MONETARY POLICY REPORT

UPDATE

– January 2005 –

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 up to 25 January 2005.

The adjustment of the Canadian economy to major global developments continues to shape the economic outlook. These developments include solid world economic growth; a realignment of world currencies, including the Canadian dollar; movements in the prices of crude oil and non-energy commodities; and the growing global presence of China and India. Canadian monetary policy facilitates the adjustment process by aiming to keep inflation at its 2 per cent target and the economy operating near its production capacity.

The near-term outlook for the global economy is a touch weaker than projected in the October *Monetary Policy Report*, but there is now greater confidence in the momentum of the U.S. economy in 2005.

The Canadian economy is expected to have been marginally weaker in the fourth quarter of 2004 than projected in the last *Report*, owing partly to a somewhat more pronounced adjustment to the past appreciation of the Canadian dollar. As well, since October, the dollar has traded in a higher range than it had prior to the October *Report*.

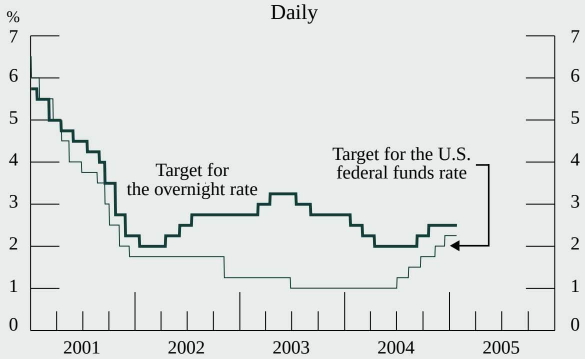
Largely reflecting the dampening effects on aggregate demand of the recent appreciation of the Canadian dollar, the economy is expected to operate a little further below its full production capacity in 2005 than was anticipated at the time of the last *Report*. For 2006, growth is projected to pick up to slightly more than 3 per cent, consistent with returning the economy to its production capacity in the second half of the year, and returning core inflation to the 2 per cent target around the end of 2006.

In line with this revised outlook, the pace of reduction in monetary stimulus is likely to be slower than envisioned in the

Highlights

- The economy is expected to operate a little further below its production capacity in 2005 than was anticipated at the time of the October *Monetary Policy Report*.
- The pace of reduction in monetary stimulus is likely to be slower than envisioned in the October *Report*.
- Growth is expected to pick up to slightly more than 3 per cent in 2006.
- With the economy moving back to its production capacity in the second half of 2006, core inflation should return to the 2 per cent target around the end of 2006.
- There are both upside and downside risks around the outlook, which continue to relate to the adjustment to global developments.

Chart 1
Target for the Overnight Rate and Target for the U.S. Federal Funds Rate
Daily



October *Report*. Against this background, the Bank left its target for the overnight rate unchanged in December and January (Chart 1).

This outlook is subject to both upside and downside risks and to uncertainties. While the near-term risks surrounding the global economic outlook have lessened, there are still significant medium-term risks related to the evolution of oil prices, the pace of expansion in China, the way in which current account balances in the United States and East Asia will be resolved, and geopolitical developments.

Uncertainties with respect to the Canadian outlook continue to relate to the ongoing adjustments to changes in the global economy, including changes in the exchange rate. Understanding the reasons behind exchange rate movements is crucial, because they may have different implications for aggregate demand and thus for monetary policy (Box p. 3).

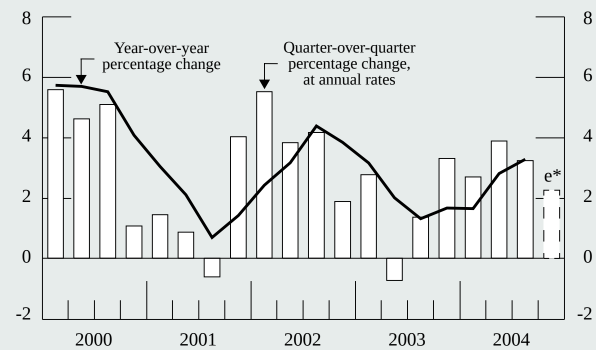
Recent Economic Developments

Canada's real GDP advanced at an annual rate of 3.2 per cent in the third quarter of 2004 (Chart 2), supported by a rise in final domestic demand (Chart 3). Exports, however, were considerably weaker than expected, contributing to a larger-than-anticipated buildup of inventories. Economic growth is expected to have slowed to about 2 1/4 per cent in the fourth quarter of 2004 as firms began to correct this buildup.

Growth for the second half of 2004 is thus estimated to have been around 2 3/4 per cent—slightly lower than projected in the October *Report*. This is also marginally below the Bank's estimate of growth in the economy's production potential.

