BANK OF CANADA

Monetary Policy Report

April 2005

Canada's Inflation-Control Strategy

Inflation control and the economy

- Inflation control is not an end in itself; it is the means whereby monetary policy contributes to solid economic performance.
- Low inflation allows the economy to function more effectively. This contributes to better economic growth over time and works to moderate cyclical fluctuations in output and employment.

The monetary policy instrument

- Announcements regarding the Bank's policy instrument—the target overnight interest rate—take place, under normal circumstances, on eight prespecified dates during the year.
- In setting a target for the overnight rate, the Bank of Canada influences short-term interest rates to achieve a rate of monetary expansion consistent with the inflation-control target. The transmission mechanism is complex and involves long and variable lags—the impact on inflation from changes in policy rates is usually spread over six to eight quarters.

The targets

- In February 1991, the federal government and the Bank of Canada jointly announced a series of targets for reducing total CPI inflation to the midpoint of a range of 1 to 3 per cent by the end of 1995. That inflation-control target range was extended a number of times, most recently in May 2001, in this last case to the end of 2006. Monetary policy will continue to aim at keeping future inflation at the 2 per cent target midpoint of this range, both to maximize the likelihood that inflation stays within the target range and to increase the predictability of inflation over the longer term (Crawford 2001).

Monitoring inflation

- In the short run, a good deal of movement in the CPI is caused by transitory fluctuations in the prices of such volatile components as fruit and gasoline, as well as by changes in indirect taxes. For this reason, the Bank focuses on a *core* measure of CPI inflation that excludes the eight most volatile components of the CPI and adjusts the remaining components to remove the effect of changes in indirect taxes. Core inflation also tends to be a better predictor of future changes in the total CPI than does the recent history of CPI inflation (Macklem 2001).

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Monetary Policy Report

— April 2005 —

*This is a report of the Governing Council of the Bank of Canada:
David Dodge, Paul Jenkins, Sheryl Kennedy, Pierre Duguay,
David Longworth, and Tiff Macklem.*

The Canadian economy has had to adjust to sharp movements, not just in the external value of our dollar, but also in the foreign demand for many of our goods and services. Inflation targeting gives the Bank an important guideline for dealing with the currency appreciation, allowing us to maintain our focus on macroeconomic stabilization at a time when various sectors of the economy are dealing with the exchange rate shock.

David Dodge

Governor, Bank of Canada
21 March 2005

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Foreword: Ten Years of the *Monetary Policy Report*

Ten years ago this spring, the Bank of Canada issued its first semi-annual *Monetary Policy Report.*

The Introduction to that *Report* noted that

> The report reflects the framework used by the Bank in its conduct of policy. This framework includes: (i) a clear policy objective, (ii) a medium-term perspective (given the long lags for the full impact of monetary policy actions on the economy) and (iii) a recognition that monetary policy works through both interest rates and the exchange rate.
>
> The ultimate objective of Canadian monetary policy is to promote good overall economic performance. Monetary policy can contribute to this goal by preserving confidence in the value of money through price stability. In other words, price stability is a means to an end, not an end in itself.

Although our framework has been refined over time, these statements are as true today as they were in 1995. The interim period has represented the best 10 consecutive years of good economic performance that Canada has seen in the last 35 years, and a transparent inflation-targeting regime has been a significant contributor to this outcome. The introduction of the *Monetary Policy Report* marked a major step forward in the transparency of the Bank's conduct of monetary policy. With the changes we have made through time to make the *Report* more transparent, it continues to serve us well in our communications with the public.

Governing Council

1. Overview

Developments in the target for the overnight rate since the October *Report*:

7 December—Unchanged at 2.5 per cent

25 January—no change

1 March—no change

12 April—no change

The global economy has been unfolding largely as expected, and prospects for continued robust growth are quite favourable, especially over the near term. Against this backdrop, the outlook for the Canadian economy through to the end of 2006 is essentially unchanged from that in the January *Monetary Policy Report Update*.

The Canadian economy continues to adjust to major global developments. These include the realignment of currencies in response to global imbalances, the higher prices of both energy and non-energy commodities, and growing competition from emerging-market economies.

The sectoral adjustments to these developments are becoming more evident. Many Canadian commodity-producing sectors are expanding. However, firms in a number of other sectors exposed to international trade are facing pressure from the appreciation of the Canadian dollar and from foreign competition. On balance, net exports have been a drag on the economy. But with robust domestic demand, some sectors—such as retail, wholesale, and housing—have been growing strongly. Canadian monetary policy continues to facilitate the adjustment process by aiming to keep inflation at the 2 per cent target and the economy operating near its production capacity. The Bank continues to judge that the economy is operating slightly below its full production capacity.

After appreciating sharply in 2003 and 2004, the Canadian dollar has been fluctuating in a range of around 80 to 83 cents U.S. since the beginning of the year.

The Bank's base-case projection calls for annualized growth of about 2 1/2 per cent in the first half of 2005 and 3 per cent in the second half. Growth of about 3 1/2 per cent is expected over the four quarters of 2006, consistent with returning the economy to full production capacity in the second half of that year.

Expressed on an annual average basis, growth in 2005 is projected to be about 2 1/2 per cent, down slightly from the January *Update*, while the projection for 2006 is little changed at about 3 1/4 per cent.

We continue to expect core inflation to move back to the 2 per cent target around the end of 2006. Based on the scenario implied by oil-price futures, total CPI inflation is projected to remain slightly above 2 per cent this year and to move slightly below 2 per cent in the second half of 2006.

This report includes information received up to the fixed announcement date on 12 April 2005.

Growth in the Canadian economy this year and next is anticipated to come primarily from domestic demand, as net exports are expected to exert a drag on the economy. To continue to support aggregate demand, the Bank decided to leave the target for the overnight rate unchanged at 2.5 per cent on 1 March and 12 April. In line with the Bank's outlook, a reduction of monetary stimulus will be required over time.

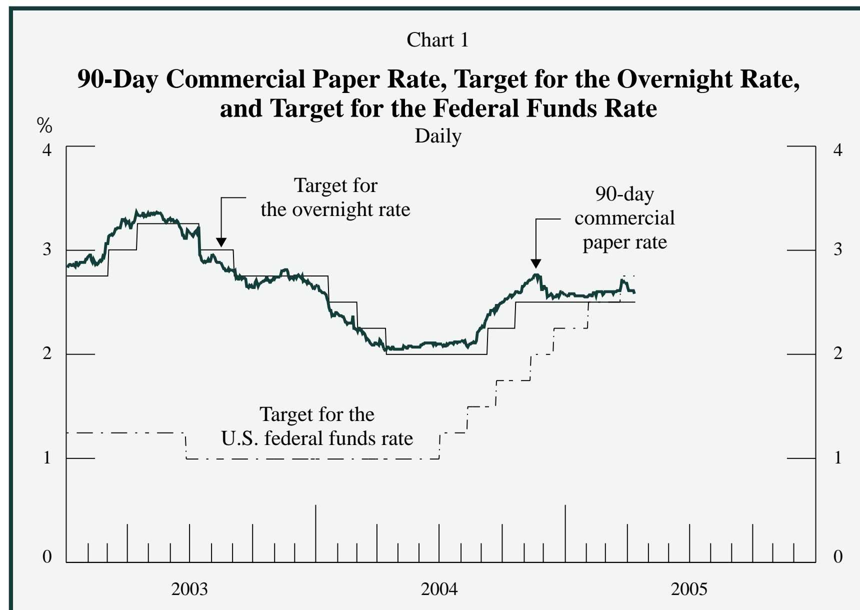
The global and Canadian economic outlooks remain subject to both upside and downside risks and to uncertainties. These risks include the pace of expansion in Asia, and the prices of oil and non-energy commodities. A further risk relates to the resolution of current account imbalances, with the risk of a disorderly correction growing over time, should these imbalances persist.

Most of the uncertainties with respect to the Canadian outlook continue to relate to how the economy is adjusting to the relative price changes associated with major global developments.

Chart 1

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

Daily



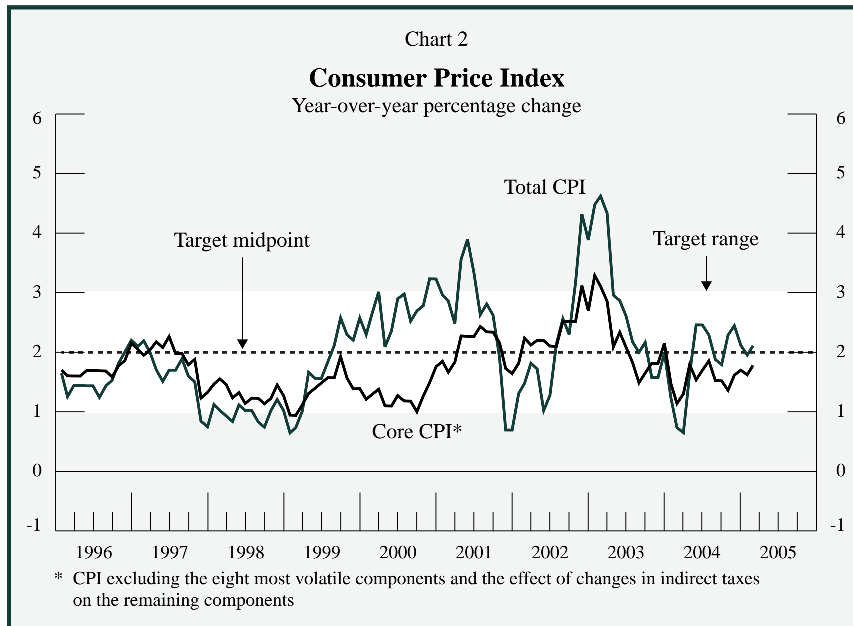
2. Recent Developments in Inflation

In the past year, core CPI inflation has been relatively stable, fluctuating in a range of 1.5 to 1.8 per cent. The surge in crude oil prices since the end of 2003 has pushed the average rate of increase in the total CPI to slightly more than 2 per cent over the same period.

