BANK OF CANADA

Monetary Policy Report

— April 2004 —

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

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).

Bank of Canada
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K1A 0G9

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The role of monetary policy is to facilitate adjustments by helping to sustain aggregate demand.

What does this mean? As always, it means that we will aim to return inflation to its 2 per cent target by trying to keep the economy operating as close as possible to its full production capacity. That is our constant goal. But it also means that we will be aware of the forces that are driving adjustments in the economy in the years ahead. We know that, with a stronger currency, the economy will have to rely more on domestic demand and less on foreign demand for ongoing, solid growth. We will take this into account as we set monetary policy.

David Dodge

Governor, Bank of Canada
11 February 2004

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1. Overview

The Canadian economy continues to adjust to developments in the global economy. These include stronger world demand, higher commodity prices, the realignment of world currencies—including the Canadian dollar—and the intensified competition, together with new trading opportunities, coming from emerging-market economies, such as China and India.

These developments require shifts in activity among sectors and create a need for adjustments by many businesses. Monetary policy is facilitating these adjustments by supporting aggregate demand, with the goal of keeping the economy near its full potential and inflation on target.

At the end of 2003, the Canadian economy was operating at a lower level than the Bank had projected in the October *Monetary Policy Report*. Although growth rebounded in the fourth quarter of last year, real GDP growth in the third quarter was weaker than had been expected, and there was a downward revision to GDP in the second quarter. This came about despite stronger global economic activity, particularly in the United States but also in Japan and other Asian economies, and strong increases in commodity prices. Preliminary indications are that growth in the first quarter of 2004 was marginally below 3 per cent at annual rates. As expected, core inflation has generally been below the Bank's 2 per cent target since the October *Report*.

Against this backdrop, the Bank lowered its key policy rate by a total of 75 basis points, reducing it by 25 basis points on each of the last three fixed announcement dates, to bring it to 2 per cent (Chart 1).

The Bank's outlook for economic growth and inflation in Canada is essentially unchanged from that of the January *Monetary Policy Report Update*. The Canadian economy is expected to grow at an annualized rate of about 2 3/4 per cent in 2004, picking up to about 3 3/4 per cent in 2005. Such growth would return the economy close to its production potential by the third quarter of next year. Core inflation is expected to average about 1 1/2 per cent for the rest of 2004 and to move back to the 2 per cent target by the end of next year.

The main uncertainty for the outlook continues to relate to how the Canadian economy adjusts to global developments. Overall, the risks to the outlook appear balanced.

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

2 Dec. — no change

20 Jan. — down 25 basis points to 2.5 per cent

2 March — down 25 basis points to 2.25 per cent

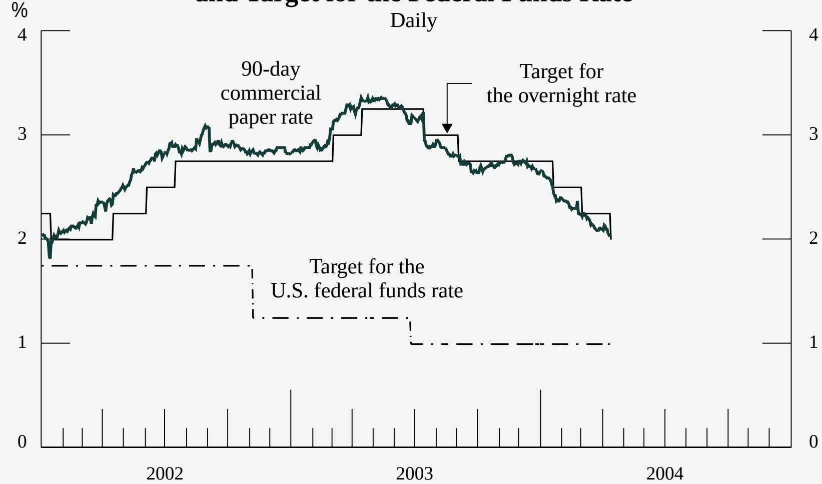
13 April — down 25 basis points to 2 per cent

This report includes information received up to the fixed announcement date on 13 April 2004.

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

The core rate of inflation fell in early 2004, and in February was well below the Bank's 2 per cent inflation-control target. The rate of increase in the total CPI came down even more, reflecting reductions in the prices of gasoline and fuel oil from year-earlier levels.

Inflation and the 2 per cent target

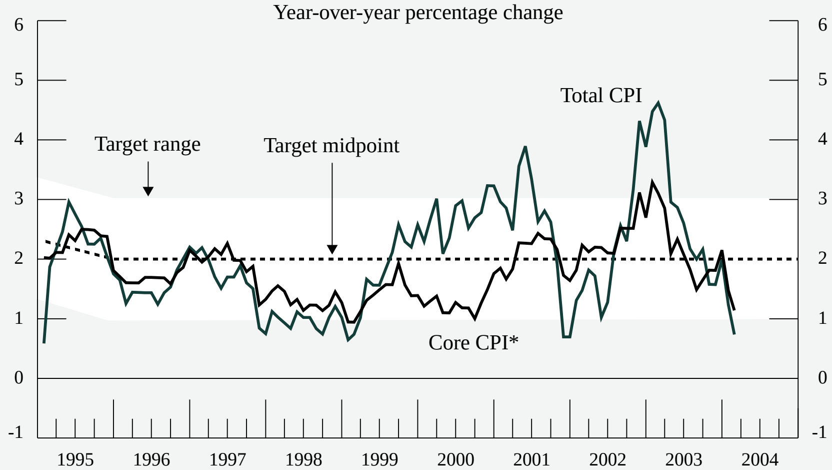
Core inflation decreased in early 2004.

As expected at the time of the October *Report*, core CPI inflation fell in early 2004, as the effects of special factors came to an end (Chart 2).[1] Between August and December of 2003, the core rate averaged 1.8 per cent, and by February it had decreased to 1.1 per cent. Other measures of the trend rate of inflation that the Bank follows closely have also fallen and in February were close to the core rate (Chart 3).

Chart 2

Consumer Price Index

Year-over-year percentage change



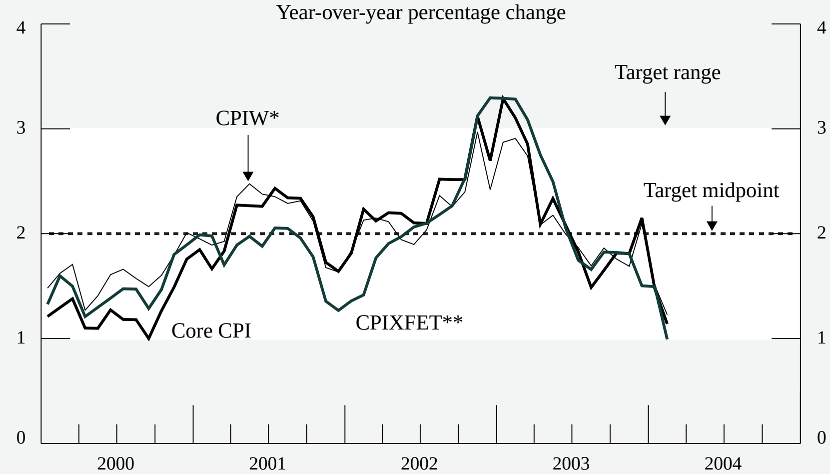
* CPI excluding the eight most volatile components and the effect of changes in indirect taxes on the remaining components

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.

