Monetary Policy Report

– May 2000 –

Summary

Bolstered by vigorous domestic demand and stronger-than-expected global economic growth, Canada's economy has outperformed expectations since last November's *Report*.

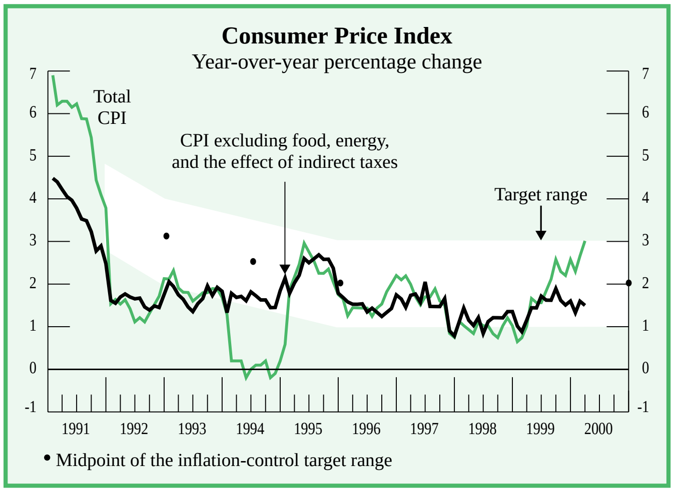
The U. S. economy has continued to soar, and the pace of activity in European economies and emerging markets has also accelerated. This stronger global economic momentum carries with it an increasing risk of potential inflation pressures. This is especially true in the United States, where levels of resource utilization are high and aggregate demand growth continues to exceed the growth of potential output. The upsurge in world oil prices has also fed into higher headline rates of inflation in most countries.

Canada's economic performance over this period has been positive, with robust growth and a trend rate of inflation that is among the lowest in the industrialized countries. Our low inflation has helped to keep interest rates below those of the United States.

These developments raise three key areas of uncertainty for the conduct of Canadian monetary policy. First, the momentum of demand in Canada from both international and domestic sources could continue to outpace expectations. Second, a buildup in inflationary pressures in the United States could

Highlights

- **The Bank has raised its projection for Canadian economic expansion this year to a range of 4 to 4.5 per cent.**
- **Given the momentum of aggregate demand and high levels of activity, core inflation is expected to rise gradually this year to close to 2.0 per cent.**
- **An important risk is the possibility that demand in Canada from both international and domestic sources will continue to outpace expectations.**
- **Although capacity output may also be higher than expected, the Bank is taking a cautious approach to projecting potential growth.**
- **In these circumstances, the Bank must carefully assess the balance between aggregate demand and supply, and be ready to adjust monetary conditions in a timely manner.**



have implications for Canada. Third, the capacity of the Canadian economy to produce goods and services without adding to inflationary pressures may be higher than previously thought.

Recent Developments

Canada's real GDP rose at an annual rate of 5.0 per cent in the second half of 1999, compared with 4.3 per cent in the first half. Current information points to a continuation of this strong forward momentum in 2000. For the first quarter of this year, the available information suggests GDP growth of between 4 and 5 per cent, with full-time employment up nearly 4.5 per cent.

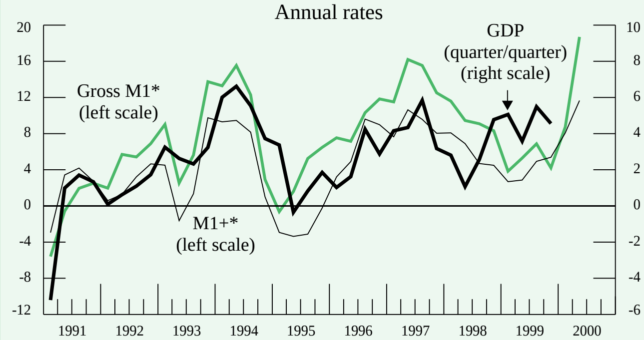
The last six months have also seen an unexpected decline in core inflation. The core CPI (CPI excluding food, energy, and the effect of changes in indirect taxes) was 1.5 per cent in March compared with 1.9 per cent last September. Some of this deceleration resulted from intense retail competition and from the appreciation of the Canadian dollar, which lowered prices for most imported non-energy consumer goods and services.