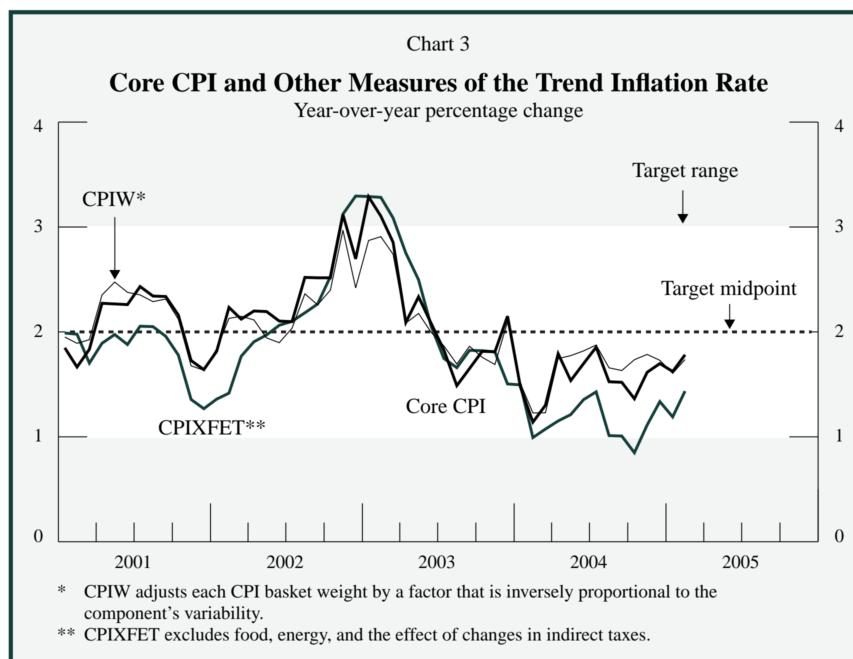
Core inflation has fluctuated in a range of 1.5 to 1.8 per cent.

Inflation and the 2 per cent target

The core rate of inflation moved up to 1.8 per cent in February from 1.5 per cent in August 2004, still below the Bank's 2 per cent inflation-control target. (Chart 2).[1] This is virtually the same as the rise projected in the January *Update*. Other measures of the trend rate of inflation that the Bank follows also remained below the 2 per cent target (Chart 3).



1. The core measure of inflation excludes the eight most volatile components of the CPI and adjusts the remaining components to remove the effect of changes in indirect taxes. The eight most volatile components are fruit, vegetables, gasoline, fuel oil, natural gas, intercity transportation, tobacco, and mortgage-interest costs.



The modest amount of excess supply in the Canadian economy through much of 2003 and 2004 contributed to keeping the core rate slightly below longer-run expectations. Further reductions in the prices of many import-intensive goods, caused by the appreciation of the Canadian dollar and ongoing decreases in the global prices of some consumer goods, also continued to put downward pressure on core inflation over the period. The rate of increase in homeowners' replacement costs, an important component of core prices for shelter, has also eased somewhat since July 2004 as a result of lower year-over-year increases in the prices of new housing. Fluctuations in car prices, reflecting changes in manufacturers' incentives programs, explain much of the short-term variation in core inflation observed since mid-2004.

The rate of increase in the total CPI has averaged just above 2 per cent since August 2004.

Since last August, the 12-month rate of increase in the total CPI was, on average, just above 2 per cent. The higher rate of increase relative to the core rate chiefly reflected the impact of substantial increases in the prices of energy commodities on selected CPI components. In particular, in February there were substantial increases in consumer prices for gasoline, fuel oil, natural gas, and intercity transportation from year-earlier levels.

Factors at work on inflation

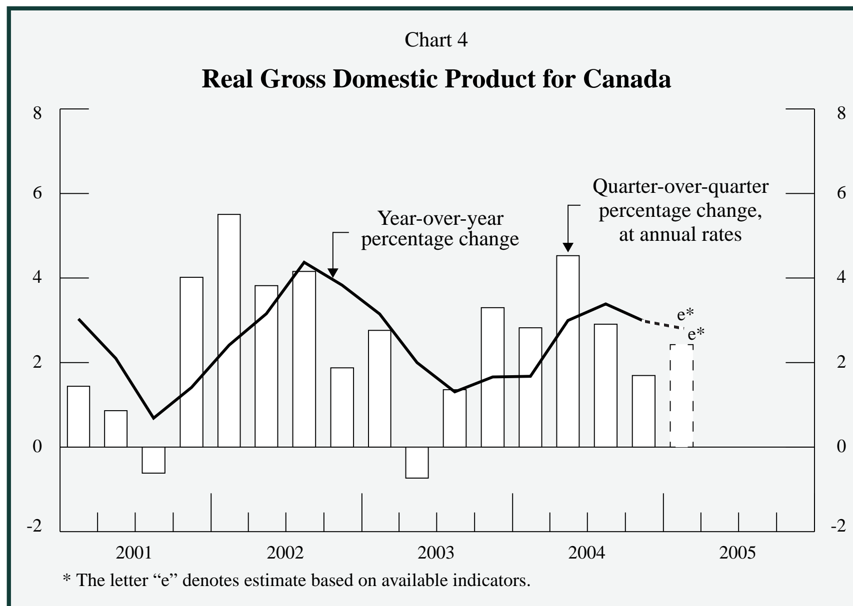
Aggregate demand

Canada's real GDP grew at an annual rate of 2.9 per cent in the third quarter of 2004, as expected in the October *Report* (Chart 4). In the fourth quarter, economic growth eased to an annual rate of 1.7 per cent. This was less than anticipated in both the last *Report* and the January *Update*. For the second half of the year as a whole, exports were markedly weaker than projected, although this was partly offset by unexpectedly large inventory investment. Economic growth is likely to be on the order of 2 1/2 per cent in the first quarter of 2005.

Economic growth in the fourth quarter was weaker than expected.

Chart 4

Real Gross Domestic Product for Canada

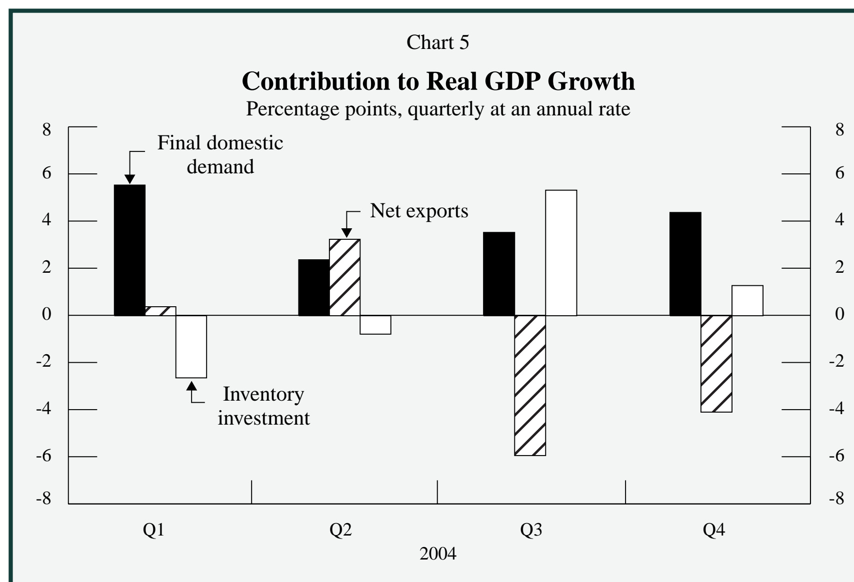


* The letter "e" denotes estimate based on available indicators.

Final domestic demand continued to rise substantially in the second half of 2004, and inventory investment rose markedly in response to this robust growth and to concerns about delivery lags. In contrast, the volume of net exports fell back (Chart 5).

Exports fell back in the second half of 2004, partly in response to the earlier rise in the Canadian dollar.

Canadian exports decreased sharply in the second half of 2004. Although a good part of this decline reflected an unwinding of the surprising surge recorded in the first half, it more fundamentally represented the ongoing adjustment to the past appreciation of the Canadian dollar. That adjustment has been most evident in those export components characterized by product differentiation (Chart 6). Indeed, in the second half of last year, export volumes of machinery and equipment and non-automotive consumer goods



relative to indicators of foreign activity resumed the steep decline that began in 2003. In contrast, exports of commodities relative to U.S. industrial production, while fluctuating over the course of 2004, were little changed at year-end from 2003 levels. Exports of automotive products were also little changed over the course of last year relative to U.S. indicators of activity for the motor vehicle sector.

Among the components of final domestic demand, the pace of business investment picked up markedly towards year-end. Household spending also rose considerably, owing to monetary stimulus and ongoing gains in real incomes.

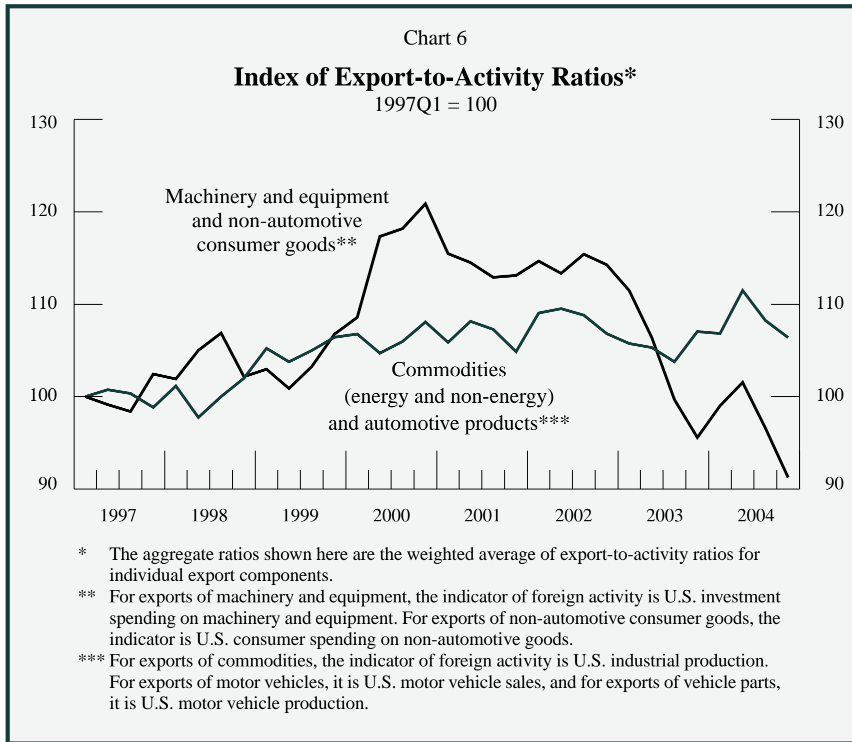
Part of the increase in final domestic demand was met by substantial gains in imports. The rise in inventory investment also contributed to boost imports. Some of the marked rise in import volumes relative to indicators of domestic activity, especially for such items as machinery and equipment and crude and fabricated materials, reflected the impact of the higher Canadian dollar, as well as growing competition from low-cost emerging markets (Chart 7).[2]

2. Imports are still estimated to have been below their long-run fundamental level at the end of 2004, since only part of their adjustment to the substantial cumulative appreciation of the Canadian dollar had been completed. However, further econometric work on imports, involving the replacement of an aggregate income variable by individual components of demand, suggests that the size of the gap relative to long-term fundamental levels is considerably smaller than that shown in Technical Box 3 of the October *Report*.