Chart 3

Core CPI and Other Measures of the Trend Inflation Rate

Year-over-year percentage change



* CPIW adjusts each CPI basket weight by a factor that is inversely proportional to the component's variability.

** CPIXFET excludes food, energy, and the effect of changes in indirect taxes.

A temporary jump in the core rate in December 2003 was the result of Ontario electricity rebates at the end of 2002. In January and February of 2004, the core rate of inflation moved lower, since the effects from some special factors had, for the most part, ended. In particular, the effect of past substantial increases in auto insurance premiums, which had boosted the year-over-year rate of increase in the core CPI for some time, diminished significantly. The rate of increase in the food component of the core CPI also came down early this year, partly reflecting the impact of the Canadian dollar's appreciation since early 2003. Core inflation is expected to settle around 1 1/2 per cent in the second quarter of 2004.

The rate of increase in the total CPI fell below 1 per cent in February.

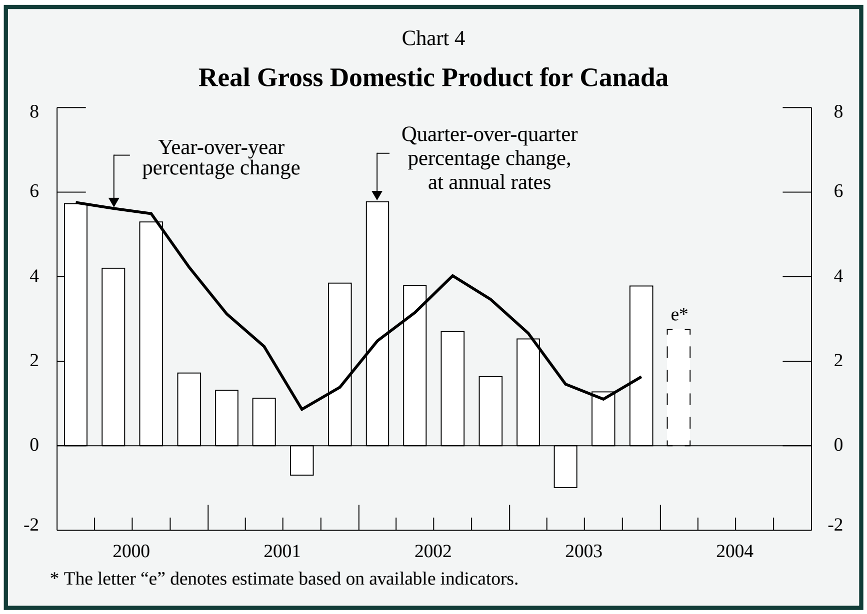
The 12-month rate of increase in the total CPI was 0.7 per cent in February, down from 2.0 per cent in August. This drop relative to the core rate was chiefly due to reductions in the consumer prices of gasoline and fuel oil from their levels a year earlier, as well as a marked easing in the year-to-year increase in the consumer price of natural gas. The price of crude oil has strengthened considerably since mid-October, however, reflecting strong Asian demand and the impact of relatively severe winter weather conditions on North American stocks. As a result, the price of oil is currently well above that in the base-case assumption used in the last *Report*.

Factors at work on inflation

Aggregate demand

In the third quarter of 2003, economic growth in Canada was somewhat less than expected . . .

Canada's real GDP grew at an annual rate of 1.3 per cent in the third quarter of 2003, somewhat less than had been expected in the October *Report* (Chart 4). In the fourth quarter, economic growth picked up to an annual rate of 3.8 per cent, about the same as anticipated in the last *Report* and in the January *Update*, although final domestic demand was slightly weaker than expected and external demand was slightly stronger. Recent indicators for spending and activity suggest that economic growth will be about 2 3/4 per cent in the first quarter of 2004, marginally weaker than anticipated in the January *Update*.



. . . as manufacturers and retailers made inventory corrections.

Growth in the third quarter of 2003 was held back as manufacturers and retailers undertook sharp inventory corrections (Chart 5). Economic activity was also adversely affected by the August blackout in Ontario and by the closure of international borders to imports of Canadian cattle, beef, and related products after the discovery of one case of bovine spongiform encephalopathy (BSE) last May. At the same time, final domestic demand rose strongly. Business investment surged, and household spending rose substantially, reflecting continuing monetary stimulus, a high level of consumer confidence (Chart 6), and the effects of price discounting.

Chart 5

Contribution to Real GDP Growth

Percentage points, quarterly at an annual rate

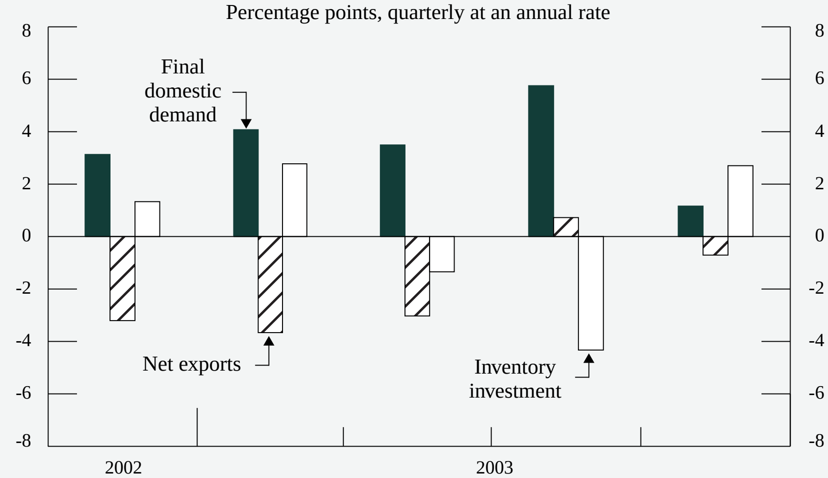
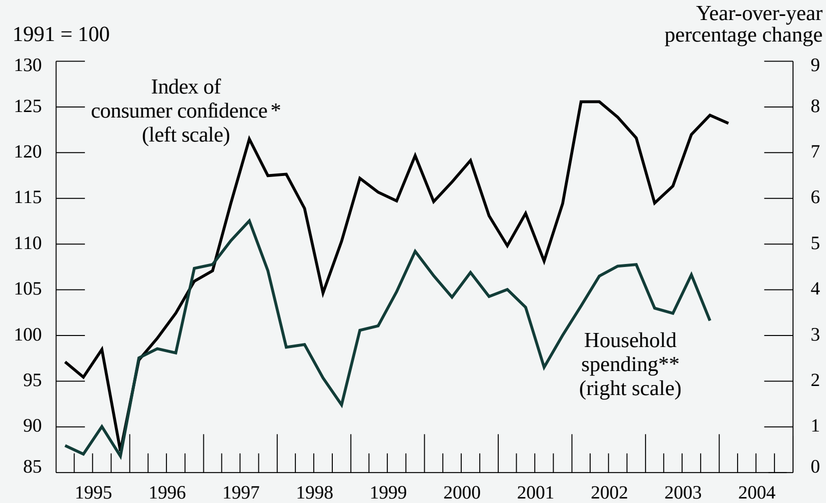


Chart 6

Consumer Confidence



* Source: Conference Board of Canada (last data point 2004Q1)
** Expenditures in constant dollars on consumer goods and services plus housing

Growth rebounded towards year-end, as expected.

