MONETARY POLICY REPORT

UPDATE

– February 2001 –

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 23 January 2001 and updates the Monetary Policy Report *of November 2000.*

On 23 January, the Bank reduced the Bank Rate by one-quarter of one percentage point to 5 3/4 per cent.* This action was taken in light of the implications of developments described below for the future trend of inflation in Canada.

* * *

In its November *Monetary Policy Report*, the Bank's projection was for continued solid global economic expansion but with a noticeable slowing in 2001, particularly in the United States.

Since then, there has been accumulating evidence that global economic growth has begun to slow somewhat more and sooner than anticipated. As a result, projections for growth in Europe and Japan have been revised downwards slightly for 2001. For the United States, we now project growth at a rate of 2.0 to 2.5 per cent, one full percentage point below the range expected in the November *Report*. This downward revision to the growth projection for 2001 primarily reflects a weaker first half, followed by a relatively strong rebound in the second half of the year.

Highlights

- The momentum of the Canadian economy remained solid through the fourth quarter of 2000, bolstered by strong growth in domestic demand.
- The outlook for the U.S. economy has weakened more abruptly than anticipated.
- On 23 January, the Bank lowered the Bank Rate by one-quarter of one percentage point to 5 3/4 per cent.
- The Bank's projection for Canada's real GDP growth in 2001 has been revised down to about 3 per cent—the bottom end of the 3 to 4 per cent range projected last November.
- Core inflation, at 1.9 per cent in December, has been marginally higher than anticipated, and is expected to steady out at about 2 per cent through 2001.
- With recent declines in world oil prices, total CPI inflation is expected to converge with the core rate in the second half of this year.

* The Bank has eight pre-specified dates each year for announcing changes to the Bank Rate. For the schedule of dates for the remainder of 2001, see Technical Box 4, November 2000 *Monetary Policy Report*, or visit our Web site.

Despite a slowing world economy and a deceleration in export growth, the pace of economic expansion in Canada remained solid in the second half of 2000, bolstered by strong domestic demand. Indeed, growth in this period slightly exceeded the Bank's expectations. Employment also grew rapidly, indicating significant momentum in the economy. In spite of this starting position going into 2001, the Bank's projection for this year has been revised down to about 3 per cent—the bottom end of the 3 to 4 per cent range projected last November—because of spillover effects from a weaker U.S. economy late in 2000 and in the first half of this year.

At 1.9 per cent, core inflation in December was marginally higher than anticipated. Although some month-to-month volatility may result in core inflation rising temporarily above 2 per cent early this year, the Bank's baseline projection is for core inflation to steady out at about 2 per cent through this year. With crude oil prices having declined to around $30 per barrel, it now seems likely that total CPI inflation, currently just above 3 per cent, will come down to around 2 per cent in the second half of 2001.

These developments over the past three months have altered the risks and uncertainties for Canada's economic outlook. The slowdown now evident in the U.S. economy raises the issue of how marked that slowdown will be and how quickly the economy will rebound. For Canada, an important question is the extent to which the current strength in domestic demand will continue to offset weaker U.S. demand for our exports. The recent decline in world oil prices has also somewhat reduced the risk that inflation expectations could heighten in response to rising headline rates of inflation. At the same time, there continues to be some uncertainty regarding the future growth of the economy's productive capacity. Recent productivity growth suggests that the economy's production capacity could be rising at a higher rate than the 3 per cent assumed by the Bank. Nevertheless, current indicators point to an economy operating at close to full capacity.

The International Environment

Emerging-market economies

Growth in the emerging-market economies has been somewhat faster than expected. Nevertheless, the near-term outlook is still subject to a number of risks. Market sentiment towards emerging markets in Asia has deteriorated over the past few months. This deterioration stems largely from concerns about a possible downturn in global demand for electronic products, the impact of high world oil prices, political instability, and, in some cases, the slow pace of restructuring in corporate and financial sectors. In addition, both Turkey and Argentina—two large international borrowers—have had to negotiate new IMF programs.

Some of these pressures on emerging-market countries will, however, be alleviated by lower interest rates in the United States and, for countries whose currencies are pegged to the U.S. dollar, by its recent depreciation.

Euro area and Japan

In the euro area, the pace of expansion slowed in the second half of 2000, partly owing to past increases in official rates by the European Central Bank. In addition, surveys suggest a recent decline in both business and household confidence. Indeed, household spending weakened significantly in the third quarter. As a result, growth in the euro area in 2001 is now expected to be slightly below the 3 per cent projected in the November *Report*.

