Monetary Policy Report

Update

– January 2003 –

This text is a commentary of the Governing Council of the Bank of Canada. It includes information received up to the fixed announcement date on 21 January 2003 and updates the October 2002 Monetary Policy Report.

At the time of the October *Monetary Policy Report,* the Bank projected that core inflation would rise in the fourth quarter of 2002, reflecting a combination of one-off factors—including the rise in insurance premiums—and the "echo effect" from developments towards the end of 2001. It was expected that the overall impact of these factors would peak in the fourth quarter, with core inflation reaching about 3 per cent at year-end, and that these effects would diminish through 2003. Thus, core inflation and total CPI inflation were expected to return to 2 per cent in the second half of 2003.

Rates of inflation since the October *Report* have come in somewhat higher than expected. This reflects not only a stronger-than-expected increase in insurance premiums but also some broadening of price pressures.

After expanding significantly faster than potential during the first half of 2002, the Canadian economy slowed to a growth rate close to potential in the second half of the year. With this slowdown, the level of economic activity in Canada has remained near capacity since mid-year. Indeed, the higher-than-expected rates of inflation, together with various

Highlights

- **Rates of inflation have risen somewhat more than expected at the time of last October's *Monetary Policy Report*.**
- **Stronger-than-expected increases in insurance premiums and some broadening of price pressures, possibly reflecting an economy operating closer to capacity than previously believed, account for this higher inflation outcome.**
- **While conditions in financial markets have improved, and it is assumed that they will continue to do so, significant geopolitical and global economic uncertainties remain.**
- **In the Bank's base-case projection for the Canadian economy, demand pressures are expected to strengthen in the second half of 2003 and into 2004, following growth at slightly below potential in the first half of this year.**
- **With the stance of monetary policy currently very stimulative, a reduction of stimulus will be required in order to return inflation to the 2 per cent target over the medium term.**

measures of capacity pressures, may be indicating that the economy is operating closer to capacity than the Bank had previously believed.

The slowdown in economic growth in the second half of 2002 reflected the effects of financial and geopolitical uncertainties and weakness in the global economy. While conditions in financial markets have improved, and it is assumed that they will continue to do so, significant geopolitical and economic uncertainties remain. In these circumstances, the Bank left the target overnight rate unchanged at 2.75 per cent on 3 December and on 21 January (Chart 1).

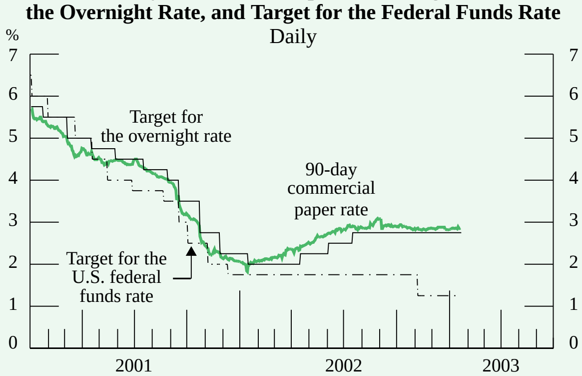
On the geopolitical front, our base-case projection for economic growth in Canada this year assumes that the uncertainties regarding Middle East tensions will dissipate in the second half of 2003. It must be recognized, however, that economic outcomes globally and in Canada could be significantly affected by how events in the Middle East actually unfold.

In the Bank's base case, the Canadian economy is expected to grow near potential in 2003. As a result, activity levels in Canada are expected to remain close to capacity. Core and total inflation are projected to decline through the year as the effects of the one-off factors diminish, but they will likely still be above 2 per cent at the end of 2003, higher than expected at the time of the October *Report*.

Chart 1

90-Day Commercial Paper Rate, Target for the Overnight Rate, and Target for the Federal Funds Rate

Daily



Overall, with the stance of monetary policy currently very stimulative, a reduction of stimulus will be required in order to return inflation to the 2 per cent target over the medium term. A number of elements, however, will come into play in determining the pace of increase in policy interest rates.

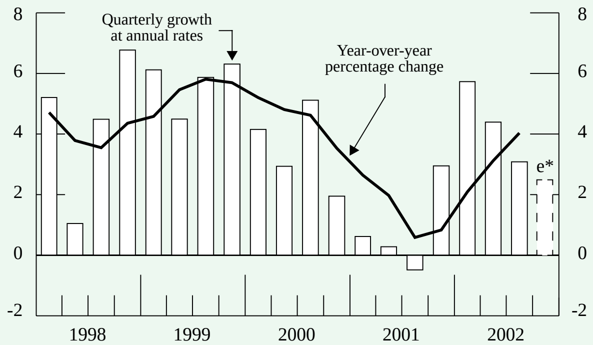
First, although much of the recent increase in inflation has been the result of one-off factors, the possibility that demand pressures are becoming more prominent cannot be ruled out. Second, the Bank must guard against the risk that inflation persistently above the 2 per cent target might lead to an increase in the expected trend of inflation. Third, although we have seen an improvement in financial conditions, business and investor confidence remain fragile because of uncertainty concerning the geopolitical situation. Fourth, the way in which developments in the Middle East unfold could affect demand and inflation, both globally and in Canada, through various channels. (See Annex.)