A pickup in inventory investment, together with some recovery from the earlier unusual shocks, contributed importantly to the resurgence in growth towards year-end.[2] Exports also rebounded in the fourth quarter of 2003 as a result of the strengthening global economic recovery (Technical Box 1). However, imports increased

2. The discovery, near the end of last year, of a case of BSE in the United States in a cow that originated in Alberta resulted in an extension of the ban on imports of live cattle from Canada, thereby delaying further recovery in Canada's cattle industry.

Technical Box 1

Recent Trends in Export Volumes

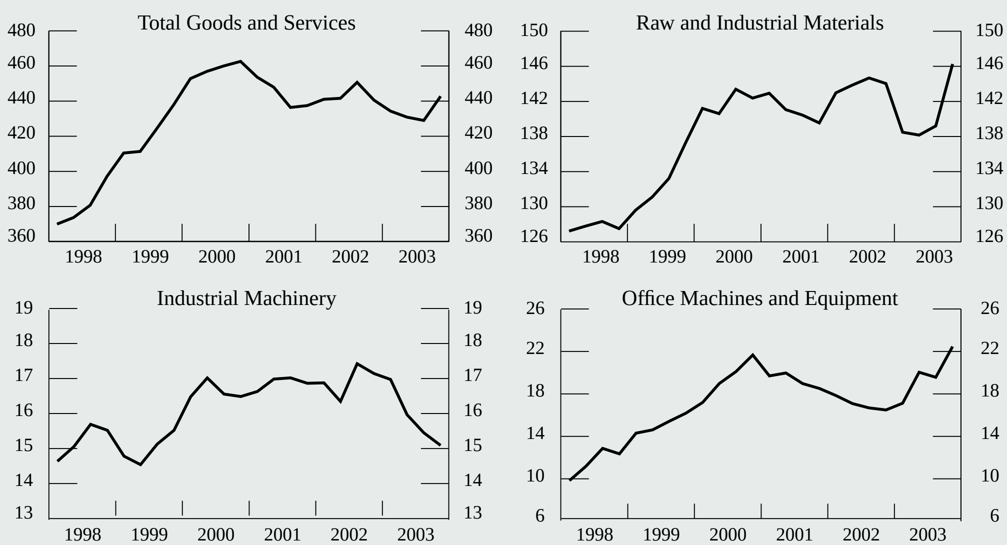
In sharp contrast to their rapid expansion through the second half of the 1990s and into 2000, exports of goods and services have been stagnant since early 2001, reflecting a number of developments. The U.S. recession and the uneven U.S. recovery until mid-2003 adversely affected export growth. Another important factor was the global collapse in demand for many types of capital goods, especially in the information and communications technology sector. There has also been pronounced weakness in the demand for aircraft and parts in the aftermath of 11 September 2001. Other developments have been the result of smaller and more temporary shocks: lower grain exports, because of poor harvests in 2001 and 2002; the BSE-related import ban on Canadian cattle and beef from late May 2003 onwards (which was partially lifted in late September 2003); and a sharp decline in the demand for travel and transportation services in the first half of 2003 because of the war with Iraq and the SARS outbreak.

Canada also appears to have lost market share for some products to foreign competition. In particular, exports of office machines and equipment declined relative to corresponding U.S. investment in 2001 and 2002, possibly reflecting more intense competition from low-cost emerging markets, as well as lower capacity utilization in the United States. More recently, the appreciation of the Canadian dollar appears to have exacerbated downward pressure on some exports, including industrial machinery.

Total exports rebounded late in 2003. This reflected a recovery from some of the previous shocks, as well as a rapid advance in exports of raw and industrial materials in response to the recovery in global industrial activity and commodity prices. The rebound was also seen in exports of office machines and equipment, supported by sharp growth in U.S. spending on these items. A recovery in exports of travel services in the second half of the year was consistent with the dissipation of earlier shocks, but because of an even larger increase in imports of travel services, perhaps reflecting the appreciation of the Canadian dollar, the travel balance worsened over this period.

Export Volume: Total and Selected Components

Billions of 1997 dollars, seasonally adjusted at annual rates

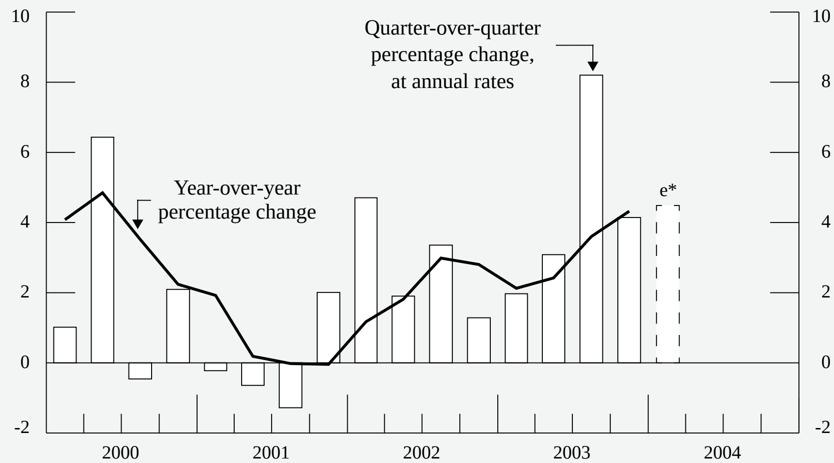


even more strongly, and growth in final domestic demand slowed from its rapid pace in the third quarter.

In the United States, an upswing in household spending on housing and consumption and in business spending on equipment and software led to strong growth of real GDP in the second half of 2003 (8.2 and 4.1 per cent in the third and fourth quarters, respectively). Based on preliminary information, additional household spending, strong business expenditures, and significant restocking of inventories should result in growth of about 4 1/2 per cent in the first quarter of 2004 (Chart 7).

Chart 7

Real Gross Domestic Product for the United States



* The letter “e” denotes estimate based on available indicators.

Adjusting to global change

Key global developments and the resulting rise in the Canadian dollar . . .

Among the key global developments affecting the Canadian economy in 2003 and early 2004 has been the marked realignment of world currencies, including the Canadian dollar. At the same time, there has been a significant strengthening in the pace of global economic growth, especially in the United States and in most Asian economies, and a rebound in world commodity prices. The growing presence of China and India on the global scene is also a factor at play. The implications of these global changes for the demand for Canadian products will require shifts in activity among sectors and significant adjustments by many firms.

. . . imply that economic growth in Canada will rely largely on domestic demand.

