007

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 16 October 2007.*

Overview

There have been a number of significant economic and financial developments since the time of the July *Monetary Policy Report Update*. Against a backdrop of robust global economic expansion and strong commodity prices, growth in the Canadian economy has been stronger than projected with considerable momentum in domestic demand. The economy is now operating further above its production potential than had been previously expected. The core rate of inflation, which has been above 2 per cent for the past year, was 2.2 per cent in August. Total consumer price inflation fell temporarily in August to 1.7 per cent, having been above the 2 per cent inflation target since the spring.

Since the July *Update*, the outlook for the U.S. economy has weakened because of greater-than-expected slowing in the housing sector. The Bank has revised down its projection for U.S. GDP growth to 1.9 per cent in 2007 and 2.1 per cent in 2008. U.S. growth is expected to pick up to 3 per cent in 2009.

The Canadian dollar generally traded in a range of 93 to 95.5 cents U.S. in July and August, but since then it has appreciated sharply to as high as US$1.03. In the Bank's new base-case projection, the Canadian dollar is assumed to average 98 cents, the midpoint of the range since the July *Update*. As well, there has been a tightening of credit conditions stemming from financial market developments this summer. For Canada, the Bank assumes that the cost of credit for firms and households relative to the overnight rate will be 25 basis points higher over the projection period than it was prior to the summer.

Despite these tighter credit conditions, momentum in domestic demand in Canada is expected to remain strong. The combined

Highlights

- The Canadian economy is operating further above its production capacity than previously expected.
- Momentum in domestic demand is projected to remain strong, but net exports will exert more of a drag.
- Canadian GDP is projected to grow by 2.6 per cent in 2007, 2.3 per cent in 2008, and 2.5 per cent in 2009.
- Both core and total inflation are expected to return to 2 per cent in the second half of 2008.
- There are significant upside and downside risks to the Bank's inflation projection that are judged to be roughly balanced, with perhaps a slight tilt to the downside.
- The Bank judges, at this time, that the current level of the target for the overnight rate is consistent with achieving the inflation target over the medium term.

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effect of a weaker U.S. outlook and a higher assumed level for the Canadian dollar implies, however, that net exports will exert a more significant drag on the economy in 2008 and 2009 than previously expected. As a result, the Canadian economy is projected to grow by 2.6 per cent in 2007, 2.3 per cent in 2008, and 2.5 per cent in 2009.

With the economy moving back towards balance, and with the direct effect of the stronger Canadian dollar on consumer prices, core inflation is projected to gradually decline to 2 per cent in the second half of 2008—slightly earlier than previously expected—and to remain there for the balance of the projection period. Higher energy prices are expected to push total inflation up sharply in the fourth quarter of 2007 to about 3 per cent. Inflation is then expected to fall back to the 2 per cent target in the second half of next year and to stay there.

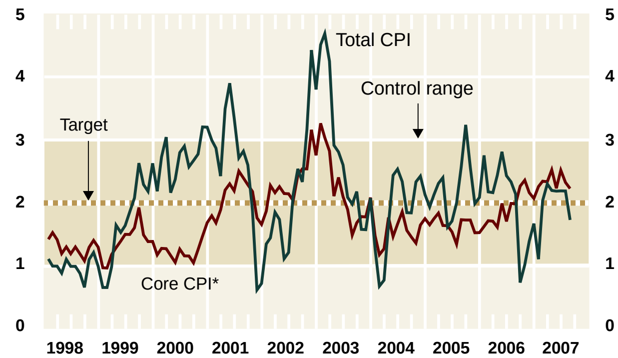
A number of the risks identified in the July *Update* have been realized to some extent. Stronger household demand in Canada, a sharper adjustment in the U.S. housing sector, and a stronger Canadian dollar have been reflected in the Bank's new base-case projection.

But significant upside and downside risks to the Bank's inflation projection remain. On the upside, excess demand in the Canadian economy could persist longer than projected. This could come from two sources: higher growth in household spending than projected and lower growth in productivity than assumed. On the downside, if the Canadian dollar were to persist above the level of 98 cents U.S. assumed over the projection horizon for reasons not associated with stronger-than-projected demand for Canadian products, this would result in lower output and inflation. In addition, the effect of the past appreciation of the Canadian dollar on demand and inflation could be greater than expected, and the effect of the weakness in the U.S. housing sector could be larger than projected.