The Japanese economy remains fragile. Real GDP rose only marginally in the second and third quarters of 2000, despite strong business investment. Household spending has remained flat, reflecting weak income growth and concerns about employment prospects. Moreover, the lagged effect of the appreciation of the yen has contributed to a marked slowing in export growth. The Japanese economy is expected to grow at about 1.0 per cent in 2001—lower than the 1.5 per cent projected in the November *Report*.

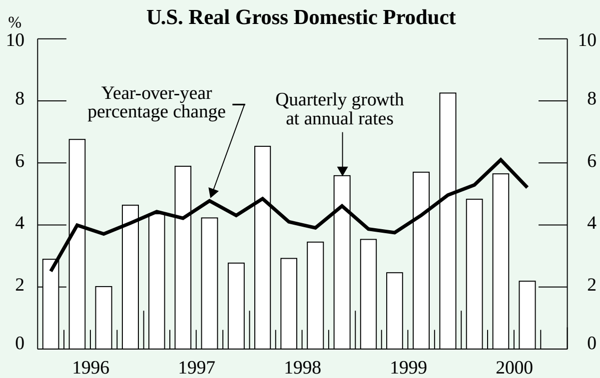
The pace of expansion in the euro area and Japan is slowing somewhat more than expected.

United States

Recent developments indicate that the slowdown of the U.S. economy has been more abrupt and more pronounced than anticipated. Because that economy has been operating in excess demand, some slowdown is warranted to reduce inflationary pressures.

U.S. real GDP rose by only 2.2 per cent in the third quarter of 2000, down sharply from previous quarters (Chart 1). Employment growth has also slowed significantly in recent months, and average hours worked have fallen markedly.

Chart 1
U.S. Real Gross Domestic Product



Consumer spending (particularly for motor vehicles) and residential construction have eased in response to past increases in interest rates, declines in personal wealth associated with weakening stock prices, and higher energy prices.

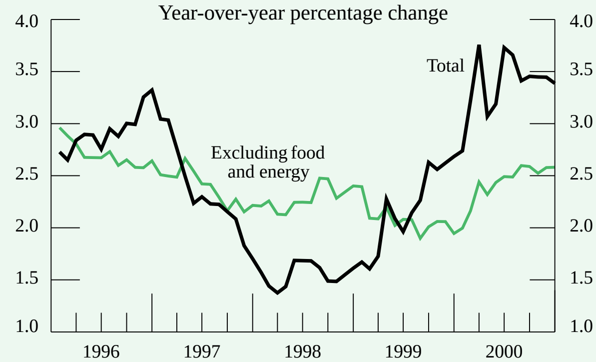
At the same time, tighter credit conditions and lending standards have combined with reduced profit margins to restrain business investment.

The Bank now expects U.S. real GDP to expand by 2.0 to 2.5 per cent, on average, in 2001. Growth is expected to be particularly weak in the first half of the year, before rebounding relatively strongly in the third and fourth quarters.

Despite the slowdown in the U.S. economy to a rate below that of potential growth, core inflation has not yet shown signs of easing (Chart 2). The U.S. economy continues to operate at a high level, as evidenced by the low unemployment rate.

Nonetheless, at its December meeting, in light of the slowing in the pace of activity, the Federal Open Market Committee shifted its forward-looking focus from heightened inflation pressures to economic weakness. And in early January, the Committee made an intermeeting decision to lower its target federal funds rate by 50 basis points.

Chart 2
U.S. Consumer Price Index
Year-over-year percentage change



As of 23 January, financial markets were expecting that the U.S. Federal Reserve would reduce its federal funds target by an additional 50 basis points at its end-January meeting and a further 50 basis points by mid-year.

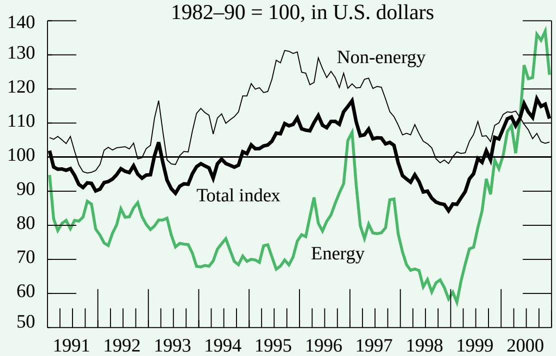
The expected slowdown of the U.S. economy has been more abrupt than anticipated.