The rise in the Canadian dollar implies that economic growth in Canada will rely largely on domestic demand. Indeed, economic activity in the last quarter of 2003 and in early 2004 appears to have been held back by the impact of the Canadian dollar’s appreciation on real net exports. In addition, there are likely to be shifts in activity towards the export of commodities and away from the export of highly manufactured products. Moreover, some Canadian exporters are likely to shift towards markets in countries whose currencies have appreciated significantly in relation to the U.S. dollar. The reduction in the cost of machinery and equipment imported from the United States should help boost capital spending and improve Canadian productivity. Finally, firms will develop new supply chains and new niches for their own products and services in response to changing global markets.

Some of the economic adjustments in Canada caused by the key global changes became evident in 2003, although most of these shifts in activity across sectors are still to come. While overall corporate profitability remained high through 2003, profits have tended to weaken in those sectors with high exposure to international competition (Technical Box 2). Output growth was also stronger, and employment tended to rise, on average, in those industries producing commodities or having low exposure to foreign competition.

Many firms adversely affected by the rise in the Canadian dollar have already initiated measures to alleviate its impact.

The Bank's most recent industry survey, completed in March, provides further evidence that changes in response to global developments have begun.[3] Firms seemed somewhat more confident in their ability to adjust to the appreciation of the Canadian dollar. Many adversely affected firms have initiated measures to alleviate the impact of the higher dollar, chiefly through cost-cutting measures and improvements to productivity. In contrast, businesses favourably affected by the higher value of the dollar (mainly through lower costs for imported inputs) have responded, in some cases, by reducing their selling prices in Canada, although many used the opportunity to improve their profit margins. Companies that were adversely affected by the rise in the Canadian dollar were generally as optimistic as other firms regarding prospects for improved sales growth, but were markedly less sanguine about their hiring and investment intentions.

Estimated pressures on capacity

The level of economic activity in Canada has been below potential since the second quarter of 2003.

Estimates of the Bank's conventional measures of potential output and the output gap suggest that the level of economic activity has been below potential since the second quarter of 2003 (Chart 8). While the output gap decreased somewhat in the fourth quarter, significant excess supply remains. With a downward revision to Canadian GDP data in the second quarter of 2003 and

3. The Bank of Canada's survey of businesses regarding their adjustment to the appreciation of the Canadian dollar is available on the Bank's Web site at <http://www.bankofcanada.ca/en/mpr/pdf/survey/mpr_survey0404.pdf>.

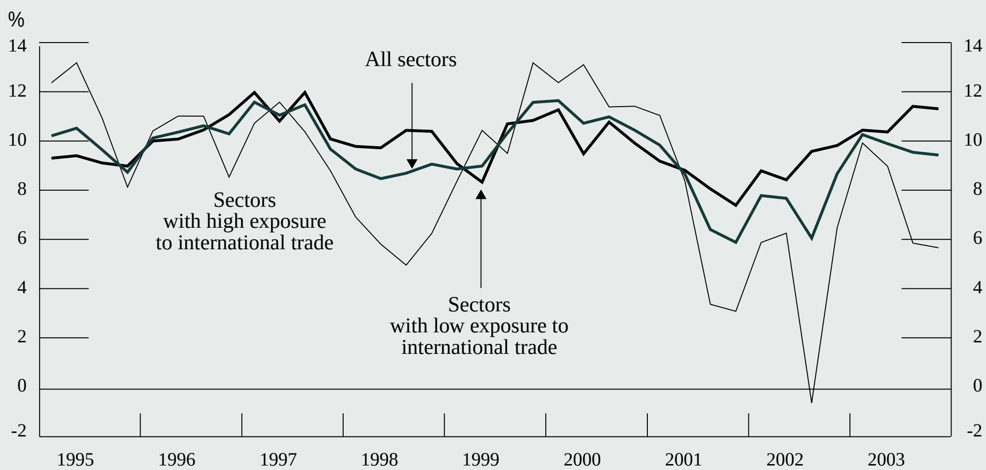
Technical Box 2

Adjusting to Global Change: Sectoral Developments in Canada in 2003

In 2003, changes in profitability and output differed widely among various sectors in Canada. This reflected several factors linked to the adjustment to global change. The higher Canadian dollar, the strengthening global economy, the associated rise in world commodity prices, and the continuing growth and integration of such major emerging-market economies as China and India have had markedly different effects on different sectors of the Canadian economy. Shifts in profitability and activity among sectors also initiated major changes in the sectoral distribution of employment.

Firms in sectors where prices are determined in world markets (and denominated in U.S. dollars) and which made limited use of hedging, quickly felt the impact of the dollar's appreciation on profitability. Indeed, while aggregate profitability remained high in 2003, the average rate of return on equity in those sectors with a relatively high, positive exposure to international trade worsened markedly in the second half of 2003.[1] The reduction in profitability was particularly pronounced in industries producing non-electrical machinery, clothing, and textiles. The rise in profitability over the past year was concentrated in sectors with a low or negative net exposure to international trade (such as wholesale and retail trade and the financial sector).

Rate of Return on Equity for Selected Sectors



1. 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, as in Dion (1999–2000). For instance, sectors that are highly export oriented or highly exposed to import competition would be said to be more positively exposed to international trade.

Technical Box 2 (continued)

All else being equal, a rise in the Canadian dollar would be expected to reduce the external demand for Canadian-produced goods and services. Indeed, over the past year, output growth in sectors highly exposed to international trade was somewhat lower than output growth in the rest of the business sector. Output fell sharply in the non-electrical machinery, clothing, and textile manufacturing industries. At the same time, in a number of these industries, the global economic recovery offset some of the adverse impact on overall demand for their products. For instance, output rose strongly in mining, primary metals manufacturing, and electronics and computer manufacturing over the past year. Strong growth in Canada's final domestic demand during the past year also boosted activity in several sectors with a low exposure to international trade, such as printing and publishing, construction, and wholesale trade.

The prolonged weakness in profitability for many firms in the industries with a high, positive exposure to international trade caused many of them to begin adjusting their operations in 2003. Employment in most of these industries fell back noticeably last year, while employment rose substantially in various sectors with a low exposure to international trade, such as construction; wholesale and retail trade; and finance, insurance, and real estate.

Changes in Sectoral Activity through 2003
Year-over-year percentage change

Sector	Share of total GDP	Real GDP growth	Employment growth
Aggregate business	81.0	+1.9	+1.4
High exposure to international trade or competition	19.2	+0.9	-1.9
Of which:			
Mineral fuels	2.2	+1.9	+7.7
Non-energy, non-farm commodity based	7.2	+2.7	-0.8
Other high-exposure sectors	9.8	-0.6	-2.4
Low exposure to international trade[a]	61.8	+2.2	+1.9

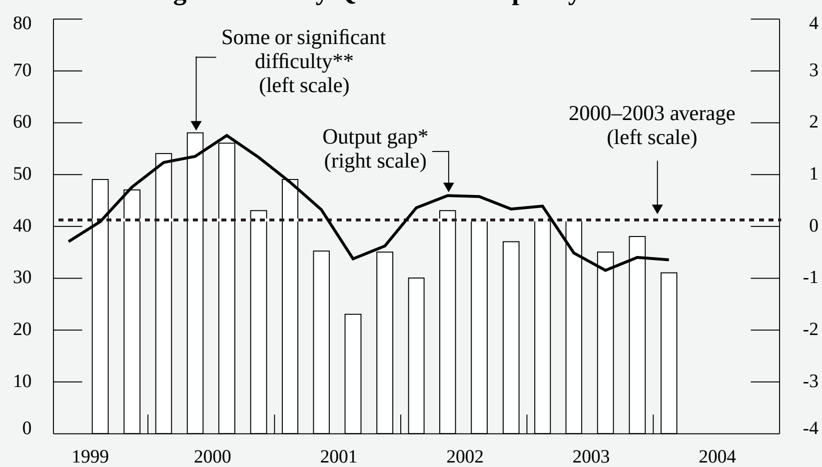
a. Includes sectors that are exposed as net importers lower-than-expected growth in the second half of that year, the estimated output gap at year-end was somewhat larger than projected in the last *Report*.