Chart 6

Index of Export-to-Activity Ratios*

1997Q1 = 100



* The aggregate ratios shown here are the weighted average of export-to-activity ratios for individual export components.

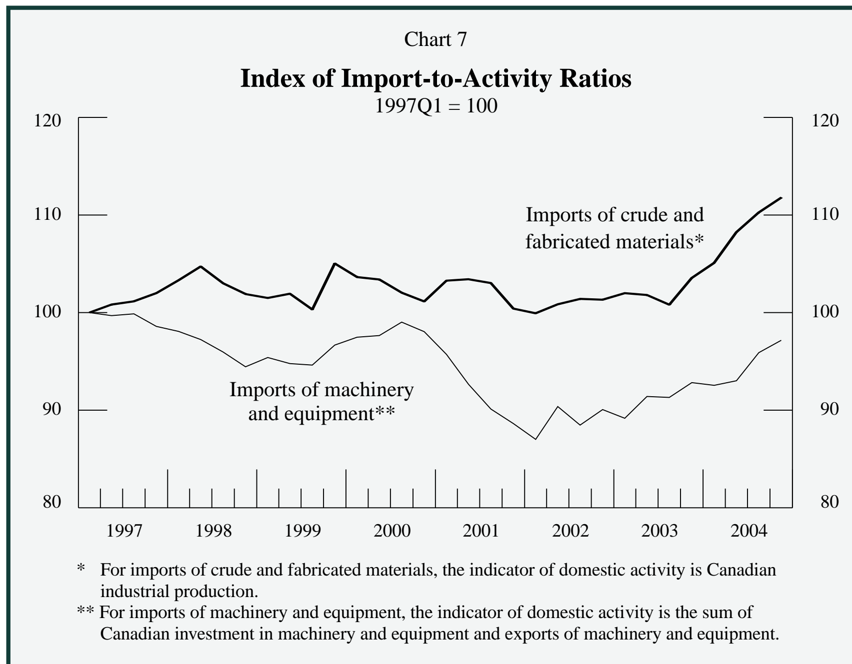
** For exports of machinery and equipment, the indicator of foreign activity is U.S. investment spending on machinery and equipment. For exports of non-automotive consumer goods, the indicator is U.S. consumer spending on non-automotive goods.

*** For exports of commodities, the indicator of foreign activity is U.S. industrial production. For exports of motor vehicles, it is U.S. motor vehicle sales, and for exports of vehicle parts, it is U.S. motor vehicle production.

Chart 7

Index of Import-to-Activity Ratios

1997Q1 = 100



* For imports of crude and fabricated materials, the indicator of domestic activity is Canadian industrial production.

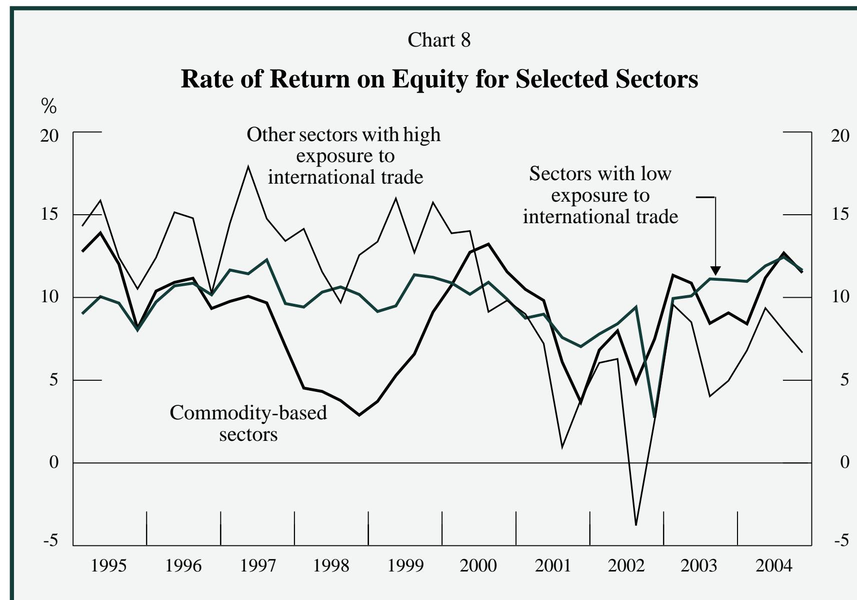
** For imports of machinery and equipment, the indicator of domestic activity is the sum of Canadian investment in machinery and equipment and exports of machinery and equipment.

Adjusting to global change

There are more indications of the adjustments being made in response to major global developments . . .

The Canadian economy is continuing to adjust to major global developments. These include a marked realignment of world currencies, including the Canadian dollar; high price levels for crude oil and non-energy commodities; and the growing global economic impact of China and India. Since the October *Report*, there have been more indications of the sectoral effects of these global developments and of firms' responses to these changes.

The strong global economic expansion boosted profitability for most of the industries with high exposure to international trade in the first three quarters of 2004 (Chart 8).[3] In the fourth quarter of last year, however, profitability eased off in many of these industries, following a reduction in the global demand for Canadian products and a further appreciation of the Canadian dollar from the middle of 2004. As a result, there was only marginal growth in the overall level of activity in sectors highly exposed to international competition from August 2004 to January 2005. In contrast, most sectors with a low exposure to foreign competition—such as housing, retail and wholesale trade, and finance, insurance and real estate—made further solid gains in output. Some of these sectors also benefited from lower costs for imported products.



3. Net exposure to international trade is calculated by adding the proportion of production that is exported and the share of imports in domestic consumption, and subtracting the share of imported inputs in production. If a sector's net exposure to international trade ratio was at least 0.5 in 2001, then that sector is defined as being highly exposed to international trade or competition.

These global economic developments can be expected to lead to important shifts in the composition of activity among the broad sectors of the Canadian economy. One important channel through which this takes place is major shifts in capital spending at the sectoral level in response to expected persistent changes in profitability.

. . . as is evident in the sectoral composition of business investment spending.

Consistent with this, the largest cumulative gains in actual and planned capital spending for 2004 and 2005 occurred in commodity-producing industries in response to the substantial rebound in global commodity prices and the expectation that these price gains would persist for some time (Table 1). Increases in investment expenditures are particularly pronounced in oil and natural gas extraction, other mining activity, and in the manufacture of wood products. The substantial gains in Canada's final domestic demand in recent years have also led to a marked rise in capital spending in many sectors with a low exposure to international trade, especially electric power generation, finance and insurance, information and cultural industries, and the manufacture of refined petroleum products. Moreover, in many of the sectors either producing commodities or with a low exposure to international trade, a large part of the increase in capital spending is directed at expanding capacity.

In contrast, there is likely to be prolonged downward pressure on profitability in many industries highly exposed to international competition (other than those producing energy and other commodities), primarily because of the Canadian dollar's appreciation and growing competition from such economies as China and India. As a result, investment spending in these industries seems to be directed at reducing costs and improving competitiveness rather than at increasing capacity.

Table 1
Current-Dollar Investment in Capital Spending
Annual percentage change

Sector	2003	2004	2005
Aggregate private sector	2.9	6.5	8.8
Oil and gas extraction	13.9	8.2	12.0
Other commodity-producing industries	6.1	6.0	12.9
Other manufacturing with high exposure to international trade or competition*	1.4	-3.5	10.9
Low exposure to international trade	-0.4	7.2	7.0

* Includes sectors that are exposed as net importers
Source: Statistics Canada, *Private and Public Investment in Canada, Intentions 2005.*

More broadly, the Bank's *Business Outlook Surveys* have shown that many firms adversely affected by global developments are taking various measures to improve productivity and reduce costs. For instance, an increasing number of producers are choosing to cut costs by importing more inputs from Asia. Others are adjusting to the higher Canadian dollar by phasing out production of goods and services with low profit margins and concentrating on those with higher returns.

The adjustments being made by firms in response to global economic developments also continued to be reflected in the sectoral composition of employment changes. Employment has tended to rise since the end of 2003 in those industries producing commodities or having low exposure to foreign competition. On the other hand, employment has fallen in the other manufacturing industries highly exposed to international trade, reflecting to some extent the substitution of capital for labour in order to reduce costs. The spring *Business Outlook Survey* indicates that employment growth over the next 12 months will be concentrated in service industries.

This reallocation of capital and labour involves adjustment costs that may cause a temporary slowdown in productivity growth and, therefore, in the growth of potential output. (See Technical Box 1.)

Estimated pressures on capacity

The level of economic activity at the end of 2004 was broadly in line with the Bank's expectations in the January *Update*. While output growth in the fourth quarter of 2004 was somewhat lower than expected, this was largely offset by upward revisions to Statistics Canada's estimates of growth earlier in the year. At the same time, the Bank's conventional measure of potential output for 2004 was revised down slightly relative to the estimate used in the January *Update*.[4] As a result, the Bank's conventional measure of the output gap indicated that the economy was operating at about its capacity limits in the fourth quarter of 2004, instead of slightly below its effective capacity, as in the last *Update* (Chart 9).

Other indicators point to greater pressure on capacity than the conventional measure. For instance, capacity utilization in the non-farm, goods-producing sector in the fourth quarter of 2004 remained considerably higher than its average for 2000 to 2003, because growth of capacity in this sector has been relatively low in recent years, owing to weak investment spending and some write-off of uneconomic capacity as a result of relative price changes.

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4. Potential output is now estimated to have increased at an annual rate of 2.7 per cent in 2004, compared with a rise of 2.9 per cent in the *Update*.