Recent Economic and Financial Developments

In the second half of 2002, Canada's economic growth eased from the very strong pace registered earlier in the year. Real GDP (Chart 2), after rising at an annual rate of 5.1 per cent in the first half of 2002, is estimated to have advanced at a rate close to 3 per cent in the second half.

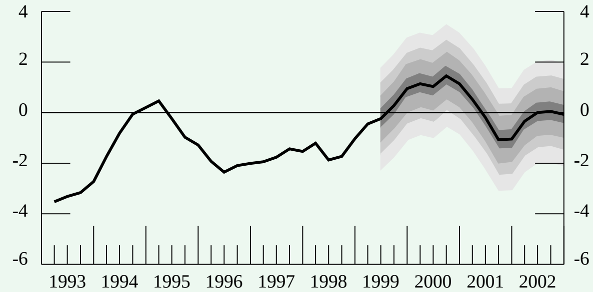
With the significant monetary stimulus provided by low interest rates, household spending rose strongly in 2002. Expenditures by businesses on machinery and equipment also recovered significantly. Increased uncertainty about the

Chart 2
Real Gross Domestic Product for Canada



* The letter "e" denotes estimate based on available indicators.

Chart 3
Estimated Output Gap*
Difference between actual output and estimated potential output



* The shading around the values of the estimated output gap shows (from darkest to lightest) confidence intervals of 25 per cent, 50 per cent, 75 per cent, and 95 per cent.

Note: The estimate for the fourth quarter of 2002 is based on a projected rise in output of 2.5 per cent (at annual rates) for the quarter.

economic outlook, however, held back the pace of non-residential construction and inventory accumulation in the second half of the year. Although growth in Canada's exports was robust through most of 2002, it appears to have eased towards year-end because of the slowdown in the rate of economic expansion in the United States.

Conditions in financial markets have improved since the last *Report*. Equity prices in both Canada and the United States have recovered from their October lows, and volatility in equity and bond markets has declined. Spreads between yields on corporate and government bonds have narrowed but are still at high levels, particularly for riskier borrowers. For their part, banks have remained cautious in their lending to large corporate borrowers. Nonetheless, higher-quality borrowers have access to financing through debt capital markets at interest rates that are now near 10-year lows.

Estimates of the Bank's conventional measures of potential output and the output gap indicate that levels of activity have been close to full production capacity since mid-2002 (Chart 3). A number of other indicators are consistent with this assessment, including the rate of capacity utilization in the non-farm goods-producing sector, the cyclical position of profit margins, and the proportion of firms reporting shortages of skilled labour in the survey conducted by the Bank's regional offices.

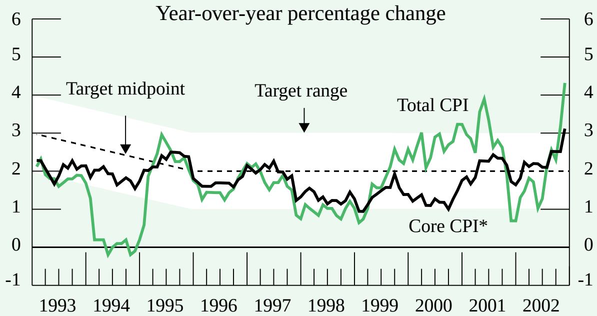
However, other labour market indicators suggest somewhat greater slack than the conventional measure of the output gap. In particular, the substantial increases in employment since the beginning of 2002 seem to have been met largely through an increased supply of labour, as evidenced by a marked increase in the participation rate and the absence of pressure on wages.

The higher-than-expected rate of core inflation also raises the possibility that there is less slack in the economy than the Bank estimated at the time of the October *Report*.

Core inflation was 3.1 per cent in November, higher than the level anticipated at the time of the October *Report* (Chart 4). Other measures of trend inflation that the Bank follows closely also rose to about the same rate (Chart 5).

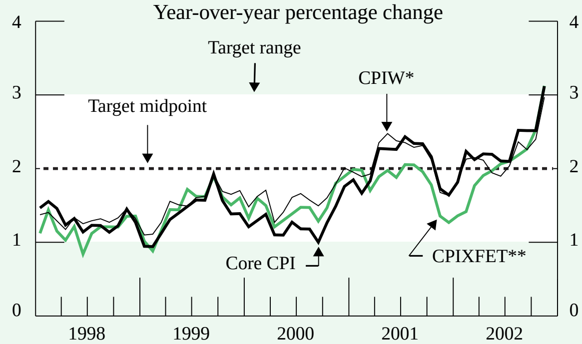
Several one-off factors helped push core inflation up in the fourth quarter of

Chart 4
Consumer Price Index
Year-over-year percentage change



* CPI excluding the eight most volatile components and the effect of changes in indirect taxes on the remaining components

Chart 5
Core CPI and Other Measures of the Trend Inflation Rate
Year-over-year percentage change



* CPIW adjusts each CPI basket weight by a factor that is inversely proportional to the component's variability.
** CPIXFET excludes food, energy, and the effect of changes in indirect taxes.

