Recent Developments: An Update to the *Monetary Policy Report*

This update is a commentary of the Governing Council of the Bank of Canada. It includes information received to 14 January 2000.

Highlights

- The pace of economic activity in the United States remains strong, exceeding earlier expectations.
- With the stronger momentum of external demand, the Bank now expects Canada's real GDP growth in 2000 to be in the upper half of the 2.75 to 3.75 per cent range projected in the last *Monetary Policy Report*.
- Core inflation was below expectations in November, partly because of price discounting on certain semi-durables.
- The Bank expects core inflation to increase to 2 per cent in the first quarter of 2000.
- Because of higher energy prices, the rate of increase in total CPI is expected to rise to close to 3 per cent early in the year.
- Developments during the last three months underscore the risks to Canada's economic outlook highlighted in the last *Report*: stronger momentum of demand for Canadian output from both domestic and external sources and potential inflationary pressures in the United States.

Information received since the last *Monetary Policy Report*, released on 17 November, points to a stronger pace of economic expansion in the United States and Europe than was expected at that time, and confirms the hesitant nature of the recovery in Japan. With the further strengthening of global demand, world prices of non-agricultural commodities have continued to bounce back from the lows reached a year ago. This has been particularly true for oil, lumber, and nickel, where production constraints have also been a factor.

Higher crude oil prices have led to higher energy prices for consumers, raising the headline rate of inflation in a number of Canada's trading partners. As yet, however, these countries have not seen any significant increases in pressure on the underlying trend of inflation as measured by consumer prices excluding energy.

Nonetheless, in light of the stronger-than-expected pace of economic expansion, monetary authorities in the United States and Europe have raised policy interest rates in recent months to counter potential inflation pressures. Renewed concerns that U.S. short-term interest rates may have to rise further to stem inflation pressures have led to increases in U.S. interest rate futures and in medium- and long-term bond yields.

In Canada, the growth rate of aggregate demand in the third quarter of 1999 was broadly in line with expectations. Supported by rising exports and household demand, real GDP advanced at an annual rate of 4.7 per cent. Based on available indicators, the Bank estimates that growth in the fourth quarter remained strong at about 4 per cent. Employment has also been expanding rapidly, taking the unemployment rate to its lowest level in 18 years.

Recent hikes in energy prices have pushed the year-over-year rate of increase in the total CPI in Canada into the upper half of the 1 to 3 per cent target range for inflation control, but the rate of increase in the core CPI (CPI excluding food, energy, and the effect of changes in indirect taxes) has remained in the lower half of the range. In November, it fell to 1.5 per cent, partly because of temporary discounts on items such as women's clothing. Core inflation is expected to move back up near the midpoint of the target range over the next few months.

Overall, developments in the last three months underscore the risks to Canada's economic outlook highlighted in the last *Report*: stronger momentum of demand for Canadian output from both domestic and external sources and potential inflationary pressures in the United States.

On 17 November, after holding the Bank Rate steady at 4.75 per cent since early May, the Bank of Canada raised the Bank Rate by 25 basis points, to 5 per cent, following a similar increase in the U.S. Federal Reserve's target for the federal funds rate. The Bank's action, which was aimed at keeping future inflation comfortably inside the target range, took into consideration the implications for Canada of U.S. economic and financial developments, as well as evidence of robust growth in domestic demand.

The International Environment

Emerging-market economies

The performance of emerging-market economies has generally been better than expected, although some areas of concern remain. The recovery in Asia has gained momentum, especially in those countries that have undertaken significant structural reforms. The Mexican economy has surged in recent quarters, but growth remains weak in most other Latin American countries. Faced with significant external debt-service burdens, many Latin American economies remain vulnerable to possible increases in global interest rates.

Conditions in emerging markets continue to improve.

Europe and Japan

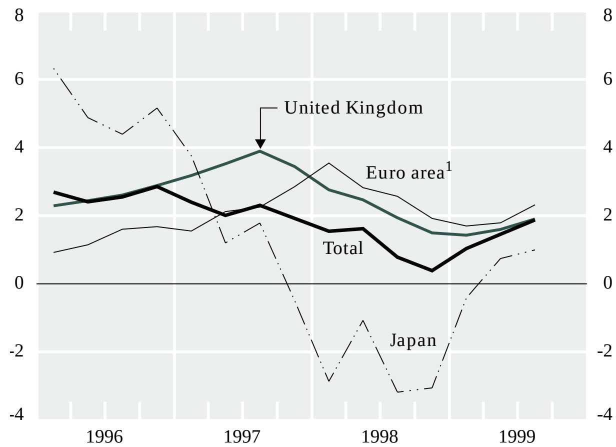
In the euro area, the pace of economic expansion accelerated more quickly in the second half of 1999 than had been anticipated, primarily reflecting stronger growth in France. Although the strengthening trend has taken hold less rapidly in Germany and Italy, the pace of activity in the euro area should continue to pick up, supported by improving consumer and business confidence. Market concerns about lagging growth in some regions and the lack of progress on structural reform have, however, contributed to downward pressure on the euro. The euro hovered at just over parity with the U.S. dollar in late December, before picking up somewhat in early January. The U.K. economy has also picked up more rapidly than expected. The economies of both the euro area and the United Kingdom now appear poised to expand at an annual pace of 3 per cent or better over the near term.

Recent information points to a stronger-than-expected pickup in economic activity in Europe and confirms the hesitant nature of the Japanese recovery.

The Japanese economy enjoyed unexpectedly strong growth of about 5 per cent (at annual rates) in the first half of 1999. Nevertheless, the decline in output in the third quarter, when fiscal support diminished, highlights the continued dependence of the recovery on government stimulus. A self-sustaining recovery based on private sector demand is, as yet, not apparent. Moreover, the yen's sharp appreciation since the middle of 1999, the impact of higher energy prices, and the continuing need for structural adjustment in both the financial and industrial sectors lend additional uncertainty to the near-term outlook. However, the new fiscal-stimulus package announced in November should help counter these factors and cause GDP to expand in 2000.