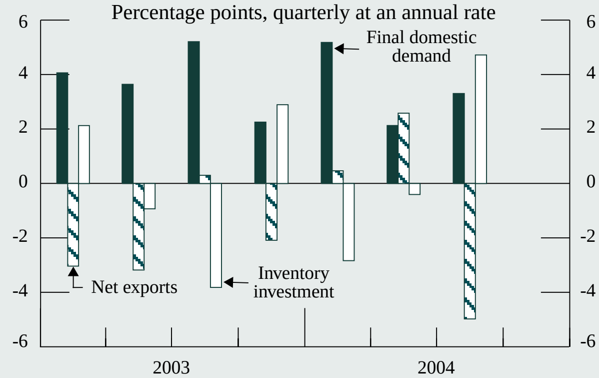
Although considerable uncertainty is associated with any estimate of the output gap, the Bank judges that the economy is operating slightly below its capacity limits, consistent with its conventional measure of the output gap (Chart 4). This judgment is also broadly consistent with the response of firms to the question on capacity pressures in the Bank's latest *Business Outlook Survey*. Some indicators, however, point to more slack.

Chart 2
Real Gross Domestic Product for Canada



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

Chart 3
Contribution to Real GDP Growth
Percentage points, quarterly at an annual rate



Monetary Policy and Exchange Rate Movements

Over the past two years, the Canadian dollar has appreciated by about 25 per cent relative to the U.S. dollar, from an average of 65 cents U.S. in January 2003 to an average of 82 cents U.S. in January 2005.

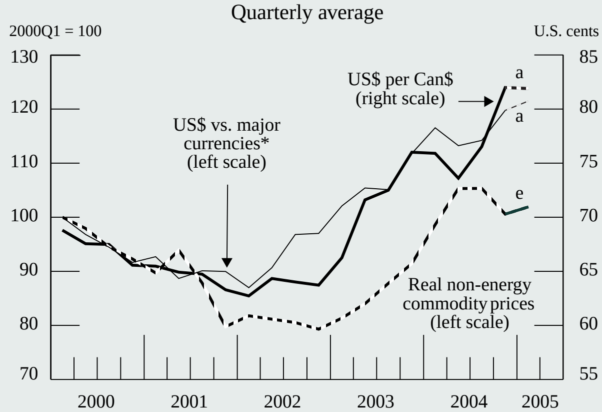
Understanding the causes of exchange rate movements is important because the implications for the Canadian economy of a change in the exchange rate depend crucially on the cause of the change, and may therefore require a different monetary policy response. From the standpoint of monetary policy, these causes can be divided into two broad types: those that stem from changes in the demand for Canadian goods and services, and those that do not. Developments over the past two years provide a useful illustration of these two types of forces.

The first type relates to the strengthening global economic recovery, which led to a substantial increase in world commodity prices and to strong foreign demand for Canadian products, especially raw materials. This development represented a direct increase in Canadian aggregate demand. The associated appreciation of the Canadian dollar dampened the increase in aggregate demand and helped to facilitate the adjustment of the Canadian economy by encouraging a shift in activity towards Canada's commodity-exporting sector. To the extent that the dampening effect on aggregate demand exactly offsets the direct increase in demand, there would be no need for a policy response.

The second type, independent of the demand for Canadian goods and services, relates to the general weakening of the U.S. dollar against most major floating currencies. This reflects growing concerns about a shortage of savings in the United States, partly related to the expanding U.S. fiscal deficit, and a surplus of savings elsewhere, mainly in Asia. The associated appreciation of the Canadian dollar works to reduce foreign demand for Canadian products. All other things being equal, this would require monetary policy to be more stimulative than it otherwise would have been.

Two Factors Acting on the Canadian Dollar

Quarterly average

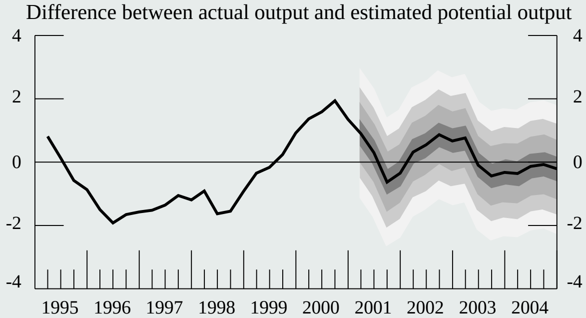


* An increase represents a depreciation of the U.S. dollar against a trade-weighted average of the euro, the yen, the U.K. pound, and the Swiss franc.

