As it does every fall, this morning, the Bank of Canada released its Monetary Policy Report. It contains the Bank’s latest observations and projections regarding the global and Canadian economies, inflation and monetary policy.

**Highlights**

- According to the Bank of Canada’s estimates, Canada’s real GDP should grow by about 3% in the third quarter and 2.7% in the final quarter of 2005. Forecast economic growth is therefore 2.8% for 2005, 2.9% for 2006, and 3.0% for 2007.
- Consumer spending should continue to progress vigorously throughout 2006 and 2007, though the rise in energy prices will tend to slightly slow the expansion of consumption. Foreign trade should not be more than a slight brake on real GDP growth, and businesses will continue to increase investment substantially.
- The Bank believes Canada’s economy is currently operating at production capacity. It should also grow at about the same pace as production potential until the end of 2007.
- Next year, the total consumer price index (CPI) will continue to be heavily influenced by the evolution of oil, natural gas, gas and fuel oil prices. Inflation as measured by total CPI should therefore be about 3% on average for the rest of 2005 and the first half of 2006. In fact, total inflation probably went above 3% in September; the data will be released on Tuesday. Total inflation should, however, drop back to the 2% target in the second half of 2006.
- Core inflation, as measured by the CPIX, should remain at about 1.6% on average until the end of 2005. The appreciation of Canada’s dollar combined with the pullback by global prices for some consumer goods (particularly goods from China) and some temporary effects on automobile prices are curbing the progression of core inflation. However, the annual variation in the CPIX should be about 2% by the middle of next year.

Given its outlook and the fact that Canada’s economy appears to be operating at capacity, the Bank believes that “some further reduction of monetary stimulus will be required to maintain a balance between aggregate supply and demand over the next four to six quarters” and keep inflation on target.

- After oscillating within a band of US$0.79 to US$0.83 for most of 2005, the Canadian dollar’s price has been evolving in a higher band since the end of the summer. Most of the major currencies have weakened against the U.S. dollar, so the loonie has appreciated more vigorously against the other currencies.
- For the next four to six quarters, the risks affecting the economic outlook seem to be balanced. However, Canada’s monetary authorities seem to have some concern about risks as to how global imbalances will be absorbed starting in 2007. A major concern is that domestic demand in countries other than the United States may not accelerate enough to support global demand.

**Conclusion: Monetary tightening seems to be well underway**

Statements by monetary authorities leave no room for doubt: further key interest rate hikes will be announced in the coming quarters. In the short term, a 25 basis point increase is almost guaranteed when the central bank renders its next decision, on December 6th. A further 25 basis point increase could also be ordered at the start of 2006, unless Canada’s economy is hit harder than expected by the adverse effects of energy price increases, the loonie’s appreciation, or the U.S. economy’s slowdown. Like the U.S. Federal Reserve, the Bank of Canada could, however, then interrupt monetary tightening for a few months. Such a status quo period is possible due to the major stability in core inflation and the economy’s expected weakening in the last quarter of 2005, providing for some leeway in conducting the monetary policy. The pause would allow monetary authorities to do a more thorough evaluation of the impacts on our economy of high energy prices and the loonie’s appreciation.