BANK OF CANADA

Monetary Policy Report Update

– July 2003 –

This text is a commentary of the Governing Council of the Bank of Canada. It presents the Bank's updated outlook based on information received between 15 April and 15 July 2003.

Since the April *Monetary Policy Report*, there have been a number of unanticipated developments that have changed the outlook for inflation and economic activity in Canada. Both inflation and inflation expectations have declined more rapidly than the Bank had expected. Near-term domestic activity has been undercut by the effects of severe acute respiratory syndrome (SARS) and an isolated case of bovine spongiform encephalopathy (BSE) in Canada. Foreign demand for Canadian products has also been weaker than earlier anticipated. As well, the substantial rise in the value of the Canadian dollar against the U.S. dollar will have a dampening effect on the future growth of demand for Canadian goods and services and will contribute to downward pressure on the prices of some components of the CPI.

In this context, inflation pressures have eased, more slack is developing in the economy than had been expected, and the output gap at the end of 2003 will be larger than projected in the April *Report*. It now appears that core inflation will fall below the 2 per cent target by year-end.

In response to these changing circumstances, the Bank left the target for the overnight rate unchanged on 3 June, seeing less need to reduce the amount of monetary stimulus being provided, and on 15 July it lowered the target rate by 25 basis points to 3 per cent. This change in policy stance will provide additional near-term support for

Highlights

- **Inflation pressures have eased, and more slack is developing than previously projected.**
- **It now appears that core inflation will fall below the 2 per cent target by year-end.**
- **To support growth in domestic demand and aggregate levels of activity, the Bank lowered its target for the overnight rate by 25 basis points on 15 July.**
- **The Bank expects that growth in the Canadian economy will strengthen towards the end of 2003 and through 2004.**
- **The Bank will closely monitor the strength of domestic and external demand with a view to keeping inflation on track to meet the 2 per cent target over the medium term.**

domestic demand growth and, consequently, for levels of aggregate demand consistent with keeping inflation on track to meet the 2 per cent target over the medium term.

The Bank expects that growth in the Canadian economy will strengthen towards the end of 2003 and through 2004. Factors supporting this outlook include the unwinding of the adverse effects of SARS and BSE, the expected rebound in the U.S. economy, the much-improved tone in capital markets, and the underlying strength of Canadian domestic demand.

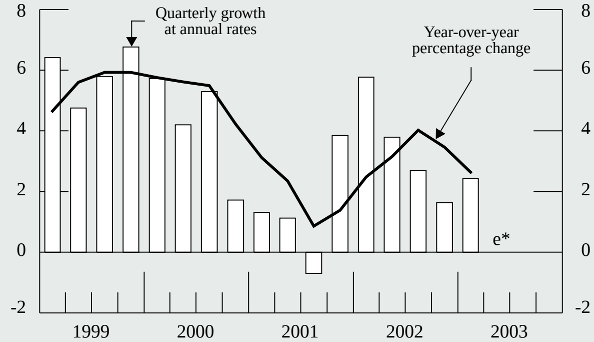
A number of risks surround this base-case scenario. On the upside, the recent strengthening in global equity markets, combined with the stimulative stance of macroeconomic policies in the major industrialized countries, could lead to a stronger global economic recovery than assumed in this *Update*. On the downside, prospects for U.S. demand for Canadian goods and services could be weaker than currently assumed, particularly if the expected recovery in U.S. investment spending is delayed. The Bank will monitor these risks closely.

Overview of Recent Economic and Financial Developments

After expanding at a vigorous pace in the first half of 2002, Canada's real GDP advanced by a modest 2.3 per cent (annual rate) between mid-2002 and the first quarter of 2003 and is estimated to have been flat in the second quarter (Chart 1).

Exports fell in the fourth quarter of 2002 and in the first half of 2003 as the pace of economic expansion in the United States slowed. Exports in the second quarter of 2003 were also held back by the adverse economic effects associated with SARS and BSE. Travel to Canada decreased sharply following the outbreak of SARS in the Greater Toronto Area, and cattle and beef exports have been halted pending the investigation of one case of BSE in Alberta.

Chart 1
Real Gross Domestic Product for Canada



* The letter "e" denotes estimate based on available indicators. The estimate for 2003Q2 is 0 per cent growth.

In contrast, growth in household spending was robust in the second half of 2002 and in the first quarter of 2003, boosted by low interest rates. However, the pace of expansion of household expenditures moderated somewhat in the second quarter.

