Q: Reference: Page 7, Lines 13 and 14

Please provide the Conference Board of Canada report *"Canadian Outlook –Summer 2007"* and the Bank of Canada July 2007 report *"Monetary Policy Report Update."*

A: The requested documents are attached.

Canadian Outlook Executive Summary Summer 2007

Loonie's Rise to Take a Bite Out of Growth

OVERVIEW

The Canadian economy charged ahead early this year, posting annualized growth of 3.7 per cent in the first quarter. While this is in line with the performance forecast in the Board's spring *Canadian Outlook*, growth prospects for 2007 have been revised down. This is due entirely to the impact that the second-quarter surge in the loonie is expected to have on Canada's economic growth over the remainder of the year. The loonie's rise was unexpected, bolstered not by changes to fundamental drivers but by financial market sentiment surrounding the strength of the economy, potential interest rate moves, and the effects of a number of foreign companies announcing their intentions to acquire Canadian businesses. Indeed, the difference between the first- and second-quarter averages for the Canadian dollar was nine cents U.S.—a swift 11 per cent appreciation in just three months! That pace of increase far exceeds anything we've seen in the recent past.

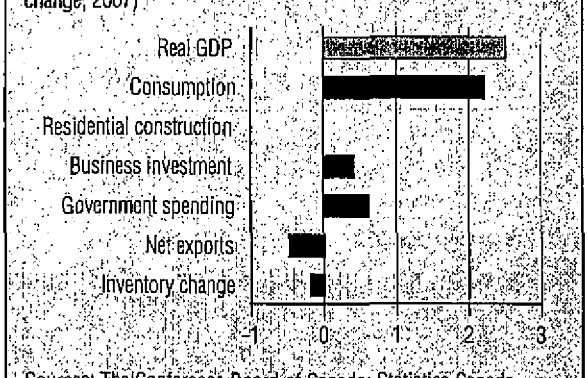
HIGHLIGHTS

- The U.S. economy should rebound strongly from a very weak first-quarter performance. Consumer spending is hanging on despite slumping new home construction, while business investment and trade will also add to growth.
- Real gross domestic product (GDP) growth for Canada is forecast to ease to 2.5 per cent in 2007, as the high-flying loonie will hurt net exports. Economic growth is expected to accelerate to 3.2 per cent in 2008, helped by a better trade performance and steady domestic demand.
- Core inflation nationally has recently been boosted by overheated Western provincial economies. The Canadian dollar's surge to above US$0.95 is expected to restrain the Bank of Canada from raising short-term rates further.
- The general rise in commodity prices may be here to stay. Seemingly insatiable global demand for raw materials, coupled with a recovery in forestry product prices, should keep prices elevated and shore up resource revenues and investment.
- Sound the trumpets . . . Canada's provincial governments are all expecting surpluses! Spending by all levels of government is expected to continue growing at a strong and steady pace.

As a result of the jump in the dollar, Canadian exporters and manufacturers will struggle. For the most part, Canadian manufacturers have met the challenge of the loonie's strengthening since 2002 by cutting back on workers and investing heavily in productivity-enhancing machinery. If the 31,000 job losses in manufacturing over April and May are any indication, this trend will likely continue through the rest of this year. A strengthening loonie goes a long way toward reducing the cost of imported machinery, while accelerated capital consumption allowances, announced in the 2007 federal budget, should also help encourage investment. As the restructuring continues, Canada's export performance will remain muted again in 2007, with real growth of only 2.1 per cent. Moreover, lower prices for goods produced outside Canada will undoubtedly encourage robust gains in imports, with the result being that the trade balance is expected to strip 0.5 percentage points from growth in 2007. While an eroding trade balance has been the trend over the past five years, expectations of a more stable exchange rate in our spring forecast suggested that the trade sector might have contributed to, rather than taken away from, growth this year. Overall then, real gross domestic product (GDP) is expected to advance by 2.5 per cent in 2007, down from the 2.8 per cent forecast in the spring *Canadian Outlook*, with growth this year sustained by momentum in household spending. (See Chart 1.)

Canada's export performance is also being held back by weaker U.S. growth. Exports of lumber and other construction materials for example, have fallen off sharply as a major correction in new home construction continues to play itself out in the United States. The good news is that new home construction levels have adjusted rapidly enough to avoid a major correction in home values. As such, U.S. households are expected to see only an easing in the pace of consumer spending (rather than the more

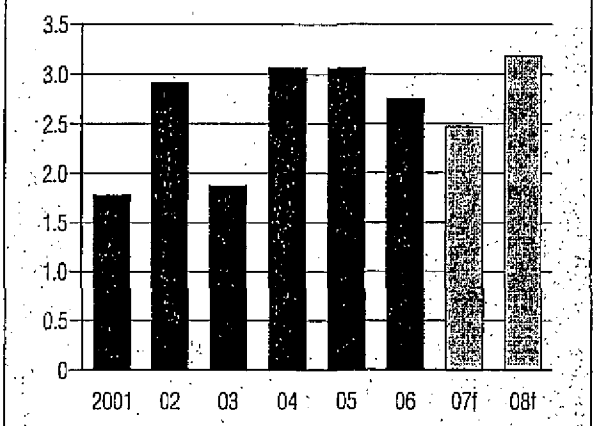
Chart 1
Adding Up GDP: Trade Sector Drags Down Growth Again
(forecast contribution to annualized real GDP growth; percentage change; 2007)



Sources: The Conference Board of Canada; Statistics Canada.

severe retrenchment that many had been anticipating). Real U.S. GDP growth is expected to fade to 2.2 per cent in 2007 but regain its strength in 2008, with growth of 3.1 per cent expected. The rebound in U.S. growth next year, coupled with a more stable Canadian dollar, will help boost real Canadian exports by over 3 per cent. This, coupled with a still strong domestic economy, should help propel Canada's economy by 3.2 per cent in 2008. (See Chart 2.)

Chart 2
Elevated Currency to Hold Back Growth in 2007
(real GDP; percentage change)



f = forecast
Sources: The Conference Board of Canada; Statistics Canada.

While Canada will continue to lose out on trade, there is plenty of momentum in household spending, at least through the rest of this year. The wealth effect of higher resource prices culminated in peak growth in real after-tax household income last year. Benefiting from solid employment gains, generous growth in real wages, and the redistribution (through various channels) of roughly $11 billion from federal and provincial coffers to households, real disposable income posted exceptional growth of 5 per cent in 2006. This year, the fiscal dividend going to consumers will be smaller, although households in some provinces (Quebec in particular) will benefit from tax reductions and other government transfers to persons. Overall though, growth in real disposable income will still reach 3.6 per cent in 2007, as employment and real wage gains remain healthy. The strength in household income is expected to boost real consumer spending by 3.8 per cent this year, following a 4.2 per cent gain in 2006. In 2008, fiscal measures are expected to dry up while employment growth will be more muted, resulting in softer growth in consumer spending.

Whereas Budget 2006 allotted a generous fiscal dividend to households, the lion's share of new federal measures in Budget 2007 was aimed at restoring "fiscal balance" through increased transfers to the provinces. While the transfers will undoubtedly open regional purse strings a bit wider, direct federal government spending on current programs will also post unabated growth this year and in 2008. And, despite the generous measures to households and regional governments announced in the previous two budgets and the steady growth in spending, the federal government's fiscal stance is looking very healthy. Indeed, stronger-than-expected personal and corporate income taxes continue to buoy public balance sheets at both the federal and provincial levels. That trend suggests there may be upside risk to our forecast for real government spending on goods and services which is expected to average 2.5 per cent growth this year and next.

Statistics Canada's latest Private and Public Investment (PPI) intentions survey suggests that business investment intentions have moderated from last year. In particular, machinery and equipment investment posted a rare decline in the first quarter of this year although growth is expected to rebound going forward. The forecast for energy investment is also down sharply—not because of diminished oil sands construction, but mostly because of a steep decline in energy exploration expected this year. On a more positive note, non-energy construction is getting a substantial boost in 2007 from new office and commercial building construction. As well, new home construction remains at elevated levels, held up by still rising home prices and strong demand, especially out west. But the Bank of Canada boosted its key rate a quarter point on July 10, and longer term rates, including mortgage rates, have been on the rise. Rising financing costs, coupled with softer growth in household after-tax income, should help moderate new home construction over the next few years to below 190,000 annual starts—a level more closely aligned with our estimates of demographic requirements.