Several indicators are consistent with the view that economic slack has opened up since early 2003. In the most recent survey conducted by the Bank's regional offices, the proportion of firms reporting pressures on capacity has decreased relative to indications at the beginning of 2003. As well, core inflation has moved below the 2 per cent target. On the other hand, capacity utilization in the non-farm, goods-producing sector in the fourth quarter of 2003 was, on balance, largely unchanged from levels early in the year, and about the same as its 2000–2003 average.

Based on an analysis of all the indicators of capacity pressures, the Bank judges that there is currently more excess supply in the Canadian economy than indicated by its conventional measure. However, there is more uncertainty than usual around estimates of the output gap, because it is harder to pin down effective capacity in times of demand-driven shifts in sectoral activity.

Chart 8

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 first quarter of 2004 is based on a projected rise in output of 2 3/4 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

Cost control and output prices

Unit labour costs in the business sector in the fourth quarter of 2003 were virtually unchanged from year-earlier levels, even though there was only a small rise in productivity over the past year (Chart 9). This resulted from the fact that hourly labour compensation in the business sector was little changed between the fourth quarter of 2002 and the fourth quarter of 2003. This weakness in the rate of increase of compensation was particularly pronounced in sectors adversely affected by the series of unusual shocks that hit the Canadian economy in 2003 and is therefore likely to prove temporary. Indeed, the underlying rate of increase in wages, based on such measures as the average hourly earnings of permanent workers, seems to have moved up to about 2 3/4 per cent since mid-2003 (Chart 10).[4]

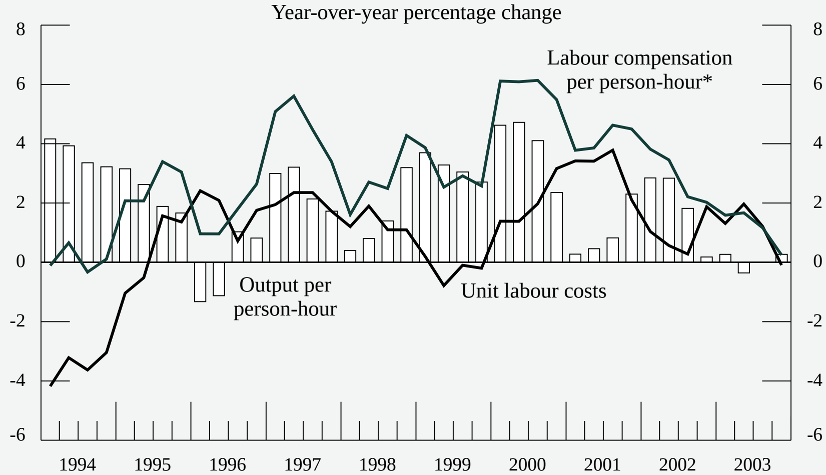
Unit labour costs in the fourth quarter of 2003 were virtually unchanged from year-earlier levels.

The underlying increase in wages is about 2 3/4 per cent.

Chart 9

Unit Labour Costs and Labour Productivity: Business Sector

Year-over-year percentage change



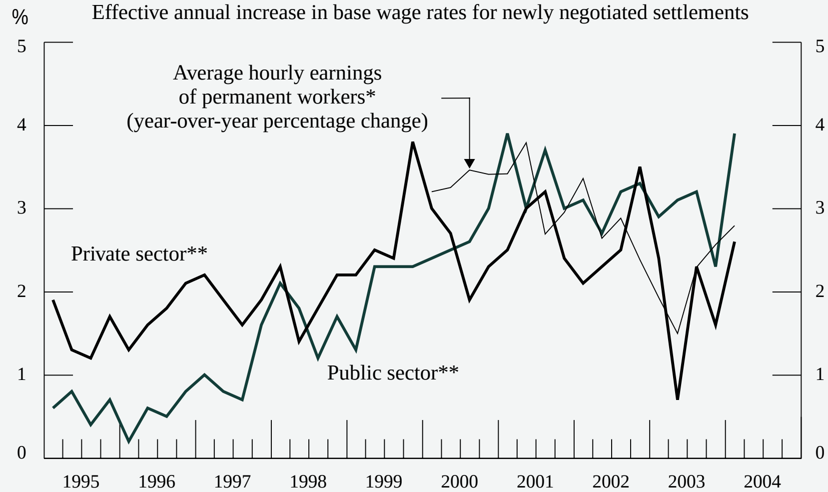
* Labour compensation includes the labour income of paid workers, plus imputed labour income for self-employed workers.
Source: Statistics Canada *Daily*

4. The average annual wage increase negotiated in the public sector in January 2004 was relatively high, but the number of employees covered by the new contracts was much lower than usual.

Chart 10

Wage Settlements and Average Hourly Earnings

Effective annual increase in base wage rates for newly negotiated settlements



* Source: Statistics Canada, *Labour Force Information*, last data point plotted, March 2004
** Source: Human Resources Development Canada, last data point plotted, January 2004

The substantial year-over-year increases in the global prices of Canada's commodity exports during 2003 pushed the annual rise in the chain price index for GDP (a broad price measure of the goods and services produced in Canada) above the core rate of inflation last year (Chart 11). The prices of non-energy commodities have risen further since the end of 2003 (Chart 12). Strong Asian demand has helped maintain the prices of both metals and grains at high levels. At the same time, expectations of continued strong demand for housing in North America for 2004 and a desire by U.S. lumber wholesalers to restore inventories to more normal levels contributed to a sharp rise in lumber prices.