Conditions in financial markets have continued to improve since the April *Report*. The predominant developments have been a global portfolio reallocation into higher-yield fixed-income assets, which has further reduced spreads on corporate and emerging-market debt vis-à-vis benchmark government bonds, and a continuation of the equity market recovery that began in March. Equity markets were buoyed by a combination of low interest rates, generally positive first-quarter earnings, and increasing confidence that the pace of expansion in the U.S. economy will pick up. Over the period, yields on longer-term bonds fell by about 80 basis points but subsequently rose by some 50 basis points.

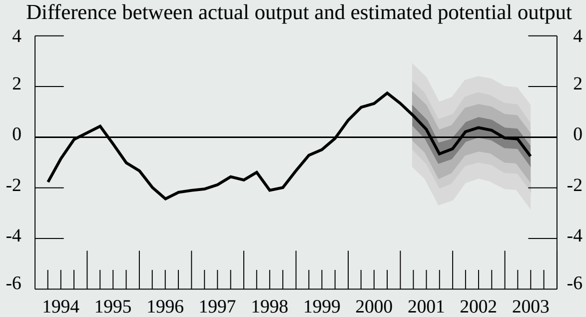
The Canadian dollar has appreciated from a range of 67.5 to 69 U.S. cents to a range of 72 to 75 U.S. cents since the April *Report*. Both the magnitude and speed of this appreciation have been greater than the Bank had anticipated. This movement is part of a broader multilateral adjustment in the U.S. real exchange rate. Foreign investors have become less willing to accumulate U.S.-dollar assets to finance large ongoing U.S. current account deficits. The appreciation also reflects the relative strength of domestic demand in Canada, where the economy is operating closer to full capacity than in the United States. This relative strength has been reflected in widening interest rate differentials with the United States.

The Bank's conventional measures of potential output and the output gap indicate that the level of economic activity was near full capacity in the first quarter of 2003 and fell below full capacity in the second quarter (Chart 2).[1]

A number of indicators support the view that a small amount of slack had opened up by mid-year. The unemployment rate rose slightly, and in the regular survey conducted by the Bank's regional offices the proportion of firms reporting shortages of labour diminished further. Rates of increase in the prices of both new and existing homes have also eased since late 2002.

Core inflation was 2.3 per cent in May, lower than projected at the time of the April *Report* and down considerably since February (Chart 3). Other measures of trend inflation have also eased. A sharp slowdown in the rate of increase in the premiums for automobile insurance was a significant contributing factor in these developments. Sharply lower levels of activity in tourism-related sectors contributed to marked price reductions, although much of this price discounting is expected to be temporary. A somewhat lower-than-expected level of inflation was also evident in the prices of a broad range of core products and services.

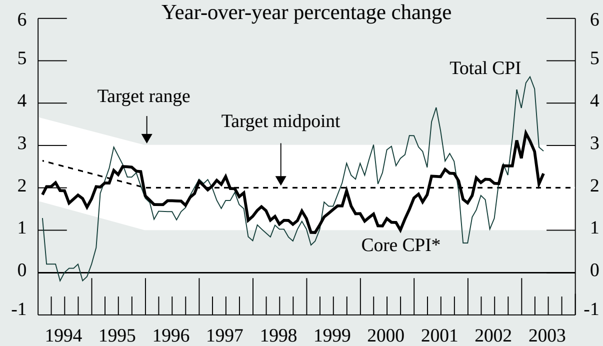
Chart 2
Estimated Output Gap*
Difference between actual output and estimated potential output



* The shading around the values of the estimated output gap shows (from darkest to lightest) confidence intervals of 25 per cent, 50 per cent, 75 per cent, and 95 per cent.
Note: The estimate for the second quarter of 2003 is based on a projection of 0 per cent growth for the quarter.

1. The data period used in the filter that determines potential output ends in the first quarter of 2003 because of special factors affecting GDP in the second quarter.

Chart 3
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

The 12-month rate of increase in the total CPI was 2.9 per cent in May, down from 4.6 per cent in February. In addition to the factors pushing down the core rate, the prices of gasoline and fuel oil eased considerably from the levels reached in February.

Most of the measures of inflation expectations that the Bank follows have declined since mid-April, and all the medium- and longer-term measures are now close to 2 per cent. In particular, the consensus forecast for CPI inflation in 2004 is 2 per cent. As well, the percentage of firms in the Bank's regional survey that expect CPI inflation to exceed 3 per cent on average over the next two years has fallen to 5 per cent in the most recent survey, from 26 per cent in the survey conducted three months earlier.

