

MONETARY POLICY REPORT

– November 2001 –

Summary

Canada's economy is feeling the effects of two major events: the global economic slowdown that began last year in the United States and the aftermath of the 11 September terrorist attacks. Together, these factors have led to a highly uncertain environment, so the band of confidence around the economic outlook is much wider than usual.

By midsummer, evidence began to accumulate that the economic slowdown would be deeper and more protracted than previously anticipated, both globally and in Canada. Canada's economic outlook weakened further as a result of the terrorist attacks in the United States.

It now appears that economic growth will be close to zero or slightly negative in the second half of 2001, leaving real GDP growth for the year as a whole at about 1 1/2 per cent.

Because of the unusual nature of the uncertainty we are facing, the Bank's economic outlook for 2002 is based on a set of working assumptions about business and consumer confidence. These assumptions are that there will be no further major escalation of terrorism and that business and consumer confidence will return to normal levels in the second half of next year.

Highlights

- **Given the unusual nature of the uncertainty we face, the Bank's economic outlook is based on a set of working assumptions about business and consumer confidence.**
- **These assumptions are that there will be no further major escalation of terrorism, and that consumer and business confidence will return to normal levels in the second half of 2002.**
- **Under these assumptions, growth in the second half of 2001 is expected to be close to zero or slightly negative, leaving growth for the year as a whole at about 1 1/2 per cent. Growth in 2002 is expected to be 1 1/2 per cent, with the economy gaining speed through the year and growing faster than potential output in the second half.**
- **In this scenario, with more slack opening up in the economy, core inflation is expected to fall to about 1 1/2 per cent in the second half of 2002. Total CPI inflation in 2002 is also expected to move below the 2 per cent midpoint of the Bank's inflation-control target range.**

Under these assumptions, growth would increase to about 2 per cent in the first half of 2002 and to about 4 per cent in the second half. On an average annual basis, this would produce growth of about 1 1/2 per cent in 2002.

With Canada's economy already in a position of excess supply in the third quarter of 2001, the implication of this growth scenario is that the economy would operate even further below capacity throughout next year. This would mean more persistent downward pressure on core inflation, which is expected to fall to about 1 1/2 per cent in the second half of next year. Core inflation would then move back close to the 2 per cent midpoint of the Bank's 1 to 3 per cent inflation-control range by the end of 2003. Total CPI inflation is expected to move in a similar manner, if world energy prices remain at or below their early-September levels.

Recent Economic and Financial Developments

Even before the terrorist attacks in the United States, a more pronounced

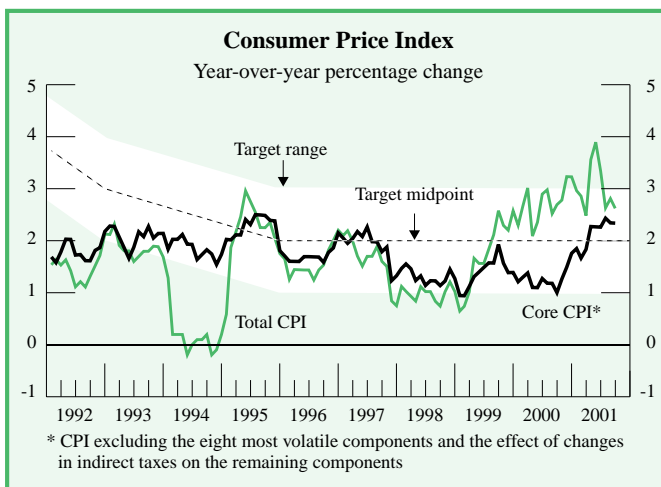
weakening trend had become evident globally and in Canada, with economic growth slowing sharply through the first half of 2001 and into the third quarter. This weakness had its roots in the slowdown that had begun in the United States in the second half of last year.

While Canada's growth through this period had slowed because of reduced exports to the United States, it remained at higher levels than U.S. growth. But final domestic demand had also begun to soften, owing to weak business investment and a slowdown in household spending.

In response to these trends, the Bank lowered interest rates beginning in early 2001. In total, the Bank has dropped its target for the overnight rate by 3 percentage points, including the 75-basis-point reduction on 23 October. The unusual step of lowering rates by 50 basis points on 17 September, between scheduled announcement dates, was taken because of the need for prompt action to underpin consumer and business confidence following the terrorist attacks.

The slowing world economy and the resulting drop in commodity prices have led to weakness in the Canadian dollar. The global economic uncertainty stemming from the terrorist attacks has also weighed on the Canadian dollar.

Core inflation rose above 2 per cent in the spring and hovered around 2.3 per cent through the summer months. This movement was consistent with the lagged effects of the economy operating above capacity earlier this year. In contrast, because of declining energy prices, total CPI inflation has fallen sharply from a peak rate of nearly 4 per cent in May and is moving down towards core inflation.