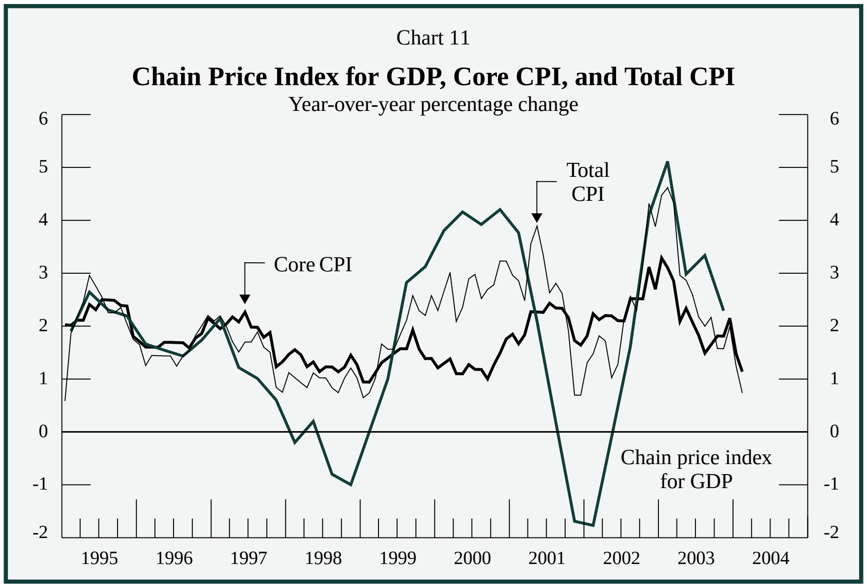


Chart 11
Chain Price Index for GDP, Core CPI, and Total CPI
Year-over-year percentage change
Total CPI
Core CPI
Chain price index for GDP
6
5
4
3
2
1
0
-1
-2
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004

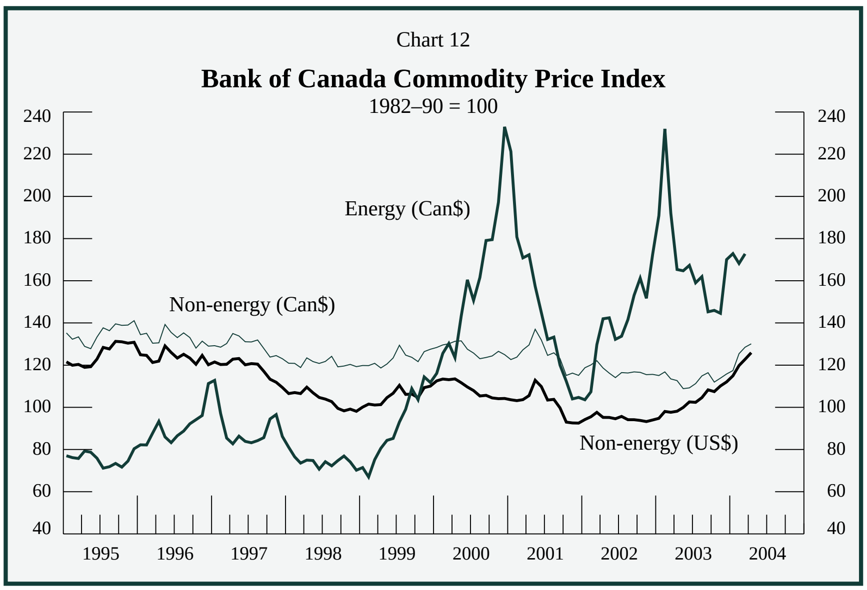


Chart 12
Bank of Canada Commodity Price Index
1982–90 = 100
Energy (Can$)
Non-energy (Can$)
Non-energy (US$)
240
220
200
180
160
140
120
100
80
60
40
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004

3. Financial Developments

Financial conditions have continued to improve.

Financial conditions in Canada, as in the rest of the world generally, have continued the improvement noted in the October *Report*. Stock markets have strengthened further, corporate bond spreads are narrower, and the yield curve has shifted down. The financial situations and profitability of banks in Canada remain healthy—a positive sign for future credit conditions—and there is an abundance of liquidity.

Credit demand by non-financial businesses picked up in the past few months but remains modest, since growth in earnings has allowed businesses to finance most of their investment needs with internal funds (Chart 13). Longer-term business credit, buoyed by the strong issuance of bonds and the income-trust component of equities, has grown at a solid pace, but short-term credit remains below levels of a year ago.

Chart 13

Business and Household Credit

Year-over-year percentage change

Household credit is still expanding at a rapid pace, reflecting consumer spending and activity in the housing market. Low interest rates have held debt-service ratios at low levels, and rising house prices have supported household balance sheets. This suggests that household finances should not be a drag on economic growth in the period ahead.

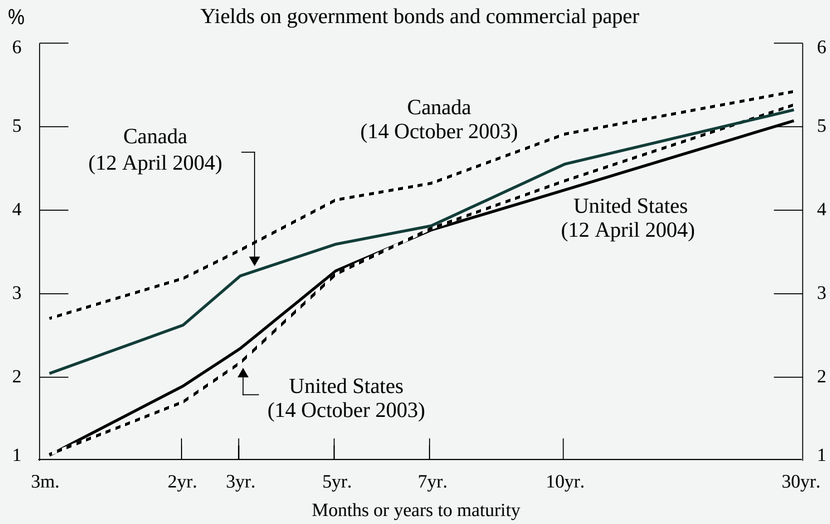
The yield curve in Canada has shifted down since the October *Report*. At shorter maturities, this movement reflected both the actual and anticipated lowering of policy rates.

Yield spreads between Canadian and U.S. bonds at shorter maturities narrowed sharply in the period between October and February, as interest rates fell in Canada while yields on U.S. Treasuries remained fairly stable (Chart 14). This narrowing in spreads was particularly pronounced for 2-year maturities. Since February, spreads have remained relatively stable.

Chart 14

Term Structure of Interest Rates in Canada and the United States

Yields on government bonds and commercial paper



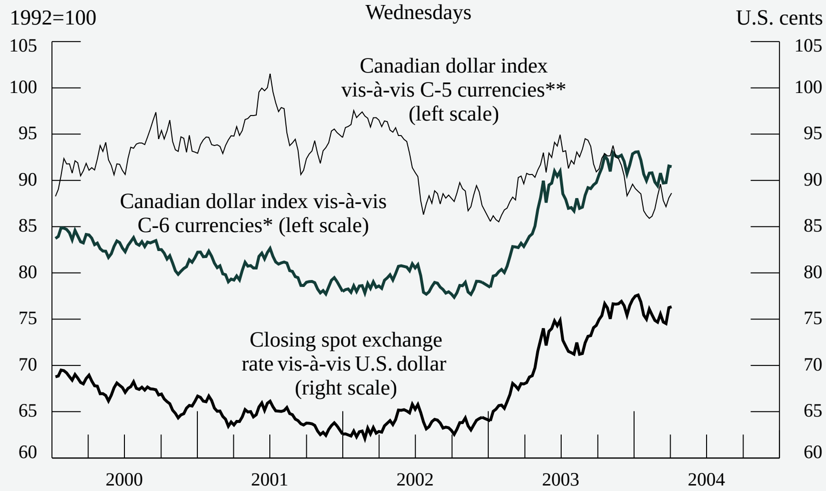
The period from October to January saw broad-based weakness in the U.S. dollar relative to most currencies. In this context, the Canadian dollar touched a 10-year high of 78.86 cents U.S. in early January (Chart 15). Since then, many currencies, including the Canadian dollar, have traded in fairly wide but more stable ranges. The Canadian dollar traded in a range of 74 1/2 to 76 1/2 cents U.S., similar to the level at the time of the October *Report*.