ASSUMPTIONS

U.S. ECONOMY

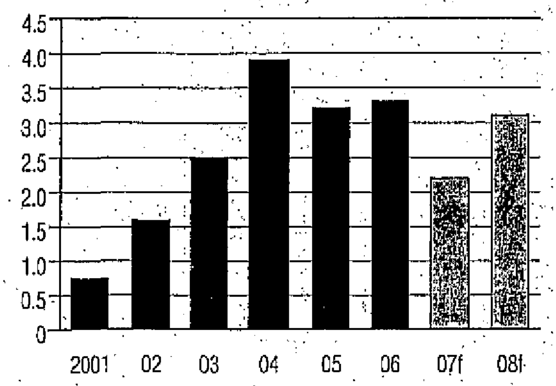
Confidence in the U.S. economy has improved recently as the economic slowdown that transpired in the first quarter of this year seems to be coming to an end. While the economy expanded by a miniscule annualized pace of 0.7 per cent in the first quarter, growth in the second quarter was on track to increase by over 3 per cent. The revival in economic activity is partially explained by the completion of a massive inventory drawdown. Inventories are currently back in line with sales, and manufacturing activity has consequently rebounded. Following a winter lull, there has also been a welcome surge in investment spending brought on by the introduction of tougher environmental regulations for heavy trucks. Record high corporate profitability and solid balance sheets will leave many U.S. firms in a solid position to expand operations.

International trade has finally emerged as a source of strength after many years of dragging down overall economic growth. The trade deficit has started to narrow as exports grow at a nearly double-digit pace while import growth has tapered off over the past few quarters. Export activity has also benefited from the healthy state of the U.S. economy and the gradual depreciation of the dollar since 2002. While the trade deficit with China continues to widen, Chinese government officials now seem more willing to permit the yuan to appreciate at a faster clip. This should enable the trade deficit with China to stabilize in the latter part of the decade.

Investment spending and strength in exports will negate the anticipated slowdown in growth in household spending. While real consumer spending increased at an annualized pace above 4 per cent in the first quarter, growth will decline to the 2 per cent range over the near term. High gasoline prices, more modest growth in household income, and the negative impact of weaker home prices are the main factors that will restrain spending. Real GDP is expected to increase by 2.2 per cent in 2007 before growth rebounds to 3.1 per cent in 2008. (See Chart 3).

Inflation is expected to moderate into the Federal Reserve's target range in the second half of this year. A weaker job market will keep labour costs under control while the over-supplied housing market will restrain consumer prices for housing services. The unemployment rate is forecast to gradually increase to close to 5 per cent by the end of 2008. Monetary policy will remain on hold for the remainder of this year as the Federal Reserve holds its federal funds rate at 5.25 per cent. (In the early part of 2007, financial markets anticipated rate cuts due to the weak growth in the economy. However, the rebound in activity in the second quarter has significantly diminished the prospects for rate cuts in the second half of 2007.)

Chart 3
U.S. Growth Kept in Check This Year
(real GDP; percentage change)



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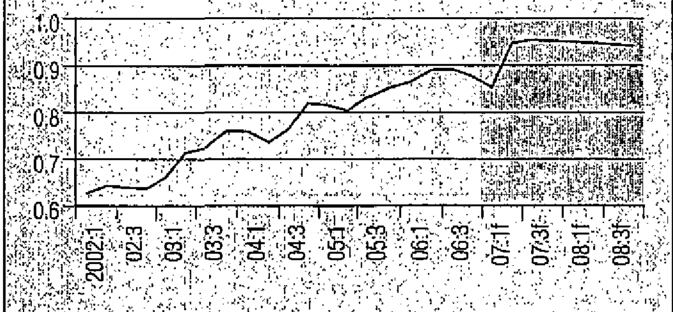
Sources: The Conference Board of Canada; U.S. Bureau of Economic Analysis (BEA).

MONETARY POLICY

The prospect that rates will not come down in the United States is welcome news for Canadian manufacturers and exporters already struggling with the swift appreciation in the loonie. On a quarterly basis, the Canadian dollar appreciated by nine cents U.S. (or 11 per cent) in the second quarter of 2007, a rapid surge that has by far outpaced any other in recent history. (See Chart 4). While expectations that the U.S. Federal Reserve will cut rates have eased, the Bank of Canada reinforced its message that keeping inflation under control was its number one priority. The Bank's strong wording was meant to address core inflation rates that have recently crept uncomfortably above its 2 per cent target. Even before the Bank of Canada boosted its key rate, financial markets had already bid up the value of the loonie by a few cents in expectation that the interest rate gap that currently favours the United States would soon be cut.

Chart 4
Loonie Soars to New Highs
(US$ per C$)



f = forecast
Sources: The Conference Board of Canada; The Bank of Canada.

Aside from potential interest rate movements, a number of announcements about acquisitions (or potential acquisitions) of Canadian firms by foreign companies had important repercussions on the value of the Canadian dollar. While it is difficult to disentangle the effect of potential mergers and acquisitions on the currency, the Canadian dollar was ratcheted up significantly over the April-to-June period by numerous large merger or acquisition announcements. (By way of example, in mid-April, the global conglomerate Essar announced that it would bid to acquire Algoma steel for nearly $1.9 billion. In the days immediately following that announcement, the Canadian dollar gained nearly a cent.) Stronger oil and commodity prices, along with a stellar first-quarter GDP performance, also helped bolster the loonie in recent months. While the Board's own forecast was optimistic for the first quarter, the consensus among forecasters was for more modest growth. Ironically, the first quarter strength helped lift the value of the loonie, and the stronger loonie is now expected to drag down growth significantly over the remainder of the year.

It is this slowdown in growth that is expected to ensure the Bank of Canada moves cautiously with respect to further increases in its key lending rate. The loonie is forecast to average US$0.953 over the last six months of the year, representing an appreciation of 8.3 per cent over last year's already strong level. With the loonie appreciating sharply over the second quarter against every other major currency, the strength of the currency will continue to dampen aggregate demand by favouring the consumption of imports. Weaker prices for imported goods should help contain inflationary pressures. This is true as well for goods from domestic producers that compete with U.S. (not to mention Chinese) producers. Indeed, flow-through effects are far from being fully realized as prices for many imported goods have not yet adjusted to the extent suggested by the loonie's appreciation. This should continue to hold inflationary pressures at bay in Canada, even though concerns about global inflation have been building.

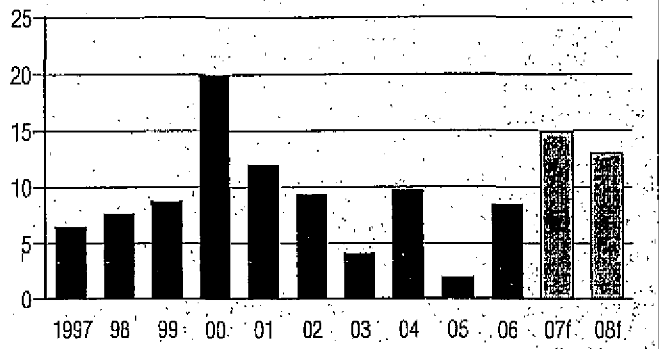
The possibility of further rate hikes, however, remains. The Bank of Canada used strong wording in its latest public addresses, suggesting that it would keep its focus on inflation despite the regional divergence in economic growth and inflation and despite the strength of the currency. Nation-wide, capacity constraints have pushed core inflation up above the Bank's 2 per cent mark, reaching a peak of 2.5 per cent in March. The Bank is concerned about the impact that very tight labour markets may have on wage inflation, and it might not be willing to wait for the deflationary effects of the stronger currency to take hold.

FISCAL POLICY

Over the last few years, the federal government has found itself in the enviable position of consistently ending up with much more fiscal room than first projected in its annual budgetary exercise. Despite accounting for numerous personal income tax cuts, some of which are still being phased in, personal income tax revenues have continuously outpaced budgetary growth projections and provided much of the generous boost to federal surpluses in recent years. Measured on a National Accounts basis,[1] in 2006, the federal government registered its 10th straight year of posting surpluses—and 2007 will undoubtedly mark the 11th. (See Chart 5.) In Budget 2007, the federal government took aim at correcting the "fiscal imbalance" (a term that describes the situation in which the federal government was running huge surpluses while many provinces were struggling to balance their books) through generous increases to provincial transfers. However, while the provincial books are generally in pretty good shape, the federal government's fiscal position is starting off on a very strong footing that will likely see another year of better-than-expected fiscal results.