Commodity prices

Prices for crude oil and natural gas have been volatile since the end of October, driven by low inventories of petroleum products such as heating oil, by cold winter weather, and by short-term concerns over tensions in the Middle East. On balance, however, oil prices have eased over the period, as the effects of increases in world supply have become more apparent. Natural gas prices, while currently very high because of tight supplies and winter weather conditions, are also expected to ease somewhat this year.

Although cattle and grains prices have recovered, the U.S.-dollar price of non-energy commodities has been below the Bank's previous expectations (Chart 3).

Chart 3
Bank of Canada Commodity Price Index
1982–90 = 100, in U.S. dollars

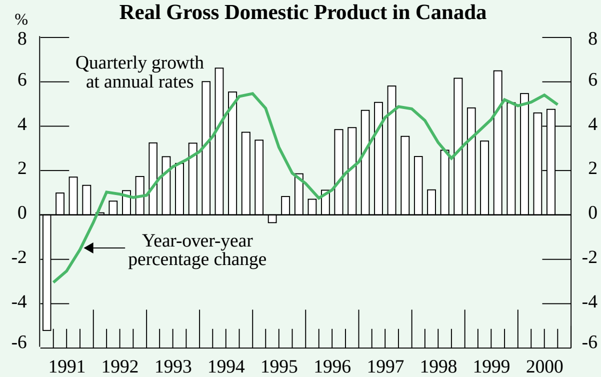


Canadian Economic Developments

Aggregate demand, output, and estimated pressures on capacity

Real GDP rose at an annual rate of 4.8 per cent in the third quarter of 2000, above the upper end of the range projected in the November *Report* (Chart 4).[1] Once again, business investment in machinery and equipment increased considerably, reflecting further gains in profits. Household spending also grew quite strongly. Export volumes edged down, however, mainly owing to a marked slowing in the growth of U.S. aggregate demand and to supply problems in the energy and automotive sectors. This abrupt weakening in the growth of external demand for Canadian goods contributed to a substantial rise in inventories in the manufacturing sector.

Chart 4
Real Gross Domestic Product in Canada



For the last quarter of 2000, current information suggests that economic growth was in a range of 3 to 3.5 per cent. A modest recovery in exports seems to have occurred, as the above-mentioned supply problems were resolved. Residential construction appears to have risen considerably, while overall consumer expenditures were supported by a further rise in employment. Spending on motor vehicles fell back, however, as dealer incentives became less attractive. Early information also suggests that the pace of business investment eased substantially.

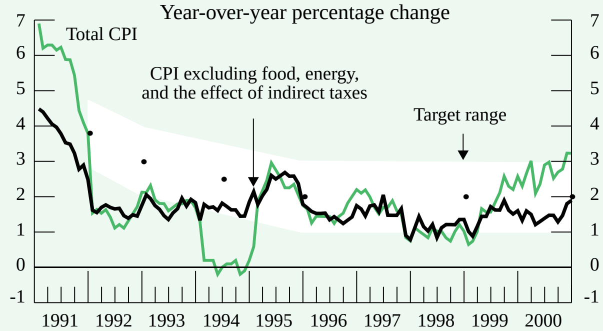
The Canadian economy, after a very strong performance in 2000, is expected to grow by about 3 per cent this year.

With higher-than-expected growth in the third quarter and small upward revisions to real GDP in the first half of the year, economic activity in 2000 is expected to have grown by 5 per cent on an annual average basis. For

1. In the November *Report*, real growth in the third quarter was expected to be between 3.5 and 4.5 per cent.

2001, the Bank is now projecting economic growth of about 3 per cent—the bottom of the 3 to 4 per cent range projected last November and about equal to the Bank's projected rate of potential growth for the economy. This downward revision reflects the implications for Canada of a weaker U.S. economy, especially in the first half of the year.

Chart 5
Consumer Price Index
Year-over-year percentage change



• Midpoint of the inflation-control target range

The Canadian economy is operating at about full capacity.

The strength of Canada's economic growth in the third quarter of 2000 and the monitored good performance in the fourth quarter suggest that the Canadian economy is operating at about full capacity, as projected in the November *Report*.

Statistics Canada's measured rate of capacity utilization for the non-farm, goods-producing sector in the third quarter was at about the same level as in the late 1980s. There are continuing reports of skilled labour shortages in areas such as the high-technology and construction sectors. As well, vacancy rates in the residential and commercial real estate sectors are very low.