The Canadian dollar has traded in a wide but stable range since October.

Chart 15

Canadian Dollar Exchange Rate

Wednesdays



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

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

4. The Outlook

International background

The global economic recovery is gaining momentum . . .

The recovery in global economic activity is broadening and gaining momentum. This is reflected in both official and private sector forecasts. This recovery is strongly supported by expansionary fiscal and monetary policies in many countries. It is also being driven by the continuing integration into the world economy of major emerging-market economies such as China and India. Indeed, the contribution of China and newly industrialized Asian economies to projected world economic growth is larger than that of the United States (see Table 1).

Short-term prospects for strong growth in the United States have improved. The Bank expects to see growth of about 5 per cent in 2004 and 4 1/2 per cent in 2005. The main drivers of U.S. growth will be robust investment and consumer spending. Firms are expected to plow back their profits to meet anticipated demand and replenish their inventories. And households will benefit from tax rebates and projected employment gains. However, should they persist, high oil prices would dampen U.S. growth prospects over the next two years.

Table 1
Global Growth Projections[a]

	Share of real global GDP[b] (per cent)	Projected growth (per cent)			Contribution to global economic growth (percentage points)		
		2003	2004	2005	2003	2004	2005
United States	21	3.1	5.0	4.5	**0.65**	**1.05**	**0.95**
European Union	20	0.7	1.8	2.5	**0.14**	**0.36**	**0.50**
Japan	7	2.7	3.2	2.2	**0.19**	**0.22**	**0.15**
China and Asian NIEs[c]	16	6.2	6.9	6.4	**0.99**	**1.10**	**1.02**
Others	36	3.0	4.3	4.0	**1.08**	**1.55**	**1.44**
World	100	3.1	4.3	4.1	3.1	4.3	4.1

a. Source: Bank of Canada projections for the United States, Japan, and the European Union. Forecasts for other regions were calculated from Consensus Economics (8 March and 5 April 2004).

b. GDP shares are based on the purchasing-power-parity valuation of country GDPs for 2002. Source: IMF, WEO Database, September 2003.

c. NIEs are newly industrialized economies. These include Hong Kong (Special Administrative Region), Taiwan (Province of China), Korea, and Singapore.

Although much remains to be done in terms of economic and financial reform, a sustained recovery in Japan may be in progress boosted by strong exports and investment. While prospects appear to be improving in the euro area, the near-term outlook remains subdued. In contrast, the U.K. economy is operating at close to full capacity. Among emerging markets, growth prospects for China and India are very favourable.

While the short-term outlook is clearly more positive, risks and uncertainties remain as we look further out. It is unclear, for example, whether the large fiscal and current account imbalances in many major economies will be resolved in a way that maintains growth.

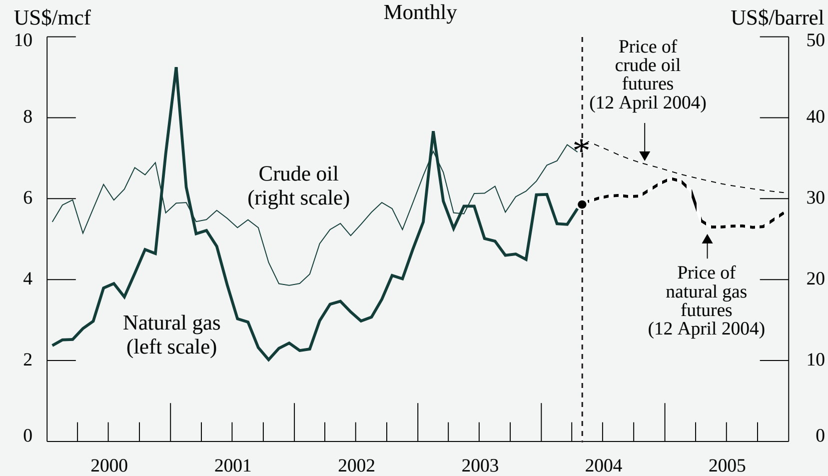
. . . supporting the prices of non-energy commodities.

The expected strong economic expansion, especially in various Asian economies, should continue to support the price of non-energy commodities over the remainder of 2004 and through 2005. With regard to crude oil, the Bank's base-case scenario assumes that prices will ease to about US$32 per barrel by the middle of this year and remain there through mid-2005. Natural gas prices are expected to stay near their current high levels throughout 2004. These assumptions, based on current futures prices, are significantly above the levels of six months ago (Chart 16).

Chart 16

Crude Oil and Natural Gas: Spot and Futures Prices

Monthly



* Spot price for crude oil (12 April 2004)
• Spot price for natural gas (12 April 2004)
Source: Canadian Enerdata Ltd., *Canadian Gas Price Reporter*

Aggregate demand and supply in Canada

Economic growth in Canada will come mainly from private domestic demand.

Economic growth in Canada in 2004 and 2005 is expected to come primarily from private domestic demand, supported by the degree of monetary stimulus and high levels of business and consumer confidence. The expanding global economy and the resulting high level of commodity prices, the contribution of the higher Canadian dollar to reduced costs of imported machinery and equipment, and favourable financial conditions should all lead to robust growth in capital expenditures by businesses. And, despite some softening towards the end of 2003, household spending is still expected to grow solidly, with additional support from projected stronger gains in real incomes. Spending on goods and services by all levels of government is projected to rise moderately during this period.

Canadian exports are expected to receive continued support from further strong gains in U.S. and global economic activity. Nonetheless, the lower value of the U.S. dollar is expected to hold back the growth of Canada's exports and boost imports. Indeed, net exports are not expected to contribute to growth in 2004 and 2005 (Table 2).

Table 2
Contributions to Average Annual Real GDP Growth
Percentage points

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

Growth is expected to strengthen this year and next . . .

The Bank's base-case outlook now projects real GDP growth, on an average annual basis, of about 2 3/4 per cent in 2004, picking up to about 3 3/4 per cent in 2005. While lower than that given in the October *Report*, the projection for 2004 is the same as that in the January *Update*. This projection for 2004 is also very close to the most recent average private sector forecast, while the Bank's growth projection for 2005 is slightly higher than the latest consensus outlook.

. . . with the economy operating near potential by the third quarter of 2005.

The Bank's projection assumes real GDP growth of about 2 3/4 per cent, at an annual rate, in the first half of 2004. This is expected to move up to about 3 1/2 per cent in the second half of this year and to peak around 4 per cent in the first half of 2005. This outlook for growth would imply little change in the output gap by the end of 2004, but by the third quarter of 2005 the economy should be operating near potential.

The main uncertainty for the outlook continues to relate to how the Canadian economy adjusts to global developments. Overall, the risks to the outlook appear balanced.

