MONETARY POLICY REPORT

UPDATE

– July 2004 –

This text is a commentary of the Governing Council of the Bank of Canada. It presents the Bank's updated outlook based on information received up to 20 July 2004.

Since the April *Monetary Policy Report*, three developments have led the Bank of Canada to make small modifications to its outlook for economic growth and inflation in Canada.

First, economic growth in the first half of 2004 is now estimated to be somewhat higher than projected in April because of stronger foreign and final domestic demand for Canadian products. This, combined with a small upward revision to GDP data for 2003, implies somewhat less excess supply at mid-year than had been anticipated.

Second, world oil prices have been higher than expected. This has led the Bank to raise its projection for total CPI inflation over the next few quarters, but is not expected to have any significant effect on the path of core inflation. While higher oil prices will tend to dampen growth in the United States and the major overseas economies relative to earlier projections, the overall growth of output in Canada is unlikely to be appreciably affected.

Third, recent indicators point to some slowing in economic growth in the United States for reasons other than the effect of higher oil prices.

When all of these factors are taken into account, the Bank expects economic growth in Canada to be about 2 3/4 per cent in 2004, on an average annual basis—unchanged from the April *Report*—and 3 1/2 per cent in 2005—slightly lower than in the April *Report*.

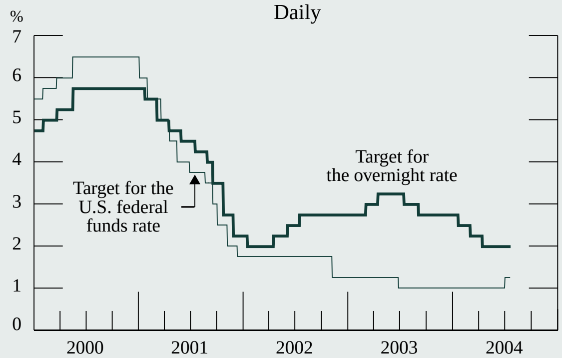
Highlights

- The Bank's outlook for economic growth and core inflation in Canada is little changed from the April *Monetary Policy Report*.
- The Canadian economy is judged to be operating slightly closer to full capacity than was anticipated in April and is now expected to reach its production potential by mid-2005.
- Core CPI inflation is still projected to move back up to 2 per cent by the end of 2005.
- The short-term projection for total CPI inflation has been raised to reflect higher-than-expected world oil prices.
- Monetary stimulus will have to be removed to avoid a buildup of inflation pressures. The pace of the withdrawal will depend on the evolving prospects for inflation and for capacity pressures.

On a fourth-quarter-to-fourth-quarter basis, the Bank's projection calls for growth of about 3 1/2 per cent in 2004—higher than expected in April owing to a stronger first half—and 3 1/4 per cent in 2005—lower than projected in April. This outlook implies that the output gap would close by mid-2005, with core inflation moving back up to 2 per cent by the end of 2005.

Against this background, the Bank held its target overnight rate unchanged at 2 per cent on 20 July (Chart 1). Experience tells us, however, that as economies approach their production capacity, monetary stimulus must be removed to avoid a buildup of inflation pressures. Indeed, market interest rates, in Canada and elsewhere, incorporate expectations of such adjustment to policy interest rates. The timing and magnitude of rate increases will clearly vary according to each country's economic circumstances.

Chart 1
Target for the Overnight Rate and Target for the U.S. Federal Funds Rate
Daily



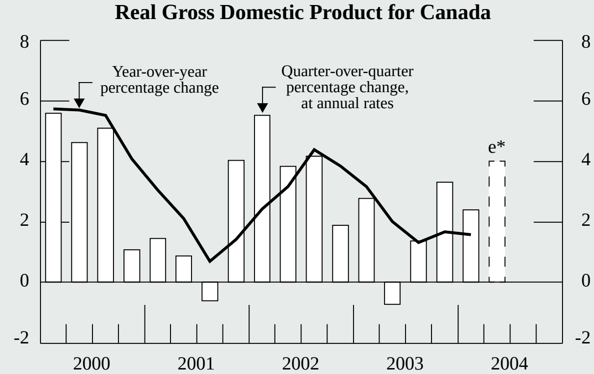
In Canada, the withdrawal of monetary stimulus will depend on the evolving prospects for inflation and for pressures on capacity. Three factors will play a particularly important role in this respect. The first is the assessment of the size of the output gap. The second is the future growth of Canadian exports and imports, which is particularly uncertain because of the ongoing adjustments to global changes and the recent patterns in trade growth. The third is the overall effect on the Canadian economy of current and future movements in the world prices of oil and non-energy commodities. In addition to these three factors, there continue to be heightened geopolitical concerns.