2002. Substantial increases in the premiums for both auto and home insurance contributed 1.0 percentage point to core inflation in November. Year-to-year increases in electricity prices in Ontario, while easing somewhat since August, remained high.[1] Also contributing was the echo effect of the temporary price discounting in the fourth quarter of 2001.

At the same time, a combination of cost increases and strong demand is exerting upward pressure on prices in some sectors, such as shelter, food, and some services. More broadly, the fact that the various one-off relative price increases are having a large impact on measures of trend inflation reflects an underlying firmness in the price-setting environment.

The 12-month rate of increase in the total CPI was 4.3 per cent in November, up from 2.6 per cent in August. This marked increase relative to the core rate chiefly reflected substantial increases in the consumer prices of gasoline, fuel oil, and natural gas.

Economic Prospects

Prospects for economic growth in 2003 for the United States, the major overseas economies, and the emerging markets have moderated somewhat since the October *Report*. However, we continue to expect global economic growth to pick up appreciably in the second half of the year and into 2004.

U.S. economic growth, after slowing in the fourth quarter of last year by more than projected, should regain its momentum in 2003, supported by ongoing stimulative policies. In particular, if financial conditions continue to improve, the U.S. economy is expected to outpace growth in capacity in the second half of the year, aided by a strengthening in capital spending. On an average annual basis, U.S. real GDP should increase by almost 3 per cent in 2003.

In Europe, the lower projection for growth in real GDP in 2003 reflects sluggish domestic demand and slow recovery in the export sector. In Japan, a gradual recovery should continue this year, but at a slower pace than expected at the time of the last *Report*, given weaker external

1. Electricity prices in Ontario are expected to have fallen sharply in December as a result of a temporary rebate. This should result in a dip in core inflation followed by a reversal in January.

demand. In the rest of Asia, economic growth is expected to remain relatively strong.

For Canada, the Bank's base case projects that economic growth in 2003 will average close to the growth in potential output, which is estimated at 3 per cent. This projection is a little lower than the most recent average private sector consensus forecast for 2003; it is also slightly below that indicated in the October *Report*, largely as a result of the slower growth prospects for the U.S. and overseas economies. Nonetheless, we anticipate increased demand pressures in the second half of 2003 and into 2004, following growth at slightly below potential in the first half of this year.

The Bank expects that the level of risk premiums in financial markets will continue to decline as corporate profitability and investor confidence solidify. This should improve the environment for business investment.

The Outlook for Inflation

While the core rate of inflation will likely remain well above the 2 per cent midpoint of the target range in the near term because of the one-off factors described above, the combined effect of these factors is likely to have largely run its course by early 2004.

The echo effect on the core rate arising from the unusual price discounting in the fourth quarter of 2001 should disappear by the end of the first quarter of 2003. The recently announced return to regulated pricing of electricity in Ontario implies that the upward pressure on core inflation from electricity prices should continue to ease in coming months. The upward movement in insurance premiums, however, is now expected to be more persistent than had been anticipated earlier. And the effects of the drought in western Canada and elsewhere are putting pressure on the prices of some food components of the core CPI.

With a reduction in the amount of monetary stimulus, the level of output is projected to remain close to capacity during 2003 and into 2004. As a result, we do not expect persistent pressure on inflation from the demand-supply balance. Overall, core inflation is projected to move down to 2 per cent in early 2004.

The outlook for the 12-month rate of increase in the total CPI will continue to be importantly affected by developments in crude oil prices. If oil prices were to stay near their current high levels of just over US$30 per barrel, total CPI inflation could move up to between 4.0 and 4.5 per cent in the first quarter of 2003. In the second half of the year, if oil prices ease back, consistent with current market expectations, total CPI inflation would move down, back in line with core inflation.

With the persistence of high rates of inflation, there is a risk of an increase in inflation expectations. If this were to occur, inflation pressures would be stronger and the need for policy action by the Bank would be correspondingly greater.

Annex

The Effect of Hostilities in the Middle East

The possible outbreak of a major military conflict in the Middle East constitutes a particularly important source of uncertainty at this time. The effects of such a conflict on the Canadian and global economies are difficult to determine with any precision, since they depend on a variety of factors, including the timing, length, and severity of any action. A short, decisive conflict, or an early non-military resolution of the dispute, could reduce geopolitical uncertainties fairly rapidly. On the other hand, a prolonged major military conflict could intensify uncertainty regarding the world economic outlook and adversely affect consumer and business confidence. In this last case, petroleum supplies could be seriously disrupted, resulting in higher oil prices, which would restrain world economic activity. Such a price rise would also raise the value of Canadian oil exports and feed into higher total CPI inflation. Finally, higher military spending could provide significant stimulus to U.S. aggregate demand.

Copies of the *Monetary Policy Report* and the *Update* can be obtained by contacting the Bank at:

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