All factors considered, the Bank judges that the risks to its inflation projection are roughly balanced, with perhaps a slight tilt to the downside.

Consumer Price Index

Year-over-year percentage change



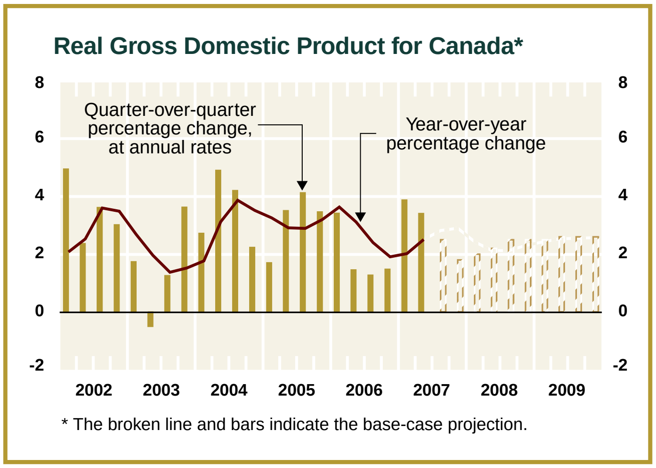
* CPI excluding eight of the most volatile components and the effect of changes in indirect taxes on the remaining components

In addition, the duration and economic repercussions of recent financial market developments and the possibility of a disorderly unwinding of global imbalances represent an uncertainty for the outlook.

Against this backdrop, the Bank left its key policy rate unchanged on 5 September and 16 October at 4.50 per cent. The Bank judges, at this time, that the current level of the target for the overnight rate is consistent with achieving the inflation target over the medium term.

Recent Developments

Total consumer price inflation fell temporarily to 1.7 per cent in August, after remaining above the 2 per cent target since the spring. The August dip reflected unexpected softness in the prices of some of the most volatile components of the index, particularly gasoline and natural gas. The core rate of inflation has remained above 2 per cent for the past year, reflecting ongoing pressures on production capacity in the economy. In August, core inflation was 2.2 per cent. Signs of strong domestic demand were seen in the rising costs of services, including shelter-related costs. Core food prices have also risen sharply, reflecting higher prices for grains and oilseeds.



Growth in the Canadian economy over the first half of the year was stronger than earlier projected. Real GDP growth was 3.4 per cent in the second quarter, higher than the 2.8 per cent projected in the July *Update*. Final domestic demand continued to be the main driver of growth in the first half, underpinned by growth in disposable income, a strong increase in household credit, and gains in household net worth that reflected rising house prices and Canada's improved terms of trade.

Canadian exports increased modestly in the first half of 2007, but imports grew more vigorously, reflecting the strength of domestic demand. Currently available information suggests that the economy grew at an annual rate of 2.5 per cent in the third quarter, slightly lower than the 2.7 per cent projected in the July *Update*.

With the stronger-than-expected growth in the first half, the Canadian economy is now operating further above its production capacity than was previously expected. The Governing Council judges that the economy was operating about 3/4 of one per cent above its production capacity in the third quarter of 2007.

In financial markets, greater-than-expected losses related to U.S. subprime mortgages led to global uncertainty about the valuations of structured products, a decline in investor appetite for risk, and increased demand for liquidity. Investors shifted into less-risky government securities, causing credit spreads to widen and funding costs for financial institutions to rise. As a result, credit conditions have tightened since late July, with financial institutions modestly restricting access to credit by tightening their terms of credit to firms and increasing the price of credit to both firms and households.

The Canadian dollar generally traded in the range of 93 to 95.5 cents U.S. assumed in the *Update* through July and August, but has since appreciated sharply to as high as US$1.03. This recent movement reflects broad-based weakness in the U.S. dollar, as well as support for the Canadian dollar from commodity prices—particularly oil—and continued strong domestic demand. That said, the magnitude of the recent appreciation appears to be stronger than historical experience would have suggested.

