MONETARY POLICY REPORT

UPDATE

– July 2002 –

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 16 July 2002 and updates the April 2002 Monetary Policy Report.

At the time of the April *Monetary Policy Report*, it was evident that a robust economic recovery was underway in Canada. The Bank therefore began to reduce the substantial amount of monetary stimulus in the economy.

In the past three months, the Canadian economy has continued to register strong growth. Spending on housing and consumer durables has been much stronger than expected. Business fixed investment no longer appears to be acting as a drag on growth, with signs of recovery in investment in machinery and equipment emerging. Among Canada's major trading partners, economic growth has been broadly in line with expectations.

Overall, in the first half of the year, the Canadian economy grew at a faster pace than anticipated. As a result, it has moved towards full production capacity more quickly than was expected in April. In addition, core inflation has been running slightly higher than projected.

In light of these developments, the Bank has continued to reduce the amount of monetary stimulus in the economy by raising its target for the overnight interest rate by 25 basis points on 4 June and again on 16 July. As we look forward, given the limited amount of excess capacity in the economy and the lags involved for the effects of interest rate changes to work through the economy, the Bank must remain focused on taking the necessary actions to achieve the 2 per cent target for inflation control.

Highlights

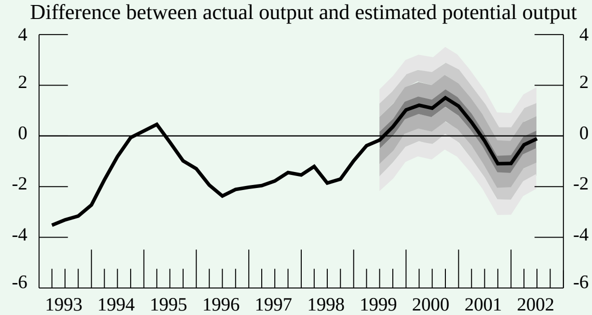
- **The Canadian economy has continued to register strong growth and, as a result, has moved towards full production capacity more quickly than expected.**
- **The Bank has continued to reduce the substantial amount of monetary stimulus in the economy, raising its target for the overnight interest rate to 2.75 per cent.**
- **Economic growth in Canada is projected to be in the range of 3 to 4 per cent over the period to the end of 2003.**
- **There are both upside and downside risks to the outlook for the Canadian economy.**
- **The Bank remains focused on taking the necessary actions to achieve the 2 per cent target for inflation control.**

With monetary policy still very accommodative, economic growth in Canada could well turn out to be stronger than the Bank's revised projection presented in this *Update*. At the same time, there are downside risks and uncertainties regarding the outlook. Most recently, global corporate and financial market developments have been adversely affecting investor confidence, resulting in rising risk premiums and falling equity prices. The near-term strength of final sales growth in the U.S. economy thus remains uncertain. Conditions in Latin America have deteriorated somewhat, and the geopolitical situation remains unsettled.

Chart 2

Conventional Estimate of 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 second quarter of 2002 is based on a projected rise in output of 4.5 per cent (at annual rates) for the quarter.

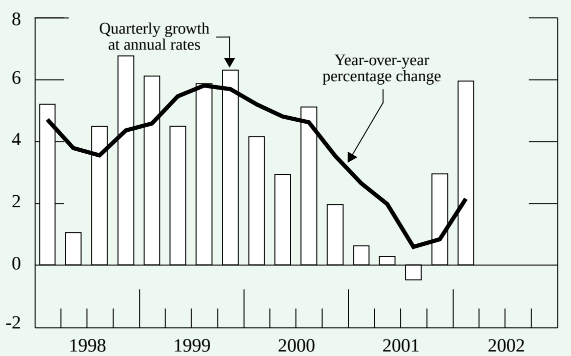
Recent Developments

Canada's economic recovery, which began in the last quarter of 2001, gathered momentum in the first half of this year. Real GDP (Chart 1) surged by 6 per cent at an annual rate in the first quarter of 2002 and is likely to have risen by about 4.5 per cent in the second quarter.

The significant easing of monetary policy during 2001 was a key factor behind the strong growth of household demand in the first half of this year. Canada's exports also rose considerably, as the U.S. economy began to recover. At the same time, the levels of both inventories and capital spending were stronger than anticipated. Together, these developments suggest a broadening of the recovery across sectors.

Chart 1

Gross Domestic Product for Canada in Constant Dollars

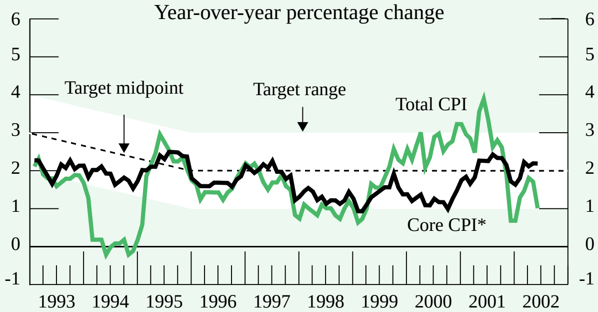


The economy is now operating with less excess supply than was projected in the last *Report*. Current estimates of the Bank's *conventional measure* of potential output and the output gap indicate that economic slack largely disappeared in the first half of 2002 (Chart 2). Other indicators, however, point to less pressure on capacity. For example, recent marked increases in employment have been accompanied by higher labour supply, given the greater-than-expected rise in the labour force participation rate. As well, information gathered by the Bank's regional offices does not suggest widespread capacity pressures. On balance, it is the Bank's judgment that the economy was operating at mid-year with somewhat more slack than the *conventional measure* of the output gap would suggest.