Provincial governments, too, are reporting better-than-expected revenue gains and more room to manoeuvre on their fiscal plans. On a Public Accounts basis, all the provincial governments are forecasting surpluses for their respective 2007–08 budgets—with the exception of Quebec, which is aiming for a balanced budget despite generous tax cuts and other transfers to persons occurring this year. Municipal government are in a more difficult bind. Statistics Canada's figures suggest that the consolidated balance at the local government level has posted deepening deficits over the past few years and averaged a shortfall of nearly $5 billion over the past four quarters.[2] But, despite weaker spending forecast at the local level in 2007, improving fiscal positions at the federal and provincial level should help keep real government spending on goods and services on track to post steady growth of around 2.5 per cent this year and next.

Chart 5
A Decade of Surpluses . . . and Counting
(federal government balance, National Accounts basis; $ billions)



f = forecast
Sources: The Conference Board of Canada; Statistics Canada.

NATIONAL OUTLOOK

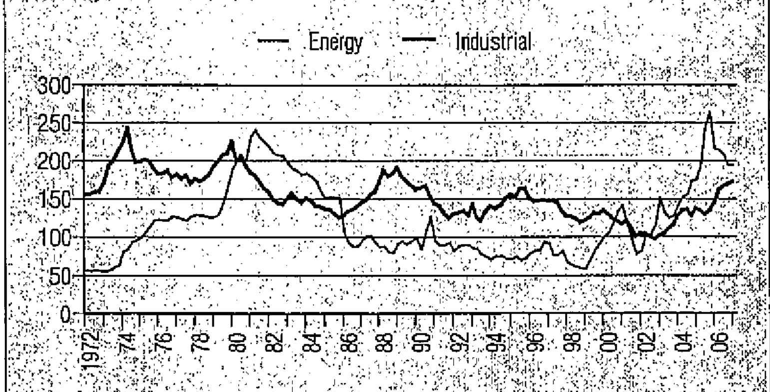
COSTS AND PRICES

Canada continues to benefit from the wealth effect of higher commodity prices. Oil prices edged back above the US$70 per barrel range recently, levels roughly two-and-a-half times where they were in 2002. That has added generously to the profitability and income of Canadian producers. Numerous other commodities have also undergone substantial price increases. Nickel, copper, and uranium prices, for example, have all increased more than have crude oil prices. (Uranium now sells for US$125 per pound, a more than twelve-fold increase from the US$10 per pound it sold for in 2002.) Aside from forestry products and agriculture, the rise in commodity prices has been widespread. Looking ahead, the question that begs answering is whether commodity prices are likely to see a sizeable downward correction. The Board believes that this will not occur since commodity prices, taken together, are not out of range of historical levels. As such, while some commodities risk seeing important price corrections from weaker demand or as new sources of supply come on stream, others are expected to remain elevated and even rise over the medium term.

Chart 6 displays the historical movements of a weighted index of commodity prices denominated in US$ but adjusted for U.S. GDP inflation. In other words, the chart reveals the cyclical and trend changes of real commodity prices separated into a basket of industrial commodities (such as metallic and non-metallic minerals) and energy. While the energy price basket is at a historic high, it is important to note that other industrial prices are not out of line with their historical averages. Indeed, the industrial index is being affected by very low lumber prices, which should come up considerably, albeit slowly, with the correction in U.S. residential construction now in sight. Copper prices have remained elevated despite the weakness in U.S. home construction—an important source of demand for copper. That's because demand for copper has been sustained by the expanding Asian economies. Moreover, while energy prices are elevated with respect to historical averages, a similarly unquenchable global demand for energy is expected to limit near-term corrections. Denominated in Canadian dollars, the overall raw materials price index is forecast to advance a further 4.3 per cent in 2007, and growth is expected to remain positive, although more modest, through to the end of the medium-term forecast.

The Consumer Price Index (CPI) suffered a strong upward blow from rising gasoline prices and homeownership costs earlier this year. More recently, food prices have added to mounting costs. With capacity utilization at North American refineries at peak levels, any disruption in production can send gasoline prices soaring. This is exactly what happened earlier this year as a number of production stoppages, both in Canada and the United States, drew down gasoline inventories and lifted prices substantially. While the jump was initially expected to be temporary, strong demand for gasoline over the spring, along with rising oil prices, have kept North American pump prices at peak levels. With oil prices expected to remain elevated, it seems that there will be little reprieve for the energy component of the CPI (although the forecast does assume that a decline in gasoline prices will occur as the peak driving season comes to an end in late August). Nevertheless, the strong hit to consumer prices has lifted the inflation forecast for 2007 significantly, with the CPI now forecast to average 2.4 per cent growth this year. That's despite last July's decline in the federal goods and services tax cut which is taking roughly 0.3 percentage points from inflation this year. Backing out the effect of indirect taxes and volatile energy and food prices, core inflation is expected to rise by a more restrained 2 per cent in 2007 despite the fact that monthly core inflation numbers have recently come up above the Bank of Canada's comfort level.

Chart 6
Industrial Commodity Prices Within Normal Cycle
(quarterly index to 2007:1; 2002 = 100 in real US$)



Sources: The Conference Board of Canada; The Bank of Canada; BEA.

HOUSEHOLD SECTOR

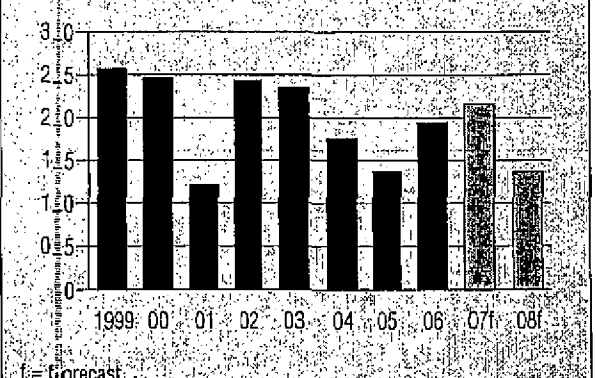
Job growth has surpassed expectations of late. Over the seven months from September 2006 to March 2007, the economy generated a red-hot 306,000 jobs and sent the unemployment rate to rock-bottom levels. While job gains have been muted in April and May of this year, the slowdown is likely due to lack of labour supply rather than easing demand—the unemployment rate has remained steady at a 33-year low of 6.1 per cent. Indeed, numerous sectors are facing very tight labour markets, not only because of an expanding economy but also because of the growing number of people retiring from the workforce. The demand for replacement workers is leaving some employers scrabbling, especially among key occupations that include health care workers, teachers, and public servants. As the workforce continues to age, this situation will only become more acute and spread to other sectors of the economy. Demand for construction workers will also remain elevated as large energy projects (especially oil sands development) continue to draw workers from across the country. Some modest reprieve in demand for tradespeople will come from softer residential construction this year and next, while oil and gas drilling is forecast to ease temporarily in 2007 from peak levels attained last year. Overall, employment growth is expected to moderate over the remainder of 2007 but still average 2.2 per cent growth for the year. Tight labour markets will restrain job gains to only 1.4 per cent growth in 2008, with an increase in average hours worked and a better productivity performance helping to make up the difference. (See Chart 7.)

Strong employment growth, healthy real wage gains, and a further appreciation in the loonie will shore up household purchasing power again this year. For 2008, more modest employment gains, coupled with the drying up of the generous fiscal stimulus provided to households through recent federal/provincial tax cuts and transfers, will result in much weaker growth in real after-tax income. As such, on the heels of a 5 per cent gain last year, real disposable income will advance by 3.6 per cent this year but is expected to register a much more subdued 2.6 per cent gain in 2008. Household spending growth will also ease, from above 4 per cent real growth in 2006 to around 3 per cent in 2008—still high enough to result in some erosion to the aggregate household savings rate.

Despite a poor start to the year, growth in automobile purchases is expected to rebound, spurred on by still-low financing rates and incentives from the federal and various provincial governments to encourage the purchase of fuel-efficient vehicles. Consumption of other durable goods was remarkably strong over the first quarter of the year, as demand for high-tech goods and home furnishings seemed unquenchable. Nonetheless, more modest income growth and a softer real estate market are expected to take some steam from this component of household spending in 2008. Real consumer spending on non-durables (including food and energy) and the very large service component (which includes imputed and paid rent and other services) tends to have a more stable growth pattern.

Despite monthly volatility, housing starts have remained above 220,000 (annualized) over the first half of this year. *Strong housing demand, especially in the* Western provinces, has kept resale and new home prices increasing and construction levels up. Looking ahead, housing starts will remain elevated but will ease to levels more in line with estimated demographic requirements. This is particularly true for those provinces east of Ontario.