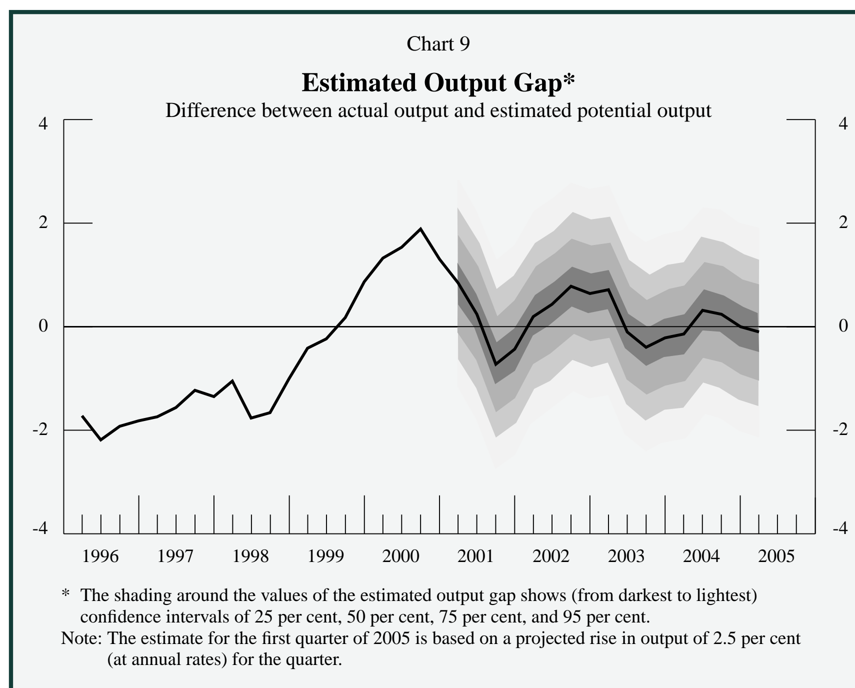
Technical Box 1

Economic Adjustment and Productivity Growth

The Canadian economy has been adjusting to significant global developments, such as the realignment of world currencies, including the Canadian dollar, and the surge in commodity prices. These shocks are largely structural in nature and will lead to a reallocation of capital and labour away from the production of non-commodity manufactured goods towards the production of primary materials and non-tradable goods and services. This reallocation will take some time, however, and productivity growth could be lower during the adjustment period.

Before making adjustments to their workforce, firms often wait to ensure that the shock is permanent. Workers with skills tied to a particular industry may require retraining or other assistance to become fully functional in areas of the economy that are expanding. They may have to relocate, and, once on the job, it may take time for new staff to develop the firm-specific skills often associated with productivity gains. Thus, major sectoral shifts in the allocation of labour will initially tend to dampen productivity growth.

With respect to capital, there are typically lags between the decision to invest, the acquisition of capital, and its integration into the production process, either to expand capacity or to make the production process more efficient. When investment is in the form of machinery and equipment rather than structures, adjustment costs are an important consideration. For example, in spite of the substantial investment in information and communications technologies (ICT) in the past decade, productivity growth initially remained sluggish, especially outside the ICT production sector. This is because it takes more than physical investment in new technologies to generate widespread productivity gains. Firms must train workers to use new technologies or wait for newly trained graduates. Businesses may also have to reorganize their workplaces to benefit fully from new technologies. These adjustment costs will temporarily lower measured output, and thus productivity growth, until the adjustment period is over. The lag between investment in new technology and its payoff in terms of greater productivity growth could extend to a few years.



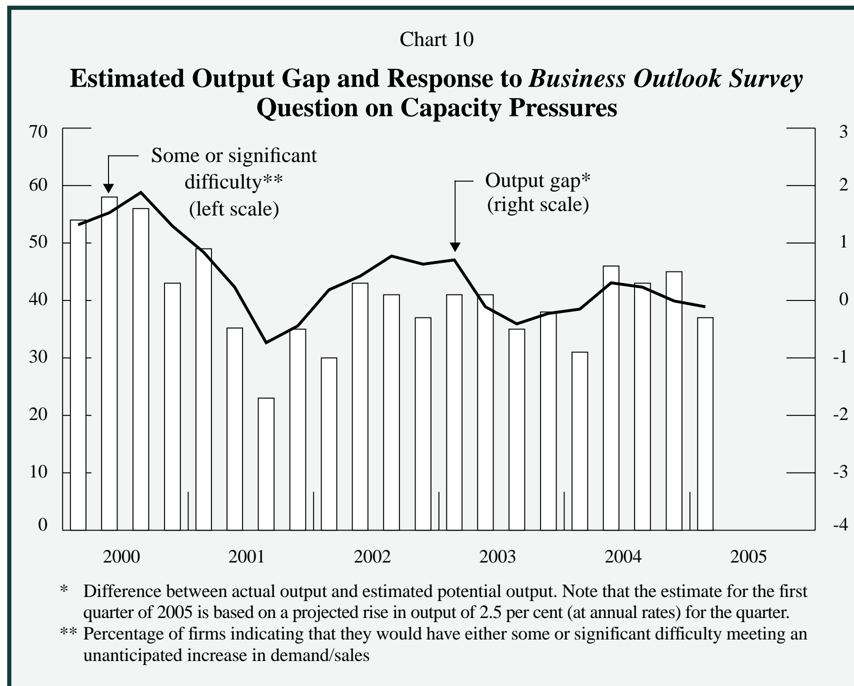
* The shading around the values of the estimated output gap shows (from darkest to lightest) confidence intervals of 25 per cent, 50 per cent, 75 per cent, and 95 per cent.
Note: The estimate for the first quarter of 2005 is based on a projected rise in output of 2.5 per cent (at annual rates) for the quarter.

Nevertheless, it is important to note that several indicators currently suggest more economic slack than is implied by the conventional measure. On average, the core rate of inflation has been below the 2 per cent midpoint of the target range since mid-2003. As well, wage increases have remained quite moderate, and the proportion of firms reporting labour shortages or difficulties in meeting an unanticipated increase in demand was lower than average in the spring *Business Outlook Survey*.

The degree of economic slack varies across industries and regions because of the ongoing process of adjusting to global changes. But what matters for monetary policy is the economy as a whole.

The Bank judges that the output gap is somewhat larger than suggested by its conventional measure.

Based on an assessment of all the indicators of capacity pressures, including those from the *Business Outlook Survey*, the Bank judges that there is slightly more excess supply in the Canadian economy than suggested by its conventional measure (Chart 10). This view of the current size of the output gap is similar to that held in the January *Update*.



Cost control and output prices

The underlying rate of increase in wages, based on such measures as the average hourly earnings of permanent workers, appears to have remained in a range between 2 1/4 and 3 1/4 per cent since the middle of 2004 (Chart 11). The year-to-year gain in another wage measure—hourly labour compensation in the business sector—was somewhat lower, at 2 per cent at the end of last year.

These overall figures mask important regional differences. For example, in Western Canada, wage gains have generally been higher than in the rest of the country, reflecting a greater prevalence of labour shortages in that region.

With only a slight increase in productivity over the past year, unit labour costs in the business sector in the fourth quarter of 2004 rose by just under 2 per cent from year-earlier levels (Chart 12). Indeed, productivity growth was surprisingly low in both 2003 and 2004, easing markedly from its average performance over the 1998 to 2002 period.[5] That reduction in productivity growth was broadly based across sectors and stands in sharp contrast to the U.S. experience.[6] The assumption about the pace of productivity growth embodied in the Bank's outlook is discussed in Section 4.

Unit labour costs in the fourth quarter rose by just under 2 per cent from year-earlier levels.

5. It should be kept in mind that Statistics Canada's estimates of productivity growth for 2003 and 2004 are preliminary and are subject to revision as more reliable benchmark data become available.

6. It is doubtful that the type of adjustment costs reviewed in Technical Box 1 accounted for a significant part of the reported slowdown.