Real Gross Domestic Product in Overseas Countries

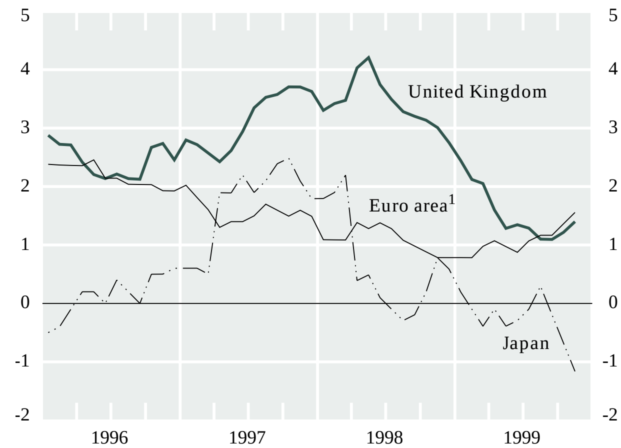
4-quarter percentage change



1. Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain

Consumer Price Index in Overseas Countries

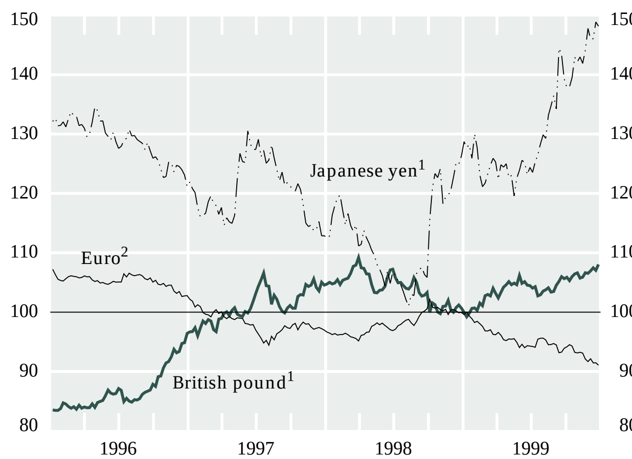
12-month percentage change



1. Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Portugal, and Spain

Exchange Rates of Selected Overseas Currencies

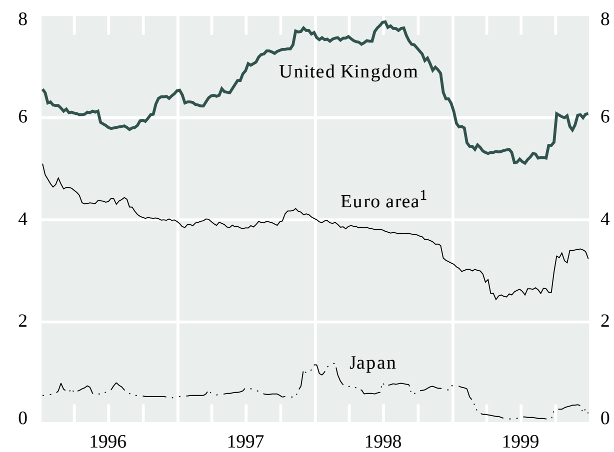
Nominal effective index vis-à-vis C-6 currencies, 1987 = 100, Wednesdays



1. Prior to 1999, based on the bilateral exchange rates of the participating countries in the euro area
2. Prior to 1999, based on the ECU

90-Day Interest Rates in Overseas Countries

Wednesdays



1. Synthetic euro-area interest rates are calculated for the period prior to January 1999 on the basis of GDP-weighted interest rates for Austria, Belgium, Finland, France, Germany, Ireland, Italy, Netherlands, and Spain.

Owing largely to higher energy prices, consumer prices increased by about 1 1/2 per cent in the euro area and the United Kingdom in the year to November. The European Central Bank raised policy interest rates by 50 basis points in November, noting that, in the context of the current strengthening climate, its move should help restrain inflation expectations.

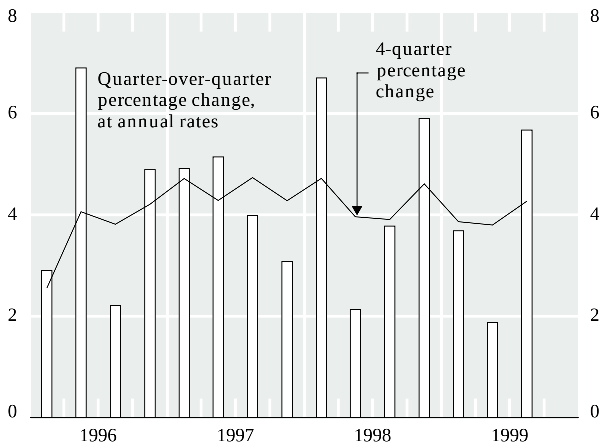
The Bank of England raised its repo rate by 25 basis points in November and again in January to counter developing pressures in labour markets and on productive capacity. In Japan, with the CPI declining by about 1 per cent in the year to November, the Bank of Japan maintained domestic short-term interest rates at very low levels.

United States

In the United States, growth in real GDP has continued to outstrip most expectations, reaching 5.7 per cent (at an annual rate) in the third quarter of 1999. Although housing expenditures weakened over this period (likely because of higher financing costs), consumer spending and business investment in machinery and equipment were buoyant. Labour markets remain very tight, with the unemployment rate at 4.1 per cent in December, its lowest level since 1970.