Chart 7
Tight Labour Markets to Restrain Job Gains in 2008
(employment growth; per cent)



f = forecast
Sources: The Conference Board of Canada; Statistics Canada.

Housing starts are forecast to slow from 227,000 units in 2006 to an average of 212,000 in 2007 and 196,000 in 2008. Although modest, the decline will serve to keep real residential construction spending flat this year, while a 0.4 per cent decline is forecast for 2008.

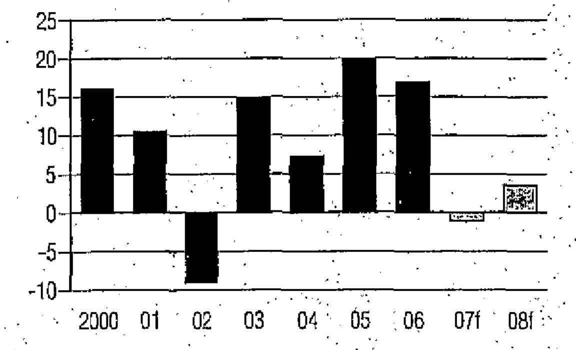
NON-RESIDENTIAL BUSINESS INVESTMENT

The conditions that have driven strong machinery and equipment investment in recent years—including excellent gains in corporate profits, tight capacity, low financing rates, and falling prices for imported machinery—remain largely in place. However, according to Statistics Canada's Private and Public Investment[3] (PPI) survey, businesses were intending to hold back spending on new machinery this year, at least in comparison to the 7.4 per cent real gain registered in 2006. In fact, real machinery and equipment investment fell in the first quarter of 2007, the first quarterly decline in over four years. Yet despite this surprising first-quarter drop, machinery and equipment investment is forecast to rebound in the second quarter and remain strong into 2008. In addition to the factors that have boosted spending over the past four years, tight labour markets and another significant appreciation in the loonie are sure to boost investment. Moreover, the federal government's accelerated capital consumption allowances for capital investments made by manufacturers before 2009 will further stoke investment intentions. As such, while real machinery and equipment *investment will slow to growth of just 3.6 per cent this* year, a healthy 8.7 per cent gain is anticipated for 2008.

As machinery and equipment investment eased recently, non-energy, non-residential construction charged ahead boosted by a turnaround in commercial and office construction and steady growth in mineral exploration and mine construction activity. Noting that the regional performance remains mixed, real non-energy, non-residential investment is forecast to post growth of 7.2 per cent in 2007, but growth will ease to only 1.3 per cent in 2008 as a number of major projects are completed. Also important to note is that business investment in inventories underwent a significant correction early this year. On an annual basis, the build in non-farm business inventories is expected to ease to $6.8 billion in 2007, down from a $9.3 billion build in 2006. Current inventory levels have resulted in a significant drop in the economy-wide stock-to-sales ratio, suggesting that the businesses are likely to invest more heavily in inventory build over the rest of 2007 and into next year.

Stronger-than-expected global demand, a number of production difficulties, and ever-present geopolitical risk have boosted oil prices. The West Texas Intermediate (WTI) oil price, which averaged just US$54 per barrel this past January, has recently been up around the US$72 per barrel level. Oil prices are expected to remain elevated over the medium term as new supply barely keeps traction with expanding global demand. This situation will continue to stoke growth in energy investment in Canada. Current projects in Alberta's oil sands suggest that investment spending is far from peaking as construction on new mines and upgraders continues to rise. Moreover, pipeline construction will intensify in 2008, and Hydro-Québec investment activity, which is expected to take a breather in 2007, will also get a boost in 2008 as activity on the Eastmain-1-A project solidifies. But despite the strength in energy construction, a major slowdown in exploration activity is anticipated for this year. Lower prices for natural gas at the end of 2006 led a number of large players to substantially cut exploration budgets, while an early spring thaw out west forced drillers to shut down and left many rigs stranded. The most recent data from the Petroleum Services Association of Canada suggests that only 19,200 wells will be drilled this year, an 18 per cent decline from the 2006 peak. The steep decline in exploration activity will result in a 1.1 per cent drop in overall energy construction this year. A rebound in drilling should help restore growth in 2008. (See Chart 8.)

Chart 8
Lower Drilling Activity to Slow Overall Energy Investment
(real energy investment; percentage change)



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Source: Statistics Canada.

FOREIGN TRADE

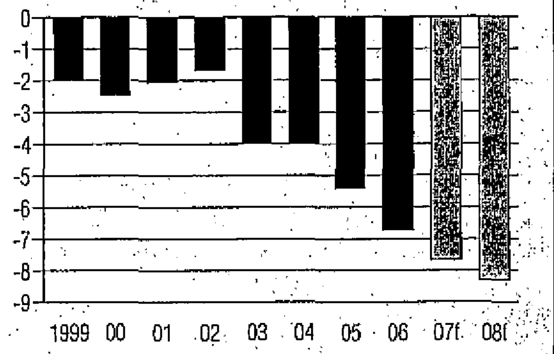
A slumping U.S. housing market and an unfavourable exchange rate will combine to make 2007 another difficult year for Canada's forestry sector. Housing starts in the United States are projected to drop by 19 per cent—from 1.8 million units in 2006 to 1.5 million units in 2007—although relief may be near as new home construction is thought to have bottomed out. Nevertheless, the grim conditions in the forestry sector have already forced several mills across the country to shut down, with the majority of job cuts occurring in Quebec. Better news comes from manufacturers of machinery and equipment, automobiles, and aerospace which have all posted excellent export growth over the past two quarters. This recent strength masks the difficulties these sectors will undoubtedly face in light of the recent surge in the loonie. Moreover, the auto sector is still undergoing restructuring, and exports are expected to fall off sharply in the second quarter of 2007.

Despite the difficulties faced by some sectors, total merchandise exports are expected to grow by 2.4 per cent in 2007, a significant improvement over the 1 per cent pace registered last year. Elevated prices for many commodities have boosted investment in the resource sector, and output will post solid growth over the next few years as new capacity comes on line. For this year, exports of natural gas, crude metals, and minerals will add nicely to overall growth. While the forecast for export growth is relatively positive, the surge in the loonie has made imported goods much cheaper, helping to boost growth in merchandise imports to a forecast 3.1 per cent this year. For 2008, a more stable currency and recovering U.S. economy will boost real merchandise export growth to a more respectable 3.6 per cent, closing the gap on the expected 3.9 per cent growth in merchandise imports.

The non-merchandise trade balance is also being eroded, due largely to a deteriorating travel balance. Canadians are being enticed abroad, especially to U.S. dollar destinations, by the significant gains in their purchasing power abroad. At the same time, the lofty loonie is discouraging U.S. and other foreign travellers from coming to Canada. The eroding travel balance is not being helped by the recent Western Hemisphere Travel Initiative (WHTI). This U.S. initiative to tighten border security now requires all air travellers to carry passports when entering the United States. This includes U.S. citizens returning home. The WHTI is set to be extended to land and sea border crossings in January of 2008, but the passport requirements will be eased for at least the first six months to include other government-issued photo identification. As a result of the WHTI, the Conference

Board expects the travel balance to erode from a deficit of $6.7 billion in 2006 to an $8.3 billion deficit in 2008. (See Chart 9.)

Chart 9
Lofty Loonie to Hurt Tourism
(net travel balance; billions of current dollars)



f = forecast
Sources: The Conference Board of Canada; Statistics Canada.

RISKS

Pushed along by the rapid ascension of the BRIC (Brazil, Russia, India, and China) countries, global economic growth has been surprisingly steady and strong, averaging real gains of nearly 4 per cent annually over the past three years. Moreover, there seems to be growing confidence that the global economy's performance is now much less dependent on that of the United States. While there is certainly some truth to this argument, it is important to remember that the United States still produces roughly 25 per cent of global GDP and that, in many ways, the rise of China and the other BRIC countries is intimately tied to supplying U.S. households, businesses, and governments with all of the goods and services they consume. The relationship is even more precarious when one considers that the United States as a whole is still consuming far more than its income, attested to by an $800 billion current account deficit largely financed by those very same BRIC and oil-producing countries that are now flush with cash.

