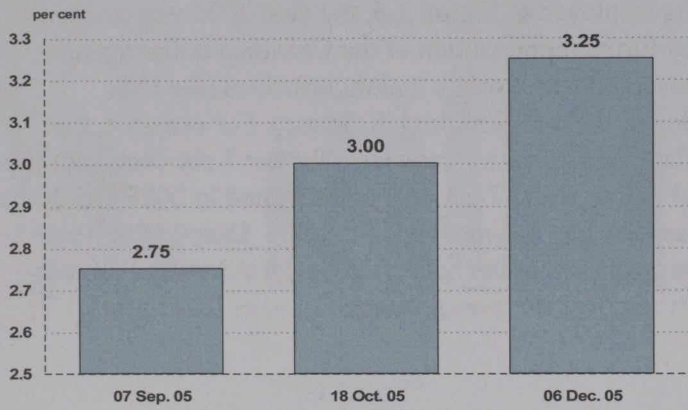
Interest Rates

The year 2005 was also characterized by continuously rising short-term interest rates. As shown in Figure 3-8, the Bank of Canada raised its key policy interest rate by 25 basis points on September 7, 2005, on October 18, 2005 and again on December 6, 2005, bringing it to 3.25 per cent.[1] This gradual upward trend continued in 2006. It now stands at 4.25 per cent.

Figure 3-8
The Bank of Canada Key Policy Rate



Source: Bank of Canada

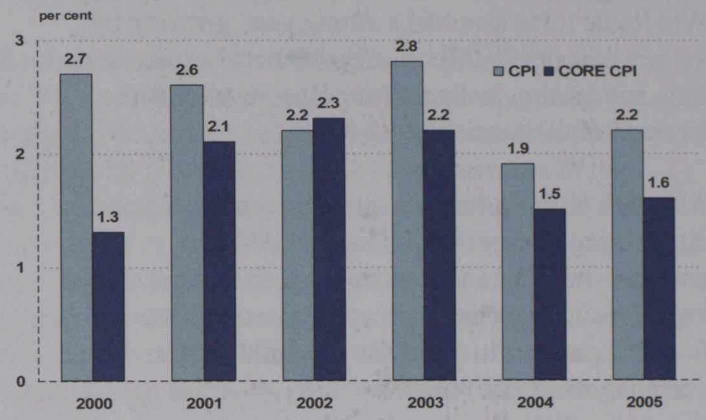
Prices

For the entire year 2005, consumers paid an average of 2.2 per cent more than they did in 2004 for the goods and services included in the Consumer Price Index (CPI) basket, up from the 1.9 per cent annual average rise in 2004. The main contributors to this increase were gasoline (12.8 per cent), homeowner's replacement cost (5.2 per cent), restaurant meals (2.9 per cent), property taxes (4.1 per cent), as well as fuel oil (25.5 per cent). On the other hand, some factors had a moderating effect on this increase such as computer equipment and supplies (-20.7 per cent) and traveller accommodation (-4.8 per cent).

The Core CPI, which excludes volatile items such energy and food, rose much less, at 1.6 per cent in 2005 and was only slightly higher than the 1.5 per cent increase witnessed in 2004.

Therefore, not only did higher energy prices boost incomes (corporate profits and labour incomes), but also they had a major impact on consumer price index.

Figure 3-9
CPI and Core CPI Annual Increases



Source: Bank of Canada

Productivity Gap

In spite of solid economic growth in 2005 and sound macroeconomic fundamentals, there remain weaknesses in the Canadian economy that could be seen as risks to medium and long-term growth. Poor productivity performance is perhaps Canada's most significant weakness. Figure 3-10 displays the relative labour productivity levels in the total economy in Canada, as a percentage of the U.S. In 2005, labour productivity levels in the Canadian economy as a whole as proxied by the GDP per worker, represented 84 per cent of that the United States. Canadian performance was even worse (82.2 per cent) when productivity was measured by GDP per hour. This

Figure 3-10
Relative Labour Productivity Levels in the Total Economy in Canada, 1961-2005 (Canada as % of the Unites States)

Source: Center for the Study of Living Standards

[1] The key policy rate is the overnight rate at which major financial institutions borrow and lend one-day funds among themselves; the Bank sets a target level for that rate. Changes in the target for the overnight rate influence other interest rates, such as those for consumer loans and mortgages. They can also affect the exchange rate.