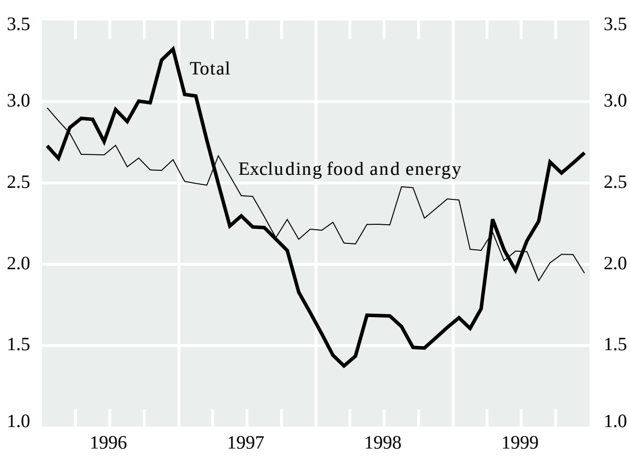
U.S. Real Gross Domestic Product

Quarterly



U.S. Consumer Price Index

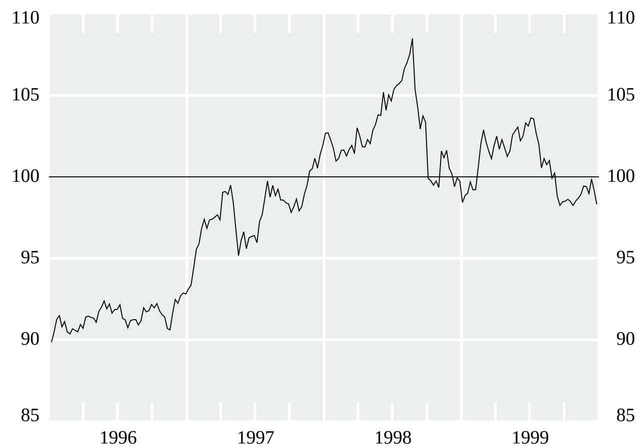
12-month percentage change



Since the year-2000 changeover may temporarily be distorting consumer and business spending patterns, it is difficult to judge whether the U.S. economy is slowing from its recent trend growth rate of about 4 per cent. Several factors are, nevertheless, expected to moderate the expansion of demand over the course of this year. In particular, the low personal savings rate and a less rapid increase in household wealth are expected to slow the growth of household spending. Higher interest rates (including medium- and long-term rates) should also eventually make themselves felt across the economy. And the increase in energy prices, if sustained, may have a restraining effect on growth.[1]

U.S. Dollar Exchange Rate

Nominal effective index vis-à-vis C-6 currencies, 1987 = 100, Wednesdays



Boosted by a 13 per cent increase in energy prices, the total CPI in the United States rose by 2.7 per cent (on a year-over-year basis) in December 1999, compared with 1.6 per cent a year earlier. In contrast, core inflation has been contained at 1.9 per cent, down from a year ago. Despite this favourable price performance, the overall high level of resource utilization and the rapid pace of growth in the U.S. economy continue to pose a potential inflation risk. Some factors that had helped to restrain inflation in the past have also turned around—the recovery in economic growth outside North America has begun to take up slack globally; commodity prices, particularly energy prices, are on an upward path; and the U.S. dollar has stopped appreciating on a trade-weighted basis. In view of the potential inflationary risks, U.S. monetary

1. For a quantitative analysis of the possible impact of higher oil prices on output and inflation in the industrialized economies, see OECD (1999, 8).

authorities raised policy rates by 25 basis points in mid-November, the third increase in 1999, thereby reversing all of the 75-basis-point reduction that was implemented in response to financial turbulence in the autumn of 1998.

The extent of additional interest rate increases would appear to depend on the prospects for continued strong productivity growth. Recently revised data show significantly stronger U.S. output growth in the latter half of the 1990s than was originally reported, with correspondingly stronger growth in labour productivity. Data for the third quarter of 1999 indicate that labour productivity in the non-farm private sector rose by slightly more than 3 per cent over the past year. These strong productivity gains have helped to offset the impact of wage increases on production costs, thereby containing price pressures. Productivity growth at this rate may not be sustainable, however.

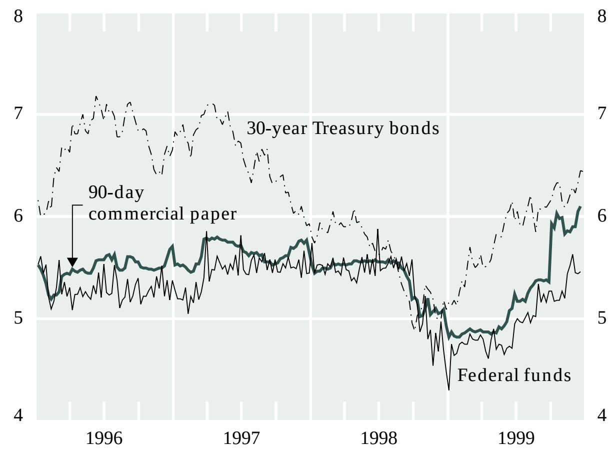
In the United States, the pace of economic expansion continues to exceed expectations . . . posing potential inflation risks and thus raising expectations of increases in U.S. policy rates.

The spread between U.S. conventional and inflation-protected (real return) bonds suggests that longer-term inflation expectations, after having been relatively stable during most of the second half of 1999, increased early in the new year. In response to changing market perceptions of the inflation risks, long-term interest rates have exhibited some volatility around a rising trend. As well, most market participants are anticipating one or more additional quarter-point increases in U.S. policy rates in the first part of 2000.

Another source of uncertainty for the U.S. economy is that country's large current account deficit, which now stands at about 4 per cent of GDP. While this could be expected to eventually lead to a lower U.S. dollar, the timing and extent of such exchange rate movements are difficult to predict.