Thus far, U.S. households seem completely oblivious to the concerns surrounding the correction to housing markets, as consumer spending has kept advancing strongly throughout the "adjustment" period. In fact, over the two quarters that ended in March 2007, real U.S. consumer spending grew at an annualized pace of well over 4 per cent! Thus, while some have claimed that the global economy can keep on humming despite a U.S. slowdown, it is important to be aware that the U.S. economy has not really slowed down at all. Leaving out the steep declines in residential construction and the correction in the build in business inventories, there have been few hiccups to growth thus far. Moreover, U.S. consumers are still vulnerable. Housing prices initially declined and then remained flat for the past year. Aggregate household debt levels are high while savings rates are negative. Rising gasoline prices have taken a bite out of discretionary income, and a depreciating greenback could fuel inflationary pressures. Looking ahead then, the risk of a more important slowdown in U.S. household spending could have important repercussions on the global economy. For Canada, the hit could be twofold. Weaker U.S. growth would significantly impact Canadian export growth, while a weaker global economy could cause commodity prices to fall off sharply, thus reducing the income effect that has benefited Canada since prices started to rise back in 2003.

Another downward risk to the forecast comes from the possibility of tighter monetary action by the Bank of Canada. If core inflation acts up in the coming months, interest rates could come up by another 25 or 50 basis points over the summer and fall of 2007. Such a move would likely have more impact on Canada's domestic demand growth in 2008, although the likely accompanying result of a stronger Canadian dollar could have more immediate repercussions on trade.

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1 Statistics Canada compiles the National Accounts at the federal, regional, and local levels of government. At the federal level, the National Accounts estimates are based on federal Public Accounts data. However, Public Accounts revenue and spending estimates are realigned so that they occur at the same time as they impact the economy. For example, government investment spending would occur not when the funds are set aside (as is often done in budget documents) but when the spending actually occurs and measurably impacts economic growth.

2 The government sector in the Board's National Medium Term Forecasting Model (MTFM) has been extended to separate out provincial and local levels of government from the more aggregate regional government accounts. In other words, historical data and forecasts are now available separately for aggregate municipal accounts and for aggregate provincial and territorial accounts, whereas in the past these were combined into a total regional government accounts.

3 Statistics Canada's *Private and Public Investment in Canada, Intentions 2007*, released in February 2007, is the most recent of an annual publication that reports investment intentions by region, sector, and type of investment. This year, the survey sampled 27,000 businesses and governments and was conducted from October 2006 to late January 2007.

4 World real GDP growth estimates compiled by Consensus Economics.

Table 1—Key Economic Indicators

(Forecast completed June 20, 2007)

	2006:1	2006:2	2006:3	2006:4	2007:1	2007:2	2007:3	2007:4	2008:1	2008:2	2008:3	2008:4	2006	2007	2008
GDP at market prices (1997 $ millions)	1,275,510	1,280,142	1,284,213	1,288,949	1,300,566	1,309,109	1,318,242	1,327,817	1,340,198	1,351,245	1,360,851	1,370,976	1,282,204	1,313,934	1,355,818
	0.8	*0.4*	*0.3*	*0.4*	*0.9*	*0.7*	*0.7*	*0.7*	*0.9*	*0.8*	*0.7*	*0.7*	*2.8*	*2.5*	*3.2*
Implicit price deflator— GDP at market prices (1997 = 1.0)	1.122	1.127	1.131	1.132	1.149	1.158	1.163	1.168	1.172	1.175	1.180	1.185	1.128	1.160	1.178
	0.0	*0.4*	*0.4*	*0.1*	*1.5*	*0.7*	*0.5*	*0.5*	*0.3*	*0.3*	*0.4*	*0.4*	*2.4*	*2.8*	*1.6*
U.S. GDP at market prices (1996 $ billions)	11,316	11,388	11,444	11,513	11,532	11,618	11,712	11,805	11,902	11,985	12,076	12,157	11,415	11,667	12,030
	1.4	*0.6*	*0.5*	*0.6*	*0.2*	*0.8*	*0.8*	*0.8*	*0.8*	*0.7*	*0.8*	*0.7*	*3.3*	*2.2*	*3.1*
Consumer Price Index (1992 = 1.0)	1.289	1.303	1.304	1.300	1.313	1.332	1.336	1.343	1.347	1.355	1.362	1.368	1.299	1.331	1.358
	0.5	*1.1*	*0.1*	*–0.3*	*1.0*	*1.4*	*0.3*	*0.5*	*0.3*	*0.6*	*0.5*	*0.5*	*2.0*	*2.4*	*2.1*
Total employment (000s)	16,362	16,477	16,501	16,598	16,757	16,804	16,875	16,929	16,985	17,042	17,102	17,163	16,484	16,841	17,073
Unemployment rate	*6.4*	*6.2*	*6.4*	*6.2*	*6.1*	*6.1*	*6.0*	*6.0*	*6.0*	*6.0*	*6.0*	*6.0*	*6.3*	*6.1*	*6.0*
Private non-farm average hourly earnings	23.90	23.77	24.22	24.55	24.90	24.89	24.94	25.03	25.18	25.29	25.41	25.54	24.11	24.94	25.35
	0.5	*–0.6*	*1.9*	*1.4*	*1.4*	*0.0*	*0.2*	*0.4*	*0.6*	*0.4*	*0.5*	*0.5*	*2.8*	*3.4*	*1.7*
Disposable income (1997 $ millions)	787,413	782,382	792,929	804,003	814,839	817,677	820,580	826,157	832,547	838,123	843,758	849,504	791,682	819,813	840,983
	3.1	*–0.6*	*1.3*	*1.4*	*1.3*	*0.3*	*0.4*	*0.7*	*0.8*	*0.7*	*0.7*	*0.7*	*5.0*	*3.6*	*2.6*
Private non-farm productivity	46.29	45.78	46.41	46.34	46.50	46.48	46.41	46.46	46.76	46.86	46.98	47.11	46.20	46.46	46.93
	0.7	*–1.1*	*1.4*	*–0.1*	*0.4*	*0.0*	*–0.1*	*0.1*	*0.6*	*0.2*	*0.2*	*0.3*	*1.2*	*0.6*	*1.0*
Federal government balance ($ millions)	11,240	14,596	–6,512	14,592	20,088	12,523	13,502	13,456	11,944	12,102	13,461	14,736	8,479	14,892	13,061
Corporate profits before taxes ($ millions)	194,664	197,444	201,864	201,464	207,700	218,104	221,207	226,224	232,135	232,777	234,666	237,294	198,859	218,308	234,218
	–4.0	*1.4*	*2.2*	*–0.2*	*3.1*	*5.0*	*1.4*	*2.3*	*2.6*	*0.3*	*0.8*	*1.1*	*5.0*	*9.8*	*7.3*
Housing starts (000s units)	243	227	218	221	222	217	207	202	197	197	195	194	227	212	196
Prime rate	5.33	5.92	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	6.00	5.81	6.00	6.00
Cdn. 3-month Treasury bill rate	3.66	4.15	4.15	4.17	4.17	4.24	4.35	4.34	4.31	4.29	4.27	4.26	4.03	4.27	4.28
U.S. 3-month Treasury bill rate	4.50	4.83	5.03	5.03	5.12	5.08	5.05	5.03	5.01	4.99	4.98	4.96	4.85	5.07	4.99
Exchange rate (CDN$/US$)	0.866	0.891	0.892	0.878	0.854	0.948	0.954	0.953	0.950	0.948	0.945	0.942	0.882	0.927	0.946
U.S. federal funds rate	4.46	4.91	5.25	5.25	5.26	5.25	5.25	5.25	5.25	5.25	5.25	5.25	4.96	5.25	5.25
Merchandise terms of trade	1.165	1.165	1.164	1.161	1.182	1.193	1.198	1.200	1.198	1.193	1.192	1.192	1.164	1.193	1.194
Current account balance ($ millions)	35,852	17,320	22,660	18,488	25,972	37,839	39,643	39,979	39,581	39,229	37,854	37,331	23,580	35,858	38,499

White area represents forecast data.
All data are seasonally adjusted at annual rates, excluding interest rates, indexes and exchange rates.
Private non-farm productivity is the average output (000s of 1997 dollars) per person-hour in all industries, excluding agriculture, non-commercial services and public administration and defence.
Private non-farm average hourly earnings is the weighted average of average weekly wages and salaries in the other primary, manufacturing, construction and services industries divided by the corresponding average weekly hours. The weights employed are each industry's share of total non-farm employment.
Sources: The Conference Board of Canada; Statistics Canada; Bank of Canada; CMHC Housing Time Series Database; U.S. Bureau of Economic Analysis.

