BANK OF CANADA

Monetary Policy Report

– May 1997 –

The silver dollar on the cover was issued to mark the 100th anniversary of the Stanley Cup. Donated by Governor General Lord Stanley in 1893, the Cup soon became an integral part of hockey's heritage. This design, by Canadian artist Stewart Sherwood, portrays the Stanley Cup as it evolved from the early days of hockey to the present.

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“Canada has made significant progress in restoring the credibility of its macroeconomic policies and making the adjustments necessary to lay the foundation for a more efficient, prosperous economy in the future.... The best contribution the Bank of Canada can make to sustaining these positive trends is to foster a monetary environment of confidence and stability. And that is what we intend to deliver with our commitment to targets for inflation control.”

— Gordon Thiessen

Speech to the Canadian Association for Business Economics and the Ottawa Economics Association, Ottawa, 21 March 1997

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Canada's Inflation-Control Strategy

Inflation control and the economy

- Inflation control is not an end in itself but the means whereby monetary policy contributes to good economic performance.

- Low inflation allows the economy to function more effectively and thereby contributes to better growth potential over time.

- Inflation-control targets ensure that monetary policy will help to moderate cyclical fluctuations in income and employment and assist the Bank in making more accurate judgments about the growth potential of the economy.

The monetary policy instrument

- A wide variety of evidence suggests that, in the longer term, inflation results from excessive monetary expansion. The transmission mechanism is complex and involves long and variable lags. Through its influence on short-term interest rates, the Bank of Canada aims to achieve a rate of monetary expansion consistent with the inflation-control target range.

The targets

- In December 1993, the federal government and the Bank of Canada announced the objective of keeping annual increases in the consumer price index (CPI) inside a range of 1 to 3 per cent.

- By the end of 1998, a decision will be taken on a future inflation-control target range that would be consistent with price stability.

Monitoring inflation

- In the short run, the Bank focusses on the CPI excluding food, energy, and the effect of indirect taxes, because there is a good deal of movement in the CPI caused by transitory fluctuations in the prices of food and energy, as well as by changes in indirect taxes. This measure is referred to as the *core CPI*.

- Over longer periods of time, the measures of inflation based on the total CPI and the core CPI tend to follow similar paths. In the event of persistent differences between the trends of the two measures, the Bank would adjust its desired path for core CPI inflation so that total CPI inflation would come within the target range.

1. Introduction

While easy monetary conditions have led to a pickup in economic activity, inflation remains low.

Since the last *Report*, the Canadian economy has advanced broadly in line with expectations. Inflation has remained low, the domestic economy has begun to respond to the substantial degree of monetary ease in place, and the external economic environment has been favourable.

With rapidly improving fiscal positions of governments and expectations of continued low inflation underpinning the value of the Canadian dollar, short- and medium-term interest rates have remained appreciably lower than those in the United States. In this low-interest-rate environment, private sector activity has begun to pick up significantly and to offset the dampening effects on spending and consumer confidence coming from public sector restraint. Economy-wide, however, the level of aggregate demand remains well below capacity limits.

In this set of circumstances, the Bank of Canada has kept monetary conditions accommodative. With the economy gathering momentum, the challenge for monetary policy will be to encourage monetary conditions that support a durable expansion and preserve Canada's low trend rate of inflation.

This report includes information received to 22 April 1997.

2. Recent Developments in Inflation

CPI inflation picked up somewhat over the past six months, largely in response to temporary influences. However, slack in markets is still exerting downward pressure, and core inflation has remained in the lower half of the Bank's target range for inflation control.

Inflation and the target range

Core inflation has remained in the lower half of the inflation-control target range.

As anticipated at the time of the last *Report*, the 12-month rate of increase in the core CPI has remained in the lower half of the inflation-control target range, although it has moved up somewhat since the autumn of 1996. As of March 1997, core inflation was 1.7 per cent compared with a recent low of 1.2 per cent in September 1996 (Chart 1).

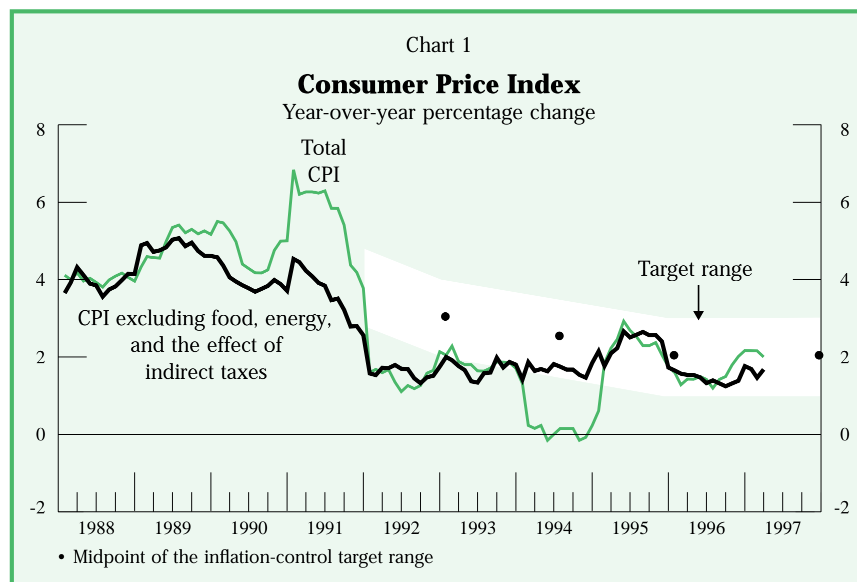
The increase in the core measure appears to have largely stemmed from transitory factors that will not have a lasting effect on inflation. These include a rise in air fares due to higher fuel costs, an increase in auto insurance costs in Ontario following a government-mandated change in the insurance system, and some reconstitution of retail profit margins.

The 12-month rate of increase in the total CPI was 2.0 per cent in March 1997, compared with 1.5 per cent last September. Higher energy prices contributed to this rise, but this effect is expected to be only temporary since prices at the producer level have declined significantly since mid-January.

Chart 1

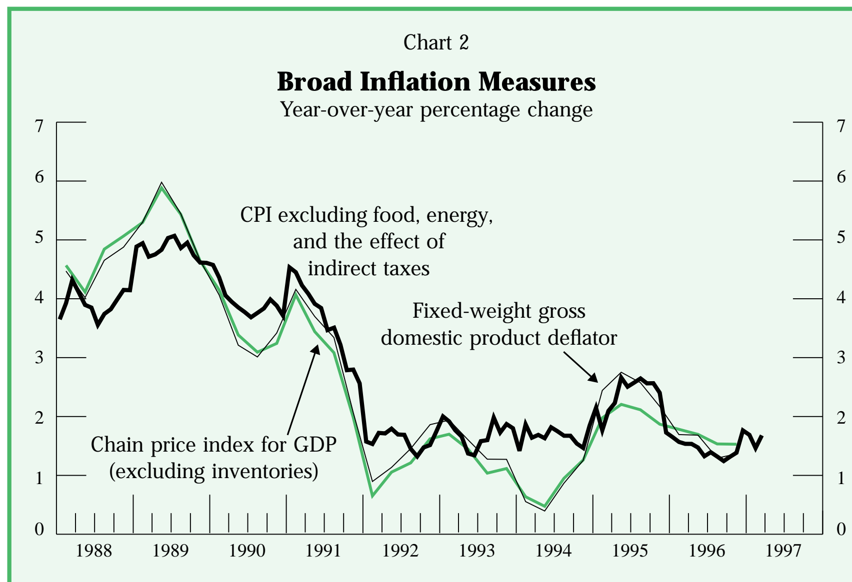
Consumer Price Index

Year-over-year percentage change



In contrast, other broad measures of inflation have fallen since the last *Report*, partly because of a decline in the terms of trade—the price of exports relative to the price of imports. The rate of increase in the fixed-weight gross domestic product (GDP) deflator was 1.4 per cent in the fourth quarter of 1996 on a year-over-year basis, compared with 1.7 per cent in the second quarter (Chart 2). The year-over-year rate of increase in the chain price index for GDP excluding inventories[1]—a measure of price changes that adjusts for shifts in the composition of spending—also edged down to 1.5 per cent over the same period.

