MONETARY POLICY REPORT

– November 2000 –

Summary

Continuing strong demand worldwide, together with robust domestic demand, has bolstered Canada's output growth this year. Although growth has exceeded expectations, the trend of inflation has continued to be lower than projected.

While growth in the U.S. economy has been robust, the pace of activity moderated in the third quarter. Growth in the euro area has been solid, and recoveries have taken hold in many emerging-market economies.

The combination of strong global demand, the rapid ascent of oil prices, and the increased likelihood that oil prices will remain above previously expected levels has heightened the risk of higher inflation rates in the major industrial countries.

In this environment, there are three main areas of uncertainty for Canada's economic outlook. These are: the path of demand growth in the United States, the current level and the prospective growth of Canada's production capacity, and world energy prices.

Recent Developments

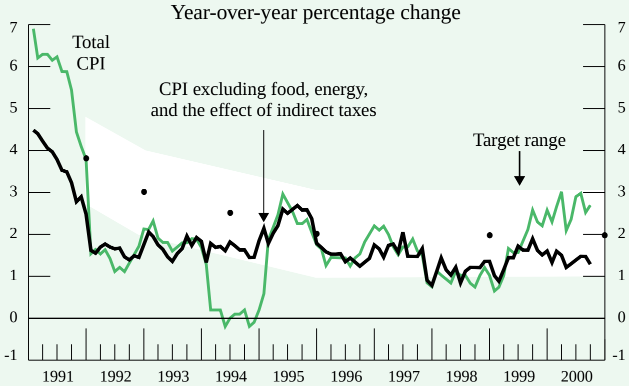
While Canada's real GDP growth eased slightly in the first half of 2000, at 4.9 per cent, it was still well above the estimated growth of potential output. Current information points to continued solid growth in a range of 3.5 to 4.5 per cent for the third quarter.

Highlights

- **The Bank has revised up its projection of output growth for this year to 5 per cent and anticipates output growth between 3 and 4 per cent for 2001.**
- **At these rates of expansion, pressures on production capacity will intensify, and, as a result, core inflation is expected to rise to 2 per cent in the second half of next year.**
- **If oil prices were to stabilize at levels just below US$30 a barrel, the rate of increase in the total CPI would be expected to move down to about 2 per cent by the end of 2001.**
- **The three main areas of uncertainty for this outlook are: the path of demand growth in the United States, the current level and prospective growth of Canada's production capacity, and world energy prices.**

Consumer Price Index

Year-over-year percentage change



• Midpoint of the inflation-control target range

Over the same period, core CPI inflation (the CPI excluding food, energy, and the effect of changes in indirect taxes) remained in the lower half of the Bank's inflation-control target range, below the level projected in the May *Report*.

While surging energy prices have pushed up the total CPI, there has been, as yet, little effect on core inflation and inflation expectations.

Wages appear to have risen by close to 3 per cent in the first half of 2000. However, considerable gains in labour productivity held down unit labour costs.

The latest information provides a more optimistic assessment of the current level and prospective growth of potential output than at the time of the May *Report*.

The conventional measure now suggests that the economy may have moved into a position of excess demand by mid-2000, instead of in the second half of 1999, as previously estimated. (See Technical Box 3 of the full *Report*.) However, because of the uncertainty surrounding estimates of the output gap, the Bank continues to examine a broad range of indicators of pressure on capacity before coming to a view on the level of potential output relative to actual GDP.

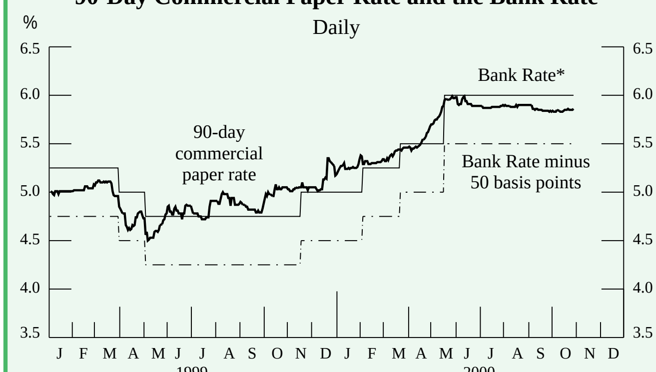
Overall, it is the Bank's judgment that the weight of evidence, including the fact that core inflation has been lower than expected, does not confirm that the economy had moved into excess demand by mid-year, but it does point to a level of activity close to capacity limits.

Starting in December 2000, the Bank will be moving to a fixed schedule for setting the Bank Rate. This should help focus attention on the Canadian economic situation and will also provide the Bank with more opportunities to comment on the path of monetary policy.

Concern about future pressure on capacity limits arising from strong international and domestic demand prompted the Bank to raise the Bank Rate by 50 basis points on 17 May to keep the trend of inflation within the Bank's target range. This action

90-Day Commercial Paper Rate and the Bank Rate

Daily



* The Bank Rate is the upper limit of the 50-basis-point operating band for the overnight rate.