Table 2—Gross Domestic Product, Expenditure Based, at Market Prices (1997 $ millions)

(Forecast completed June 20, 2007)

	2006:1	2006:2	2006:3	2006:4	2007:1	2007:2	2007:3	2007:4	2008:1	2008:2	2008:3	2008:4	2006	2007	2008
Consumer expenditures	743,529	750,550	759,897	766,839	774,178	780,614	786,796	792,700	799,178	805,324	811,551	817,783	755,204	783,572	808,459
	1.4	*0.9*	*1.2*	*0.9*	*1.0*	*0.8*	*0.8*	*0.8*	*0.8*	*0.8*	*0.8*	*0.8*	*4.2*	*3.8*	*3.2*
Net government spending *(goods and services)*	248,187	250,155	251,113	252,961	254,672	256,261	257,851	259,458	261,036	262,630	264,229	265,838	250,604	257,060	263,433
	1.2	*0.8*	*0.4*	*0.7*	*0.7*	*0.6*	*0.6*	*0.6*	*0.6*	*0.6*	*0.6*	*0.6*	*3.3*	*2.6*	*2.5*
Gross fixed capital formation	295,786	297,994	300,453	303,611	304,973	302,769	305,380	308,008	312,036	314,686	317,773	320,940	299,461	305,283	316,359
	2.2	*0.7*	*0.8*	*1.1*	*0.4*	*−0.7*	*0.9*	*0.9*	*1.3*	*0.8*	*1.0*	*1.0*	*7.2*	*1.9*	*3.6*
Government	37,502	37,928	37,972	38,333	38,254	38,675	39,101	39,532	39,968	40,409	40,855	41,306	37,934	38,890	40,634
	2.2	*1.1*	*0.1*	*1.0*	*−0.2*	*1.1*	*1.1*	*1.1*	*1.1*	*1.1*	*1.1*	*1.1*	*8.1*	*2.5*	*4.5*
Business	258,290	260,072	262,487	265,284	266,726	264,098	266,282	268,479	272,071	274,280	276,921	279,637	261,533	266,396	275,727
	2.2	*0.7*	*0.9*	*1.1*	*0.5*	*−1.0*	*0.8*	*0.8*	*1.3*	*0.8*	*1.0*	*1.0*	*7.1*	*1.9*	*3.5*
Residential construction	80,041	78,974	77,711	77,690	79,109	78,516	78,635	78,533	78,492	78,175	78,293	78,551	78,604	78,698	78,378
	2.3	*−1.3*	*−1.6*	*0.0*	*1.8*	*−0.7*	*0.2*	*−0.1*	*−0.1*	*−0.4*	*0.2*	*0.3*	*2.1*	*0.1*	*(0.4)*
Non-residential construction	68,787	70,523	72,651	74,707	75,681	72,026	72,224	72,712	74,150	74,849	75,497	76,092	71,667	73,161	75,147
	3.4	*2.5*	*3.0*	*2.8*	*1.3*	*−4.8*	*0.3*	*0.7*	*2.0*	*0.9*	*0.9*	*0.8*	*12.9*	*2.1*	*2.7*
Machinery & equipment	110,247	111,598	113,532	114,184	112,439	115,409	117,860	120,251	122,939	125,388	127,796	130,165	112,390	116,490	126,572
	1.1	*1.2*	*1.7*	*0.6*	*−1.5*	*2.6*	*2.1*	*2.0*	*2.2*	*2.0*	*1.9*	*1.9*	*7.4*	*3.6*	*8.7*
Final domestic demand	1,286,677	1,297,838	1,310,523	1,322,465	1,332,855	1,338,701	1,349,053	1,359,168	1,371,210	1,381,571	1,392,450	1,403,425	1,304,376	1,344,944	1,387,164
	1.5	*0.9*	*1.0*	*0.9*	*0.8*	*0.4*	*0.8*	*0.7*	*0.9*	*0.8*	*0.8*	*0.8*	*4.7*	*3.1*	*3.1*
Exports	504,602	502,355	505,539	508,881	511,521	514,198	517,242	520,723	525,777	531,174	534,284	538,092	505,344	515,921	532,332
	−1.8	*−0.4*	*0.6*	*0.7*	*0.5*	*0.5*	*0.6*	*0.7*	*1.0*	*1.0*	*0.6*	*0.7*	*0.7*	*2.1*	*3.2*
Merchandise	440,489	437,427	441,107	444,776	446,847	450,179	453,156	456,610	461,725	467,002	470,086	473,650	440,950	451,698	468,116
	−1.7	*−0.7*	*0.8*	*0.8*	*0.5*	*0.7*	*0.7*	*0.8*	*1.1*	*1.1*	*0.7*	*0.8*	*1.0*	*2.4*	*3.6*
Imports	532,055	544,582	552,820	551,615	555,139	559,707	564,243	568,792	573,646	578,567	583,343	588,225	545,268	561,970	580,945
	−0.7	*2.4*	*1.5*	*−0.2*	*0.6*	*0.8*	*0.8*	*0.8*	*0.9*	*0.9*	*0.8*	*0.8*	*5.0*	*3.1*	*3.4*
Merchandise	443,064	454,479	462,483	461,088	464,594	466,790	470,949	475,449	480,360	485,260	489,981	494,701	455,279	469,445	487,575
	−0.8	*2.6*	*1.8*	*−0.3*	*0.8*	*0.5*	*0.9*	*1.0*	*1.0*	*1.0*	*1.0*	*1.0*	*5.2*	*3.1*	*3.9*
Net exports	−27,453	−42,227	−47,281	−42,734	−43,618	−45,509	−47,002	−48,069	−47,869	−47,393	−49,058	−50,133	−39,924	−46,049	(48,613)
Final demand	1,241,883	1,240,370	1,248,728	1,263,785	1,273,078	1,277,493	1,286,422	1,295,502	1,307,541	1,318,288	1,327,534	1,337,422	1,248,692	1,283,124	1,322,696
	1.0	*−0.1*	*0.7*	*1.2*	*0.7*	*0.3*	*0.7*	*0.7*	*0.9*	*0.8*	*0.7*	*0.7*	*3.1*	*2.8*	*3.1*
Value of physical change in inventories	10,306	17,584	12,857	72	3,607	8,080	8,045	8,314	8,297	8,273	8,343	8,415	10,205	7,011	8,332
Government	88	−84	−96	−40	24	0	0	0	0	0	0	0	−33	6	0
Business	10,218	17,668	12,953	112	3,583	8,080	8,045	8,314	8,297	8,273	8,343	8,415	10,238	7,005	8,332
Residual error	*189*	*−195*	*−410*	*237*	*−804*	*−668*	*−539*	*−402*	*−266*	*−137*	*0*	*0*	*−45*	*−603*	*−101*
GDP at market prices	1,275,510	1,280,142	1,284,213	1,288,949	1,300,566	1,309,109	1,318,242	1,327,817	1,340,198	1,351,245	1,360,851	1,370,976	1,282,204	1,313,934	1,355,818
	0.8	*0.4*	*0.3*	*0.4*	*0.9*	*0.7*	*0.7*	*0.7*	*0.9*	*0.8*	*0.7*	*0.7*	*2.8*	*2.5*	*3.2*

White area represents forecast data.
All data are seasonally adjusted at annual rates.
Sources: The Conference Board of Canada; Statistics Canada.

Canadian Outlook Executive Summary: Summer 2007
by *Pedro Antunes*

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BANK OF CANADA
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Monetary Policy Report Update

July 2007

This text is a commentary of the Governing Council of the Bank of Canada. It presents the Bank's updated outlook based on information received up to 10 July 2007.

Overview

Economic growth and inflation in Canada in the first half of this year have been stronger than 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 back into balance in 2009.

Inflation is projected to be slightly higher and more persistent than in the April *Report*. However, as excess demand diminishes, total CPI and core inflation should decline to 2 per cent by early 2009. Also contributing to the decline in inflation are greater downward pressure on import prices related to the stronger Canadian dollar, and continued deceleration in the pace of price increases for new houses. With the direct effect of the GST cut ending and the impact of the temporary easing in gasoline prices in late 2006, total

Highlights

- The Canadian economy is operating further above its potential than was projected in the April *Report*.
- The Bank projects average annual economic growth of about 2 1/2 per cent through 2009, with the economy returning to its production potential in 2009.
- Inflation is projected to be slightly higher than in the April *Report*, returning to the 2 per cent target by early 2009.
- There are both upside and downside risks to the projection for inflation, and these appear to be roughly balanced.
- In line with the Bank's outlook, some modest further increase in the policy rate may be required.

inflation is projected to peak at about 3 per cent in the fourth quarter of this year.