At the same time, substantially higher energy prices have pushed the total CPI to 3.0 per cent.

Wage growth has increased somewhat since mid-1999, but remains modest relative to productivity gains and inflation. The recent increase in investment by businesses in machinery and equipment, particularly computers, bodes well for future productivity growth.

Based on the Bank's conventional measures, the Canadian economy appeared to be operating above its estimated capacity output at the end of 1999. Because of the uncertainty that surrounds these estimates, we have stressed the need to look at a range of indicators of pressures on capacity. Some of these indicators, which include the unexpectedly lower rate of core inflation, suggest that the Bank's conventional measures

Real GDP Growth and Growth of Real Gross M1 and M1+
Annual rates



* Two-quarter moving average of growth in gross M1, M1+ (deflated by the core CPI), one quarter earlier

may have been underestimating the economy's ability to produce goods and services without adding to inflationary pressures.

On balance, based on the full range of indicators, it is the Bank's judgment that the economy, as of the end of 1999, had not yet moved into a position of excess demand but that it was rapidly absorbing capacity.

To ensure that the stronger-than-expected momentum of aggregate demand did not risk placing undue pressure on the economy's production capacity, and thus on inflation, the Bank raised the Bank Rate by 25 basis points on both 3 February and 22 March, moving the Bank's target overnight lending rate to 5.25 per cent. These actions also took into account the implications for Canada of increases in the U.S. Federal Reserve's target rate for federal funds as well as the implications of the strong demand pressures in the United States spilling over into Canada. Having already anticipated these policy actions, money markets in both countries were largely unaffected by the moves.

The trade-weighted value of the Canadian dollar has remained relatively firm, reflecting Canada's positive economic fundamentals. Combined with the rise in short-term interest rates, this has tightened overall monetary conditions.

The Outlook for Inflation

The U.S. economy has continued to steam ahead. Real GDP growth averaged 4.6 per cent over the four quarters of 1999, and this forward momentum has carried into the new year. The high level of resource utilization and the underlying rate of growth of aggregate demand relative to potential output continue to pose a possible inflation risk. In response, the U.S. monetary authorities have been gradually raising interest rates. While price and cost pressures have so far been contained, there is a clear need for the pace of growth of the U.S. economy to slow to rates close to, or below, the growth of potential output as we progress through this year and into 2001.

This buoyant U.S. picture, combined with Canada's high levels of business investment and solid employment gains, augurs well for continued strong economic growth in Canada this year. The rapid growth of the narrow monetary aggregates reinforces this view.

Given this strong momentum of aggregate demand, the Bank has raised its projection of growth for the

Canadian economy this year to a range of 4 to 4.5 per cent. At this pace, capacity pressures will intensify. Therefore, core inflation is expected to rise close to the midpoint of the inflation-control target range. For the core inflation rate to remain steady near 2 per cent, some deceleration in the overall pace of economic expansion in Canada will be required during 2001. This would entail a combination of a slowdown in the U.S. economy and some moderation in the growth of domestic spending in Canada.

The rate of increase in the total CPI is expected to move down towards core inflation. On the assumption that world prices for crude oil remain near US$25 per barrel, this movement should begin in the second quarter of this year.

The main risks to this outlook are the possibility of continued stronger-than-expected momentum of aggregate demand from both the U.S. economy and domestic spending as well as the possibility of a potential increase in inflation pressures in the United States. While capacity output in Canada may be higher over the projection period than expected, the Bank is inclined to take a cautious approach to projecting a permanently higher rate of potential growth.

The challenge for monetary policy will be to carefully assess the balance between aggregate demand and supply under these circumstances of strong demand growth and high levels of activity. To preserve the low trend of inflation that has been benefiting the Canadian economy, the Bank must be ready to adjust monetary conditions in a timely manner.

The Bank of Canada's *Monetary Policy Report* is published semi-annually in May and November. Regular *Updates* are published in August and February. Copies of the full *Report*, the *Summary*, and the *Update* may be obtained by contacting: Publications Distribution, Communications Services, Bank of Canada, Ottawa, Ontario, Canada K1A 0G9.

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