Selected U.S. Interest Rates

Wednesdays



Commodity prices

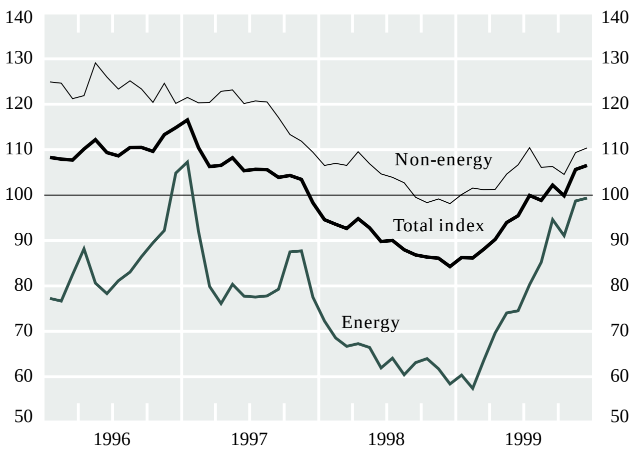
The average U.S. dollar price of Canada's key primary commodities, as measured by the Bank of Canada's commodity price index, has risen by about 6 per cent since the end of October 1999. Although much of the increase reflects the rise in the world price of crude oil, there has also been a significant recovery in the prices of other non-agricultural commodities. Prices for agricultural commodities remain low, however, owing largely to the effect on grain prices of higher estimates of global wheat production as well as higher stocks. While the recent movements continue the turnaround in commodity prices, the index for non-energy commodities is still about 7 per cent below the level reached prior to the declines sustained in the wake of the Asian crisis.

Crude oil prices have posted strong increases because of continued output restrictions by OPEC and several non-OPEC producers as well as rising demand in the United States and elsewhere. Prices were buoyed by statements from OPEC officials indicating that many members favour maintaining output restrictions beyond the March 2000 expiry date. Natural gas prices have risen to a lesser extent, under the moderating influence of milder-than-normal temperatures in much of North America.

While higher prices for non-agricultural commodities reflect an increase in world demand, pressures have been especially pronounced for commodities subjected to production constraints. For instance, much of

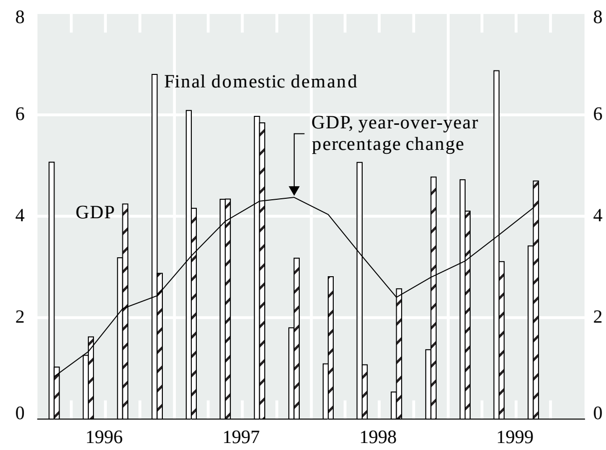
Bank of Canada Commodity Price Index

1982–90 = 100, in U.S. dollars



Output and Final Domestic Demand

Quarterly percentage change, at annual rates



the recent increase in the prices of base metals stems from a sharp rise in the price of nickel that reflected concerns about reduced supply resulting from a lock-out at a major Canadian mine. Significant increases in world production of stainless steel, a major user of nickel, have also contributed to the rebound in nickel prices. Similarly, the rise in lumber prices, while supported by the strong North American housing market, has occurred largely in response to announcements of extended winter shutdowns by several British Columbia producers who had used up their U.S. export quotas.

Canadian Economic Developments

Aggregate demand, output, and employment

Economic information released since early November has been broadly consistent with the views expressed in the November *Monetary Policy Report*. There appears, however, to be more momentum in the Canadian economic expansion arising from greater-than-anticipated strength in both the U.S. economy and world commodity markets.

Economic information released since early November has been broadly consistent with the views expressed in the last Monetary Policy Report *and underscores the risks associated with those views.*

Real GDP in Canada rose by 4.7 per cent (at an annual rate) in the third quarter of 1999, broadly in line with expectations. The composition of demand was also largely as expected. Canadian exports surged, chiefly because of the strength of the U.S. economy. Consumer spending continued to rise substantially, reflecting the relatively high level of consumer confidence, lower personal income tax rates,[2] and possibly, to a small extent, the increase in perceived personal financial wealth associated with the recent demutualization of Canadian life insurance companies.[3] At the same time, business investment, residential construction, and imports all moderated from their vigorous pace of expansion in the first half of the year. Government spending on goods and services increased by less than had been anticipated, and it appears that the rise in provincial health-care spending, related to measures in the 1999 federal budget, will take place more gradually than expected.

2. A number of measures introduced in the last federal budget reduced personal income taxes effective 1 July 1999. These included increases in the amounts used to determine basic personal and spousal tax credits, as well as the complete elimination of the general 3 per cent surtax. The Ontario provincial income tax rate was also reduced effective the same date.

3. This factor may continue to provide some support to consumer spending through the early part of 2000.

Early indicators for the fourth quarter point to continued robust economic growth. Available information on U.S. economic developments and merchandise trade data for October suggest that the growth of Canadian exports should remain healthy. Strong employment gains in Canada in the fourth quarter, especially for full-time, non-self-employed jobs,[4] raise the prospect of substantial growth in personal income and continued expansion of household spending.[5]

The momentum of stronger external demand has . . . shifted the likely outcome for economic growth in 2000 towards the upper half of the . . . range projected in November.

These recent developments reinforce the Bank's view, expressed in the last *Report*, that real GDP growth in Canada will be close to 3.75 per cent (on an annual average basis) in 1999. The momentum of stronger external demand has, however, shifted the likely outcome for economic growth in 2000 towards the upper half of the 2.75 to 3.75 per cent range projected in November.

