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Bank of Canada releases Monetary Policy Report Update

OTTAWA, Ontario, July 12, 2007 — Bank of Canada today released the July update to its Monetary Policy Report, which discusses current economic and financial trends in the context of Canada's inflation-control strategy.

Economic growth and inflation in Canada in the first half of this year have been stronger than was expected in the April Monetary Policy Report. Final domestic demand has remained the key driver of economic growth in Canada, bolstered by firm commodity prices. The Bank judges that the economy is now operating further above its production potential than was projected at the time of the April Report. Both total CPI and core inflation have been higher than projected in April and are above the 2 per cent inflation target. Longer-term interest rates have increased, and the Canadian dollar has appreciated sharply, moving well above the trading range assumed in the last Report.

The Canadian economy is now projected to grow by 2.5 per cent in 2007, somewhat stronger than was expected in April, and to grow somewhat more slowly in 2008 and 2009 than previously projected. In this new projection, higher interest rates across the yield curve and a higher assumed range for the Canadian dollar of 93 to 95.5 cents U.S. act to moderate growth in 2008 and 2009 to an average of about 2 1/2 per cent. This brings aggregate demand and supply in Canada back into balance in 2009.

Inflation is projected to be slightly higher and more persistent than in the April Report. With the direct effect of the GST cut ending, and with the impact of the temporary decrease in gasoline prices in late 2006, total inflation is projected to peak at about 3 per cent in the fourth quarter of this year. However, as excess demand diminishes, total CPI and core inflation should decline to 2 per cent by early 2009.

There are both upside and downside risks to the Bank's inflation projection. The main upside risk is that household demand in Canada could be stronger than expected. The main downside risks are related to the higher Canadian dollar and the ongoing adjustment in the U.S. housing sector. In the context of the Bank's new projection, these risks appear to be roughly balanced.

On Tuesday, the Bank raised its key policy interest rate by one-quarter of one percentage point to 4 1/2 per cent. The Bank also noted that some modest further increase in the overnight rate may be required to bring inflation back to the target over the medium term.