Other broad measures of inflation continued to decline in the second half of 1996.



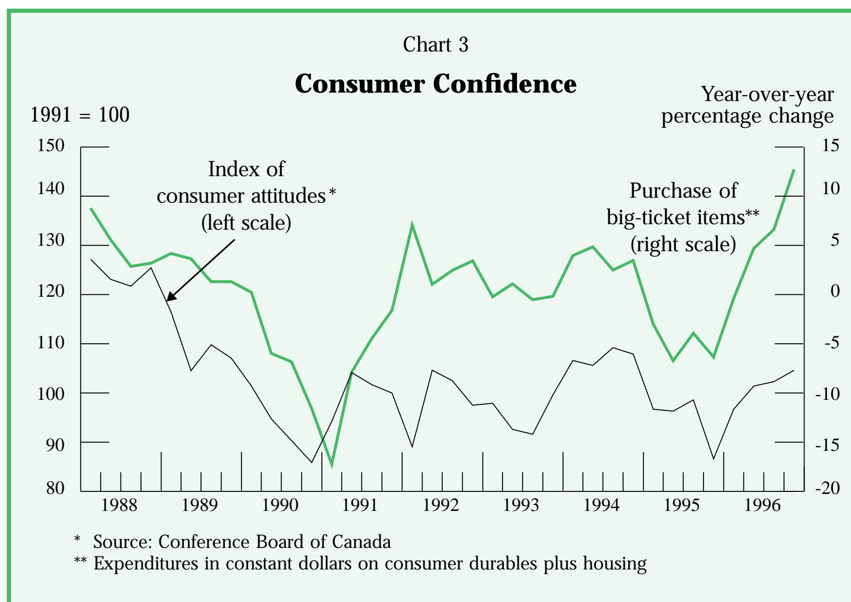
Factors at work on inflation

Aggregate demand and supply

Economic activity picked up significantly in the second half of 1996, broadly in line with expectations. In volume terms, GDP rose at a 3 per cent annual rate over this period compared with just over 1 per cent during the first half of the year. Particularly encouraging were indications of gathering momentum in domestic demand by both households and businesses.

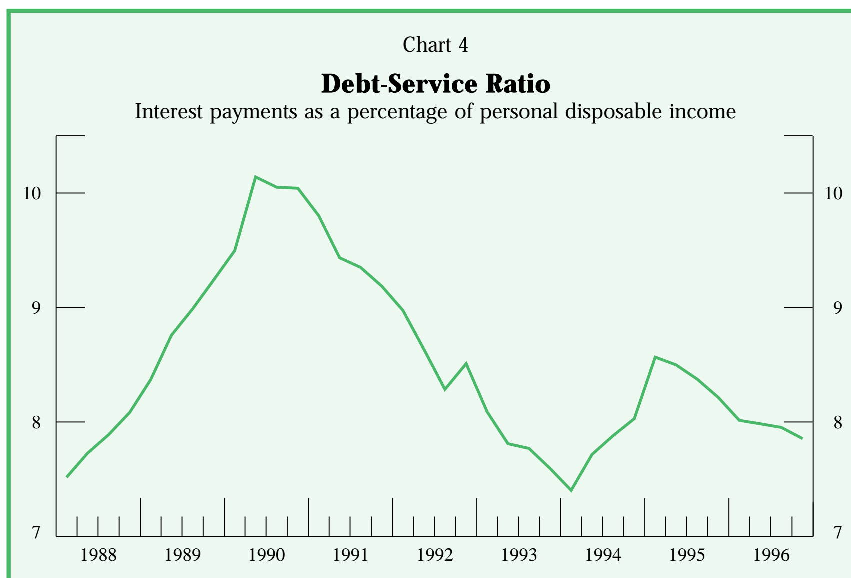
The pickup in economic activity in the second half of 1996 was broadly in line with expectations.

1. The chain price index for GDP (excluding inventories) weights quarterly price changes by the dollar value of expenditure components in the previous quarter.



Spurred by lower interest rates, household demand continued to pick up.

Household spending—especially on housing, motor vehicles, and furniture and appliances—rose strongly over the final six months of 1996. With lower interest rates and an associated improvement in the perception of their near-term financial situations, consumers were more inclined to make major purchases. Thus, consumer confidence improved (Chart 3) despite the sluggish performance of personal disposable income. Lower debt-servicing costs (Chart 4), household balance sheets that are generally in reasonable shape (Technical Box 1), continued job creation in the private sector (Technical Box 2), and pent-up demand for housing and consumer durables have all been positive influences.

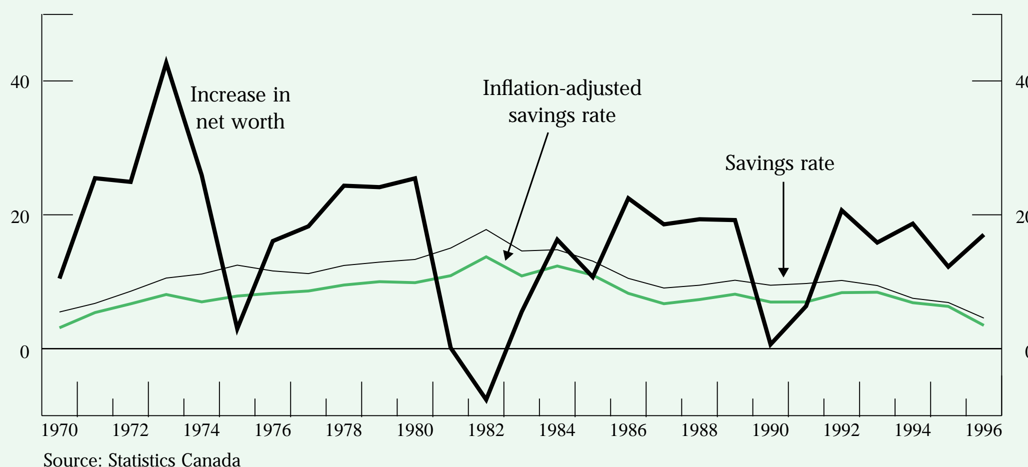


Technical Box 1

Personal Savings Rates and Household Balance Sheets

Some commentators have voiced concerns that low personal savings rates and high household debt levels will prevent the household sector from contributing significantly to the economic expansion. A closer look shows that this should not be the case.