Prices and costs

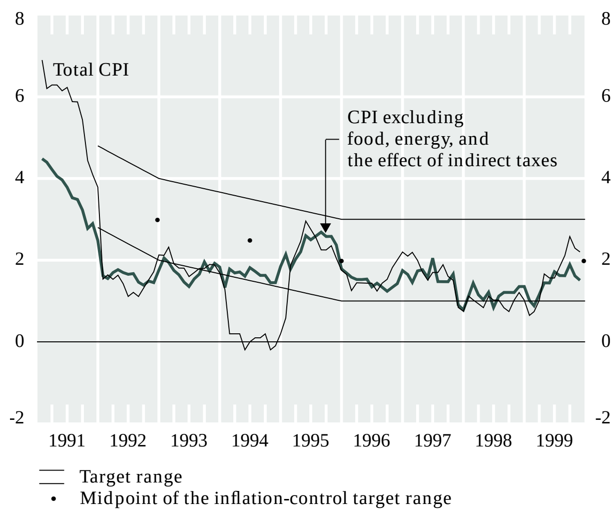
The 12-month rate of increase in the core CPI fell to 1.5 per cent in November, slightly below expectations. The main surprise was sharply lower prices for semi-durable items, particularly women's clothing, which has been a volatile component of consumer prices in recent months. Two other statistical measures of the trend rate of inflation, the CPIX and CPIW,[6] continue to be close to core inflation.

Over the coming months, three factors will be working to move core inflation back towards the 2 per cent midpoint of the Bank's target range: a reversal of recent discounts, longer-term inflation expectations that remain close to 2 per cent, and the possibility that the economy will be operating at, or slightly above, potential output.

Two factors, however, should be acting to moderate core inflation. First, recent price developments suggest that we have already seen the peak effect on

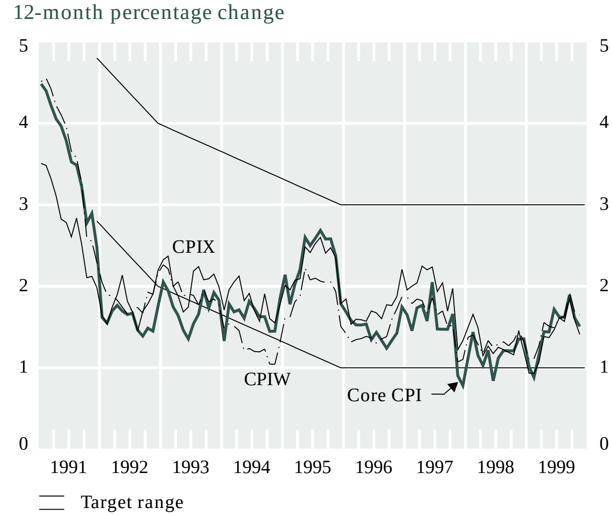
Consumer Price Index

12-month percentage change



Core CPI and Statistical Measures of the Trend Inflation Rate

12-month percentage change



4. We continue to be cautious in interpreting the short-term fluctuations in this employment measure since, in the last couple of years, its quarterly profile within a given year has not been consistent with the quarterly profile of GDP growth. Nonetheless, the underlying trend growth of employment has been strong over the past year.

5. The recent federal pay equity settlement will likely provide an additional temporary boost to household spending in 2000.

6. CPIX excludes the eight most volatile components from the CPI as well as the effect of indirect taxes on the remaining components. CPIW uses an additional adjustment to each CPI basket weight that is inversely proportional to the component's variability. For further details, see Laflèche (1997).

inflation of the pass-through to consumer prices from the depreciation of the Canadian dollar in 1998. Second, unit labour costs in the third quarter barely edged up from their level of a year earlier, since the upward movement in wage increases was largely offset by stronger productivity gains.

The Bank expects core inflation to increase to 2 per cent (on a year-over-year basis) in the first quarter of this year, partly reflecting a reversal of temporary factors that lowered core inflation late last year. The balance of other factors at work also points to a pickup in core inflation from its recent low level. Moreover, as highlighted earlier in this update, the developments of the past three months underscore the inflation risks for Canada that were discussed in last November's *Report*.

Core inflation is expected to move back up close to the 2 per cent midpoint of the target range over the next several months.

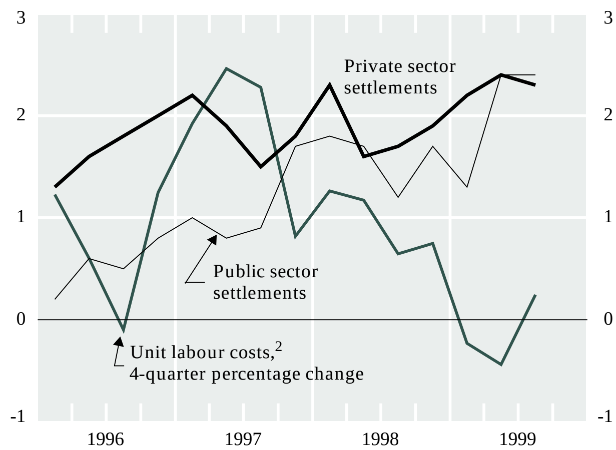
While sharply higher world energy prices have had some effect on core inflation (for example, through the impact of higher fuel costs on air fares), the marked rise in commodity prices generally has not yet been a significant source of upward pressure on the core CPI. The 12-month rate of increase in the total CPI has, however, been well above that of the core CPI in recent months, owing to the sharp rebound in the prices of gasoline, fuel oil, and natural gas. Further upward movement in crude oil prices since early November is expected to push the rate of increase in the total CPI close to 3 per cent in coming months. Subsequently, this rate is still expected to move down towards the core rate of inflation, although more slowly than projected in the November *Report*.

The Conference Board, in the winter issue of its quarterly *Survey of Forecasters*, notes that the average private sector forecast for the CPI is 2.2 per cent in 2000 and 2.0 per cent in 2001.

The marked rise in the prices of Canada's commodity exports was a major factor in the increase in the chain price index for GDP in the third quarter, which rose by 2.1 per cent on a year-over-year basis.

Wage Settlements[1] and Unit Labour Costs

Per cent



1. Effective annual increase in base wage rates for newly negotiated settlements
2. Ratio of total labour income to real GDP

Most information released since early November supports the view that prospective increases in unit labour costs will be modest. The year-over-year increase in the average hourly wage (excluding overtime) for permanent workers, according to Statistics Canada's *Labour Force Information*, was 2.8 per cent in the fourth quarter of 1999, up slightly from the third quarter. Recent compensation surveys suggest that pay increases for 2000 will be at, or slightly below, those received in 1999. The average annual increase in wage settlements in the unionized private sector jumped to 4.0 per cent in September–October 1999 because of high-profile settlements in the automobile manufacturing industry. Excluding these settlements, private and public settlements averaged 2.1 per cent over those two months. Economy-wide, unit labour costs also remain broadly unchanged on a year-over-year basis. However, with the unemployment rate falling to an 18-year low of just under 7 per cent in November and December, there have been some reports of labour shortages. The participation rate has shown little change in the past year but may rise somewhat over the near term in response to the recent favourable labour market developments.