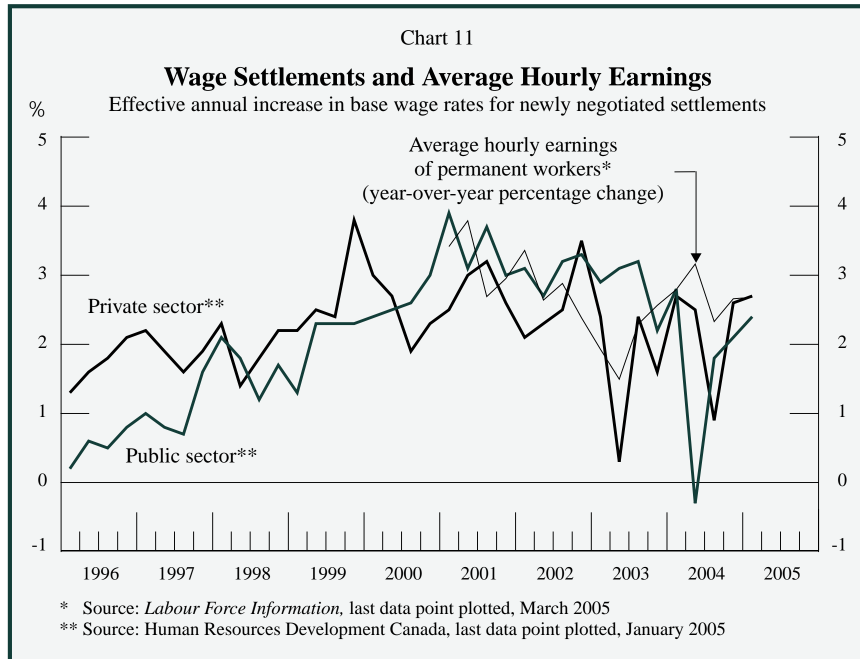


Chart 11

Wage Settlements and Average Hourly Earnings

Effective annual increase in base wage rates for newly negotiated settlements

* Source: *Labour Force Information,* last data point plotted, March 2005

** Source: Human Resources Development Canada, last data point plotted, January 2005

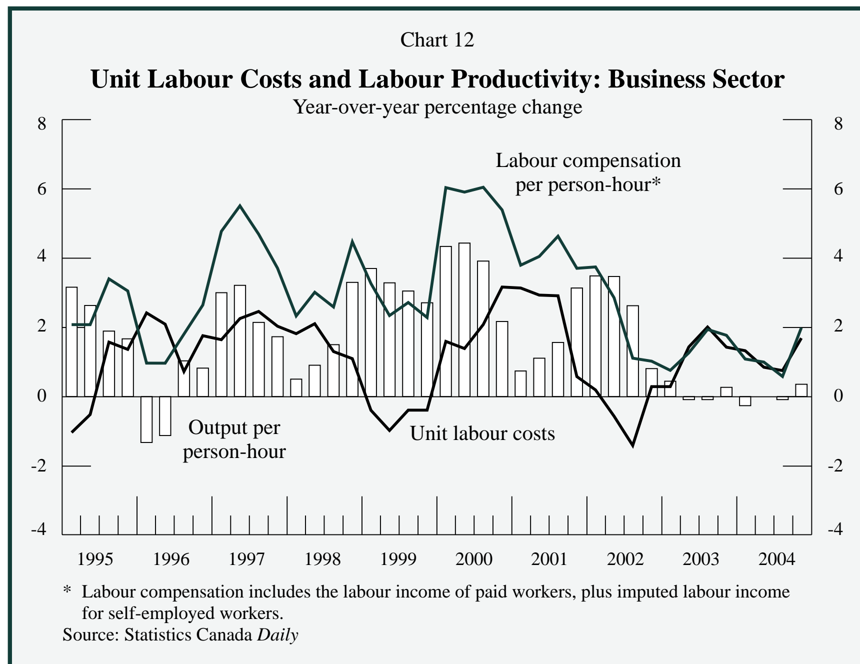


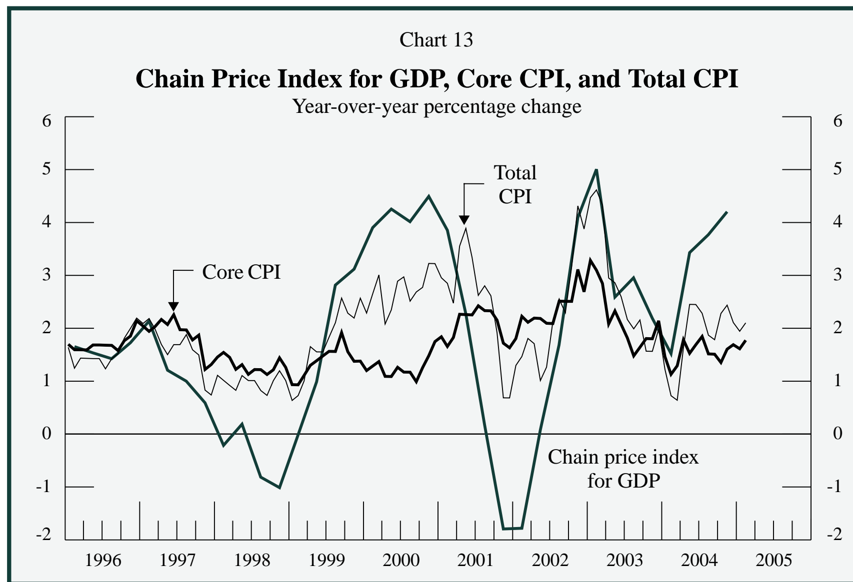
Chart 12

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*



With substantial increases in the global prices for Canadian exports of energy commodities and many industrial materials, Canada's terms of trade improved considerably in 2004.[7] As a result, the chain price index for GDP (a broad price measure of the goods and services produced in Canada) rose 4.2 per cent between the fourth quarter of 2003 and the fourth quarter of 2004 (Chart 13). By comparison, the prices of goods and services purchased by Canadians rose 2 per cent over the same period. This terms-of-trade improvement has thus produced a significant increase in real income, which has been reflected in the growth of corporate profits and government tax revenues.

Income growth was boosted by an improvement in the terms of trade.

The price of crude oil has increased further since the end of 2004, reflecting upward revisions to the projected global demand for oil and downward revisions to expected non-OPEC supplies. The prices of non-energy commodities have also risen since the end of 2004 (Chart 14). Strengthening demand has contributed to recoveries in the prices of both lumber and pulp. At the same time, continued strong global demand, as well as a number of planned production cutbacks, have led to a further rise in metals prices.

7. Over the past three years, Canada's terms of trade have risen by just over 16 per cent.

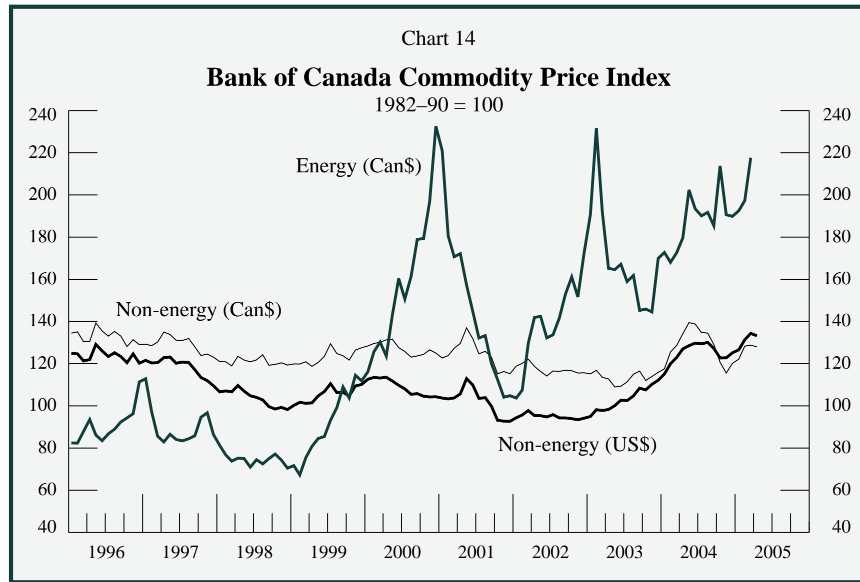


Chart 14
Bank of Canada Commodity Price Index
1982–90 = 100
Energy (Can$)
Non-energy (Can$)
Non-energy (US$)
240
220
200
180
160
140
120
100
80
60
40
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005

3. Financial Developments

Global financial conditions have remained very favourable . . .

For both the global economy and for Canada, financial conditions have remained very favourable since the October *Report*. Yields and credit spreads on corporate bonds are close to historically low levels. Equity markets have improved over recent months, and market volatility has remained low. Sustained improvement in the balance sheets of Canadian banks, aggressive competition among suppliers of credit, and modest demand for credit have led to continued easing in bank-lending conditions in Canada. Mainly because of strong supply conditions, growth in business credit continues to pick up. Meanwhile, both supply and demand continue to support robust growth in household credit.

Credit conditions

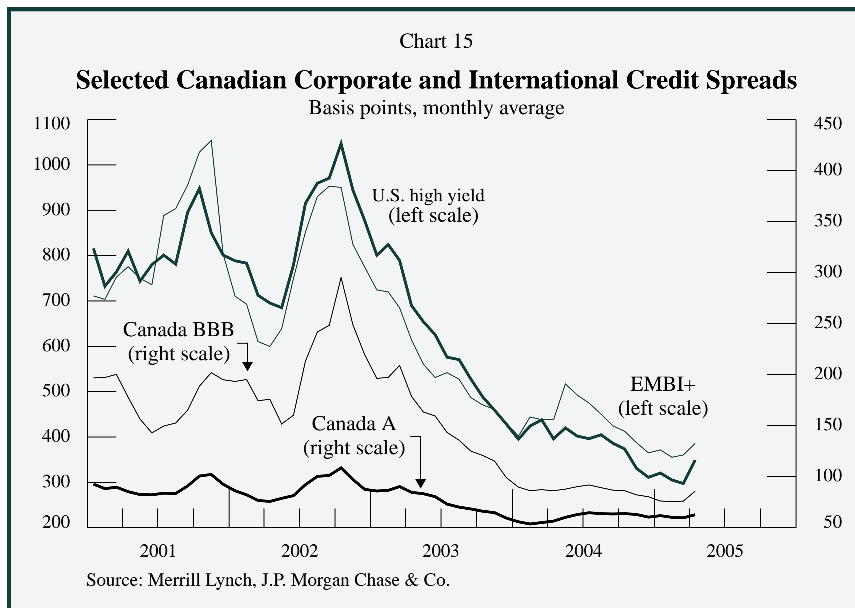
. . . and are reflected in business-credit conditions in Canada.

Business-credit conditions are quite favourable, both in Canada and internationally. In financial markets, the demand for higher-yielding, somewhat riskier products remains strong. Demand is supported by fairly robust corporate earnings and the low yields returned by government securities. This has contributed to high bond prices and relatively low credit spreads (Chart 15).

Chart 15

Selected Canadian Corporate and International Credit Spreads

Basis points, monthly average



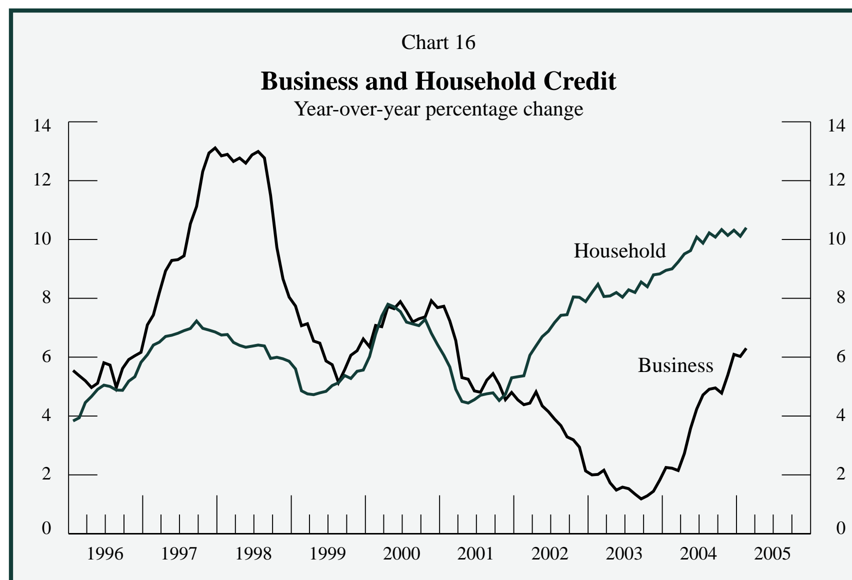
Source: Merrill Lynch, J.P. Morgan Chase & Co.

