BANK OF CANADA

Monetary Policy Report

Update

– *January 2004* –

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 October 2003 and 19 January 2004.

Since the October *Monetary Policy Report*, three developments have led the Bank of Canada to modify its outlook for economic growth and inflation in Canada. First, economic activity in the rest of the world, especially in the United States, has been stronger than expected. Second, the U.S. dollar has continued its sharp depreciation against major world currencies, including the Canadian dollar, largely as a result of global economic imbalances. Third, downward revisions to Canadian GDP data in the first half of 2003 and lower-than-expected growth in the third and fourth quarters mean that the amount of economic slack was somewhat larger at the end of 2003 than projected by the Bank in its October *Report*.

Weighing these developments and their likely persistence, the Bank lowered its projection for output over the next year and a half and concluded that additional monetary stimulus would be required to support aggregate demand and return inflation to 2 per cent over the medium term. Thus, on 20 January, the Bank lowered its target for the overnight interest rate by 25 basis points to 2 1/2 per cent (Chart 1).

But risks remain. The main uncertainties for the Canadian economic outlook relate to the adjustment to global changes. These include a stronger world economy, higher commodity prices, and the realignment of world currencies, including the Canadian dollar. In this context, the role of monetary policy is to support aggregate demand sufficient to eliminate the output gap, so as to return inflation to its target over a two-year horizon.

Highlights

- **The Bank has lowered its projection for output over the next year and a half and has provided additional monetary stimulus.**
- **After mid-2004, the Canadian economy is projected to grow faster than capacity, relying primarily on private domestic demand.**
- **The economy is projected to return to close to full production capacity by the third quarter of 2005, and inflation should return to its 2 per cent target late in that year.**
- **The main uncertainties in the outlook relate to the adjustment to global changes.**

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

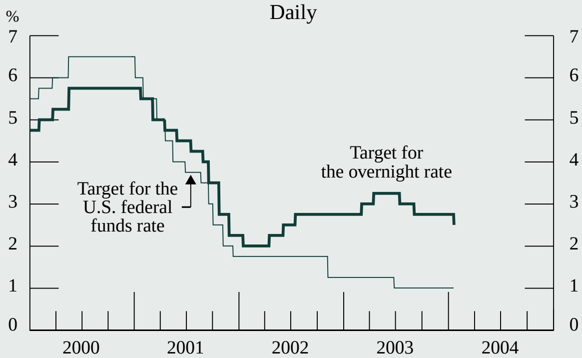
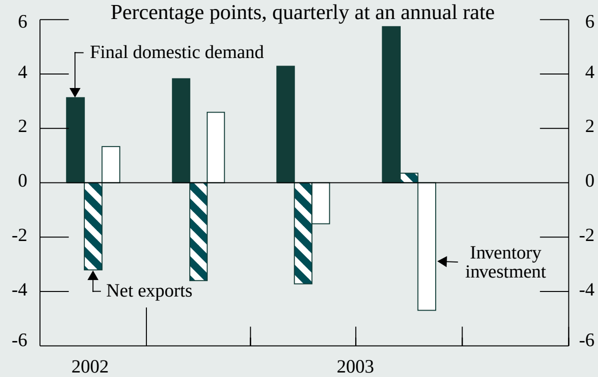


Chart 3
Contributions to Real GDP Growth
Percentage points, quarterly at an annual rate

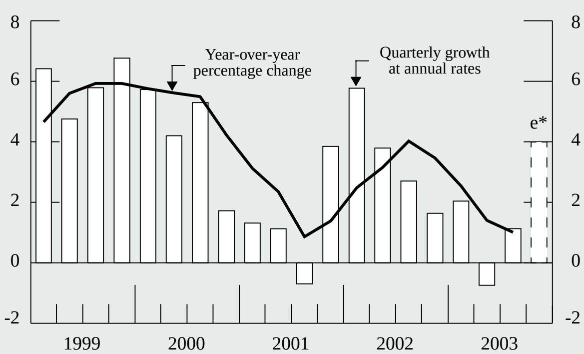


Overview of Recent Economic and Financial Developments

A global economic recovery, led by the United States, appears to be well underway and is proceeding at a somewhat stronger pace than was expected.