The Bank continues to closely monitor a wide range of indicators of pressures on capacity and inflation. Based on the Bank's *conventional* measure, it appears that the Canadian economy will be operating above estimated potential output in 2000. There is, however, a wide confidence band around such estimates, particularly given the major structural changes that have taken place in Canadian product and labour markets in the 1990s. Nevertheless, the measured rate of capacity utilization in the non-farm goods-producing sector in the third quarter was at its highest level since 1987–88, another indication that the Canadian economy may be approaching full capacity. At the same time, despite a robust economy, core inflation has been broadly in line with expectations. And while the year-over-year rise in prices for existing homes continued to be relatively buoyant in the third quarter, prices for new homes were up only moderately from year-earlier levels. As well, the ratio of unfilled orders to shipments in the manufacturing sector has shown little change in recent months, and our monetary aggregates (see next section) point to core inflation remaining close to the midpoint of the target range.

Canadian Financial Market Developments and Monetary Policy Operations

Monetary and credit developments

M1 growth has picked up somewhat since the last *Report*, with the year-over-year growth rate increasing to about 8 per cent on average in the October–November period. Part of this uptick (especially in November) may reflect a buildup of liquidity related to the transition to the year 2000. While the broader aggregates M1+ and M1++ did not grow as rapidly as M1 over this period, their year-over-year growth rates have also increased somewhat, extending a trend that started at the beginning of 1999. At around 6 to 7 per cent, this expansion is consistent with a continuing solid pace of economic activity but does not signal a buildup of inflation pressures. The Bank's M1-based model continues to suggest that inflation will remain within the inflation-control target range over the next couple of years.

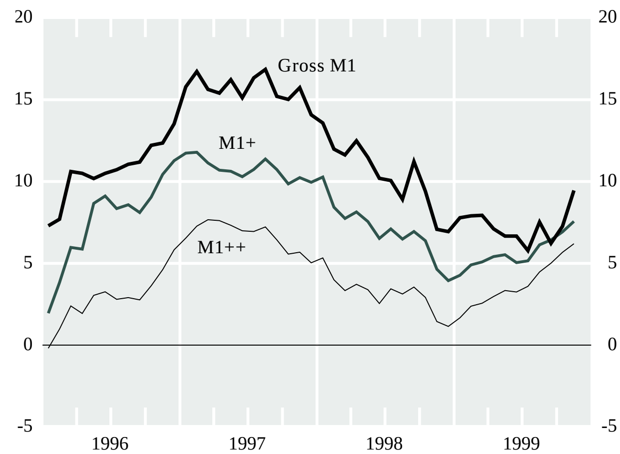
The recent growth of the monetary aggregates supports a scenario of ongoing solid economic expansion, but does not signal a buildup of inflation pressures.

On a year-over-year basis**,** the recent growth rate of the broad monetary aggregate M2++ has remained in the range of 6 to 7 per cent that characterized its behaviour for virtually all of 1999. This growth rate is consistent with inflation close to the midpoint of the target range.

Household credit has grown at a solid pace in recent months, indicating continued strong consumer spending in the near term. Growth in business credit has remained relatively modest as higher profits have limited the demand for external financing.

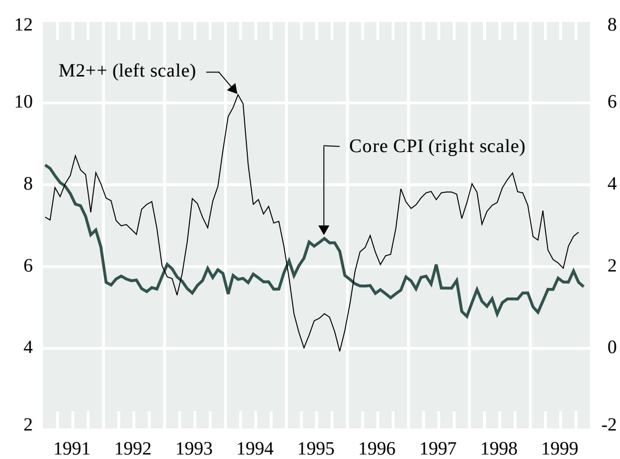
Narrow Money Growth

12-month percentage change



Core Inflation and Broad Money Growth

12-month percentage change



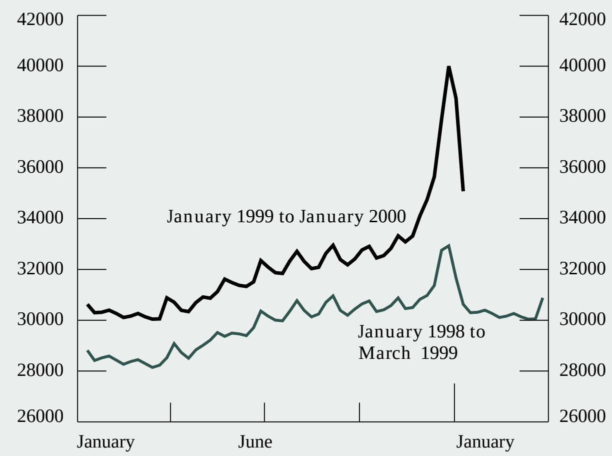
Y2K and the Demand for Bank Notes

Today, people use many methods of payment to settle their transactions, including bank notes and coins, credit cards, cheques, debit cards, and electronic transfers. In recent years, with new telecommunications and information technology, the last two options—debit cards and electronic funds transfers—have become increasingly popular. While this has reduced the use of cash, the demand for currency remains significant—in excess of $1,000 for every man, woman, and child in Canada. These notes are held primarily by businesses, particularly retailers, rather than by individuals. The demand for notes also exhibits marked seasonal variations and tends to rise sharply near the end of the year during the holiday period.

