



FOR IMMEDIATE RELEASE
24 January 2008

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Bank of Canada releases *Monetary Policy Report Update*

OTTAWA—The Bank of Canada today released its January *Monetary Policy Report Update*. In this *Update*, the Bank said that the Canadian economy continues to operate above its production capacity, despite some slowing in growth in the fourth quarter of 2007. Both total and core inflation have been lower than projected in the October *Monetary Policy Report*, largely reflecting a price-level adjustment related to increased competitive pressures in the retail sector stemming from the level of the Canadian dollar.

Financial conditions have deteriorated since October, leading to tighter credit conditions in industrialized countries. Given this, and a deeper and more prolonged decline in the U.S. housing sector, the U.S. economic outlook for 2008 has been revised downwards significantly.

The weaker U.S. economy will put additional downward pressure on Canada's export growth. Despite tighter credit conditions, domestic demand in Canada is expected to remain strong, supported by continued income growth associated with high commodity prices. Overall, the Bank now projects that the Canadian economy will expand by 1.8 per cent in 2008 and 2.8 per cent in 2009. This implies that the economy will move into excess supply in the second quarter of 2008, and then return to balance in early 2010.

Both core and total CPI inflation are projected to fall below 1 1/2 per cent by the middle of 2008 before returning to 2 per cent by the end of 2009. This primarily reflects the price-level adjustment noted above and, for total inflation, the recent reduction in the GST. Excluding the impact of the GST reduction, total inflation is projected to average close to the 2 per cent target throughout 2008 and 2009.

The risks to the Bank's inflation projection are judged to be roughly balanced. On the upside, there is continued strong momentum in domestic demand growth, and capacity pressures could be stronger than judged, especially if weak productivity growth were to persist. On the downside, the tightening in credit conditions globally and in Canada could be greater and more protracted than assumed, and there could be a more prolonged slowdown in the U.S. economy. As well, competitive pressures in Canada's retail sector could put more downward pressure on prices than assumed.

On 4 December and on 22 January, the Bank lowered its target for the overnight rate by one-quarter of one percentage point, bringing it to 4 per cent. Further monetary stimulus is likely to be required in the near term to keep aggregate supply and demand in balance, and to return inflation to target over the medium term.