The Bank's new projection for inflation is subject to both upside and downside risks. The main upside risk is that household demand in Canada could be stronger than projected, which could attenuate the downward pressure on inflation from lower import prices and from the deceleration in the pace of price increases for new houses. Higher levels of household borrowing and broad money growth point to this risk. On the downside, the adjustment in the Canadian economy to the rapid appreciation of the Canadian dollar may dampen demand for Canadian goods and services and reduce inflationary pressures more than projected. As well, the ongoing adjustment in the U.S. housing sector could be more prolonged, and this could spill over to the U.S. economy more broadly, further dampening Canadian exports. Overall, the upside and downside risks to the Bank's projection for inflation appear to be roughly balanced.

In line with this outlook, the Bank of Canada raised its key policy interest rate to 4.5 per cent on 10 July. Some modest further increase in the overnight rate may be required to bring inflation back to target over the medium term.

Recent Economic Developments

Global Developments

Economic growth outside North America has generally been more robust than expected at the time of the April *Report*. Emerging-market economies, particularly China and India, continue to outperform expectations. Over the past few months, the economic expansion in Europe and Japan has also been stronger than anticipated, with further strengthening in domestic demand.

The U.S. economy has evolved essentially in line with expectations. Following a weaker-than-anticipated first quarter, growth looks to have rebounded in the second quarter. Activity in the housing sector continues to decrease, but business investment appears to be regaining momentum. Moreover, growth in household consumption has remained firm, suggesting that there has been no significant spillover from the ongoing adjustment in the housing sector. In general, most of the recent data have been consistent with a return of the economy to near potential growth, while U.S. inflation has moderated somewhat.

With ongoing strength in global demand and concerns about supplies, oil prices have moved higher. Other commodity prices have generally remained high, largely in line with the assumptions in the April *Report*.

Canadian Economic Activity

In Canada, economic growth picked up markedly in the first quarter of 2007, with real GDP increasing at an annual rate of 3.7 per cent. This was stronger than the 2.5 per cent growth projected in the April *Report*. In spite of the weak growth in the U.S. economy in the first quarter of 2007, Canada's export volumes were higher than expected. Inventory investment was also higher than projected.

Final domestic demand continued to be the key driver of economic growth in Canada in the first quarter. Real personal disposable income rose substantially, owing mainly to strong growth in employment. The net worth of households also continued to rise, partly reflecting the impact of the strength in Canada's terms of trade. This was accompanied by further strong growth in household credit. These developments underpinned a considerable increase in household spending. Furthermore, the inventory correction that had been a significant drag on growth in the last half of 2006 was completed by early 2007.

Based on available information, real GDP appears to have increased at an annual rate of 2.8 per cent in the second quarter of 2007, higher than the 2.3 per cent rate projected in the April *Report*. In particular, both consumer spending and exports showed strong momentum early in the quarter.

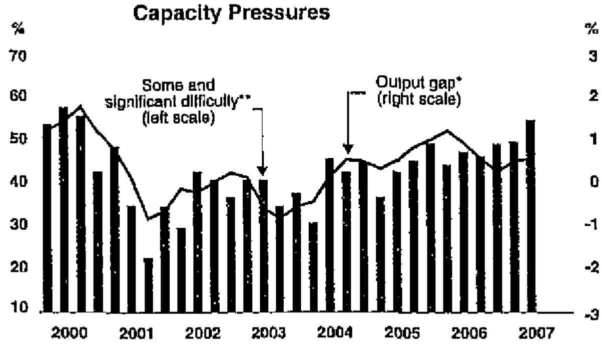
Estimated Pressures on Capacity

Several indicators suggest that the amount of excess demand in the Canadian economy increased in the second quarter of 2007 relative to that expected at the time of the April *Report*. In the Bank's latest *Business Outlook Survey*, the percentage of companies reporting that they would have difficulty in meeting an unanticipated increase in demand rose to the highest level since mid-2000 (Chart 1). The Bank's conventional measure of the output gap indicates that the economy was operating about 0.6 per cent above its production capacity in the second quarter of 2007, noticeably higher than projected in the April *Report*.[1]

A number of indicators continue to suggest tightness in labour markets, and measures of underlying labour costs have increased somewhat. The employment-to-population ratio is at a record high, and the unemployment rate is at a 33-year low. However, the percentage of firms reporting labour shortages in the recent *Business Outlook Survey* declined.

After reviewing all the indicators of capacity pressures, the Governing Council judges that, overall, the economy was operating about half a per cent above its production capacity in the second quarter of 2007.

Chart 1 Estimated Output Gap and the Response to *Business Outlook Survey* Question on Capacity Pressures



* Difference between actual output and estimated potential output based on the Bank's conventional measure. The estimate for the second quarter of 2007 is based on a projected rise in output of 2.8 per cent (at annual rates) for the quarter.

** Percentage of firms indicating that they would have either some or significant difficulty meeting an unanticipated increase in demand/sales

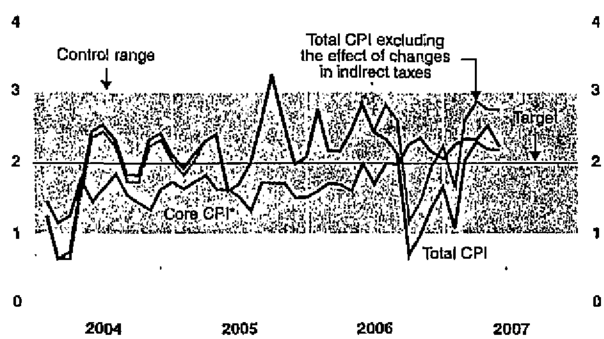
Inflation and the 2 Per Cent Target

Inflation has been higher than projected in the April *Report* and the January *Update*. This is consistent with evidence of greater excess demand in the Canadian economy. It also reflects some relative price movements.

The 12-month rate of increase in the total CPI moved up from 1.8 per cent in the first quarter of 2007 to 2.2 per cent in April and May (Chart 2). This higher-than-projected rise in the total CPI resulted from the higher-than-expected core rate of inflation and from further increases in the prices of some of the volatile components. Gasoline prices were higher, chiefly because of refinery closures and unexpected strength in demand. Fruit and vegetable prices were also higher.

Chart 2 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

1. The estimated level of excess demand in the second quarter of 2007 is close to 0.5 percentage points higher than projected in the April *Report*. This increase reflects a rise in the projected level of real GDP in the second quarter of about 0.25 per cent and a decrease in the estimated level of production capacity of about 0.2 per cent, largely reflecting ongoing weakness in labour productivity.

The core rate of inflation averaged 2.4 per cent in April and May, 0.2 percentage points higher than projected for the second quarter in the April *Report*. The rate of increase in the prices for core services excluding shelter has risen, reflecting strong demand pressures. Prices and markups for clothing and other semi-durable goods have also been higher than expected. Increases in shelter costs, while remaining relatively high, have continued to ease, largely as expected, reflecting a deceleration in price increases for new houses.

Financial Markets and Credit Conditions

Since the April *Report*, longer-term interest rates have increased in many economies (Chart 3). The increase largely reflects expectations of higher real interest rates, consistent with the outlook for continued strong global economic growth. Expectations for policy rates have also generally moved up.

In Canada, growth in household credit remains robust, and growth in business credit has moved above its historical average since the April *Report*. Monetary aggregates have also grown robustly.