Overview of Recent Economic and Financial Developments

The global economic recovery is advancing, with strong growth in the United States, Japan, and the emerging Asian economies—especially China—in the first quarter of 2004. Although growth in Canada's real GDP slowed to 2.4 per cent in the first quarter of 2004 as a result of a marked inventory correction, it is expected to have strengthened to about 4 per cent in the second quarter (Charts 2 and 3). Thus, economic growth in the first half of this year is estimated to be around 3 1/4 per cent, somewhat higher than projected in the April *Report*, with increases in both final domestic demand and exports being stronger than anticipated.

Combined with a small upward revision to Canadian real GDP data for 2003,[1]

Chart 2
Real Gross Domestic Product for Canada



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

1. Statistics Canada's estimate of real growth for 2003, on an average annual basis, was revised up to 2.0 per cent from an initial estimate of 1.7 per cent.

Chart 3
Contribution to Real GDP Growth
Percentage points, quarterly at an annual rate

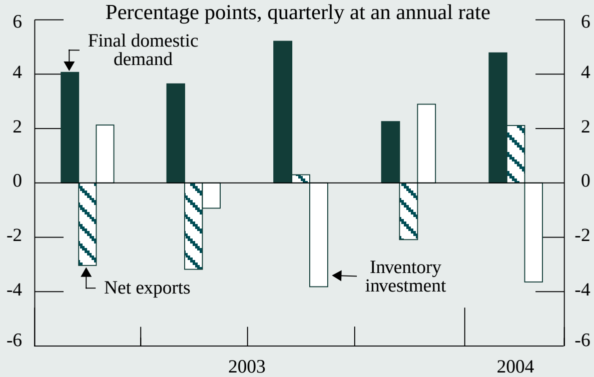
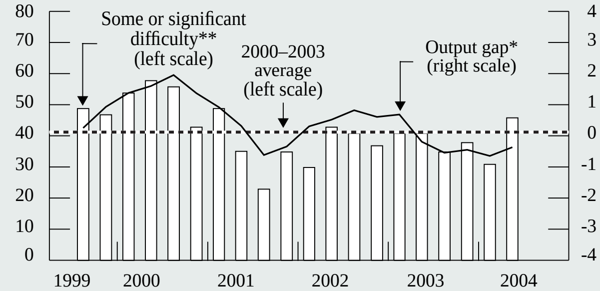


Chart 5
Estimated Output Gap and Response to Regional Survey Question on Capacity Pressures

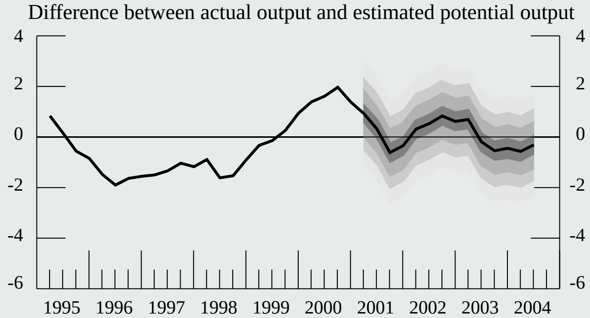


* Difference between actual output and estimated potential output. Note that the estimate for the second quarter of 2004 is based on a projected rise in output of 4 per cent (at annual rates) for the quarter.
** Percentage of firms indicating that they would have either some or significant difficulty meeting an unanticipated increase in demand/sales.

this outlook implies a somewhat smaller output gap at mid-year than was projected in the last *Report*. While recognizing that there is a wide confidence interval around any estimate of the output gap, the Bank judges that its conventional measure provides a balanced assessment of excess supply (Chart 4). Product market indicators suggest greater pressure on capacity. For example, in the Bank's latest *Business Outlook Survey*, the proportion of firms reporting pressures on capacity rose above the 2000–2003 average (Chart 5). On the other hand, some labour market indicators point to less pressure on capacity. Hours worked are below trend, and wage increases remain moderate.