Prospects for Growth and Inflation

The global economy is now projected to grow somewhat more strongly in 2007 than projected in the July *Update*, before easing modestly in 2008 and 2009, as previously expected. Strength in developing economies is offsetting a weaker outlook for GDP growth in the United States. The base-case projection for the United States has been lowered to 1.9 per cent in 2007 and 2.1 per cent in 2008. This projection includes a deeper and longer slowdown in domestic demand. But lower U.S. interest rates should help to moderate weakness from the housing sector, and the real depreciation of the U.S. dollar should boost U.S. net exports. U.S. GDP growth is projected to pick up in 2009, although excess supply is projected to remain through to the end of that year.

Although Canada's economic growth in the first half of 2007 was somewhat stronger than earlier projected, the projection for the second half of this year and for the first half of 2008 is somewhat weaker than that in the July *Update*, owing to an increased drag from net exports. This reflects the downward revision to the growth projection for U.S. GDP, as well as the effect of the higher assumed level of the Canadian dollar.

Final domestic demand will continue to be the main contributor to growth through 2009, with solid gains projected in consumer spending. The modest tightening of credit conditions is expected to slightly reduce the momentum of domestic demand, however.

With the outlook for the U.S. economy improving by 2009, net exports should begin to exert less of a drag on growth.

All told, economic growth in Canada is projected to average just over 2 per cent in the second half of 2007 and the first half of next year, before edging up to just below the growth rate of capacity by the beginning of 2009. On an average annual basis, this implies growth of 2.6 per cent in 2007, 2.3 per cent in 2008, and 2.5 per cent in 2009.

The assumption for potential output growth is 2.8 per cent this year and next, and 2.7 per cent in 2009. In the base-case projection, the economy remains in excess demand before returning to its production capacity in early 2009. The anticipated slowing in the U.S. economy, combined with the stronger Canadian dollar and modestly tighter credit conditions, more than offset the momentum in domestic demand, bringing aggregate demand and supply back into balance. In this base-case projection, there is no change in the policy interest rate.

The core rate of inflation is projected to remain above 2 per cent through mid-2008, then ease to 2 per cent and remain there through 2009. The upward pressure on inflation coming from demand pressures and higher house prices is expected to ease gradually. The effect of the higher assumed level of the Canadian dollar should also contribute directly to lower import prices, helping to bring core inflation back to 2 per cent a little earlier than projected in July.

The outlook for total CPI inflation reflects a higher projected track for energy prices. The base-case projection sees total inflation rising sharply to about 3 per cent in the fourth quarter, then moving back down to the 2 per cent target in the second half of 2008, where it remains over the rest of the projection period.

Summary of the Base-Case Projection*

	2007				2008		2009
	Q1	Q2	Q3	Q4	H1	H2	
Real GDP (quarterly growth or average quarterly growth at annual rates)**	**3.9** (3.7)	**3.4** (2.8)	**2.5** (2.7)	**1.8** (2.6)	**2.1** (2.6)	**2.5** (2.4)	**2.6** (2.5)
Real GDP (year-over-year percentage change)	**2.0** (2.0)	**2.5** (2.3)	**2.8** (2.6)	**2.9** (2.9)	**2.3** (2.6)	**2.2** (2.5)	**2.5** (2.4)
Core inflation (year-over-year percentage change)	**2.3** (2.3)	**2.4** (2.4)	**2.2** (2.3)	**2.3** (2.2)	**2.2** (2.2)	**2.0** (2.1)	**2.0** (2.0)
Total CPI (year-over-year percentage change)	**1.8** (1.8)	**2.2** (2.3)	**2.2** (2.6)	**3.0** (3.0)	**2.7** (2.4)	**1.9** (2.1)	**2.0** (2.0)
WTI *** (level)	**58** (58)	**65** (65)	**75** (71)	**81** (71)	**78** (72)	**76** (73)	**74** (73)

* Figures in parentheses are from the July *Monetary Policy Report Update*.
** For half and full years, the number reported is the average of the respective quarter-to-quarter percentage growth at annual rates.
*** 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 12 October 2007

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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