Note: The letter "a" denotes average of daily rates up to 24 January 2005. The letter "e" denotes estimate based on available indicators.

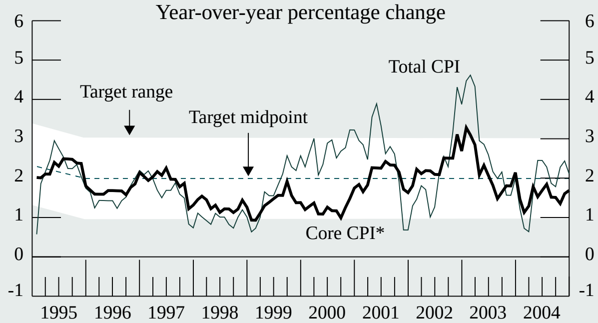
Over the past two years, an important challenge for Canadian monetary policy has been to determine the relative importance of these two main forces on the Canadian dollar and the net impact on Canadian aggregate demand. For the early part of this period, both forces were at play, although the stronger world demand and rising commodity prices appeared to be producing most of the dollar's momentum. In the past few months, however, the weakening U.S. dollar appears to have become the relatively more important factor, especially against a background of broadly stable commodity prices.

Chart 4
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 fourth quarter of 2004 is based on a projection of 2 1/4 per cent growth for the quarter.

Chart 5
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

For instance, wage increases have remained quite moderate and, on average, core inflation has been below the 2 per cent midpoint of the target range since mid-2003. In contrast, other indicators, such as capacity utilization in the non-farm, goods-producing sector, suggest greater pressure on capacity.

Core inflation remained near 1.5 per cent between August and December (Chart 5). Modest excess supply in the Canadian economy through most of 2003 and in early 2004 contributed to keeping the core rate of inflation slightly below longer-run expectations. Falling prices for many import-intensive goods, partly associated with the appreciation of the Canadian dollar, also continued to put downward pressure on core inflation in the second half of 2004.

At the same time, the 12-month rate of increase in the total CPI averaged slightly more than 2 per cent, chiefly reflecting substantial increases in the consumer prices of gasoline and fuel oil from their levels a year earlier.

Adjusting to Global Change

In the first half of 2004, the global economic upswing contributed to a surprisingly strong recovery in Canadian exports. As a result, despite the earlier appreciation of the Canadian dollar, output rose sharply between December 2003 and August 2004 in a number of industries highly exposed to international trade.

Canadian exports fell back in the third quarter of 2004, and output in sectors highly exposed to international competition decreased somewhat in September and October. The further increase in the Canadian dollar since mid-2004 and some moderation in the growth of global demand will likely weigh more heavily on these industries through 2005.

There are clearer indications of adjustment by Canadian firms to the past and recent appreciation of the dollar. The Bank's latest *Business Outlook Survey*, conducted between mid-November and mid-December, showed a clear distinction between firms that have been adversely affected by the appreciation of the Canadian dollar and those that have not. While the latter have become more optimistic about future sales prospects, the former—mostly manufacturers, exporters, and their suppliers—have become noticeably pessimistic.

The *Survey* indicates that many firms are taking measures to improve productivity and reduce costs, not only in response to the dollar's appreciation, but also because of increased competition from Asian suppliers. A growing number of firms have chosen to cut costs by increasing their imports of inputs and finished goods from Asia. Some firms are adjusting to the appreciation by moving away from low-profit products and markets towards those yielding higher returns. Still others are planning to increase their investment in machinery and equipment. In contrast to previous surveys, these now include firms that report having been adversely affected by the appreciation of the Canadian dollar.

Economic Prospects

World oil prices have eased since late October. Current oil futures contracts suggest that the West Texas Intermediate (WTI) oil price will average around US$47 per barrel in the first half of 2005, before easing to about US$42 per barrel by the second half of 2006 (see Table 2). This scenario for oil prices is somewhat lower than that used in the last *Report* and provides a more solid base for prospective growth in the global economy.

The appreciation of the euro and the yen vis-à-vis the U.S. dollar will direct demand away from Japan and the euro area towards China and the United States. U.S. economic growth will be underpinned by robust business expenditures and sustained consumer spending supported by employment gains. The U.S. economy is thus expected to grow by just under 4 per cent in 2005 and 2006.

In Canada, further strong growth of final domestic demand is expected to contribute importantly to economic growth this year and next (Table 1). Business investment is expected to increase substantially as a result of continued global economic expansion and the associated high level of commodity prices, favourable financial conditions, and ongoing reductions in the prices of imported machinery and equipment. Further gains in real incomes should contribute to solid growth in consumer spending. However, given rapid increases in recent years, housing investment is not expected to contribute further to growth in domestic demand.