Economic Prospects

Prospects for global economic growth in 2003 have softened somewhat since the April *Report*. Nevertheless, with the reduction in geopolitical uncertainty, the marked improvement in capital markets, and the easing of macroeconomic policy in many industrial countries, the Bank continues to expect the pace of global expansion to strengthen towards the end of the year and through 2004, especially in the United States and Canada.

Growth in U.S. economic activity is estimated to have been about 1 1/4 per cent over the first half of the year, weaker than assumed in the April *Report* and well below that country's growth potential. Stimulative monetary and fiscal policies, the lower level of the U.S. dollar, and the recent rise in consumer confidence, combined with the upturn in equity markets, should support a rebound in U.S. economic growth during the second half of the year. Expansion to a rate above the economy's growth potential is projected by year-end and through 2004. Business expenditures on capital equipment are expected to strengthen over this projection horizon. On an average annual basis, U.S. real GDP should increase by just over 2 per cent in 2003 and by 4 per cent in 2004. This projection is similar to the most recent average private sector consensus forecast for 2003 and slightly above the consensus outlook for 2004. Although the projection for 2003 is somewhat lower than in the April *Report*, the overall projection is broadly similar.

Owing to the restraining effects of the recent appreciation of the euro against the U.S. dollar, the recovery in Europe over the remainder of this year is expected to be more modest than was projected in the April *Report*. Economic conditions in Japan are expected to remain subdued.

With weaker global demand, prospects for emerging-market economies have deteriorated somewhat. Growth in Asia is projected to remain comparatively robust, despite the negative effects of SARS.

In Canada, economic growth is expected to strengthen towards the end of 2003 and through 2004. The Bank's base-case projection assumes that the confidence level of foreigners concerning travel to Canada will gradually improve over the remainder of this year and that cattle and beef exports will resume soon. As a result, the dampening effects of SARS and BSE on the level of aggregate economic activity in Canada should be short-lived.

Thus, while growth in the third quarter is expected to be somewhat lower than the 2 1/2 per cent anticipated last April, it is projected to pick up to the 3 per cent rate of growth of potential in the fourth quarter and to gather further strength over the course of 2004. Growth through 2004 is projected to be higher than previously anticipated. Such a scenario would imply that the slack that is expected to open up in 2003 will be largely absorbed by the end of 2004.

Since the boost to Canadian exports from the anticipated rebound in the U.S. economy will be tempered by the dampening effects of the recent appreciation of the Canadian dollar, more of the growth in aggregate demand will have to come from domestic sources. These include household spending, which is expected to rise at a solid pace, given the effects of continued monetary stimulus, and business investment, which should strengthen with the assumed improvement in business confidence.

This outlook would imply real GDP growth, on an average annual basis, of about 2 per cent in 2003 and just over 3 per cent in 2004. This projection for 2004 is in line with the most recent average private sector consensus forecast, while that for 2003 is slightly lower.

The Outlook for Inflation

The core rate of inflation is expected to move down below the 2 per cent target in the fourth quarter of 2003 and to remain below the target through 2004, before returning to 2 per cent by mid-2005 (Table 1).

The slack in product and labour markets should be a source of downward pressure on inflation over the projection horizon. The effects of one-off factors, such as the recent hikes in insurance premiums, that pushed core inflation up close to 3 per cent earlier this year should continue to diminish. The recent substantial appreciation of the Canadian dollar is likely to be another source of downward pressure on the core rate over this period—though this effect is still expected to be relatively small.

Some of the recent price discounting in tourism-related industries should moderate later in 2003 as activity returns to more normal levels.

Developments in crude oil markets will continue to have important effects on the outlook for the 12-month rate of increase in the total CPI. Based on the assumption that oil prices will ease to about US$25 per barrel early in 2004 (close to current market expectations), total CPI inflation will likely fall below core inflation in 2004, before steadying out at a rate close to 2 per cent in 2005. Since the effect of the exchange rate appreciation on the total CPI is likely to be larger than on the core CPI, this will also tend to lower total CPI inflation relative to core inflation in the next few quarters.

Table 1
Projection for Core and Total CPI Inflation
Year-over-year percentage change

	2003			2004			2005
	Q2	Q3	Q4	Q1	Q2	H2	H1
Core Inflation	**2.2**	**2.1**	**1.9**	**1.5**	**1.7**	**1.7**	**1.9**
Total CPI	**2.9**	**2.3**	**1.8**	**1.0**	**1.5**	**1.6**	**1.9**
WTI*	**29.1**	**28.4**	**26.5**	**25**	**25**	**25**	**25**

* Assumptions for the price of West Texas Intermediate Crude Oil (US$ per barrel)

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

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