Personal Savings and Increase in Net Worth as a Percentage of Disposable Income



The conventional measure of the personal savings rate, even after adjustment for inflation,* has declined steadily from 1982 to 1996. As household spending expanded strongly in the fourth quarter of 1996, the savings rate fell to 3.2 per cent. However, there is no reason why it should not remain at this level for a time or go even lower temporarily while interest rates are low and the economy is expanding. The increase in personal net worth, an alternative measure of savings,** which shows a much higher savings rate in recent years, lends credence to this possibility.

Although the ratio of household debt to personal disposable income continues to rise, the ratio of this debt to household assets has been stable at around 18 per cent, after declining substantially in the 1980s. Viewed another way, the net worth of the household sector, boosted by capital gains on securities, has grown rapidly in the past few years. While debts and assets may not be equally distributed across households, the fact that three-quarters of household debt is in the form of mortgages on residential properties suggests that most of the indebted households have offsetting assets.

What is most important, however, is that the burden of servicing household debt has diminished considerably since the early 1990s because of the large decline in interest rates. Together with the increase in net worth, this lower debt-service cost should help to sustain Canada's economic recovery.

* For more detail on the inflation adjustment to the personal savings rate, see Lau (1993).

** Net worth is the value of assets (at current prices) minus liabilities. Assets include financial assets and real estate but exclude stocks of consumer durables.

Technical Box 2

Private Sector Job Creation

The current economic expansion has been marked by a divergence between private and public sector employment. Since the middle of 1993 (when output reached its pre-recession level), private sector employment has risen by 8.4 per cent while public sector employment has fallen by over 6 per cent, for an overall increase in total employment of 5.9 per cent.

Job creation has been particularly strong in manufacturing and in the non-agricultural primary sector. In addition, some service industries have posted solid gains over the period. These include trade, transportation and communications, and community, business and personal services.

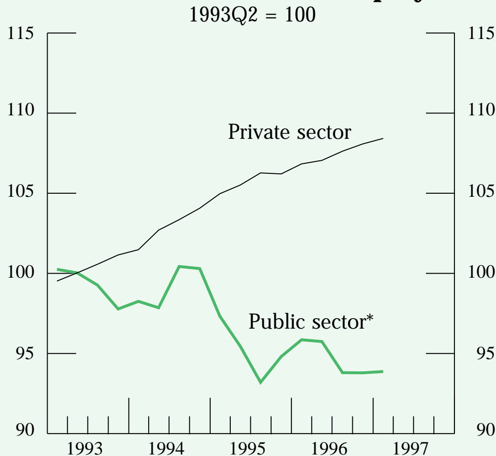
After a sizable run-up at the beginning of the decade, the trend in total public sector employment began to decline significantly starting in late 1994, as various governments and government enterprises began the process of restructuring.

As part of that restructuring, certain services have moved to the private sector together with some of the employees involved. In addition, it is probable that many of those who left the public sector have become self-employed, helping to boost the growth of this category over the last two years. Since some of these jobs are being created in business and personal services, it is not surprising that employment in that area has been growing steadily.

The strengthening of output growth that began after mid-1996 is expected to continue to stimulate private sector job creation in 1997 and beyond.

Private and Public Sector Employment

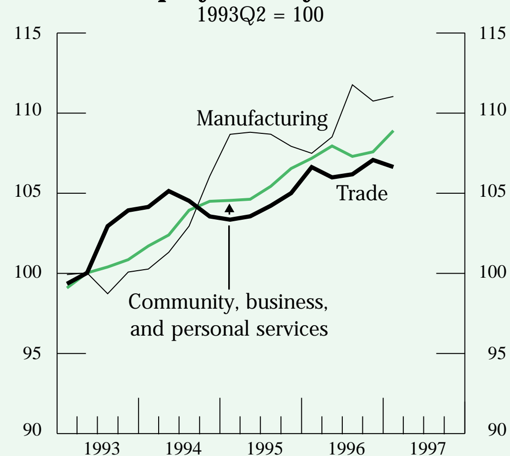
1993Q2 = 100



* Public sector employment was 15 per cent of the total as of 1997Q1.

Employment by Sector

1993Q2 = 100



Businesses also increased investment outlays considerably and began rebuilding stocks.

Business fixed investment also increased substantially in the second half of 1996, resuming the strong growth recorded in the three years up to mid-1995. Firms continued to pursue opportunities to improve productivity and to expand capacity. The increase in expenditures in 1996, as in the earlier part of this decade, was concentrated in machinery and equipment, particularly computers and other office equipment. Manufacturers and telecommunications companies both boosted investment outlays considerably.

Inventory levels also appear to be in good balance. Indeed, after substantial cuts in stocks earlier in the year, firms in the manufacturing and wholesale trade sectors began adding to inventories again in the second half of 1996 in response to higher sales levels.

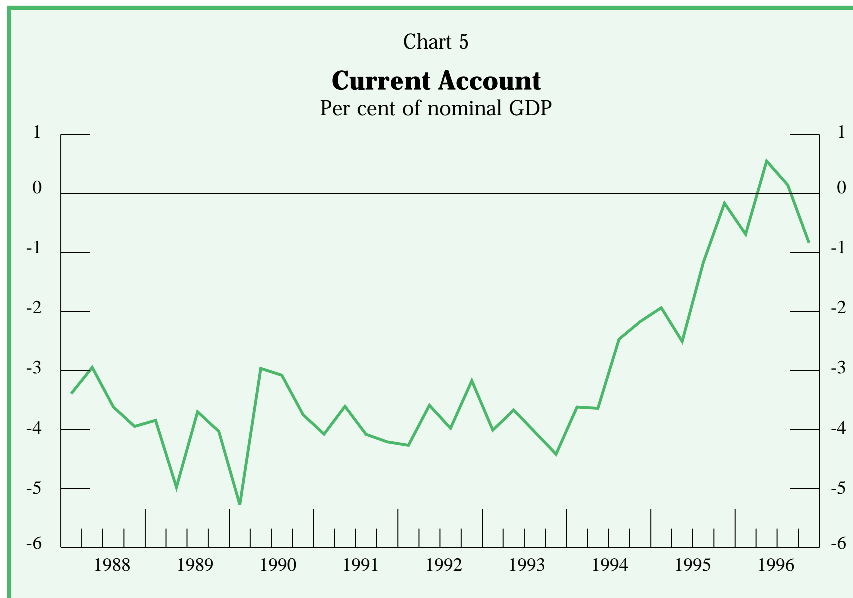
In contrast, external demand for Canadian goods fell off towards year-end.

The substantial gain in domestic demand, especially for machinery and equipment, contributed to a rebound in import volumes in the second half of 1996. In marked contrast, exports fell back noticeably towards year-end in spite of continued growth in the U.S. economy. The General Motors strike in October led to a temporary decrease in automotive export volumes—and output—in the fourth quarter of 1996. Exports also fell because of reduced activity in the U.S. housing and automobile markets, and a decline in U.S. demand for machinery and equipment. These factors, together with the strong gains in Canadian imports of machinery and equipment, returned the current account to a small deficit position by the end of the year (Chart 5).