Measures of inflation expectations

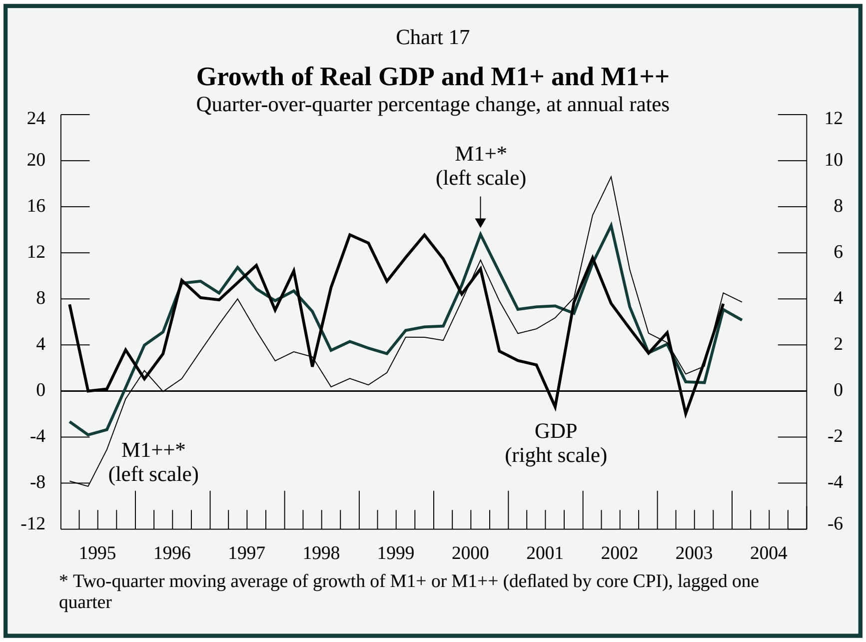
Most measures of inflation expectations have changed little since mid-October.

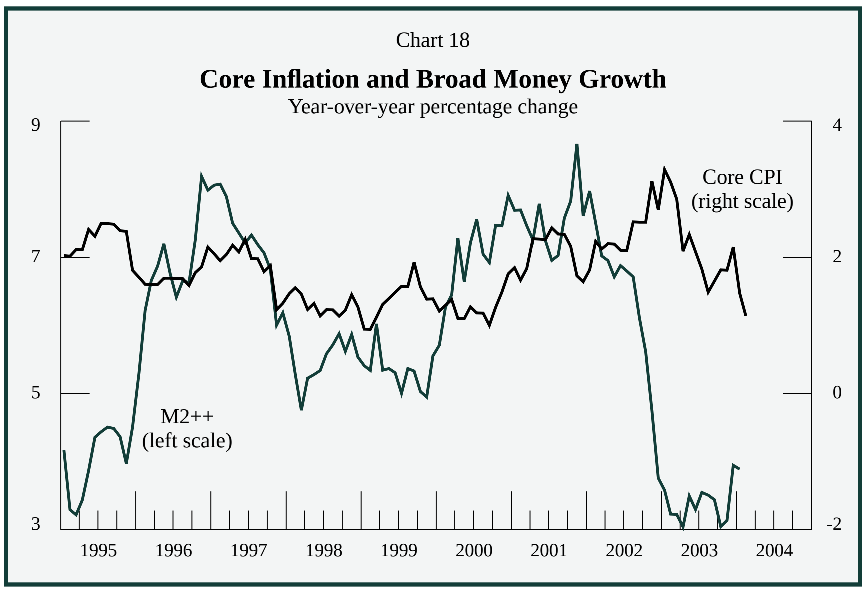
Most indicators of inflation expectations that the Bank follows have remained largely unchanged since mid-October, and many of the key medium- and longer-term measures remain close to 2 per cent. In the Conference Board of Canada's regular survey, reported in the winter issue of *Index of Business Confidence*, 84 per cent of respondents expected prices, in general, to rise over the next six months at a rate of 2 per cent or less, little changed from last autumn. As well, almost all firms in the Bank's latest regional survey expected CPI inflation to be within a range of 1 to 3 per cent, on average, over the next two years. Although the average private sector forecast for total CPI inflation in 2004 has edged down further to 1.4 per cent, the inflation forecast for 2005 is just under 2 per cent. Typical forecasts of longer-term inflation also remain very close to 2 per cent.

Implications of money growth for inflation

Growth in narrow money is consistent with the near-term outlook . . .

Growth in the narrow money aggregates—M1+, M1++—has strengthened since the last *Report*, partly in response to the low interest rate environment. This robust growth is widespread across both household and business deposits. This is consistent with the near-term outlook and with the recent pickup in output growth (Chart 17).





. . . while weak growth in M2++ points to a downside risk for inflation.

The growth rate of the broad money aggregate, M2++, has risen somewhat since the last *Report* from relatively low levels (Chart 18). This upswing largely reflects the strong growth in narrow money. Also contributing was a shift back into equity-based mutual funds from other assets, reversing the trend of the past few months. Despite this recent pickup, continued weak growth in M2++ points to a downside risk for inflation.

Inflation projection

Core inflation is expected to remain around 1 1/2 per cent through 2004 . . .

The slack in product and labour markets is expected to keep inflation below longer-term expectations until mid-2005. This effect should gradually diminish, however, as the output gap closes. The rise in the Canadian dollar since early 2003 is also likely to continue to put a limited amount of downward pressure on the core rate over the remainder of 2004.

. . . before moving back to about 2 per cent by the end of 2005.

The core rate of inflation is expected to stay around 1 1/2 per cent through 2004, before gradually moving back to the 2 per cent target by the end of 2005 (Table 3).[5]

Table 3
Projection for Core and Total CPI Inflation
Year-over-year percentage change*

	2004				2005	
	Q1	Q2	Q3	Q4	H1	H2
Core inflation	**1.3** *(1.3)*	**1.4** *(1.6)*	**1.6** *(1.6)*	**1.6** *(1.6)*	**1.7** *(1.7)*	**1.9** *(1.9)*
Total CPI	**0.9** *(0.9)*	**1.7** *(1.5)*	**1.7** *(1.5)*	**1.7** *(1.5)*	**1.6** *(1.4)*	**1.7** *(1.7)*
Assumption for the Price of West Texas Intermediate Crude Oil (US$ per barrel)						
WTI (level)	**35** *(33)*	**33** *(31)*	**32** *(30)*	**32** *(30)*	**32** *(28)*	**30** *(28)*

* Figures in parentheses are from the January *Monetary Policy Report Update*.

Total CPI inflation is projected to stay near the core rate after mid-2004.

The outlook for the 12-month rate of increase in the total CPI is critically affected by developments in the markets for crude oil (Chart 16). With the substantial rise in the price of crude oil in recent months, total CPI inflation is expected to move somewhat above the core rate of inflation in the second quarter of 2004. If the WTI price of oil eases to about US$32 per barrel by mid-2004 and to US$30 per barrel by the second half of 2005, as suggested by futures prices, total CPI inflation should fall slightly below core inflation in 2005.

5. In April 2004, the 12-month rate of increase in the core CPI is expected to rise temporarily, given that a second rebate on Ontario electricity prices lowered the level of the core CPI in April 2003.

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