Core inflation was 2.2 per cent in May, slightly above the level projected in the April *Report* (Chart 3). Strong demand for housing and furnishings is putting upward pressure on the prices of both shelter and household durables. A large upward adjustment in the premiums for auto and home insurance has also kept the core rate up in recent months.

The 12-month rate of increase in the total CPI was 1.0 per cent in May, down from 1.5 per cent in February. This reduction relative to the core rate chiefly reflected a substantial decrease in the consumer price for natural gas, itself a lagged response to

Chart 3
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

last year's sharp decline in prices at the producer level.

Since early in the year, financial markets have reflected a divergent outlook for the Canadian and U.S. economies and for the expected policy responses. Canadian money market instruments have tended to price in expectations of policy rate increases in Canada, whereas in U.S. markets, participants have pushed out their timeline for the first tightening by the Federal Reserve. This has been reflected in the Canada-U.S. spread on 2-year instruments, which has widened significantly.

Since the April *Report*, the Canadian dollar has appreciated against the U.S. dollar. While reflecting strong Canadian economic data and wider interest rate spreads, this movement has also been part of a general weakening trend of the U.S. dollar against all major currencies. Concerns about U.S. corporate profitability and accounting practices, together with the large U.S. current account deficit, have contributed to weakness in the U.S. dollar. Against major currencies other than the U.S. dollar, the Canadian dollar has weakened.

Economic Prospects

Following a robust first quarter, U.S. economic activity is estimated to have slowed to around 2 1/2 per cent in the second quarter of this year, owing to slower growth in household spending and less support from inventory investment.

In the second half of the year, supported by ongoing stimulative policies, U.S. economic growth should pick up. In particular, capital spending is projected to start to strengthen, and demand by households should be sustained. On an average annual basis, U.S. real GDP is expected to grow by about 2 3/4 per cent this year. In 2003, economic growth is projected to average about 3 3/4 per cent. The downside risks to this outlook stem largely from recent corporate and financial market developments and their possible effects on corporate and household sector confidence and balance sheets.

In Japan, the contraction this year in economic activity is expected to be less pronounced than was anticipated in the April *Report*, owing partly to the somewhat faster recovery of exports. In Europe, real GDP growth is now projected to be slightly below earlier expectations because of persistent weakness in domestic demand.

Growth prospects for a number of emerging-market economies are expected to continue to improve, particularly in Southeast Asia. The situation in Latin America has worsened, however, as reflected in the recent sharp widening of interest rate spreads.

Over the next two years, the prices of non-energy commodities are projected to strengthen somewhat as the global economic expansion proceeds. Although energy prices are not expected to change significantly over the remainder of 2002, Middle East tensions continue to make these projections particularly uncertain.

For Canada, the Bank projects continued solid growth in aggregate demand and output. Spending by households should remain strong, although outlays on housing and related items will likely ease back from recent high levels towards the end of the forecast horizon. With the economy operating close to capacity, investment spending on machinery and equipment should contribute positively to growth in aggregrate demand. As well, capital expenditures in the energy sector should increase, given expected prices for oil and gas. And foreign demand for Canadian products is projected to continue to expand.

At the same time, selected sectors, such as telecommunications, continue to experience financial difficulty and, more recently, there have been growing concerns emanating largely from developments abroad about business accounting practices and the interpretation of corporate financial statements. This has led to falling investor confidence and, in turn, to rising risk premiums on corporate bonds and weakness in equity markets in Canada.

As we go forward, it is the Bank's view that the underlying economic situation will require further reductions in the amount of monetary stimulus. The timing and pace of policy adjustments will depend on the strength of the various factors at play and the implication for pressures on capacity and on inflation.

Over the period to the end of 2003, the Bank projects that the rate of economic expansion in Canada will be in the range of 3 to 4 per cent. Given the current accommodative stance of policy, real GDP growth could be in the upper part of this range in the second half of this year. Further out, in the second half of 2003, growth could be in the lower part, as growth of household spending slows from current unsustainably high rates and as imports pick up. Such a profile would result in real GDP growth, on an annual average basis, of close to 3 1/2 per cent in both 2002 and 2003—similar to the latest private sector consensus forecast.

This growth profile would return the Canadian economy to full production capacity in early 2003—sooner than was expected in April.

There are both upside and downside risks to this projection. On the positive side, growth over the period could turn out to be stronger because of the amount of monetary stimulus still in place. On the negative side, there are the uncertainties associated with the recent global corporate and financial market developments and their potential effects on confidence and world economic growth.

The Outlook for Inflation

With the economy projected to be in a position of balance between aggregate demand and supply starting early next year, and given underlying inflation expectations, core inflation is expected to steady out at close to 2 per cent by mid-2003.

Until then, core inflation is expected to remain slightly above 2 per cent and even edge up somewhat in the fourth quarter of this year from its May level. This profile is based on several factors. The effects of the recent large increases in insurance premiums and of the earlier depreciation of the Canadian dollar will persist for some time before diminishing in 2003. Changes in the amount of price discounting are also playing a major role. Intense price discounting in the fourth quarter of last year temporarily lowered core inflation. With the strong recovery, the amount of price discounting has diminished significantly. This reversal is expected to show up as a temporary increase in the 12-month rate of growth of core inflation in the fourth quarter of this year.

Higher energy prices and increases in tobacco taxes are expected to push total CPI inflation up close to the core rate over the next two months. Through the second half of this year, the total and core rates are expected to be broadly in line. For 2003, total CPI inflation, like core inflation, is projected to level out near 2 per cent.

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

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