Chart 5

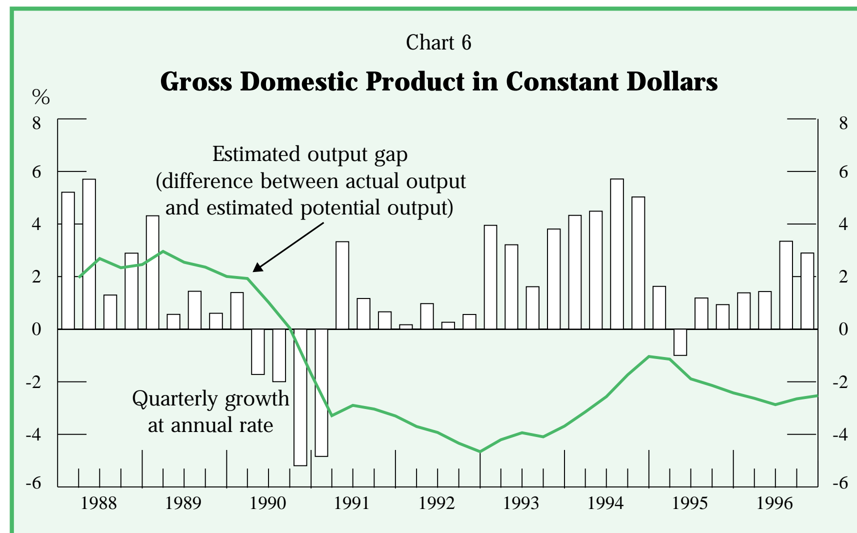
Current Account

Per cent of nominal GDP



The gap between actual and potential output narrowed.

Aggregate demand in the second half of 1996 advanced somewhat faster than estimates of the economy's capacity to produce. Such estimates, however, are imprecise and also change as the structure of the economy changes. Accordingly, calculations of potential output and the output gap should be seen as point estimates within a wide confidence band. At the end of 1996, the Bank's estimate of the output gap narrowed to around 2.5 per cent, down from a revised 3.0 per cent at midyear (Chart 6).[2]



The exchange rate and commodity prices

Earlier increases in the prices of crude oil and natural gas have contributed to the recent rise in the CPI.

A percentage change in the exchange rate typically feeds through to the core CPI by a factor of about one-fifth over a two-year period. The appreciation of the Canadian dollar over the past two years should thus be a source of slight downward pressure on consumer prices for at least the next year.

In recent months, prices at the consumer level have been significantly affected by earlier increases in energy prices at the producer level. The prices of fuel oil, gasoline, and natural gas have been directly affected, while indirect effects have raised the prices for other goods and services that are included in the core CPI, such as air travel. Since mid-January, however, much of the sharp 1996 increase in the prices of both crude oil and natural gas at the producer level has been reversed as a result of milder

2. The small downward revision of about 0.25 per cent to the midyear estimate of the output gap results from a reduction in the Bank's assessment of the trend labour force participation rate used in calculating potential output. This revision reflects a judgment that more weight should be given to recent actual values of the labour force participation rate in estimating the trend rate (see Technical Box 2 in the May 1996 *Monetary Policy Report*).

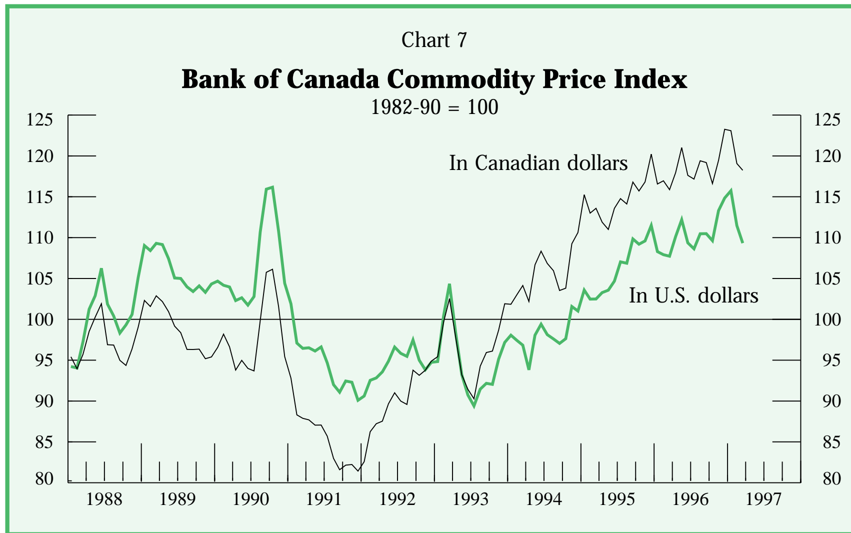
temperatures. Thus, the effect on the level of the CPI is likely to be temporary.

World commodity prices (quoted in U.S. dollars) have, on average, remained firm since last October (Chart 7). Price changes have been most pronounced for crude oil and metals. Metals prices have improved on news of strengthening demand and lower stocks.

Chart 7

Bank of Canada Commodity Price Index

1982-90 = 100

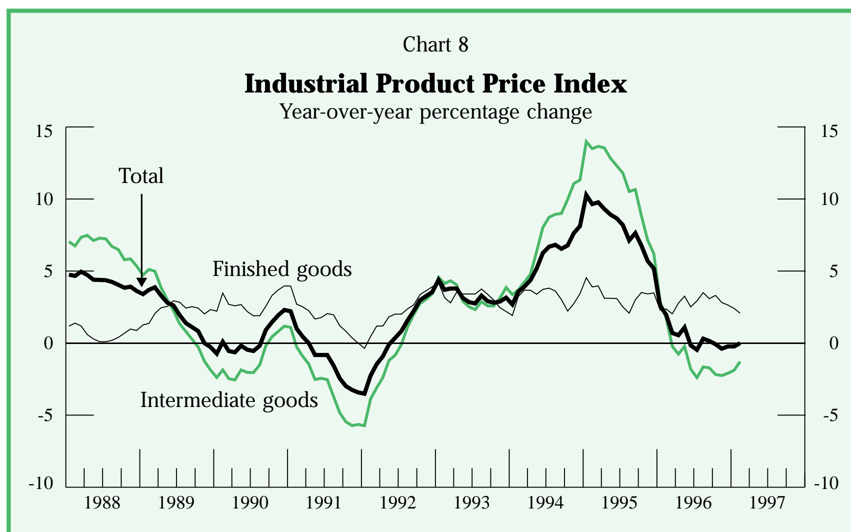


At the producer level, the aggregate industrial product price index has shown little change on a year-over-year basis (Chart 8). This has reflected higher prices for petroleum products, offset by declines (earlier in 1996) in the prices received by Canadian producers of newsprint, pulp, and metals.

Chart 8

Industrial Product Price Index

Year-over-year percentage change



Cost control

Underlying wage increases in the second half of 1996 were similar to those recorded in the first half.

Product markets in Canada are strongly competitive, maintaining the pressure on producers to control costs and to raise productivity. Cost increases were generally low in the second half of 1996.

Wages, the largest component of total costs, continued to rise at a moderate pace during the second half of the year. Average annual wage settlements in the private sector rose to 2.1 per cent over the same period (Chart 9). Settlements in the automotive sector averaged 3.5 per cent, while all other private sector settlements averaged 1.5 per cent. In recent years, settlements in the manufacturing sector have generally been high relative to those in other sectors, largely because of substantial gains in productivity. Influenced by fiscal restraint, wage settlements in the public sector in the second half of 1996 remained at very low levels (0.4 per cent). Overall, based on these and other measures of wages, underlying wage increases (i.e., excluding such factors as changes in the composition of employment) are estimated to have been in a range between 1.5 and 2 per cent on a year-over-year basis—unchanged over the last four years.