Most equity markets have improved since the October *Report*, with the TSX Composite Index increasing by about 10 per cent. Much of the improvement in Canada reflects the strong performance of the energy sector.

Both gross and net issues by corporations have shown solid growth in Canada. Credit defaults have been at cyclical lows, and the share of credit-rating upgrades in total credit-rating changes continued to rise. The growth of business credit (Chart 16) currently stands close to its 10-year average. The pickup in short-term business credit has continued, boosted by easier lending conditions. Growth in long-term business credit (including income trusts) has also remained robust since the October *Report*, helped by a stable net issuance of bonds and equities. Most of the increase in business credit has reportedly been channelled towards general business operations and debt refinancing rather than towards new investment.

Household credit has continued to advance at a rapid pace.

Household credit has continued to advance at a rapid pace since the October *Report*, with both consumer credit and residential mortgage credit contributing to the increase (Chart 16). At the same time, low interest rates and favourable labour market conditions have helped ensure that household balance sheets remain healthy. The elevated level of household credit growth is likely to be associated with strong consumption in the first part of this year.



Overall, there is a considerable amount of liquidity in the Canadian and global economies.

In summary, a broad range of financial indicators point to a considerable amount of liquidity in the global economy, as well as in the Canadian economy.

Yield curves and the exchange rate

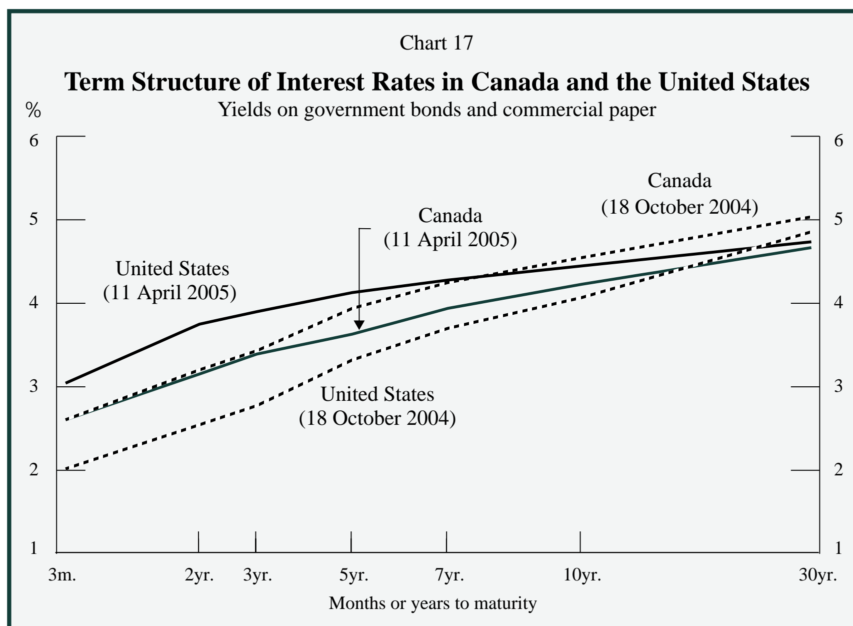
Markets anticipate further increases in the federal funds rate over the remainder of the year . . .

The yield curve in the United States has moved higher since the time of the October *Report* (Chart 17). It has also continued to flatten, mainly driven by larger increases in short-term interest rates. Futures prices indicate that markets anticipate further increases in the federal funds rate over the remainder of the year, with U.S. forward rates implying a policy rate of approximately 4.0 per cent by the end of December 2005.

Chart 17

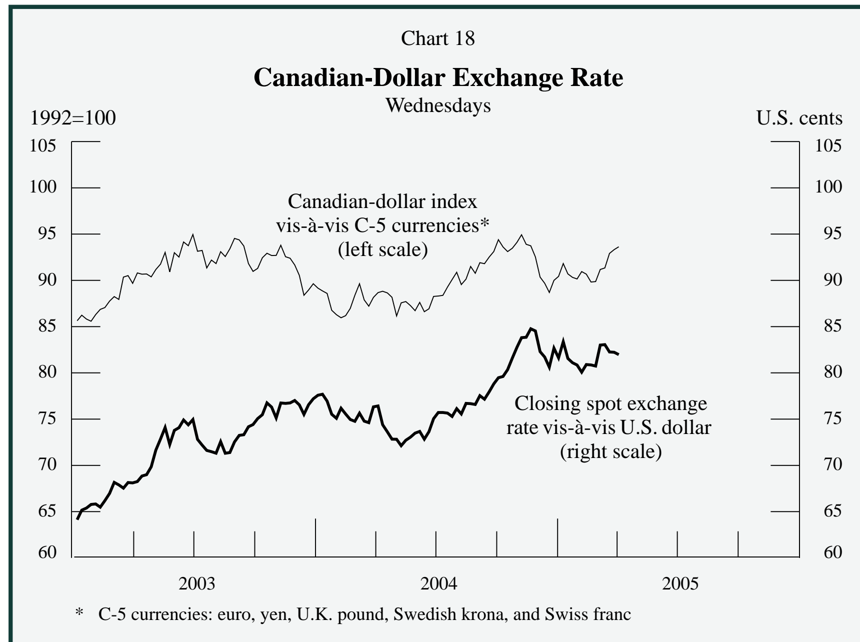
Term Structure of Interest Rates in Canada and the United States

Yields on government bonds and commercial paper



. . . and more gradual increases in Canada's policy rate.

Canadian asset prices indicate expectations of a more gradual trajectory for increases in interest rates here than in the United States. This divergence in the expected paths for policy rates in the two countries has contributed to sharply declining interest rate differentials across the yield curve. Yields on two-year Canadian bonds are now approximately 60 basis points below those on U.S. Treasuries, and yield spreads on longer-term bonds have turned negative for the first time in over four years.



The Canadian dollar has traded within a range of 80 to 83 cents U.S.

After appreciating sharply from the time of the October *Report* until early December, major currencies weakened against the U.S. dollar, and the Canadian dollar has traded within a range of 80 to 83 cents U.S. This has occurred within the context of rising U.S. interest rates, relative economic weakness in Japan and Europe, rising energy prices, and generally high prices for other commodities.

4. THE OUTLOOK

International background

The global outlook is little changed from October . . .

On balance, the global economy has been performing largely as expected at the time of the October *Report*, and growth is projected to remain relatively strong, at around 4 per cent in both 2005 and 2006, in spite of higher oil prices. While the overall growth picture for the next two years has changed little from the October *Report*, the distribution of growth is more uneven among major economies than previously expected, with upward revisions to the already strong growth prospects in non-Japan Asia offsetting downward adjustments to the growth outlook in Japan and the European Union (Table 2).

Table 2
Global Growth Projections

	Share of real global GDP[a] (per cent)	Expected growth (per cent)[b]		
		2004	2005	2006
United States	21	4.4 (4.6)	3.7 (3.7)	3.7 (4.1)
European Union	20	1.9 (2.1)	1.7 (1.9)	2.3 (2.6)
Japan	7	2.6 (4.1)	0.8 (1.5)	1.8 (2.1)
China and Asian NIEs[c]	16	8.9 (8.2)	7.6 (7.1)	7.2 (6.5)
Others	36	5.7 (4.6)	4.4 (4.1)	4.2 (4.8)
World	100	5.0 (4.7)	4.0 (3.9)	4.0 (4.3)

a. GDP shares are based on the purchasing-power-parity (PPP) valuation of country GDPs for 2003. Source: IMF, WEO Database, September 2004
b. Numbers in parentheses show projections from the October 2004 *Monetary Policy Report*.
c. NIEs are newly industrialized economies. These include Hong Kong (Special Administrative Region), Korea, Taiwan (Province of China), and Singapore.
Source: Bank of Canada

. . . with momentum in the United States remaining strong.

Recent economic developments in the United States suggest that underlying momentum remains strong. Real GDP grew at an annual rate of 4 per cent in the third quarter of 2004 and 3.8 per cent in the fourth quarter. Consumer spending and business investment were both very robust in the second half of the year. Despite the significant real effective depreciation of the U.S. dollar, net exports continued to restrain growth in the second half of 2004. Evidence to date indicates that growth remained near 4 per cent in the first quarter of 2005.

The U.S. economy is expected to post growth rates that will be somewhat above potential in 2005 and 2006, albeit lower than in 2004. As a result, excess supply (estimated at somewhat below 1 per cent of GDP at the end of 2004) should be largely eliminated over the next two years. Business investment should remain solid, since the capital stock appears unusually low at this point in the cycle. Moreover, the past depreciation of the U.S. dollar should contribute to a strong recovery in export growth. Meanwhile, household expenditures are likely to slow, partly because of the dampening impact of higher oil prices and of past and anticipated increases in interest rates.

Growth in China remains buoyant . . .

At the same time, the contribution of Asia (excluding Japan) to the world economic expansion is slightly greater than previously expected. In particular, growth in China has remained surprisingly buoyant despite the implementation of administrative tightening measures and higher domestic interest rates. Accordingly, the outlook calls for a more gradual slowing profile than was assumed at the time of the October *Report*.

. . . while that in Japan is projected to be lower than earlier expected.

In contrast, growth in Japan turned out to be weaker than anticipated.[8] Following a sharp rise in the first quarter of 2004, real GDP was relatively stagnant throughout the remainder of the year, owing largely to the impact of an inventory correction in IT-related sectors, higher oil prices, and typhoons. A gradual pickup in quarterly growth throughout 2005 is expected, as the effect of the adverse factors that restrained aggregate demand in the latter part of 2004 diminishes. Nevertheless, the average annual growth rate in 2005 should be significantly lower than in 2004, owing to the low starting point.

In the euro area, real economic activity in the final quarter of 2004 was also weaker than anticipated, and the outlook has been revised down marginally. A gradual pickup in the rate of growth of economic activity is expected this year and next, as the adverse impact stemming from the past appreciation of the euro and the rise in world oil prices gradually tapers off.

Global imbalances remain a key risk.

While the overall global short-term outlook is favourable, a number of risks and uncertainties remain, including the future course of oil prices, the pace of expansion in China, and geopolitical developments. A key risk relates to the unfolding of current account imbalances, with the risk of a disorderly correction growing over time if the imbalances persist. Indeed, despite a substantial real effective depreciation of the U.S. dollar since early 2002,[9] external imbalances have continued to widen and are likely to

8. This partly reflects revisions to national accounts that have resulted in a much lower growth profile.

9. The depreciation of the U.S. dollar between February 2002 and March 2005 amounted to 15 per cent, according to the U.S. Federal Reserve Board's real effective broad index.

continue to do so in the near term. An orderly correction of external imbalances will require increased savings in the United States, a strengthening of demand elsewhere, notably in Japan and Europe, combined with further real effective depreciation of the U.S. dollar. Greater exchange rate flexibility in Asia would facilitate the adjustment.