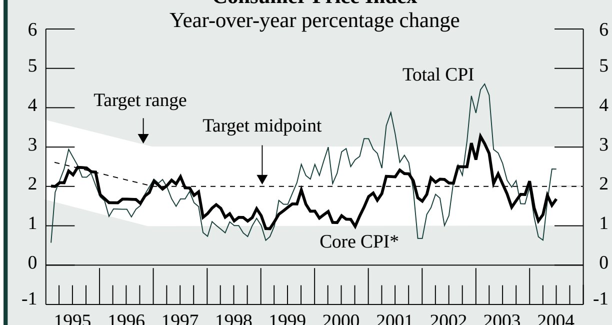
Core inflation moved up from 1.1 per cent in February to 1.7 per cent in June (Chart 6). This is higher than projected in the last *Report*, owing partly to unanticipated delays in reductions to auto insurance premiums and larger-than-expected increases in prices for motor vehicles and meat. At the same time, unexpectedly high prices for crude oil, together with unusually tight conditions in North American gasoline markets, led to a sharp rise in total CPI inflation. The 12-month rate of increase in the total CPI was 2.5 per cent in June, up from 0.7 per cent in February.

Chart 4
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 second quarter of 2004 is based on a projection of 4 per cent growth for the quarter.

Chart 6
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

Adjusting to Global Change

Canadian producers continue to adjust to developments in the global economy—substantially stronger world demand, higher commodity prices, and the realignment of the U.S. dollar against most major currencies, including the Canadian dollar.

After rising to a 10-year peak of 78.85 cents against the U.S. dollar in January, the Canadian dollar moved down to a low of 71.41 cents U.S. in mid-May. Since early June, the dollar has generally been trading in a range between 73.5 cents U.S. and 76.5 cents U.S.

These developments, and their implications for the demand for Canadian goods and services, are leading to shifts in activity and employment among sectors and to major adjustments by many firms. In particular, many firms in industries with a high exposure to international trade have focused on improving productivity and reducing costs.

Between December 2003 and April 2004, output growth in Canada continued to be particularly strong in sectors with a low exposure to foreign competition. In recent months, however, exports have also surged. It thus seems likely that even industries highly exposed to international trade could see significant increases in their output over the near term, owing to robust global economic growth. Indeed, the Bank's latest *Business Outlook Survey* suggests that firms are now more confident about sales prospects over the next 12 months, both domestically and abroad. However, the adjustment to developments in the global economy is not completed.

Moreover, it has been unusually difficult recently to explain the movements in the volumes of both exports and imports in terms of their underlying fundamentals. At mid-2003, the levels of both exports and imports appeared to be well below what their historical relationships with real income and relative prices would have suggested. Since then, exports seem to have regained lost ground, while imports have recouped only a small portion. These puzzling developments, together with the substantial revisions to these data, make it difficult to predict the future contribution of net exports to GDP growth.

Economic Prospects

Recent data point to some slowing of growth in the United States. In its base-case outlook, the Bank now expects U.S. real GDP to grow by about 4 1/2 per cent in 2004 and 4 1/4 per cent in 2005. Although lower than projected in the April *Report*, this still represents a solid performance led by robust business and consumer spending. While near-term prospects are improving in the euro-zone countries, the risk of slightly weaker growth over the next two years relative to that assumed in the April *Report* has increased. In Japan, however, prospects for a sustained recovery are now firmer. Asia's strengthening economies will continue to support the global economic upswing, so long as China manages a smooth return to a path of sustainable growth.

Consistent with the global growth profile and the expectations of financial markets, this projection also assumes rising international interest rates to moderate inflation pressures as output levels in various countries approach production capacity.

In the past several months, world oil prices have been significantly higher than expected, reflecting strong global demand for oil and heightened tensions in the Middle East. The Bank's projection assumes that the West Texas Intermediate (WTI) price will average about US$38 per barrel in the second half of 2004 (about US$6 more than assumed in the last *Report*), before easing to US$35 per barrel by the second half of next year.[2]

2. Oil prices have been volatile in recent weeks. Spot and forward prices on 20 July were somewhat higher than assumed in the Bank's current projection.

In Canada, economic growth through to the end of 2005 is expected to come primarily from domestic demand (Table 1).

