# MONETARY POLICY REPORT

# UPDATE

*– January 2002 –*

*This text is a commentary of the Governing Council of the Bank of Canada. It includes information received up to the fixed announcement date on 15 January 2002 and updates the November 2001* Monetary Policy Report.

In the November *Monetary Policy Report*, the timing and extent of the recovery in economic activity in Canada this year was seen as depending crucially on geopolitical developments and on how quickly consumer and business confidence would return to normal. Two polar scenarios were envisaged. In one, consumer and business confidence stayed fragile through 2002, contributing to sluggish growth. In the other, confidence was restored quickly, leading to robust growth early this year.

While robust growth is not yet underway, geopolitical developments have evolved positively, and consumer confidence has improved. Thus, the likelihood that economic growth this year will be between these two scenarios, and broadly in line with the Bank's "working assumptions" of last November, has increased.[1] This implies that the economy should gain significant momentum as the year progresses. However, business confidence remains weak in many countries, with the recovery in global business investment being the major area of uncertainty for the outlook. Relative to its assumptions of last November, the Bank now expects the amount of economic slack in 2002 to be somewhat greater.

1. As a result of developments over the past two months, the Bank is reverting to its customary practice of presenting a range of 1 percentage point around the midpoint of its projection for Canadian GDP growth.

## Highlights

- **The Bank has lowered its key policy rate by 75 basis points since the November *Report*, bringing the total reduction over the past 12 months to 375 basis points.**
- **Relative to last November, the amount of economic slack in 2002 is now expected to be somewhat greater.**
- **However, the likelihood that the economy will gain significant momentum as the year progresses has increased.**
- **With economic slack starting to diminish in the second half of 2002 and expected to disappear by late 2003, core and total CPI inflation should be back close to 2 per cent in about two years.**
- **The major uncertainty for the outlook is the timing and strength of the recovery in global business investment.**

Chart 1
**Gross Domestic Product for Canada in Constant Dollars**

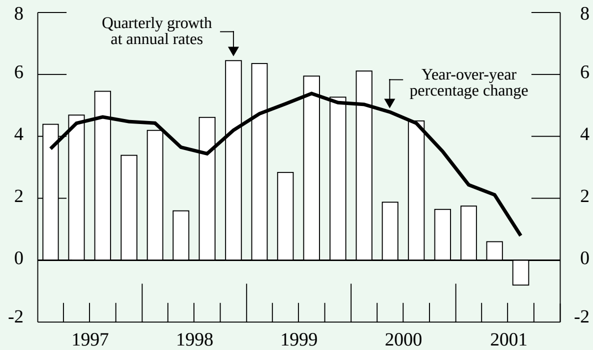
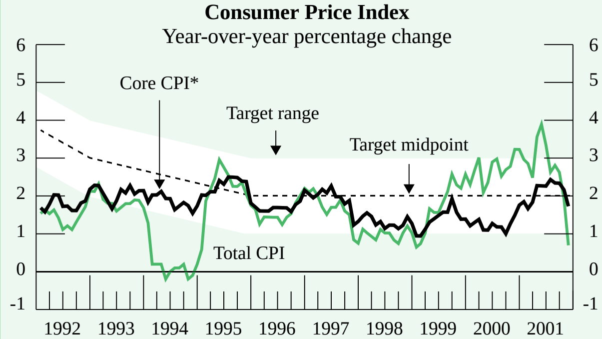



Chart 2
**Consumer Price Index**
Year-over-year percentage change




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

## Recent Economic and Financial Developments

After declining by 0.8 per cent at an annual rate in the third quarter of 2001, Canada's real GDP (Chart 1) is estimated to have remained largely unchanged in the fourth quarter. This would result in annual average growth for 2001 of about 1.5 per cent.

Some sectors of the economy have recovered quickly from the disruptions associated with the terrorist attacks on the United States last September. But in other areas, the adverse effects have persisted. In particular, activity in air travel, tourism, and certain manufacturing operations has remained well below that prior to the attacks. Automobile sales were at record levels in December, but some of these sales appear to have been brought forward from the first quarter of this year.

On balance, these sectoral developments suggest that, on average over the fourth and first quarters, the economy will have expanded by slightly less than was expected in the November *Report*, creating a correspondingly larger output gap.

The 12-month rate of increase in the core CPI was 1.7 per cent in November, down from 2.3 per cent in September (Chart 2). This decline in core inflation, while consistent with an economy that has moved into a position of excess supply, occurred sooner than expected in the last *Report*. This lower-than-expected level of core inflation mainly reflected increased price discounting by motor vehicle manufacturers and dealers, as well as by operators of travel accommodation, to stimulate sales following the sharp fall-off in September.

The 12-month rate of increase in the total CPI was 0.7 per cent in November, down sharply from 2.6 per cent in September. This marked decrease relative to the core rate stems mainly from the significant decline in the world prices of energy commodities over the past year.

In response to weaker domestic activity, rising levels of economic slack, and attendant downward pressures on inflation, the Bank lowered its target for the overnight rate by 50 basis points on 27 November 2001 and by 25 basis points on 15 January, bringing the level down to 2 per cent. Since the beginning of 2001, the Bank's key policy rate has been reduced by a total of 375 basis points. More than half of this reduction has occurred since late August (Chart 3).