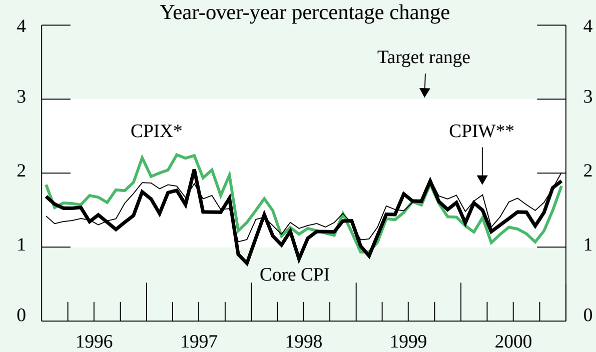
Still, several indicators of pressures on capacity suggest that a small amount of slack remained in the second half of 2000. For example, the level of inventories relative to sales has risen over the past year, and labour market participation rates have also continued to increase.

Overall, the full range of current indicators suggests that the economy is operating close to capacity.

Prices and costs

The 12-month rate of increase in the core CPI was 1.9 per cent in December, up from 1.3 per cent in September and marginally above the expectations of the November *Report* (Chart 5). The higher-than-anticipated level of core inflation partly reflected efforts by motor vehicle manufacturers and dealers to reduce price discounting. The rise in core inflation in the fourth quarter may also be another indicator that the amount of slack in product markets has largely been absorbed. Other statistical measures of the trend rate of inflation were close to the core rate (Chart 6).

Chart 6
Core CPI and Statistical Measures of the Trend Inflation Rate
Year-over-year percentage change



* CPIX excludes the eight most volatile components from the CPI as well as the effect of indirect taxes on the remaining components.
** CPIW adjusts each CPI basket weight by a factor that is inversely proportional to the component's variability.

The 12-month rate of increase in the total CPI in December was 3.2 per cent. This continued to be well above core inflation and reflected the substantial increase in energy prices at the consumer level over the past year. While the first-round effects of higher energy costs on the core CPI have been minimal, recent announcements of fare increases in the transportation sector will likely affect consumer prices in 2001.

Based on the indicators in Chart 7, as well as on labour compensation per person-hour in the business sector (Chart 8), the underlying rate of increase in the average wage appears to have edged up to just over 3 per cent.

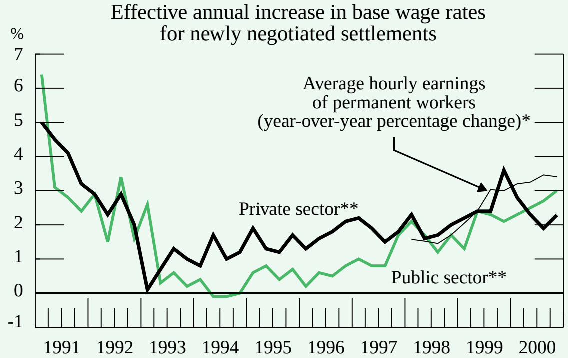
The year-over-year increase in output per person-hour in the business sector in the third quarter of 2000 was 2.1 per cent. As a result, the year-over-year rise in unit labour costs in the business sector was held to 1.0 per cent.

Core inflation is now expected to steady out at close to 2 per cent through 2001, although month-to-month volatility may cause it to exceed that rate temporarily in the near term. This outlook reflects longer-term inflation expectations remaining near 2 per cent and the economy staying broadly in balance between aggregate demand and supply.

Chart 7

Wage Settlements and Average Hourly Earnings

Effective annual increase in base wage rates for newly negotiated settlements

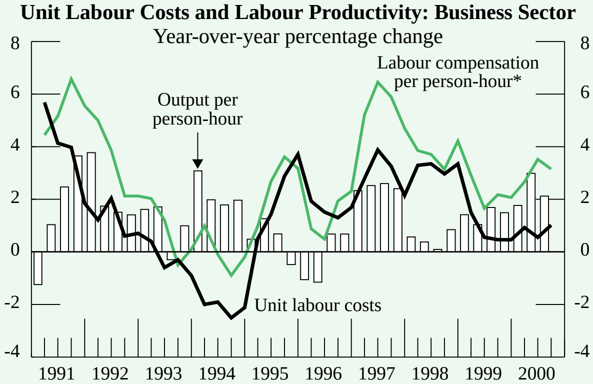


* Source: *Labour Force Information*
** Source: Human Resources Development Canada, last data point = October/November 2000

Chart 8

Unit Labour Costs and Labour Productivity: Business Sector

Year-over-year percentage change



* Labour compensation includes the labour income of paid workers, plus imputed labour income for self-employed workers.
Source: Statistics Canada *Daily*

Core inflation is expected to steady out at close to 2 per cent in 2001.