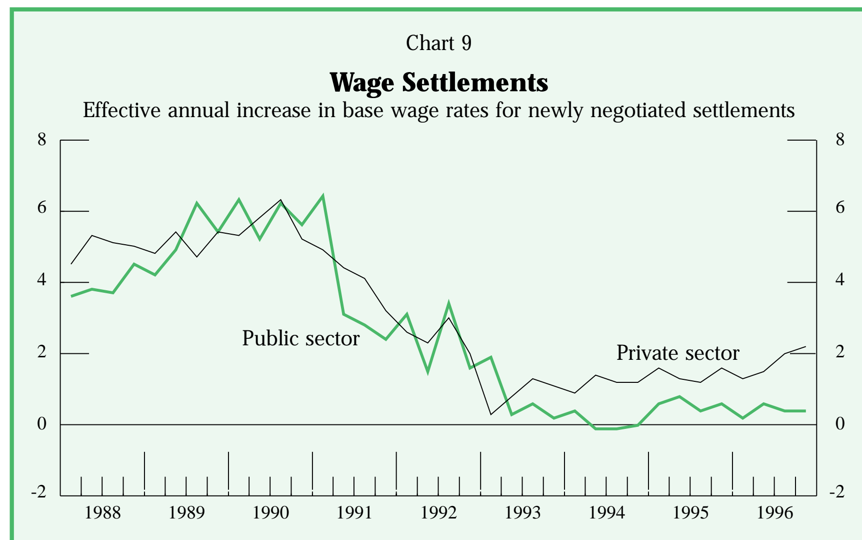


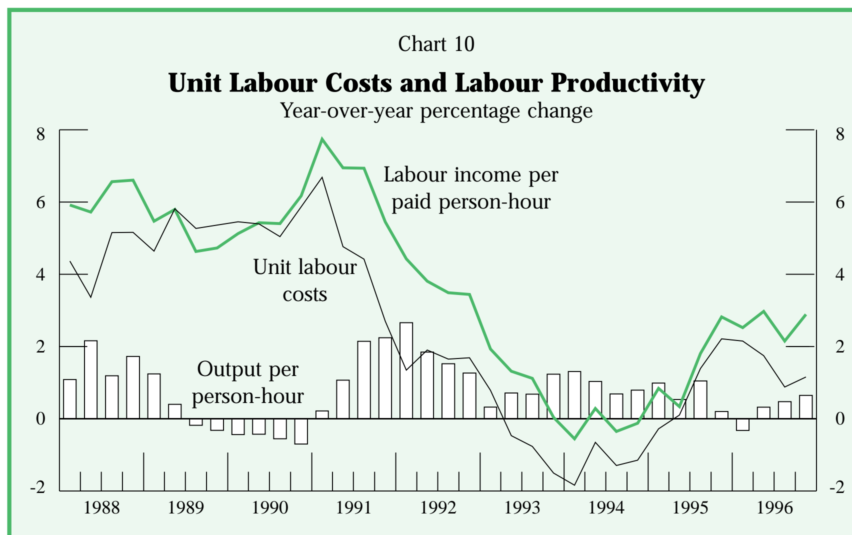
Chart 9

Wage Settlements

Effective annual increase in base wage rates for newly negotiated settlements

As productivity picked up, the year-over-year increase in unit labour costs eased.

Productivity (output per person-hour) picked up somewhat in the second half of 1996, an improvement from its earlier sluggish advance. This improvement contributed to an easing in the year-over-year rise in unit labour costs (Chart 10).



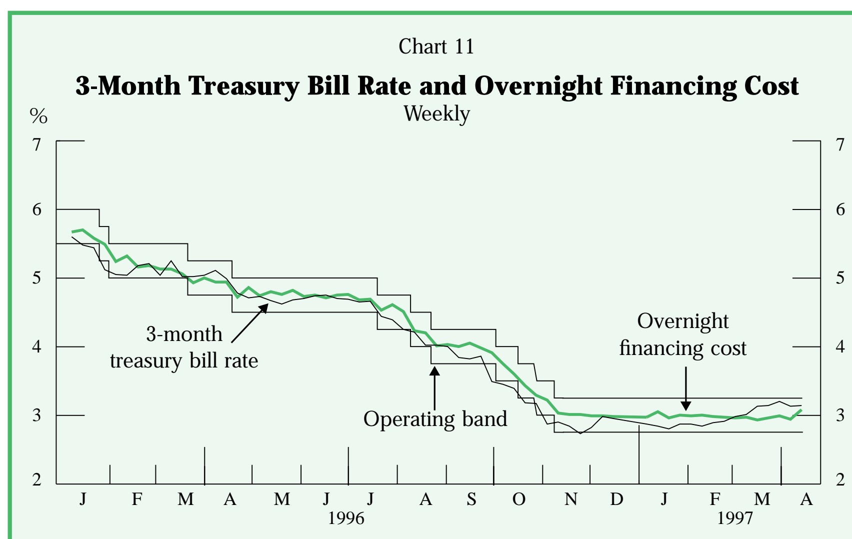
3. Achieving the Inflation-Control Targets

The Bank has broadly maintained the monetary conditions achieved last autumn.

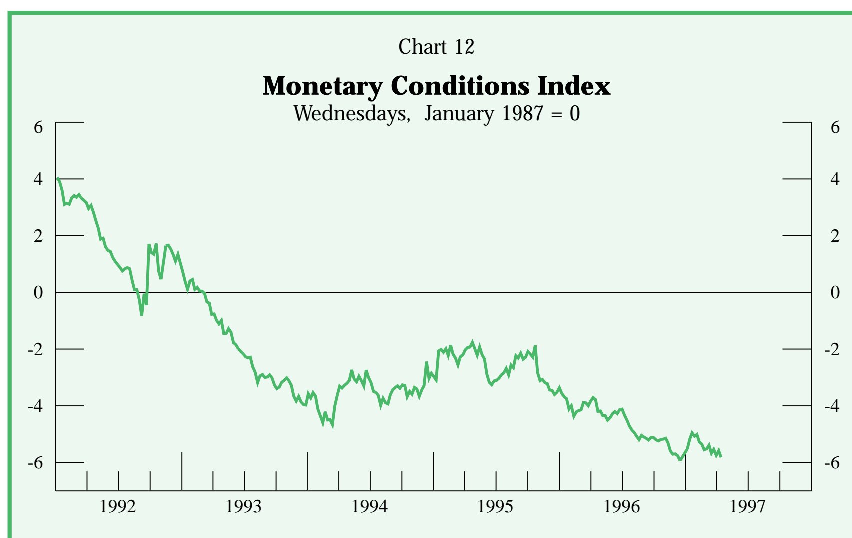
Over the period since the last *Report,* the Bank has sought to broadly maintain the monetary conditions achieved in the autumn of 1996. To keep monetary conditions from tightening as the Canadian dollar strengthened, the Bank lowered the operating band for the overnight interest rate on four occasions in October and November. The Bank Rate, which sets the upper limit for the operating band, was reduced by a quarter point each time (Chart 11). Since then, the Bank Rate has been left unchanged, and the monetary conditions index (MCI) has varied between -5 and -6 (Chart 12).

