

## MONETARY POLICY REPORT

- May 2001 -

# Summary

**A**t this time, the key issue in the conduct of monetary policy in Canada is the extent of the current slowdown in the pace of economic activity stemming primarily from developments in the United States.

The slowdown in Canada's economic growth late last year and in the first half of 2001 has been greater than expected, and the automotive, electrical, and electronic manufacturing sectors in particular have had to make significant adjustments. It remains the Bank's view that after a first-half slowdown, economic growth will pick up in the second half of the year and in 2002.

The latest economic and financial developments support this view. Recent data point to continued growth in overall activity. In addition, current developments are consistent with the view that weakness associated with an inventory adjustment will be concentrated in the first half, that business investment in new technology will continue, and that the easing in monetary conditions will support growth.

Consistent with this projection for output growth, the Bank sees the development of some downward pressure on core inflation, which will likely average somewhat below 2 per cent over the remainder of this year. The anticipated downward pressure on

core inflation this year should reverse through 2002 as the economy expands at a rate above its growth potential.

## Highlights

- **After slowing in the first half of 2001, economic growth in Canada is expected to pick up in the second half and rise somewhat further in 2002 to slightly above the economy's growth potential.**
- **As a result of slowing activity and the associated downward pressure on inflation, core inflation will likely average somewhat below 2 per cent over the remainder of 2001.**
- **In 2002, with the economy projected to grow above potential, these pressures should reverse, and core inflation should move back to 2 per cent towards the end of the year.**
- **The rate of increase in the total CPI, currently close to 3 per cent, is expected to move down to 2 per cent by the end of 2001.**
- **The main risk to this outlook is the possibility that the U.S. slowdown could be more protracted than anticipated.**

The main risk to this outlook for the Canadian economy is the possibility that the U.S. slowdown could be more protracted than anticipated. For example, if consumer and business confidence in the United States does not improve, this could lead to weaker consumption and investment spending. The Bank will have to monitor developments in this area closely.

Another development that the Bank will have to watch closely because of its possible implications for aggregate demand and inflation in Canada is the shift in international financial market sentiment that has led to a strengthening of the U.S. dollar against the Canadian dollar and other currencies.

### *Recent Economic and Financial Developments*

After increasing by 4.5 per cent on average over the first three quarters of 2000, the pace of economic expansion in Canada has slowed to a rate below the economy's growth potential. In the fourth quarter of 2000, real GDP in Canada rose at an annual rate of only 2.6 per cent. Available information suggests that real GDP growth for the first quarter of 2001 will be in a range

of 1.25 to 2.25 per cent, with robust gains in final domestic demand partly offset by sluggish exports and further reductions in inventory investment.

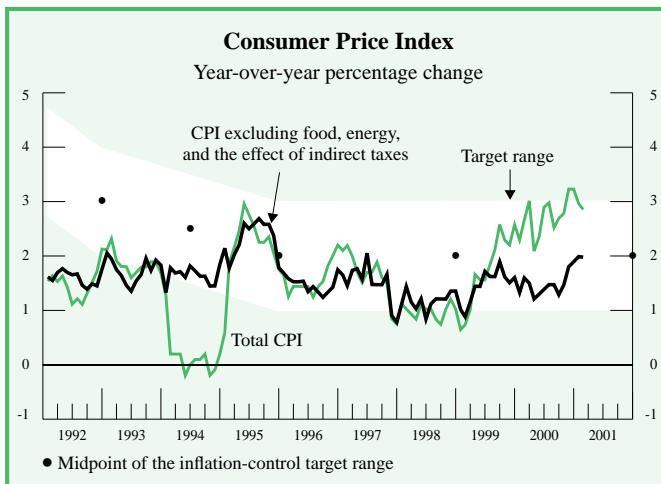
Since last autumn, core CPI inflation has moved up to the midpoint of the Bank's 1 to 3 per cent inflation-control target range slightly faster than expected. The rate of increase in the total CPI has remained close to 3 per cent, primarily reflecting increases in energy prices over the past year.

The increase in the core rate is consistent with the view that signs of excess demand emerged in product markets in the second half of 2000. The full range of indicators that the Bank monitors suggests that the economy was operating at, or slightly above, full capacity at the end of last year.

However, given the sharp slowing we have seen in the pace of activity, these pressures on capacity have eased since last autumn with the economy expected to be operating somewhat below capacity by mid-2001.

In light of this slowdown and movement towards a position of excess supply, the Bank of Canada lowered its Bank Rate by 25 basis points on the 23 January announcement date, by 50 basis points on 6 March, and by an additional 25 basis points on 17 April. These actions brought the Bank Rate down to 5.0 per cent and the target for the overnight rate to 4.75 per cent. These moves were aimed at keeping inflation close to the midpoint of the Bank's 1 to 3 per cent target range over the medium term.