Prospects for Growth

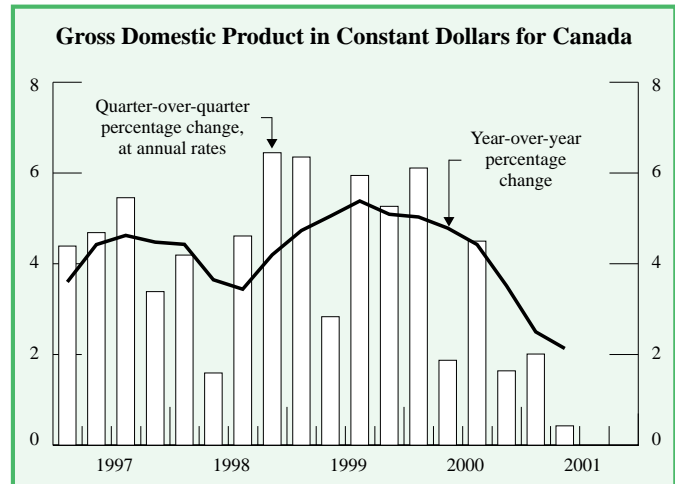
The Bank had already revised its outlook for Canada's economy in late summer, in recognition of the weaker global economy. But the terrorist attacks in the United States have further dampened Canada's near-term prospects and have introduced an unusually high degree of uncertainty.

In Canada, growth in the second half of 2001 is now expected to be close to zero or slightly negative as the direct economic effects of the attacks are felt, particularly in the air transportation, tourism, and finance industries. This would imply annual average growth for 2001 of about 1 1/2 per cent—close to the latest average private sector forecast.

The performance of the Canadian economy in 2002 will depend critically on the global environment in general and on the timing and strength of the U.S. recovery in particular. One can construct a scenario where confidence is restored quickly and, given the amount of monetary as well as fiscal stimulus that has been provided, robust growth in the North American economy resumes early in 2002. However, if consumer and business confidence stay weak for quite some time, growth would remain sluggish through most of 2002.

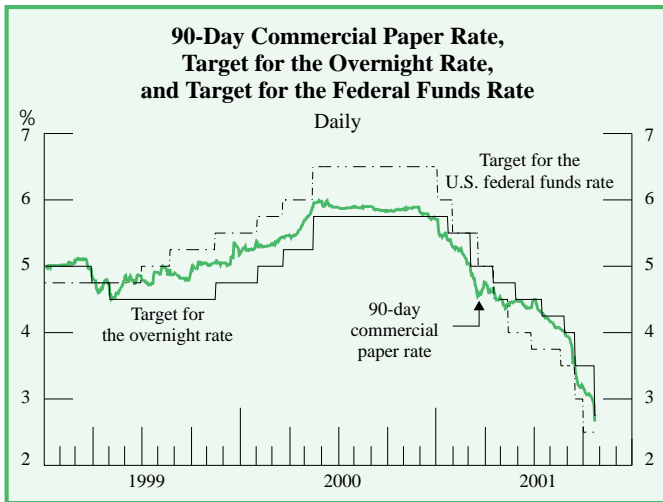
Based on its working assumptions, the Bank has formulated an economic outlook that lies between these two scenarios. These assumptions involve no further major escalation of terrorism and a return to normal levels of confidence in the second half of 2002.

Under these working assumptions, U.S. growth is expected to be positive but low in the first half of



2002. With uncertainty dissipating, confidence rebounding, and the significant amount of stimulus already provided, the U.S. economy should grow at a faster rate than potential output in the second half. On an average annual basis, this would imply growth in the U.S. economy of about 1 per cent in 2002. Growth would be considerably stronger on a fourth-quarter-over-fourth-quarter basis, at 2 3/4 per cent.

Given the Bank's working assumption about the return of business and consumer confidence, together with the domestic policy measures that have been taken, we see growth in Canada picking up modestly in the first half of next year and rising to a rate above that of growth in potential output (estimated at about 3 per cent) in the second half. On an annualized basis, growth would average about 2 per cent in the first half of 2002 and about 4 per cent in the second half. On an average annual basis, this implies growth for 2002 of about 1 1/2 per cent, compared with an average private sector forecast of about 1 3/4 per cent.



The Outlook for Inflation

Earlier this year, Canada's core inflation rate moved above the 2 per cent midpoint of the Bank's 1 to 3 per cent inflation-control target range, peaking at 2.4 per cent in July. This was broadly consistent with an economy that had been operating above its capacity early in the year.

Pressures on capacity began to ease, however, as the economy slowed. Several indicators suggest that the economy was in a position of excess supply in the third quarter of 2001. While there are still signs of tightness in some sectors, such as shortages of skilled labour, the economic slowdown has substantially reduced demand pressures.

Indeed, with the economy not expected to return to above-potential growth until the second half of 2002,

the output gap is expected to continue widening until then.

In this scenario, core inflation is expected to move below 2 per cent in early 2002 and fall to about 1 1/2 per cent in the second half of the year. Total CPI inflation should fall to about 2 per cent by the end of 2001, assuming that world energy prices remain at or below their early-September levels. Total inflation would then move slightly below core inflation in 2002.

With economic slack projected to start shrinking in the second half of 2002 and to disappear through 2003, both core and total CPI inflation would be expected to move back close to 2 per cent by the end of 2003.

Conclusions

The Bank of Canada has lowered its target for the overnight interest rate by 300 basis points since the beginning of the year. These actions have been taken to support economic growth and to keep inflation close to our 2 per cent target over the medium term.

Because of the unusual nature of the current uncertainty, the economic outlook presented in this *Report*—which led to the Bank's decision on 23 October—is based on a set of assumptions about business and consumer confidence. This outlook and the associated analysis will continue to guide the Bank's judgment about monetary policy as more information becomes available.

In 2002, the Bank of Canada's *Monetary Policy Report* will be published in April and October. Regular *Updates* will be published in January and July. Copies of the full *Report*, the *Summary*, and the *Update* may be obtained by contacting: Publications Distribution, Communications Department, Bank of Canada, Ottawa, Ontario, Canada K1A 0G9.

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