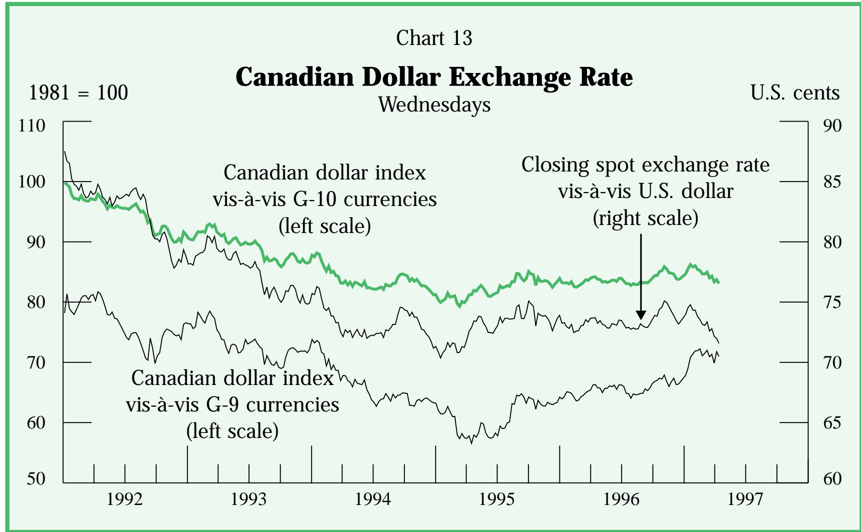
The exchange rate has fluctuated against a robust U.S. dollar, while strengthening, on average, against other G-10 currencies.

The fluctuations in the MCI have resulted largely from changes in the exchange rate (Chart 13). A key factor influencing the Canadian dollar has been the strong increase in the U.S. currency against most major currencies. The U.S. dollar has been bolstered by the robust U.S. economy and by the growing expectation that short-term interest rates in the United States would have to rise. In this situation, the Canadian dollar has weakened against the U.S. dollar, but has shown considerable strength against G-10 currencies other than the U.S. dollar (G-9 currencies). On an overall G-10 basis, while showing considerable volatility, the Canadian dollar has remained at or above the levels that prevailed through much of 1996.



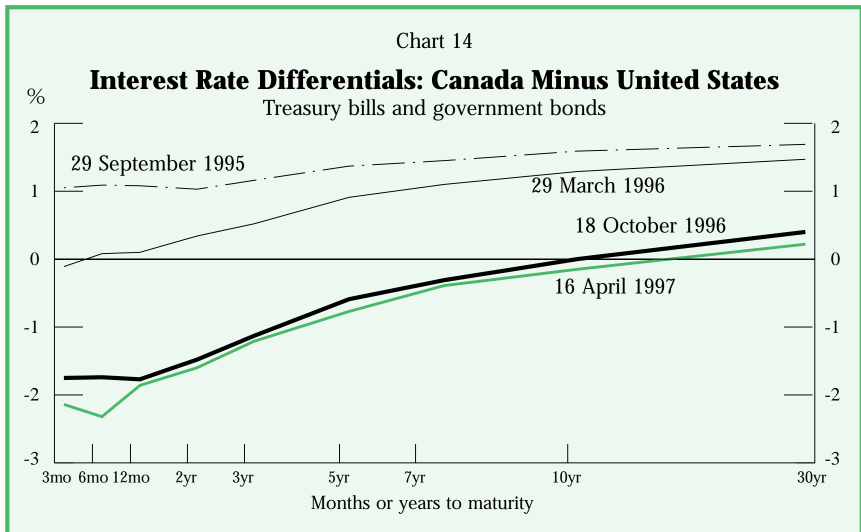
In the last week of March, the Federal Reserve raised the federal funds rate by one-quarter of a percentage point, a move that was largely anticipated by markets. Financial markets have reacted to subsequent U.S. economic data by incorporating expectations of further moves by the Federal Reserve. This reaction has spilled over to financial markets internationally. In the case of Canada, short- and medium-term interest rates have moved up. As well, the dollar has weakened further against the U.S. dollar but continues to show firmness against other major currencies. On balance, the monetary conditions index has stayed within its recent range, but with a change in the mix of interest rates and the exchange rate.





Despite the recent volatility, Canadian financial markets continue to be supported by the fundamentals of low inflation, declining public sector borrowing, and an improved external balance of payments. Over the past two years, these factors have led to a large decrease in the risk premiums that investors require on Canadian assets, and they continue to underpin market expectations of a future appreciation of the Canadian dollar. This, in turn, has allowed Canada-U.S. interest differentials from short-term to 10-year maturities to remain negative (Chart 14).

Interest rates in Canada can remain below those in the United States because of expectations that the Canadian dollar will rise.



4. The Outlook for Inflation

When evaluating the prospects for inflation, the Bank considers the key factors affecting the balance between aggregate demand and aggregate supply over the next four to six quarters. It also looks at measures of inflation expectations and at the pace of monetary expansion when forming its views on the future path of output, inflation, and desired monetary conditions.

Aggregate demand and supply

During the second half of 1996, the pace of spending in the U.S. economy strengthened more than had been expected, leading to a small estimated increase in excess demand by year-end. Indications are that spending in the first quarter of 1997 was strong as well. The rate of increase in real GDP should ease over the next few quarters as export growth falls back in line with developments in the principal trading partners of the United States. The contrast between a strong U.S. economy and moderate economic activity in the major overseas countries has led to an appreciation of the U.S. dollar. While core inflation (which excludes food and energy prices) has continued to decline slowly in the United States, partly as a result of the dollar's appreciation and the buffering effect of slack in overseas economies, there are some indications that tight labour markets are starting to put upward pressure on wages. Monetary conditions have already tightened as a result of the currency appreciation and the March increase in the federal funds target. The Federal Reserve may nonetheless see a need to raise interest rates further to prevent a buildup of inflationary pressures and thereby help to sustain the economic expansion.

Economic expansion in the major European countries was weaker than expected during the second half of 1996, while the pace of spending in Japan was somewhat more rapid than anticipated. Moderate growth is expected to continue in Europe and Japan during the first half of 1997, sustained by past easings in monetary conditions.

Prices of commodities are likely to remain under downward pressure in the near term. The price of crude oil, in particular, could fall further as supplies from non-OPEC sources increase and the tight inventory situation of late 1996 is rectified. However, a modest upward trend in the overall commodity price index should resume by mid-1997, which should support Canadian production. Prices of most industrial commodities are expected to strengthen on average as the pace of expansion among the major economies reduces the world's excess capacity.

External demand should resume its role as an important factor in Canada's output growth ...

On balance, external demand should resume its role as an important factor in the expansion of the Canadian economy in the first half of 1997, reinforced by the strong competitive position of Canadian industry. In particular, Canadian exports should rebound in early 1997 from their low level in the fourth quarter of 1996, which was caused partly by transitory factors, including the General Motors strike.