The Canadian dollar has appreciated sharply, trading between 93 and 95.5 cents U.S. since the May policy announcement

Chart 3 Term Structure of Interest Rates in Canada and the United States

Yields on government bonds and treasury bills

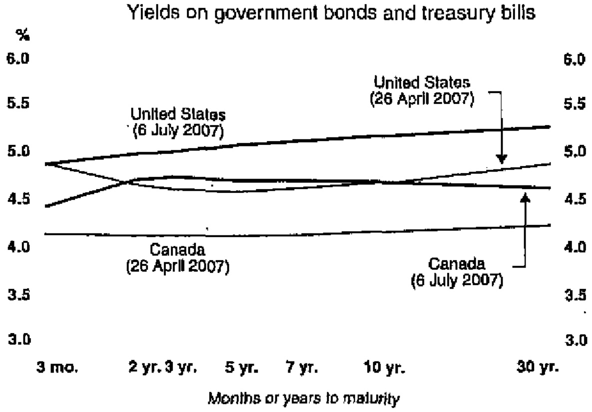
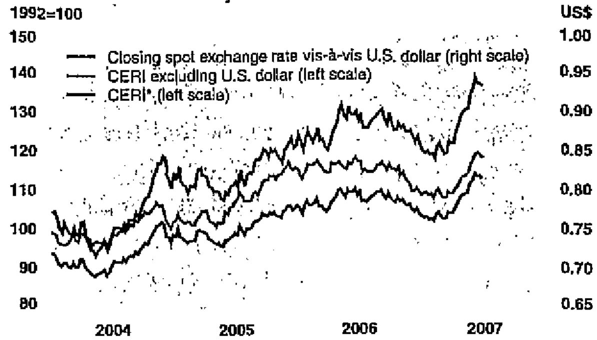


Chart 4 Canadian Dollar Exchange Rate

Wednesdays



* CERI: U.S. dollar, euro, yen, U.K. pound, Mexican peso, and Chinese renminbi

(Chart 4). The current value of the Canadian dollar is well above the range of 86.5 to 89.5 cents U.S. assumed in the projection in the April *Report*. Much of this appreciation reflects the strength of demand for Canadian goods and services and continuing firm commodity prices. However, the currency appears to have moved more strongly in response to these factors than historical experience would suggest.

The Economic Outlook

The Bank's base-case projection incorporates the following key assumptions: a gradual and orderly resolution of global imbalances, energy prices evolving in line with current futures prices, and a Canada/U.S. exchange rate in the range of 93 to 95.5 cents U.S. observed since the May policy announcement.

The outlook for the global economy is slightly stronger than in the April *Report*, with growth expected to remain robust over the next three years. Some deceleration is still expected, as global excess supply is reduced and as the impact of ongoing monetary policy tightening is felt. Global economic growth is projected to ease from 5.0 per cent in 2007 to 4.8 per cent in 2008, and to 4.6 per cent in 2009.

The projection for the U.S. economy is little changed from that in the April *Report*. GDP growth is expected to slow from about 3.3 per cent in 2006 to about 2.1 per cent in

2007. Lower residential investment is likely to continue to reduce GDP growth over the coming quarters. However, U.S. exports should be supported by stronger growth in domestic demand in other countries and by a depreciating U.S. dollar, and business investment is picking up. GDP growth is projected to be about 3 per cent in 2008 and 2009.

Futures prices for crude oil have increased relative to those in the April *Report*. The price index for non-energy commodities is at a high level and is still expected to ease gradually over the projection period.

In the Bank's projection for Canada, GDP growth is somewhat stronger in 2007 and somewhat weaker in 2008 and 2009 than was projected in the April *Report*. Quarterly growth is expected to average about 2 3/4 per cent at annual rates for the final three quarters of this year and about 2 1/2 per cent through 2008 and 2009 (Table 1).

Final domestic demand in Canada is expected to remain the key driver of economic growth over the projection period, supported by the strength of Canada's terms of trade and high levels of employment (Table 2). Growth in investment in machinery and equipment should continue to boost imports. Although the gradual strengthening of the U.S. economy over the projection period is supportive of Canadian exports, export growth is expected to be weaker than previously projected owing to the higher Canadian dollar. On balance, net exports are expected to subtract from growth in 2008 and 2009.

Compared with the April *Report*, this projection includes higher interest rates across the yield curve and a higher exchange rate, both of which act to moderate growth and bring aggregate demand and supply in Canada back into balance in 2009.[2]

Table 1
Summary of the Base-Case Projection[a]

	2007				2008		2009
	Q1	Q2	Q3	Q4	H1	H2	
Real GDP (quarterly growth or average quarterly growth, at annual rates)[b]	3.7 *(2.5)*	2.8 *(2.3)*	2.7 *(2.5)*	2.6 *(2.7)*	2.6 *(2.8)*	2.4 *(2.8)*	2.5 *(2.7)*
Real GDP (year-over-year percentage change)	2.0 *(2.0)*	2.3 *(2.1)*	2.6 *(2.2)*	2.9 *(2.5)*	2.6 *(2.6)*	2.5 *(2.8)*	2.4 *(2.7)*
Core inflation (year-over-year percentage change)	2.3 *(2.3)*	2.4 *(2.2)*	2.3 *(2.1)*	2.2 *(2.0)*	2.2 *(2.0)*	2.1 *(2.0)*	2.0 *(2.0)*
Total CPI (year-over-year percentage change)	1.8[c] *(1.9)*	2.3 *(1.9)*	2.6 *(2.3)*	3.0 *(2.8)*	2.4 *(2.2)*	2.1 *(2.0)*	2.0 *(2.0)*
Total CPI (excluding the effect of changes in indirect taxes) (year-over-year percentage change)	2.3[c] *(2.4)*	2.8 *(2.4)*	2.7 *(2.3)*	3.0 *(2.8)*	2.4 *(2.2)*	2.1 *(2.0)*	2.0 *(2.0)*
WTI[d] (level)	58 *(58)*	65 *(64)*	71 *(67)*	71 *(69)*	72 *(70)*	73 *(70)*	73 *(70)*

a. Figures in parentheses are from the April *Monetary Policy Report*.
b. For half and full years, the number reported is the average of the respective quarter-to-quarter percentage growth at annual rates.
c. Revisions to the year-over-year percentage change in the first quarter of 2007 for both the total CPI and the total CPI excluding the effect of changes in indirect taxes are the result of rounding effects associated with the change in the CPI base year from 1992 to 2002.
d. 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 6 July 2007

The projection for core inflation for 2007 and 2008 is slightly higher than in the April *Report* (Table 1). Greater excess demand than was expected in April is projected to keep core inflation above 2 per cent for a longer period. But three factors should bring core inflation back to 2 per cent by early 2009. First, with economic activity moderating somewhat in 2008 and 2009, excess demand pressures are slowly worked off. Second, with the stronger Canadian dollar, downward pressure on inflation from lower import prices is expected to be a little greater than earlier projected. And finally, the

2. The assumption for potential output growth remains unchanged from that used in the April *Report*, at 2.8 per cent in both 2007 and 2008 and at 2.7 per cent in 2009.

contribution to inflation coming from price increases for new houses is expected to continue to decline.

The projected path for the 12-month rate of increase in the total CPI reflects the revised outlook for the core rate, expectations for energy prices, and the effect of past changes in indirect taxes. With the higher futures prices for oil and the direct effect of the GST cut on inflation ending, total CPI inflation is projected to rise further in the second half of this year. Considerable year-over-year increases in gasoline prices, owing partly to the impact of the temporary easing in gasoline prices in late 2006, will cause total CPI inflation to peak in the fourth quarter at about 3 per cent. CPI inflation is then expected to decline, reaching the 2 per cent target by early 2009.

Table 2

Contributions to Average Annual Real GDP Growth[a]

Percentage points

	2006	2007	2008	2009
Consumption	2.3 *(2.2)*	2.1 *(1.8)*	1.9 *(1.6)*	1.8 *(1.7)*
Housing	0.1 *(0.2)*	0.1 *(-0.1)*	-0.1 *(-0.1)*	-0.1 *(0)*
Government	0.8 *(0.8)*	0.6 *(0.6)*	0.7 *(0.7)*	0.6 *(0.6)*
Business fixed investment	1.2 *(1.1)*	0.6 *(0.7)*	0.6 *(0.5)*	0.4 *(0.4)*
Subtotal: Final domestic demand	4.4 *(4.3)*	3.4 *(3.0)*	3.1 *(2.7)*	2.7 *(2.7)*
Exports	0.3 *(0.5)*	0.6 *(0.4)*	0.9 *(1.3)*	0.9 *(1.0)*
Imports	-1.6 *(-1.7)*	-1.4 *(-1.3)*	-1.5 *(-1.3)*	-1.2 *(-1.0)*
Subtotal: Net exports	-1.3 *(-1.2)*	-0.8 *(-0.9)*	-0.6 *(0)*	-0.3 *(0)*
Inventories	-0.3 *(-0.4)*	-0.1 *(0.1)*	0.1 *(0)*	0 *(0)*
GDP	2.8 *(2.7)*	2.5 *(2.2)*	2.6 *(2.7)*	2.4 *(2.7)*

a. Figures in parentheses are from the projection presented in the April *Report*.

The *Monetary Policy Report* and the *Update* are available on the Bank's website at: www.bankofcanada.ca

Copies can also be obtained by contacting the Bank at:
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