Table 1
Contributions to Annual Real GDP Growth[1]

	2003	2004	2005
Consumption	1.8	1.8 *(1.3)*	1.8 *(2.1)*
Housing	0.4	0.5 *(0.3)*	0.0 *(0.1)*
Government	0.9	0.5 *(0.5)*	0.7 *(0.7)*
Business fixed investment	0.4	0.7 *(0.7)*	0.9 *(0.9)*
Subtotal: Final domestic demand	3.5	3.5 *(2.8)*	3.4 *(3.8)*
Exports	-0.9	2.3 *(2.1)*	1.6 *(2.1)*
Imports	-1.4	-2.4 *(-2.1)*	-1.9 *(-2.2)*
Subtotal: Net exports	-2.3	-0.1 *(0)*	-0.3 *(-0.1)*
Inventories	0.8	-0.7 *(-0.1)*	0.4 *(0.1)*
GDP	2.0 *(1.7)*	2.7 *(2.7)*	3.5 *(3.8)*

1. Figures in parentheses are estimates used for the scenario in the April *Report*.

While strong foreign demand implies further gains in exports, despite the ongoing dampening influence of the past appreciation of the Canadian dollar, this is likely to be more than offset by faster growth in imports. Solid growth in consumer spending should be sustained by advances in real incomes. Housing expenditures are projected to slow down, however, following a period of intense activity. Business investment should continue to benefit from strong global growth, high commodity prices, favourable financial conditions, and lower prices for imported machinery and equipment.

The projection assumes that governments will maintain fiscal balance by keeping growth in spending in line with growth in revenues.

The higher world oil prices assumed in this outlook will tend to reduce demand for Canadian exports and increase production costs for Canadian firms. But they should also lead to some increase in output and capital spending by energy-producing companies. Hence, the net effect on Canadian GDP is expected to be close to zero.

The Bank's base-case projection calls for real GDP growth in Canada to average about 3 1/2 per cent in both the second half of 2004 and the first half of 2005, before easing to 3 per cent (the estimated rate of growth of potential output) in the second half.[3] In terms of annual averages, this implies GDP growth of about 2 3/4 per cent in 2004 and 3 1/2 per cent in 2005. The growth projection for 2005 is lower than that in the April *Report*, owing partly to the weaker U.S. outlook and partly to an anticipated slowing in household expenditures on durables and housing following their recent rapid expansion. With this growth profile, the Canadian economy is now expected to reach its production potential by mid-2005.

The Outlook for Inflation

The Bank's near-term outlook for core inflation is little changed from the April *Report*, since the recent surprises to core inflation are largely attributed to temporary influences. Core inflation is projected to remain just above 1.5 per cent for the rest of 2004, before gradually moving up to the 2 per cent target by the end of 2005 (Table 2).

The presence of excess supply until mid-2005 should keep core inflation below longer-run inflation expectations of 2 per cent

3. Quarter-to-quarter movements in GDP could be influenced by fluctuations in inventory investment.

Table 2
Projection for Core and Total CPI Inflation
Year-over-year percentage change*

	2004			2005		2006
	Q2	Q3	Q4	H1	H2	H1
Core inflation	**1.7** *(1.4)*	**1.7** *(1.6)*	**1.6** *(1.6)*	**1.8** *(1.7)*	**1.9** *(1.9)*	**2.0**
Total CPI	**2.2** *(1.7)*	**2.2** *(1.7)*	**2.2** *(1.7)*	**1.8** *(1.6)*	**1.6** *(1.7)*	**1.7**
WTI** (level)	**38** *(33)*	**38** *(32)*	**38** *(32)*	**36** *(32)*	**35** *(30)*	**33**

* Figures in parentheses are from the April *Monetary Policy Report*.
** Assumption for the price of West Texas Intermediate crude oil (US$ per barrel)

through to the end of 2005. The earlier appreciation of the Canadian dollar is also expected to continue to exert a small amount of downward pressure on core inflation over the remainder of 2004.

The outlook for the 12-month rate of increase in the total CPI will continue to be crucially affected by developments in the markets for crude oil. Given the outlook for the WTI price of oil, total CPI inflation is likely to remain above 2 per cent for the rest of this year, before falling slightly below core inflation in the second half of 2005.

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

Telephone: (613) 782-8248; e-mail: publications@bankofcanada.ca
Web site: http://www.bankofcanada.ca