Canada's real GDP, after edging down in the second quarter of 2003, grew at an annual rate of only 1.1 per cent in the third quarter—a weaker result than projected in the last *Report*. Recent indicators for spending and activity point to a strengthening in the pace of economic expansion in the fourth quarter, with growth at about 4 per cent (Chart 2)—a rate above that of potential.

Chart 2
Real Gross Domestic Product for Canada



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

The modest rate of growth in the third quarter largely reflected a sharp inventory correction by manufacturers and retailers (Chart 3). Economic activity was also adversely affected by the August blackout in Ontario and by the closure of international borders to imports of Canadian cattle, beef, and related products after the discovery of one case of bovine spongiform encephalopathy (BSE) in May.

The completion of the inventory correction, together with the recovery from these unusual shocks,[1] contributed importantly to the estimated rebound in growth in the fourth quarter. More generally, various aspects of the current climate, including robust employment gains and favourable financial conditions, suggest that stronger, more sustainable economic growth resumed in the fourth quarter of 2003.

Against this backdrop, the Canadian dollar has appreciated further against the U.S. dollar since last October, touching a ten-year high of 78.84 cents and averaging 76.5 cents over the period. On a trade-weighted basis, the movement has been somewhat less, given the relatively large

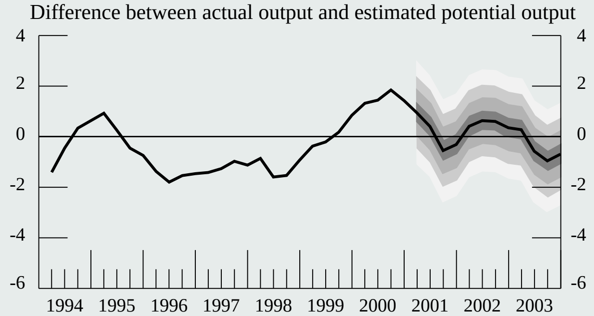
1. The recent discovery of a case of BSE in the United States in a cow that originated in Alberta has led to an extension of the ban on imports of live cattle from Canada, thereby delaying the recovery of Canada's cattle industry.

depreciation of the U.S. dollar against overseas currencies. Of note, the Canadian dollar has depreciated 4 1/2 per cent against the euro over the last three months. Overall, the stronger Canadian dollar appears to have begun to cut into the pace of economic activity in terms of weaker-than-expected export growth and signs of greater import penetration in the fourth quarter.

The Bank's conventional measures of potential output and the output gap indicate that the level of economic activity fell below full capacity in the second and third quarters of 2003 (Chart 4). And, while the amount of economic slack probably decreased somewhat in the fourth quarter, significant excess supply remains. Based on an analysis of all the indicators of capacity pressures, the size of the output gap is judged to be slightly larger than the conventional measure suggests.

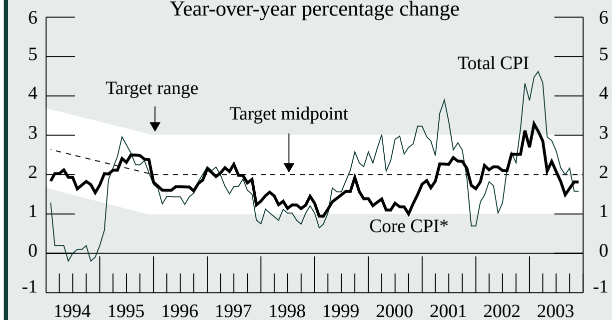
Even with a lower level of output and a strong Canadian dollar, core inflation (at 1.8 per cent in November) was slightly higher than projected in our October *Report* and up somewhat since August (Chart 5). The positive surprise in the core rate mainly reflected less price discounting of automobiles and clothing than expected; it should be temporary.

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 2003 is based on a projection of 4.0 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

Core CPI inflation is likely to continue to exhibit some near-term volatility—rising in December before falling in the first quarter of 2004. These movements will mainly reflect the effects of special factors a year ago.[2] If one looks through these influences, however, underlying price pressures and the presence of unutilized capacity suggest a core rate of inflation below current levels.

The 12-month rate of increase in the total CPI was 1.6 per cent in November, down from 2.0 per cent in August. This decrease in total CPI inflation was chiefly due to reductions in the consumer prices of gasoline and fuel oil from their levels a year earlier.