If crude oil prices remain at or below US$30 a barrel, the year-to-year increase in the total CPI is expected to decline to about 2 per cent in the second half of 2001.[2]

Developments in the monetary aggregates

Growth in gross M1 slowed further in the fourth quarter. The three-month growth rate of gross M1 fell to 7 per cent in December, well below the rates recorded earlier in the year. Nevertheless, at 15 per cent, year-over-year growth in gross M1 remains strong. The year-over-year rates of increase in M1+ and M1++ have held steady over the last three months, at about 12 and 10 per cent, respectively. Special factors are keeping the rate of expansion of the narrow aggregates stronger than the underlying growth in transactions balances. It is estimated that deposits of financial institutions with banks and deposits of businesses and individuals at investment dealers continue to account for about 3 percentage points of the year-over-year growth in gross M1.

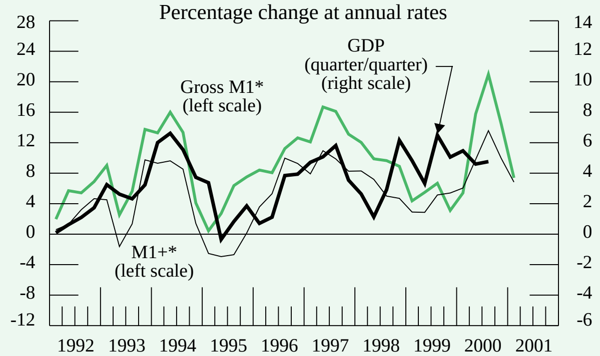
If the various data distortions are taken into account, the recent expansion in narrow money suggests that real GDP will grow at about 4 per cent in 2001—stronger than the Bank's projection for GDP growth (Chart 9). The growth in the narrow money aggregates suggests that core inflation may move above the midpoint of the target range in 2001.

2. This projection is consistent with an average annual rate of increase in the total CPI in 2001 that is very close to the average private sector forecast of 2.4 per cent (from the January 2001 issue of *Consensus Forecasts*).

Chart 9

Real GDP Growth and Growth of Real Gross M1 and M1+

Percentage change at annual rates

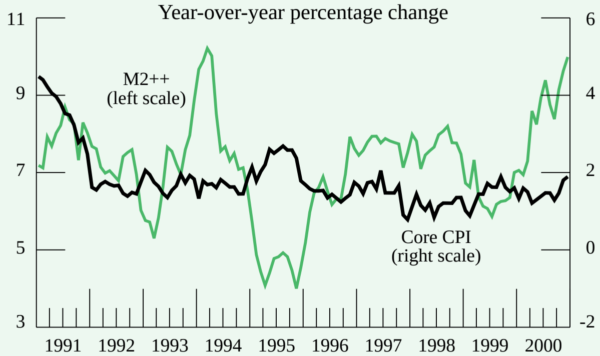


* Two-quarter moving average of growth in gross M1, M1+ (deflated by the core CPI), one quarter earlier

Chart 10

Core Inflation and Broad Money Growth

Year-over-year percentage change



Year-over-year growth in the broad aggregate M2++ rose to 10 per cent in December (Chart 10). The strength of M2++ suggests a profile for core inflation slightly above that implied by the narrow aggregates.

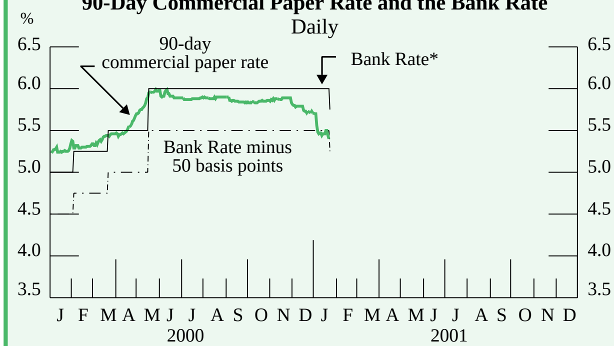
Monetary conditions and monetary policy operations

The Bank held the Bank Rate (Chart 11) constant at 6.0 per cent on 5 December, its first fixed announcement date, and lowered it to 5 3/4 per cent on its 23 January announcement date. Both decisions were largely anticipated by financial markets. Markets expect further declines in short-term interest rates between now and mid-year.