Prospects are also good for further gains in domestic demand. The past easing in interest rates should lead to further increases in household demand. Indeed, the combination of low interest rates and pent-up demand for housing and consumer durables is likely to lead to a continuation of the recent higher rates of household borrowing. This could result in a low level for the personal savings rate for a number of quarters. The increase in interest-rate-sensitive spending along with the anticipated resumption of buoyant growth in exports should boost private sector employment and, hence, support household spending. These influences should counter factors working in the opposite direction, particularly those coming from further fiscal restraint. They should also tend to offset the effects on consumer confidence coming from the current high unemployment rate. In addition, recent surveys of business confidence by the Conference Board, as well as Statistics Canada's survey of investment intentions for 1997, suggest that capital spending should remain strong during the first half of the year.

... and further gains in domestic demand are expected.

Thus, both external and domestic factors point to continued robust expansion in the first half of 1997. In our view, the economy should also have significant momentum into the second half of this year, sustained by the substantial amount of monetary easing that has already taken place. The Bank thus continues to expect average growth of around 4 per cent through to the fourth quarter of 1997, which should translate into annual growth of somewhat less than 4 per cent for the year. On a comparable annual average basis, private sector forecasters are currently looking for growth of 3.3 per cent. The Bank expects further economic slack to be taken up through 1998.

The above outlook implies that the downward pressure on core inflation from slack in product markets will remain a factor in coming quarters (Technical Box 3). Similarly, labour market conditions will continue to restrain any significant upward pressure on wages. It is expected that continued strong economic expansion this year will lead to further substantial gains in productivity, which would also limit overall cost increases. Thus, we would expect core inflation to remain in the lower half of the inflation-control target range for the balance of 1997.

Technical Box 3

Can the Economy Grow Strongly Without Rising Inflation?

With the Canadian economy entering a period of strong economic expansion, increasing attention is being focussed on whether the low inflation rates that have characterized the economy over the past several years can be sustained. The experience of the 1980s illustrates that inflation performance is determined mainly by the level of excess supply or demand, rather than by how quickly output is growing.

As shown in the table below, the Canadian economy experienced a period of strong growth in the early 1980s that was not accompanied by rising inflation. Indeed, the CPI fell from an annual rate of increase of almost 11 per cent in 1982 to 4 per cent in 1985. It was only in the latter part of the decade, as the level of demand pushed past the capacity of the economy to produce goods and services, that inflation pressures began to emerge.

	1982	1983	1984	1985	1986	1987	1988	1989
GDP growth (per cent)	-3.2	3.2	6.3	4.8	3.3	4.2	5.0	2.5
CPI inflation (per cent)	10.7	5.9	4.3	4.0	4.2	4.4	4.0	5.0
Estimated output gap* (per cent)	-4.5	-4.4	-1.7	-0.5	-0.6	+0.3	+2.4	+2.6

*The output gap (a negative gap indicates excess supply) is the percentage difference between the level of output being produced and the level of output consistent with an unchanged rate of inflation.

The Bank's *Annual Report* for 1989 noted that, with substantial excess demand in that year, consumer prices rose more rapidly than in any of the previous five years. Inflation in Canada that year exceeded inflation in the United States and in the five major overseas countries as a group. This pickup in inflation occurred despite moderating influences on the prices of products traded internationally, which stemmed from an appreciation of the exchange rate and from a decline in the U.S. dollar price of many resource exports.

With a considerable amount of excess supply at the end of 1996, the strength in demand that the Bank is predicting would still leave the economy with excess supply at the end of 1997, implying continued downward pressure on prices.

Temporary factors affecting inflation

Expectations of inflation have been steady in recent months.

The tendency of the Canadian dollar to appreciate over the last two years should put slight downward pressure on the CPI in coming months. Furthermore, both the earlier marked declines in the prices of many industrial materials and the recent easing in the prices of both crude oil and natural gas should contribute to reductions in inflation at the consumer level. On balance, these transitory factors should have little net effect on core CPI inflation over the next several quarters.

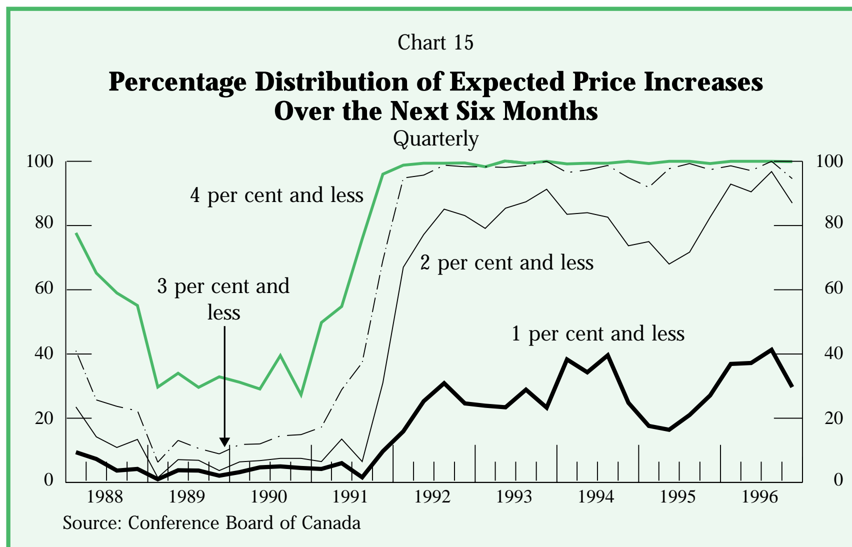
Measures of inflation expectations

Expectations of inflation, an important influence on the future path of inflation, are affected both by recent developments in inflation and by the public's perception of the Bank's inflation-control objectives. As economic agents gain confidence in the Bank's ability to meet its announced objectives, expectations may be increasingly anchored by the inflation-control target range. Short-term inflation expectations have been steady in recent months. In the regular survey reported in the Conference Board's December *Index of Business Confidence*, 87 per cent of respondents expected inflation to be 2 per cent or less over the near term (Chart 15).

Chart 15

Percentage Distribution of Expected Price Increases Over the Next Six Months

Quarterly



Source: Conference Board of Canada

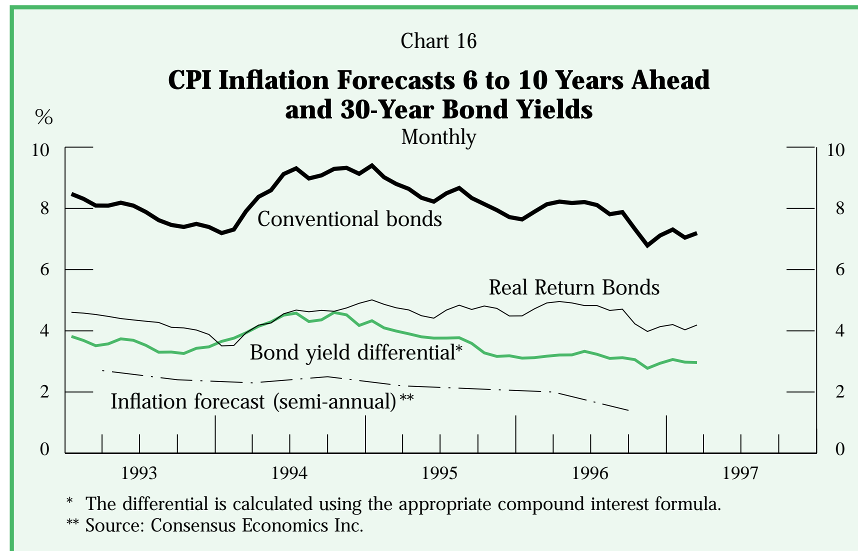
In the Conference Board's March quarterly *Survey of Forecasters*, it was anticipated that CPI inflation would average about 2.0 per cent in 1997 and would edge down to about 1.9 per cent in 1998. The 1997 forecast was marginally higher than six months earlier. Longer-term inflation forecasts as reported by Consensus Economics Inc. are also in the lower part of the inflation-control target range (Chart 16).