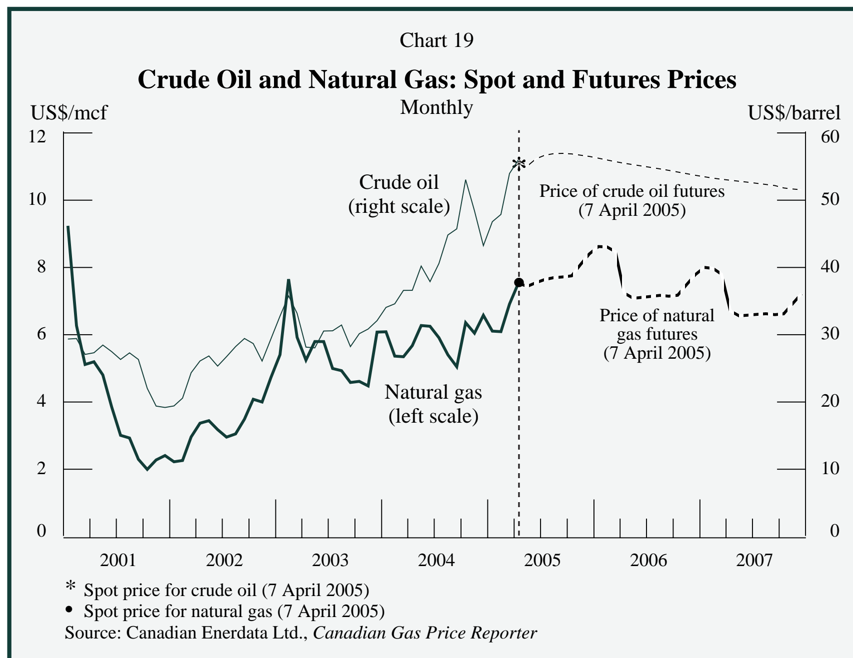
The projected global economic expansion should help maintain the U.S.-dollar prices of non-energy commodities at relatively high levels over the remainder of 2005 and through 2006, although some easing is likely as new supplies become available (Technical Box 2). On the other hand, any further real depreciation of the U.S. dollar would put upward pressure on non-energy commodity prices, expressed in U.S.-dollar terms. With regard to crude oil, the Bank's base-case scenario—which is based on recent futures prices (Chart 19)—assumes that prices will be close to US$57 per barrel over the remainder of 2005 and then ease slightly to about US$54 per barrel by the second half of 2006. Natural gas prices are expected to stay at relatively high levels through 2006. The Bank's base-case scenario for oil prices is markedly higher than in the January *Update*.

The assumed scenario for oil prices is now markedly higher.

Chart 19

Crude Oil and Natural Gas: Spot and Futures Prices

Monthly



* Spot price for crude oil (7 April 2005)
• Spot price for natural gas (7 April 2005)
Source: Canadian Enerdata Ltd., *Canadian Gas Price Reporter*

Technical Box 2

Emerging Asia: Implications for Canada

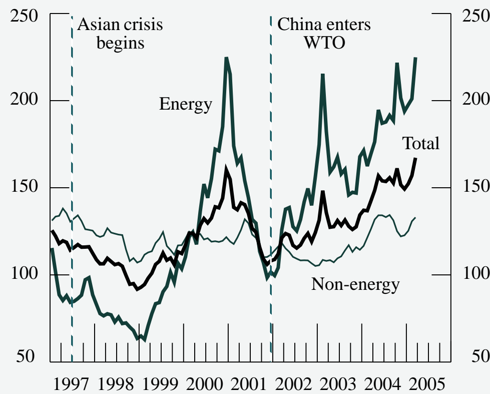
Over the past 25 years, emerging markets in Asia have been a growing source of global trade, with China becoming a dominant economic force in the region in the past few years.[1] By 2003, these economies accounted for 16 per cent of global trade, up from just 6 per cent in 1980. Although Canada's direct trade with the region is limited, the region's trade significantly affects Canada through global markets. Of particular importance is the region's growing demand for commodities and the resultant impact on global commodity prices.

Although Asian demand for commodities temporarily collapsed with the Asian crisis in 1997–98, the ensuing regional recovery and the growing economic prominence of China have led to a resurgence of demand and sharply higher prices. According to the Bank of Canada's index, commodity prices have risen by over 70 per cent in terms of G-7 currencies since mid-November 2001. This increase has been a significant factor behind the 25 per cent rise in the value of the Canadian dollar over the past two years.

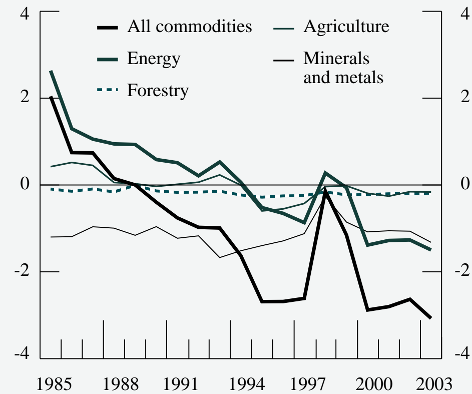
The strong Chinese demand for commodities reflects very robust domestic investment, as well as the country's growing role as a manufacturing platform for Asian firms. Although China is itself a major producer of many commodities, its rapid economic growth has caused domestic demand to outstrip domestic supply, leading the country to become a major buyer on international commodity markets.

Canadian natural-resource producers are well positioned to take advantage of these favourable market conditions. Robust global demand has resulted in strong corporate profitability despite the appreciation of the Canadian dollar. In response, resource producers have increased their investment expenditures, which suggests that Canadian firms are planning to expand production. Firms outside the resources sector are also paying closer attention to China as an important new market.

Commodity Price Indexes (G-7 Currencies)
1982-90=100



Commodity Trade Balance of Emerging Asian Economies as a Percentage of GDP



1. Emerging Asia includes China, Hong Kong, Indonesia, Korea, Malaysia, the Philippines, Singapore, and Thailand.

Aggregate demand and supply in Canada

GDP growth in Canada is projected to be about 2 1/2 per cent in 2005 and about 3 1/4 per cent in 2006 . . .

Given the effects of the past and recent appreciation of the Canadian dollar, the Bank expects growth, on an average annual basis, of about 2 1/2 per cent in 2005. Growth should pick up to about 3 1/4 per cent in 2006. The Bank's outlook for growth in 2005 is slightly lower than projected in the January *Update*, reflecting weaker-than-expected growth in the fourth quarter of 2004. Projected quarterly growth through the year, however, is unchanged from the January *Update*. While the Bank's growth projection for 2005 is the same as the latest Consensus outlook, the projection for 2006 is slightly higher.

. . . with the economy returning to its production capacity in the second half of 2006.

The Bank's projection assumes real GDP growth of 2 1/2 per cent, at an annual rate, during the first half of 2005. This is expected to move up to about 3 per cent in the second half of this year and to about 3 1/2 per cent over the four quarters of 2006. The lower rate of growth projected for the first half of 2005 stems mainly from the anticipated slowing in the rate of inventory accumulation. This outlook for growth implies a modest rise in excess supply in the first half of 2005 and a return to production capacity in the second half of 2006.

Were it to persist, the sluggish growth in labour productivity in the past two years would put the Bank's projection for potential output growth at risk. However, recent and projected increases in business investment, as well as continued rapid growth in labour productivity in the United States, make it reasonable to assume a resumption of productivity growth. In addition, there may be some upside risks to the trend rate of growth of labour inputs, at least over the near term. Therefore, at this time, the Bank continues to project growth in production capacity of 3 per cent. This is based on the assumptions of trend growth of 1 1/4 per cent in labour inputs and trend growth of 1 3/4 per cent in labour productivity.

Economic expansion is expected to be supported primarily by growth in final domestic demand . . .

Economic expansion in Canada this year and next is expected to be supported primarily by the continued substantial growth of final domestic demand (Table 3). This view is essentially unchanged from that of the January *Update*. As noted earlier, there is still considerable monetary stimulus supporting demand at this time. The Bank's outlook continues to incorporate a reduction of monetary stimulus over the projection period.

Capital spending by businesses is projected to increase even more strongly than last year, reflecting the global economic expansion and the associated high levels of prices for both energy and non-energy commodities, very favourable financial conditions, high profit levels, and further decreases in the prices of imported machinery and equipment. Ongoing gains in real incomes, the

effects of monetary stimulus, and the high level of consumer confidence (Chart 20) should contribute to further solid growth in consumer spending. However, following the rapid increases in recent years, housing investment, on balance, is expected to remain unchanged over this period. Spending on renovations is projected to rise strongly, offsetting the impact of anticipated reductions in housing starts and resale activity.

Table 3
Contributions to Average Annual Real GDP Growth
Percentage points*

	2004	2005	2006
Consumption	1.9 (1.9)	2.0 (2.0)	1.9 (1.9)
Housing	0.5 (0.4)	0.1 (0.0)	-0.1 (0.0)
Government	0.6 (0.6)	0.7 (0.8)	0.9 (0.8)
Business fixed investment	0.7 (0.5)	1.0 (0.8)	0.8 (0.9)
Subtotal: Final domestic demand	*3.7 (3.4)*	*3.8 (3.6)*	*3.5 (3.6)*
Exports	1.9 (1.9)	0.9 (1.7)	2.2 (1.8)
Imports	-2.7 (-2.4)	-2.0 (-2.5)	-2.4 (-2.1)
Subtotal: Net exports	*-0.8 (-0.5)*	*-1.1 (-0.8)*	*-0.2 (-0.3)*
Inventories	-0.1 (-0.2)	-0.1 (0.0)	0.0 (0.0)
GDP	*2.8 (2.7)*	*2.6 (2.8)*	*3.3 (3.3)*

* Figures in parentheses are from the scenario in the January *Update*.

This outlook incorporates the expectations that spending by all levels of government will rise at about the same rate as revenues, as governments continue to work to maintain fiscal balance.