Towards the end of 1999, with public concern about year-2000 computer problems and their possible effect on electronic payment services, there was a risk that the demand for cash would rise. The Bank of Canada and financial institutions therefore stockpiled bank notes. Having increased its stock of notes fourfold to $23 billion, the Bank was easily able to accommodate the demand from financial institutions and the public. As of 31 December 1999, the Bank of Canada had placed an additional $5.5 billion in notes into circulation. The bulk of this (some $4 billion) was in the hands of financial institutions. There was, in fact, only a relatively small increase in demand from Canadian households compared with the amount they normally hold at year-end. With the arrival of the year 2000, it was soon apparent that all was well, and Y2K fears faded. The surplus notes in circulation were quickly returned to the Bank of Canada.

Notes in Circulation

$ millions, Wednesdays

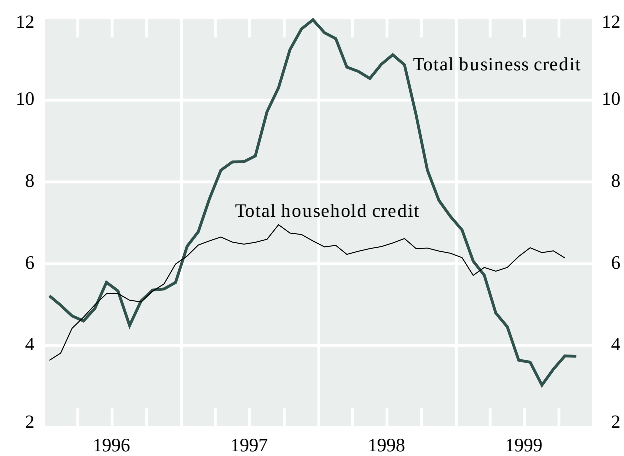


Altogether, the information coming from financial variables is consistent with output growth in the 2.75 to 3.75 per cent range in 2000. Simple indicator models, based solely on the growth rate of the narrow monetary aggregates, suggest that growth will be within that range. Models that also include the spread between long-term and short-term interest rates predict growth slightly above the upper end of the range.[7] The solid growth in household credit and in long-term business credit is also consistent with the projected growth in economic activity.

With household credit rising somewhat faster than disposable income, the ratio of outstanding personal debt to disposable income edged up in the third quarter. Nonetheless, the estimated ratio of debt interest payments to disposable income is well below its average for the past 20 years.

Credit Aggregates

12-month percentage change



7. For a description of these models, see Tkacz and Hu (1999).

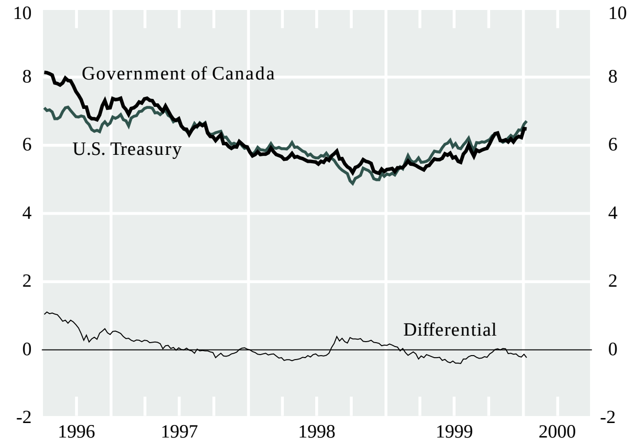
Monetary conditions and monetary policy operations

Soon after the completion of the November 1999 *Report*, evidence of robust domestic economic growth and continued strong external demand emanating from the United States prompted the Bank to raise the Bank Rate by 25 basis points to 5 per cent. This followed the U.S. Federal Reserve's move to increase its target for the federal funds rate by the same amount. The Bank had held the Bank Rate unchanged through two previous increases in the federal funds rate. The Bank's action in November was taken with a view to keeping inflation well within its inflation-control target range of 1 to 3 per cent. The decision to raise rates was anticipated by the markets, and thus did not significantly alter market interest rates.

Long-term bond rates around the world began to drift higher in November on concerns that inflationary pressures may emerge as demand pushes against capacity constraints. Canadian bond yields have not risen as much as those in the United States, however, and spreads on nominal bond yields are once again negative.

Government 30-Year Bond Yields—Canada and the United States

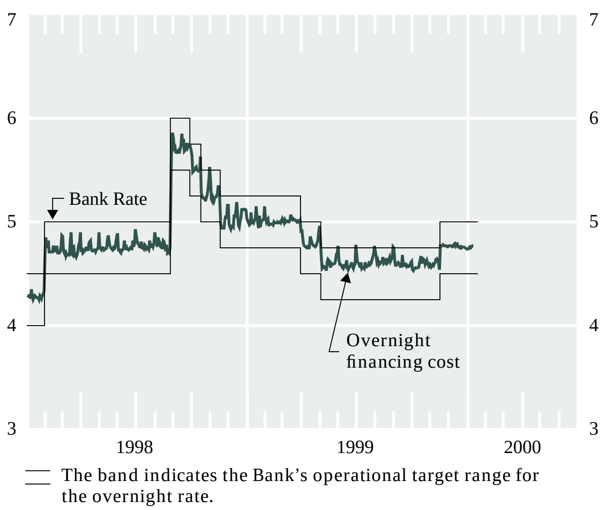
Wednesdays



Short-term interest rates have moved up, reflecting market expectations of possible central bank moves. The Canadian dollar has strengthened.