Any significant changes in the inflation expectations of investors would likely be captured in the spread between the yield on a conventional long-term federal government bond and that on a Real Return Bond. The tendency of this spread to decline since 1994 suggests that expectations in the financial markets have been consolidating around a low inflation rate. However, it is difficult to estimate precisely the implied level of expected inflation because the differential between the yields on the two types of bonds is also affected by factors such as liquidity and investor preferences as well as by inflation uncertainty.

Chart 16

CPI Inflation Forecasts 6 to 10 Years Ahead and 30-Year Bond Yields

Monthly



* The differential is calculated using the appropriate compound interest formula.
** Source: Consensus Economics Inc.

Monetary indicators

While the acceleration in M1 points to faster economic growth ...

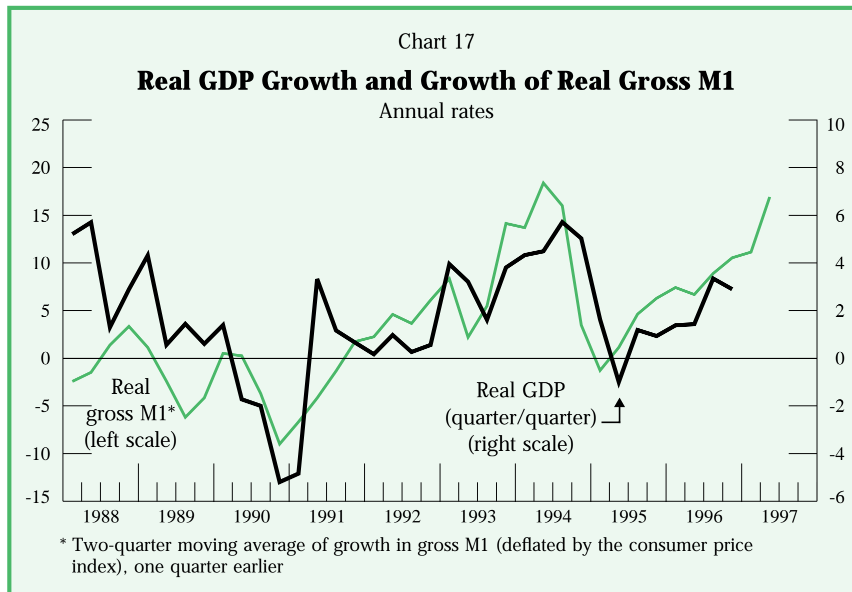
Growth in M1 (the narrow definition of money) has increased at a double-digit rate in the last six months. This increased demand for transactions balances has been driven primarily by the low interest rates permitted by the low-inflation environment, but also to some extent by the introduction of highly competitive interest rates on current accounts over the past couple of years.

Moreover, historical data show that an acceleration in the real value of M1 is typically followed by an increase in the rate of growth of real GDP (Chart 17). A temporary increase in M1 growth is therefore consistent with a return of the Canadian economy to full capacity.

Chart 17

Real GDP Growth and Growth of Real Gross M1

Annual rates



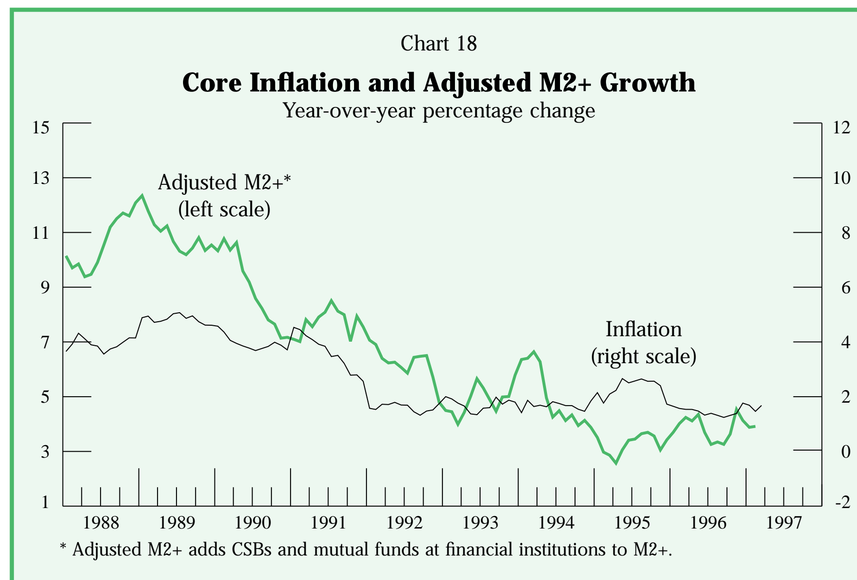
* Two-quarter moving average of growth in gross M1 (deflated by the consumer price index), one quarter earlier

... it will require close monitoring.

However, if such rapid growth in M1 were to persist into 1998, it would not be consistent with preserving low inflation. Accordingly, M1 growth will require close monitoring.

Broad money growth, even when adjusted for the boom in mutual funds, remains moderate.

Broad definitions of money, which have been useful short-term indicators of inflation, have become more difficult to interpret over the past five years or so because of the large expansion of mutual funds. Holders of deposits have switched on a large scale into equity and bond funds, which are outside the M2+ aggregate. Thus, measures of broad money that take account of this substitution have grown more rapidly than M2+. Nevertheless, the rate of increase of broad aggregates generally remains moderate (Chart 18). Forecasts based on adjusted M2+ show an annual inflation rate of about 1.5 per cent in the second quarter of 1997.



The slope of the yield curve is another variable that often contains information about the expected evolution of the economy. During recent quarters, the difference between the long-term government bond yield and the 90-day commercial paper rate has been unusually wide, at about 4 percentage points. In the past, spreads of this magnitude have been followed by a rapid expansion of activity during the next year.

5. Conclusions

Inflation, measured by either core CPI or the total CPI, has been somewhat higher than was expected at the time of the last *Report*. This increase, however, largely reflects the influence of temporary factors, and with excess supply continuing to be a source of downward pressure on inflation, the outlook for the next half-year is for core inflation to remain in the lower half of the inflation-control target range.

Economic developments during the second half of 1996, as well as more recent indicators, point to a continuation of robust expansion through the balance of 1997 and into 1998. This momentum has significantly reduced the risk that inflation will drift below the 1 to 3 per cent target range.

Thus, in the absence of unexpected developments in either inflation or demand pressures, the possible need for further easing in monetary conditions discussed in the last *Report* has largely disappeared. Over the medium term, as slack in the economy is absorbed, the Bank will need to promote a less stimulative path for monetary conditions in order to maintain Canada's low trend of inflation, and thereby contribute to a durable expansion in activity consistent with the capacity of the economy to produce goods and services.

This is a report of the Governing Council of the Bank of Canada:
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Tim Noël, and Sheryl Kennedy.

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