Developments in financial markets have generally been consistent with expectations of a sharper slowdown in the United States than in Canada. Yield spreads between Canadian and U.S. government securities turned positive for maturities of 2 to 30 years in late 2000 and subsequently



widened out. But this also reflects an increased preference for U.S. assets on the part of global investors who have sought the safety and liquidity of U.S. financial markets at a time of market uncertainty.

This swing in investor sentiment has also been reflected in the strength of the U.S. dollar against all major currencies. A number of recent developments have been behind this shift in sentiment: volatile global equity markets; the slowing global economy; economic and financial difficulties in several emerging-market economies; and concern about the direction of macroeconomic and structural policies in certain industrial countries.

As a result of these market swings, the Canadian dollar has declined from about 67 cents (U.S.) at the turn of the year to around 64 cents more recently. Compared with other major currencies, however, the Canadian dollar has remained quite firm.

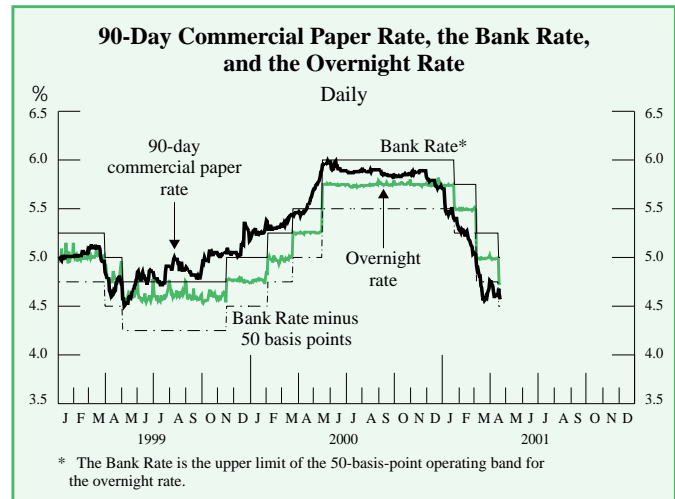
With declining short-term interest rates and a lower Canadian dollar, monetary conditions have eased substantially since the November *Report*.

### The Outlook for Inflation

With inflation expectations solidly anchored around 2 per cent, the outlook for inflation depends on the balance between demand and supply in the Canadian economy. This balance is strongly influenced by external developments.

Projections of world economic growth for 2001 have been revised down, primarily reflecting the abrupt slowdown in the United States.

The Bank's projection for the United States is for economic growth of between 1.0 and 2.0 per cent this year, on an annual average basis, with growth in the second half of the year averaging 2.0 to 3.0 per cent. In 2002, the Bank



projects U.S. economic growth of 2.5 to 3.5 per cent.<sup>1</sup> A number of factors, including declines in interest rates, are expected to lead to this rebound. As noted earlier, however, there are risks that the U.S. slowdown could be more protracted than projected.

For Canada, the Bank continues to see a strengthening in economic activity in the second half of this year and in 2002. This view reflects several factors: a second-half rebound in the U.S. economy; completion of the current inventory correction; continued investment in new technology by businesses; recent tax cuts; and the easing in domestic monetary conditions.

Since the February *Update*, the economic information on the first half of 2001 has been mixed, with both positive and negative indicators. On balance, the data confirm the slowdown in the first half of the year anticipated in the *Update*. It now looks as if growth over the first six months will average between 1.25 and 2.25 per cent. For the second half of the year, we see growth picking up significantly to between 2.5 and 3.5 per cent.

1. The midpoint of the Bank's projection range for 2001 is slightly below the latest consensus U.S. forecast. For 2002, it is very close to the consensus.

Based on this first-half/second-half profile, together with the downward revision to GDP in 2000, the Bank's projection for economic growth in 2001 (on an annual average basis) has been revised down to between 2.0 and 3.0 per cent. The pace of activity in 2002 is expected to be somewhat stronger than in the second half of 2001, with the economy expanding at a rate slightly above the Bank's estimate of potential output growth of 3 per cent.<sup>2</sup>

The expected re-emergence of excess supply in the economy this year should contribute to downward pressure on core inflation during the rest of 2001. Two factors, however, are expected to limit the impact of excess supply on the core rate this year. First, longer-term inflation expectations are still very close to 2 per cent—about the same as the current level of core inflation. Second, wage increases are expected to remain steady, or possibly even edge up if current pressures in some sectors and professions become more widespread, while productivity

growth may ease, thus putting upward pressure on unit labour costs.

On balance, it seems likely that core inflation over the remainder of this year will average somewhat below 2 per cent. In 2002, with the economy projected to grow above potential, these pressures should reverse, and core inflation should move back to 2 per cent by the end of the year.

The rate of increase in the total CPI, currently close to 3 per cent, is expected to move down to 2 per cent by the end of 2001 on the assumption that world energy prices remain close to current levels.

2. This outlook is not materially affected by forthcoming changes in the measurement of GDP. (See Technical Box 3 in the full *Report* for more details.)

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 Department, Bank of Canada, Ottawa, Ontario, Canada K1A 0G9.

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