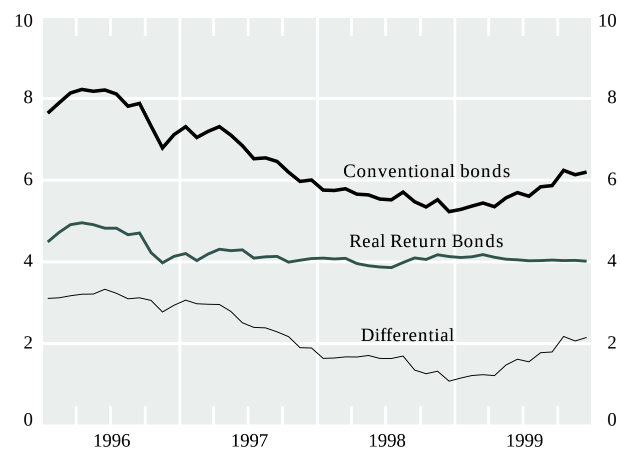
Bank Rate and Overnight Financing Cost

Wednesdays



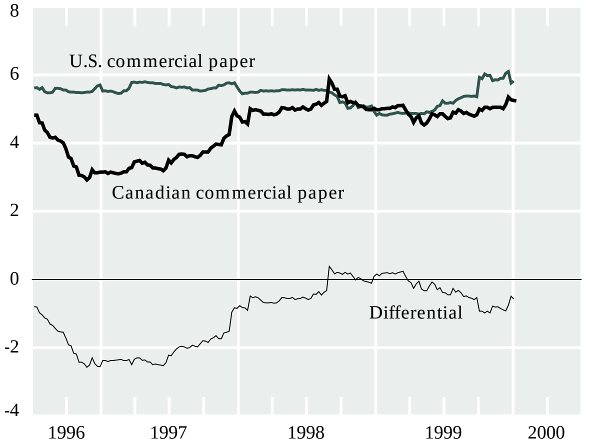
Yields on 30-Year Government Bonds

Monthly



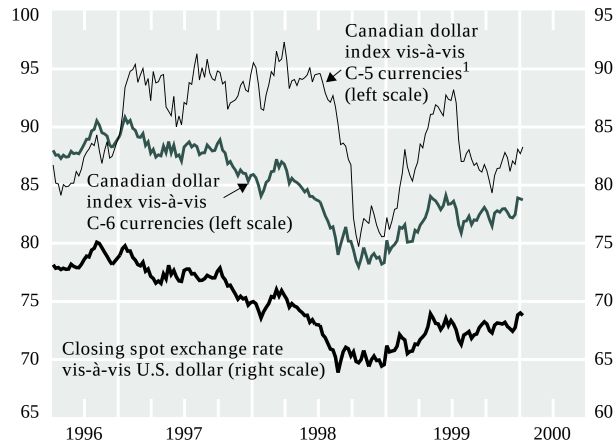
90-Day Interest Rates—Canada and the United States

Wednesdays



Canadian Dollar Exchange Rate

1992 = 100, Wednesdays In U.S. cents



1. The C-5 index excludes the U.S. dollar.

The yield differential between conventional and Real Return bonds, which tends to reflect financial market expectations of future inflation,[8] has remained relatively unchanged at about 2 per cent since the last *Report*, after increasing through the course of 1999.

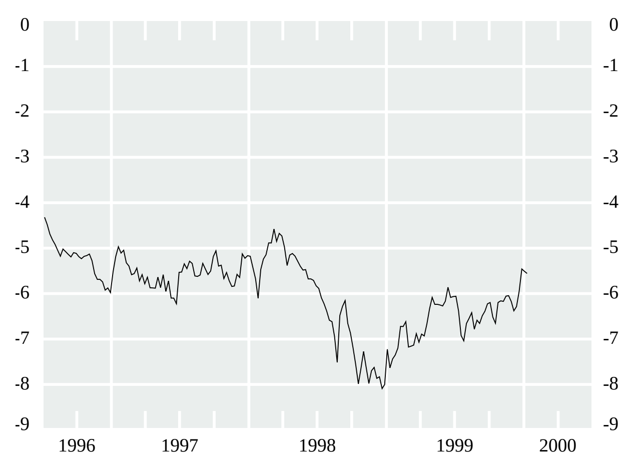
North American 90-day commercial paper rates, particularly in the United States, showed considerable volatility as maturity dates crossed over into the year 2000, and again towards the end of 1999. To help minimize potential year-2000 effects, both the Federal Reserve and the Bank of Canada put in place contingency liquidity arrangements.[9] By mid-January, short-term rates in North America better reflected actual overnight rates and had built in expectations of possible future central bank rate moves.

Financial market participants also took precautionary measures throughout 1999 to avoid the need for transactions over the year-end period. For example, corporations switched to longer-term financing and transactions were timed not to mature near the end of the year. Such activity led to diminished liquidity in fixed-income and foreign-exchange markets towards the end of December, but not as much as had been expected.

The Canada / U.S. exchange rate fluctuated in a range of 67.50 to 68.50 U.S. cents from mid-November to mid-December. During that period, perceptions of seasonal weakness in the Canadian dollar may have weighed on the currency. Since then, the dollar strengthened to 69 U.S. cents, reflecting continued strength in commodity markets, a current account surplus in the third quarter of 1999, and the strong fundamentals of the Canadian economy. The Bank's monetary conditions index has fluctuated between -6.5 and -5.5 since mid-November.

Monetary Conditions Index

Wednesdays, January 1987 = 0



This index is calculated as the change in the 90-day commercial paper rate since January 1987 plus one-third of the percentage change in the effective exchange rate of the Canadian dollar against the other C-6 currencies since January 1987.

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8. See Technical Box 3 in the November 1997 *Monetary Policy Report*.

9. In Canada, these measures included a special borrowing facility to meet any unusual demand for liquidity at year-end. The Bank was also prepared to accept a broader range of collateral to support any liquidity loans it provided. As well, some measures were taken to prevent unusual pressure on overnight interest rates. The Bank's Web site: (**http://www.bank-banque-canada.ca**) contains detailed information about the year-2000 liquidity arrangements provided by the Bank.

Literature Cited

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