This outlook assumes that spending by all levels of government will increase broadly in line with revenues, as governments continue to strive to maintain fiscal balance.

While ongoing growth abroad implies further gains in demand for Canadian exports, these gains are expected to be more than offset by faster growth in imports. The past and recent appreciation of the Canadian dollar is expected to dampen export growth and to boost imports over the projection period. However, the contribution of net exports to GDP growth continues to be highly uncertain. Analyzing the evolution of Canada's international trade volumes in terms of the underlying fundamentals has been

Table 1
Contributions to Annual Real GDP Growth[1]
Percentage points

	2004	2005	2006
Consumption	1.9 *(1.8)*	2.0 *(1.7)*	1.9 *(1.7)*
Housing	0.4 *(0.4)*	0 *(0)*	0 *(0)*
Government	0.6 *(0.6)*	0.8 *(0.7)*	0.8 *(0.8)*
Business fixed investment	0.5 *(0.6)*	0.8 *(0.8)*	0.9 *(0.9)*
Subtotal: Final domestic demand	3.4 *(3.4)*	3.6 *(3.2)*	3.6 *(3.4)*
Exports	1.9 *(3.0)*	1.7 *(2.0)*	1.8 *(1.7)*
Imports	-2.4 *(-2.8)*	-2.5 *(-2.5)*	-2.1 *(-1.9)*
Subtotal: Net exports	-0.5 *(0.2)*	-0.8 *(-0.5)*	-0.3 *(-0.2)*
Inventories	-0.2 *(-0.7)*	0 *(0.2)*	0 *(0)*
GDP	2.7 *(2.9)*	2.8 *(2.9)*	3.3 *(3.2)*

1. Figures in parentheses are estimates used for the scenario in the October *Report*.

particularly difficult over the past two years, owing to the volatility of trade data, their susceptibility to revisions, and some puzzling developments in the context of major structural changes in the global economy. [1]

The high level of oil prices assumed in the October *Report* was expected to have a small negative effect on Canadian aggregate demand in 2005, before the positive impact on capital spending and output by energy-producing companies became evident in 2006. With the lower oil-price scenario assumed in this *Update*, the adverse short-term effects on growth coming from the rise in oil and gas prices since late 2003 should be somewhat more muted.

The Bank's base-case projection calls for aggregate demand for Canadian goods and services to increase, on average over the projection period, just slightly faster than the 3 per cent estimated growth rate of potential output. Given the effects of the past and recent appreciation of the Canadian dollar, the Bank projects real GDP growth to average a little less than 3 per cent in 2005 and a little more than 3 per cent in 2006, with a somewhat larger drag from net exports than projected in the October *Report*, but stronger growth in domestic demand (Table 1). This growth scenario implies some increase in excess supply in 2005 and a return to production potential in the second half of 2006.

The Outlook for Inflation

The core rate of inflation is projected to average just above 1.5 per cent in the first half of 2005, before gradually rising to the 2 per cent target around the end of 2006 (Table 2).

1. *Monetary Policy Report*, October 2004, Box 3, p. 27

The projected slack in product and labour markets is expected to keep core inflation below longer-run expectations through 2005 and most of 2006. With the economy expected to move back to its production potential in the second half of 2006 and with inflation expectations remaining well anchored, the core rate should rise gradually to 2 per cent over the projection period. The past and recent appreciation of the Canadian dollar is also expected to exert a small amount of downward pressure on the core rate during this period.

The outlook for the 12-month rate of increase in the total CPI will continue to be importantly affected by developments in the market for crude oil. Based on the scenario embodied in oil price futures, total CPI inflation is expected to remain just above 2 per cent in the first half of 2005 and then to fall considerably in the second half of the year before rising towards the core rate of inflation through 2006.

Table 2
Projection for Core and Total CPI Inflation
Year-over-year percentage change*

	2005			2006	
	Q1	Q2	H2	H1	H2
Core inflation	**1.7** *(1.7)*	**1.6** *(1.8)*	**1.7** *(1.9)*	**1.8** *(2.0)*	**1.9** *(2.0)*
Total CPI	**2.4** *(3.1)*	**2.0** *(3.0)*	**1.5** *(1.9)*	**1.7** *(1.5)*	**1.8** *(1.7)*
WTI** (level)	**47** *(53)*	**47** *(51)*	**45** *(48)*	**43** *(45)*	**42** *(43)*

* Figures in parentheses are from the October *Monetary Policy Report*.
** Assumption for the price of West Texas Intermediate crude oil (US$ per barrel), based on an average of futures contracts over the two weeks ending 21 January 2005

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

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