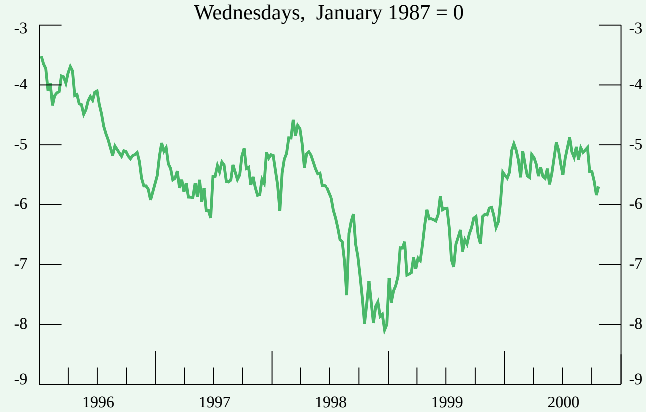
followed a similar move by the U.S. Federal Reserve in response to the rapid growth in that economy. The Fed's action served to underscore the continued risk that strong U.S. demand pressures could spill over into Canada. After these actions, bond yields declined as markets perceived a lower inflation risk.

A dominant feature in foreign exchange markets over the past six months has been the strength of the U.S. dollar. Against this background, the Canadian dollar has fluctuated between 65.3 and 68.3 cents (US) and has risen strongly against most other major currencies.

For most of the past six months, the Bank's monetary conditions index fluctuated in a range of -5.5 and -5.0. More recently, it has been in the -5.5 to -6.0 range, reflecting the movement of the Canadian dollar against the U.S. dollar.

Monetary Conditions Index

Wednesdays, January 1987 = 0



The Outlook for Inflation

In the United States, the recent interest rate increases by the Federal Reserve appear to have dampened activity in interest-sensitive areas of the economy to more sustainable levels. Nevertheless, real GDP is expected to grow by about 5 per cent in 2000 and slow to a range of 3.0 to 3.5 per cent in 2001, and the labour market remains very tight.

In the euro area, real GDP growth is expected to remain solid in coming quarters. Many emerging-market economies have continued to recover from the 1997–98 financial crisis, and the Japanese economy, although still fragile, is improving.

While high and volatile world oil prices could dampen these growth prospects, the underlying strength of the global economy, together with the potential inflation consequences of higher energy prices, continues to tilt the balance of risks towards increased inflation pressures.

Over the next 18 months, Canadian export growth should ease in response to the projected slowing of the U.S. expansion. Household spending in Canada should remain relatively robust, while business investment is expected to moderate from its recent intense pace.

Thus, the Bank is currently projecting output growth for this year at close to 5 per cent. At this robust rate, pressures on production capacity will intensify. If, as assumed, growth of potential output is 3 per cent, this will also lead to conditions of excess demand by early 2001. As a result, core inflation is still projected to rise to 2 per cent, but not until the second half of next year.

Output growth in 2001 is projected to slow to a range of 3 to 4 per cent (on an annual average basis), primarily reflecting the expected slowdown in the U.S. economy. This is expected to lead to conditions that will keep core inflation steady at 2 per cent as the pace of growth decelerates through the year. Were this slowdown not to materialize, a situation of excess demand in the economy would persist, resulting in further upward pressure on inflation.

If oil prices were to stabilize at levels just below US$30 a barrel, the rate of increase in the total CPI would be expected to move down to about 2 per cent by the end of 2001.

The principal risks surrounding this outlook revolve around demand, supply, and expectations for inflation.

Continued robust growth in U.S. demand for Canada's exports could increase inflation pressures here. On the supply side, there is a possibility that brisk spending on machinery and equipment, combined with recent productivity gains, could raise capacity limits beyond currently projected levels. However, until further evidence accumulates, the Bank will continue to take a cautious view regarding the growth potential of the Canadian economy. In addition, there is the risk that if current high energy prices are maintained, they will feed through to the prices of other goods and services and, possibly, into expectations of future inflation.

In this climate of strong economic expansion, high levels of activity relative to potential, and increased energy prices, the challenge for monetary policy will be to judge the balance between aggregate demand and supply and to guard against the risk that higher energy prices could affect core inflation and expectations of future inflation. To preserve the low trend of inflation that has been benefiting the Canadian economy, the Bank must be prepared to adjust monetary conditions in a timely manner.

The Bank of Canada's *Monetary Policy Report* is published semi-annually in May and November. Regular *Updates* are published in August and February. Copies of the full *Report*, the *Summary*, and the *Update* may be obtained by contacting: Publications Distribution, Communications Services, Bank of Canada, Ottawa, Ontario, Canada K1A 0G9.

Telephone: (613) 782-8248; e-mail: publications@bankofcanada.ca

Web site: http://www.bankofcanada.ca