Chart 11

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.

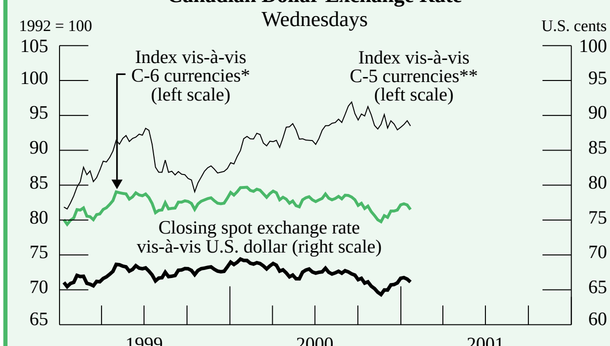
Over the past three months, the monetary conditions index has fluctuated between -6.7 and -5.5, reflecting the combination of declines in short-term interest rates and some firming of the Canadian dollar (Chart 12). The appreciation of the Canadian dollar in part reflects an adjustment of the U.S. dollar against many major currencies in response to the slowdown of the U.S. economy relative to other economies and the declines in U.S. interest rates.

The term structure of interest rates on government debt (Chart 13) has drifted lower in both Canada and the United States as market participants have become increasingly convinced that economic growth

Chart 12

Canadian Dollar Exchange Rate

Wednesdays



* C-6 currencies: U.S. dollar, euro, yen, U.K. pound, Swedish krona, and Swiss franc

** C-5: excludes U.S. dollar

Chart 13

Term Structure of Interest Rates in Canada

Yields on treasury bills, government bonds, commercial paper, and corporate bonds

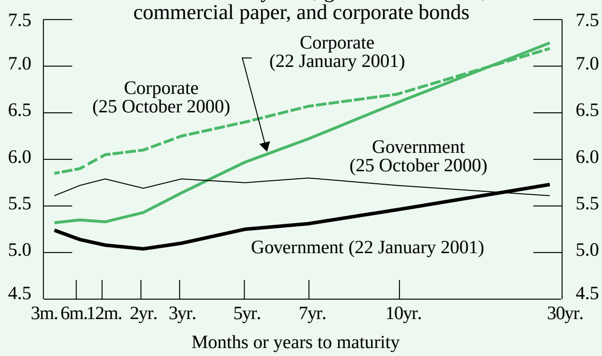
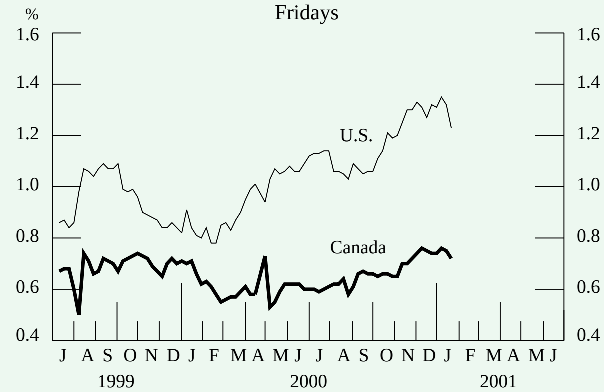


Chart 14

Credit Spread: 5-Year A-Rated Corporate–Government Bonds

Fridays



Note: The levels of U.S. and Canadian corporate spreads are not directly comparable, mainly because of coverage differences.

in the United States is slowing to a rate below potential. Yield spreads between Canadian and U.S. government securities turned modestly positive for maturities of 2 to 30 years late in 2000 and have remained so since then.

Credit conditions faced by Canadian borrowers have been tightening somewhat as lenders have become more risk-averse at this point in the economic cycle.

In the United States, credit conditions have generally tightened more than in Canada, likely reflecting market sentiment about the extent of the U.S. economic slowdown. Those conditions, reflected in credit spreads, have eased somewhat following the recent move by the Federal Reserve to lower interest rates (Chart 14).

Since the peaks established last summer, most of the world's major stock market indexes have declined. Movements in technology stocks have been particularly volatile. More recently, while most stock markets have risen, they remain well below their earlier peaks and volatility persists. Stock prices may now embody more realistic expectations of future profit growth, particularly in the technology sector. At the same time, the volatility in stock prices may reflect market participants' uncertainty about the future prospects for global economic expansion.

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 may be obtained from:

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