Biannual Monetary Policy Report: Bank of Canada's outlook remains mostly the same

According to the Bank of Canada:

• The growth of the Canadian economy has been essentially in line with the Bank’s expectations as set out in January.

• Inflation has been higher than expected, however, due to strong pressure on production capacity and recent increases in the price of food and gas.

• The Canadian economy is projected to grow by 2.2% in 2007 and 2.7% in both 2008 and 2009. Real GDP growth could approach 2.5% in Q1 of 2007, followed by a 2.3% increase in the second quarter.

• The Bank now judges that the Canadian economy is operating just above its production capacity. This gap should be absorbed in the second half of 2007 and production capacity should remain at potential until 2009.

• After holding just under the 2% bar on average in Q2 of 2007, total CPI inflation is projected to approach the upper target of 3% near the end of 2007. It should, however, return to 2% by mid-2008. Core inflation could sink to 2% before the end of 2007 and remain steady until 2009.

• Upside risks to inflation are linked to the persistence of the recently strong price growth (from strong household credit, smaller decline in import prices and rising costs for food and energy).

• The main downside risk continues to be the possibility of a longer than expected slowdown in the American economy.

• The Bank still considers the risks to be roughly balanced, although there is now a slight tilt to the upside.

Commentary:

First off, the Bank of Canada’s economic scenario remains practically unchanged: the real GDP growth expected for 2007 and 2008 has been reduced by only 0.1%. In fact, the biggest news in this report is the revision by monetary authorities to their measurement of the Canadian economy’s growth potential.

Weaker productivity gains over the last few years have in fact resulted in a slight downward revision to the Canadian economy’s potential. The average pace of expansion for output potential for 2004 to 2006 has therefore been lowered to 2.6% compared to an initial 2.8%. This means that surplus demand is currently slightly higher than initially estimated. Consequently, upward pressure on inflation has perhaps been slightly more significant than we had believed. Combined with recent growth in food and gas prices, as well as a smaller impact by the decline in import prices, we understand why monetary authorities are being a bit more cautious about inflationary pressures.

So even though the Bank of Canada judges that risks to inflation are balanced, the Bank is indicating that there is a slight tilt to the upside. In our opinion, this modification to the balance of risks sends a clear message: there is a greater chance that the next key interest rate movement will eventually be upward, rather than downward. However, until the downside risks to inflation go down significantly, all signs point to the current stability in key rates continuing throughout 2007. We are also thus maintaining our scenario for a gradual increase by the target for the overnight rate starting in 2008.