. . . which is projected to be partly offset by the drag on net exports arising from the past appreciation of the Canadian dollar.

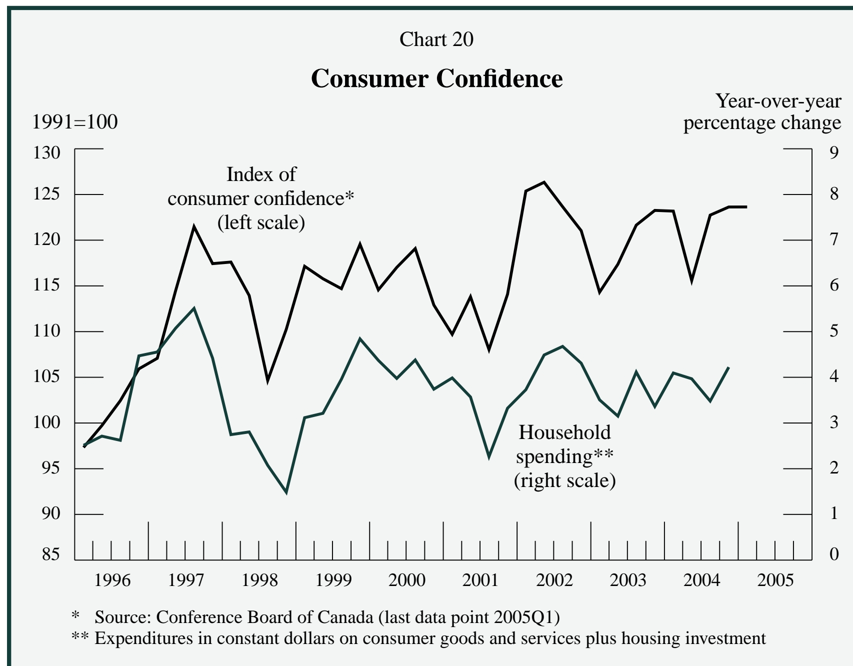
Further economic growth abroad, especially in the United States, should lead to increased demand for Canadian exports. However, this is expected to be more than offset by rapid growth in imports in both 2005 and 2006. The past appreciation of the Canadian dollar is expected to continue to dampen the growth of Canada's exports and to boost import growth over the projection period. As well, imports will be boosted by strong investment in machinery and equipment.

In the January *Update*, the high level of oil prices was expected to have a slight adverse effect on aggregate demand in Canada in 2005, before the positive impact on investment and production in the energy sector became evident in 2006. Given the markedly

higher outlook for oil prices in this *Report*, the downside pressure on demand for Canadian exports and on household spending is likely to be somewhat larger than expected in the last *Update*. However, stronger-than-expected growth in capital spending by energy producers, based on recent investment intentions, should more than offset that negative effect by 2006.

Chart 20

Consumer Confidence



* Source: Conference Board of Canada (last data point 2005Q1)
** Expenditures in constant dollars on consumer goods and services plus housing investment

Measures of inflation expectations

Most measures of inflation expectations are little changed.

Most indicators of inflation expectations that the Bank follows have been little changed since mid-October, and many of the key medium- and longer-term measures remain very close to 2 per cent. In the regular survey reported in the winter issue of the Conference Board of Canada's *Index of Business Confidence*, 74 per cent of respondents expected prices, in general, to rise over the next six months at a rate of 2 per cent or less, virtually unchanged from last autumn. However, even though 93 per cent of firms in the Bank's spring *Business Outlook Survey* expected CPI inflation to be within a range of 1 to 3 per cent, on average, over the next two years, 60 per cent of respondents expected inflation to be in the upper part of the range. On the other hand, the average private sector forecast for total CPI inflation in both 2005 and 2006 is just under 2 per cent. Consensus forecasts of inflation for 2007 and beyond also continue to be very close to 2 per cent.

Other factors affecting inflation

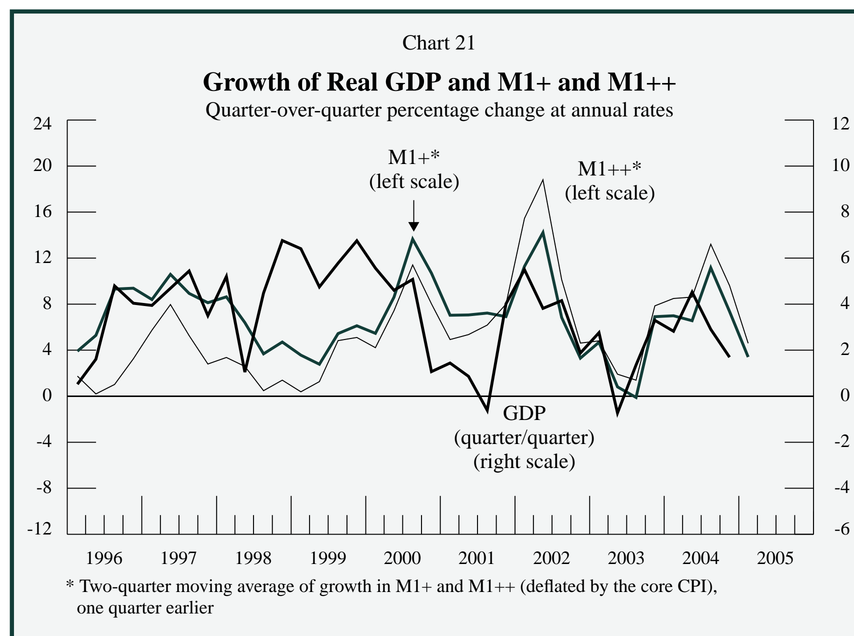
There remains a risk that the higher costs arising from the persistently high level of the global prices of energy and other raw materials could be passed through to the prices of non-energy goods and services. Indeed, there is some anecdotal evidence that part of the sharply higher costs of some metals is raising the prices of some durable goods, such as major appliances. The most recent experience, however, suggests that this pass-through effect is likely to be relatively small and spread out over time.

In contrast, the appreciation of the Canadian dollar since early 2003 is expected to be a continuing source of slight downward pressure on core inflation during the projection period. There also appear to be ongoing reductions in the world prices of some consumer goods as a result of increasing supplies from countries such as China.

Increases in average hourly earnings of permanent workers are expected to move up somewhat through 2006. Nevertheless, with labour-productivity growth anticipated to resume over this period, year-to-year gains in unit labour costs should remain at or below 2 per cent through the projection period.

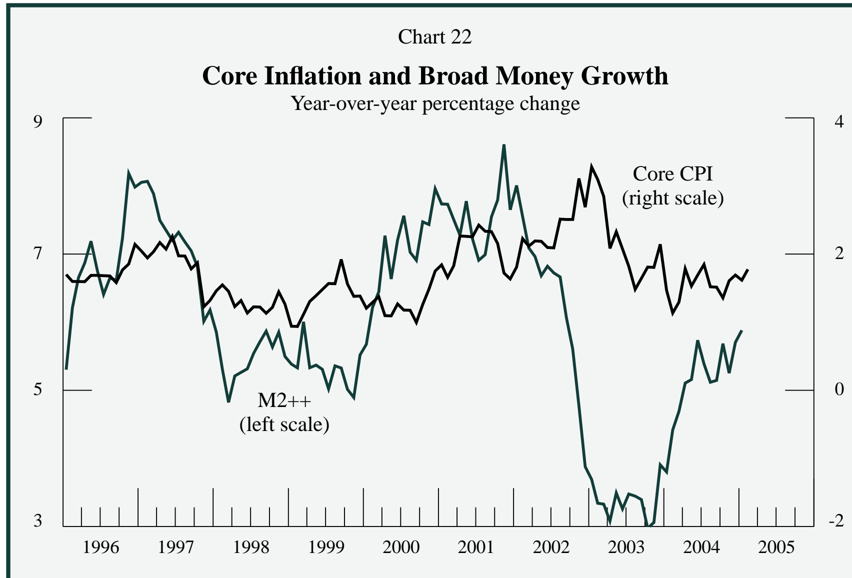
Implications of money growth

Growth in the narrow money aggregates—M1+ and M1++—has slowed since the last *Report* (Chart 21) and is broadly consistent



with projected output growth of slightly above 2 per cent in the first quarter of 2005.

Since the October *Report*, the growth of M2++ has stabilized at just under 6 per cent on a year-over-year basis, despite the strength in the narrow money aggregates over the same period. This rate of growth for M2++ is consistent with inflation under 2 per cent (Chart 22).



Inflation projection

Core inflation is expected to stay near 1.7 per cent for the rest of 2005 . . .

The small amount of excess supply projected for the Canadian economy should keep core inflation slightly below longer-run expectations through 2005 and most of 2006. The past and recent appreciation of the Canadian dollar is also expected to exert a small amount of downward pressure on the core rate during this period.

. . . before moving up to 2 per cent around the end of 2006.

The core rate of inflation is projected to stay near 1.7 per cent through to the end of 2005. With the economy expected to move back to its production potential in the second half of 2006 and with inflation expectations remaining well anchored, the core rate should rise gradually to 2 per cent around the end of 2006 (Table 4).

Total CPI inflation is expected to stay above 2 per cent into 2006.

The outlook for the 12-month rate of increase in the total CPI will continue to be crucially affected by developments in the market for crude oil. Based on the scenario embodied in oil-price futures (Chart 19), total CPI inflation is projected to stay above 2 per cent for some time, before moving down slightly below 2 per cent in the second half of 2006.

Table 4
Projection for Core and Total CPI Inflation
Year-over-year percentage change*

	2005				2006	
	Q1	Q2	Q3	Q4	H1	H2
Core inflation	**1.7** *(1.7)*	**1.6** *(1.6)*	**1.7** *(1.7)*	**1.7** *(1.7)*	**1.8** *(1.8)*	**1.9** *(1.9)*
Total CPI	**2.1** *(2.4)*	**2.1** *(2.0)*	**2.3** *(1.5)*	**2.3** *(1.5)*	**2.2** *(1.7)*	**1.8** *(1.8)*
WTI (level)**	**50** *(47)*	**56** *(47)*	**57** *(45)*	**57** *(45)*	**56** *(43)*	**54** *(42)*

* Figures in parentheses are from the January *Monetary Policy Report Update*.
** Assumption for the price of West Texas Intermediate crude oil (US$ per barrel), based on an average of futures contracts over the two weeks ending 7 April 2005.

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