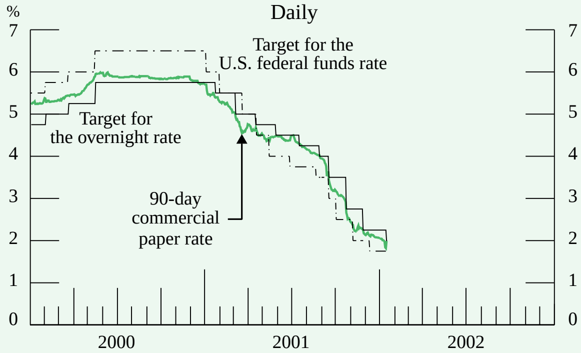
Over the two months up to 15 January (the last fixed announcement date), the Canadian dollar fluctuated around a relatively low level against its U.S. counterpart. This situation reflected the general cyclical weakness of the world economy and commodity prices, as well as the uncertain international economic and political situation. The Canadian dollar strengthened somewhat against other major currencies over this period.

Because of the weakness in economic growth and the uncertainty surrounding

Chart 3

**90-Day Commercial Paper Rate, Target for the Overnight Rate, and Target for the U.S. Federal Funds Rate**

Daily




the outlook, certain sectors of the Canadian economy have experienced somewhat tighter credit conditions. There has recently been some easing in these conditions, however. As well, equity markets have recovered from the lows that followed the terrorist attacks.

## Prospects for Growth

Recent geopolitical and economic developments increasingly point to the likelihood that economic growth in North America will gather significant momentum over the course of the year. The geopolitical situation has improved, and there are indications of a recovery in consumer confidence in both the United States and Canada from the low points reached after the terrorist attacks. However, business confidence in both countries remains weak, primarily reflecting the fact that the adjustment in inventories and fixed investment has not yet fully run its course and that corporate profits are low. The timing and strength of the recovery in global business investment represents the major uncertainty for the outlook.

Growth in the U.S. economy is projected to be modest in the first half of 2002. Business investment is expected to remain sluggish through the period, while the phasing out of generous price incentives on motor vehicles, a high level of consumer indebtedness, and rising unemployment are likely to slow the rate of increase in household spending. Lower energy prices will, however, be a positive factor for households.

In the second half of the year, business confidence is assumed to recover as the inventory correction ends and the significant amount of fiscal and monetary stimulus continues to support household spending. Investment spending should begin to pick up as corporate earnings start to recover. These developments should lead to a strong rebound in the U.S. economy in the second half of the year—to growth rates above that of potential output.

On an annual average basis, this would imply a growth rate for U.S. real GDP of around 3/4 per cent in 2002, slightly below the rate expected in the Bank's last *Report*. Nevertheless, with the pace of activity firming over the course of the year, U.S. growth is expected to be close to 2 1/4 per cent on a fourth-quarter-over-fourth-quarter basis.

Prospects for economic growth in other industrialized countries have weakened since the release of the November *Report*. In Europe, the spillover effects to domestic demand from geopolitical uncertainties and the U.S. slowdown have apparently dampened economic growth by more than had been anticipated. Nevertheless, economic activity is expected to strengthen somewhat during the second half of the year in response to the earlier easing in monetary policy, lower energy prices, and the projected U.S. recovery. The economic outlook in Japan has also worsened, owing to ongoing structural difficulties and deteriorating business and household confidence.

Activity in emerging-market economies is generally expected to recover through 2002 as global demand picks up. The Argentine default has had little impact on other emerging-market borrowers.

The projected recovery in world economic growth should gradually boost the U.S.-dollar prices of non-energy commodities through 2002 from their current low levels. Prices for both crude oil and natural gas are also likely to recover somewhat over this period.

In Canada, economic growth in the first half of 2002 is also projected to be modest and slightly lower than was previously projected on the basis of the Bank's working assumptions. Although household spending is expected to increase moderately, business investment and export growth are likely to remain weak. Cash-flow effects from lower energy prices will be one factor constraining capital spending in Canada. Growth of real GDP, on an annualized basis, is now expected to average between 1 and 2 per cent in the first half of this year.

Demand for Canadian exports should increase significantly in the second half of the year as a result of the strengthening of the U.S. economy. As well, the substantial amount of monetary stimulus that has been provided, together with the impact of recent government measures to improve national security and further reduce tax rates, will continue to support growth in domestic spending. These conditions should lead to a restoration of business confidence and to the start of a recovery in business investment.

Thus, the pace of economic activity in Canada is still expected to be above potential growth in the second half of the year—in the range of 3 to 4 per cent. On an annual average basis, GDP growth for 2002 would be in a range around a midpoint of slightly above 1 per cent—broadly in line with the latest average private sector forecast. This growth profile means that the amount of economic slack through 2002 would be somewhat greater than was anticipated at the time of the last *Report*.

Since last autumn, financial markets have remained volatile, reflecting uncertainty regarding the international economic and geopolitical outlook. Nevertheless, expectations for future economic prospects have become more optimistic. In equity markets, the recovery from the effects of 11 September points to expectations of an economic recovery and of higher earnings. The more positive economic outlook among financial market participants is also reflected in the current steepness of the yield curve in bond markets.

## The Outlook for Inflation

Although the November level of core inflation was somewhat lower than expected as a result of increased price discounting, most of this discounting is expected to diminish appreciably in coming months, in line with the recovery in consumer confidence. Nonetheless, core inflation will likely remain around its current level in the first half of the year, given the increased excess supply in the economy.

With slightly greater economic slack through 2002, core inflation is now expected to average just under 1 1/2 per cent in the second half. Total CPI inflation should remain below the core rate until late 2002, on the assumption that world energy prices increase only moderately from current levels.

By lowering its target for the overnight interest rate by 375 basis points since the beginning of 2001, the Bank has taken vigorous action to support growth in domestic demand. As a result, economic slack should start to diminish in the second half of 2002 and would be expected to disappear by late 2003. Consequently, both core and total CPI inflation should be back close to 2 per cent in about two years.

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

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Web site: http://www.bankofcanada.ca