Adjusting to Global Changes

The stronger Canadian dollar largely reflects a response to global economic and financial forces. These include not only elements reflecting stronger world demand, such as higher world commodity prices, but also the adjustments associated with redressing global economic imbalances.

The stronger dollar means that the Canadian economy will be relying less on net exports and more on domestic demand.

2. For example, the 12-month rate of increase in the core CPI is expected to rise temporarily in December 2003, given that the first rebate on Ontario electricity prices lowered the level of the core CPI in December 2002.

This will require shifts in activity among sectors and changes on the part of many businesses. The Bank's recent regional survey suggests that these changes are underway. In particular, it indicates that firms affected by the appreciation have made plans to adjust—for example, by installing new machinery and equipment.

Canadian monetary policy facilitates the overall adjustment process by helping to sustain aggregate demand.

Economic Prospects

The global economic expansion is expected to strengthen over the next year or so, although economic imbalances still create uncertainty about its sustainability.

Growth in U.S. real GDP is projected to remain above the economy's growth potential in 2004, supported by stimulative policies and the depreciation of the U.S. dollar. Strengthening capital spending by businesses, combined with a considerable contribution from inventory investment, should underpin the expansion in activity. The Bank expects that U.S. economic activity will increase by about 4 1/2 per cent in 2004, on an average annual basis, which is somewhat stronger than was projected in the October *Report*. And, while prospects for sustained U.S. economic growth are clouded by the accumulation of fiscal and external imbalances, U.S. output growth is projected to remain above that of potential in 2005.

In the euro area, a gradual pickup in economic momentum is projected, while conditions in Japan should continue to improve, largely because of exports to the rest of Asia, especially China. Strong growth in emerging Asian markets should also continue to support U.S.-dollar prices for many commodities.

In Canada, economic growth in the period ahead will come primarily from private domestic demand, supported by monetary stimulus and by strong business confidence. Growth in household spending should also be underpinned by rising employment and incomes. A stronger global economy, the reduced cost of machinery and equipment resulting from the higher Canadian dollar, and ready access to capital markets should stimulate stronger business investment. Exports should receive some support from rising U.S. and global economic activity, notwithstanding a marked reduction, since 2001, in the U.S. propensity to import. However, the lower value of the U.S. dollar is expected to put continuing downward pressure on Canadian exports over the course of 2004.

The Bank's base-case projection now calls for real GDP growth in Canada to average about 2 3/4 per cent in 2004 (compared with 1.6 per cent in 2003), and to pick up to about 3 3/4 per cent in 2005. The Bank's projection assumes growth of about 3 per cent, at an annual rate, in the first half of 2004, moving to 3–3 1/2 per cent in the second half and peaking around 4 per cent in the first half of 2005. This would imply that the output gap would not change materially before the end of 2004, but would be substantially closed by the third quarter of 2005.

The Outlook for Inflation

Core inflation is projected to fall below 1.5 per cent in early 2004 (as the effect of past substantial increases in auto insurance premiums rapidly diminishes) before gradually moving back towards the 2 per cent target (Table 1) by the end of 2005.

The slack in product and labour markets should keep inflation below longer-run inflation expectations over the next year and a half. But this effect should disappear as the output gap closes.

The appreciation of the Canadian dollar over the last year is likely to continue to temper the rise in consumer prices

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

	2003	2004			2005	
	Q4	Q1	Q2	H2	H1	H2
Core inflation	**1.9** *(1.6)*	**1.3** *(1.2)*	**1.6** *(1.6)*	**1.6** *(1.7)*	**1.7** *(1.9)*	**1.9** *(2.0)*
Total CPI	**1.7** *(1.7)*	**0.9** *(0.9)*	**1.5** *(1.4)*	**1.5** *(1.5)*	**1.4** *(1.8)*	**1.7** *(2.0)*
Assumption for the Price of West Texas Intermediate Crude Oil (US$ per barrel)						
WTI (level)	**31** *(30)*	**33** *(28)*	**31** *(27)*	**30** *(27)*	**28** *(27)*	**28** *(27)*

Numbers in brackets are from the October *Monetary Policy Report* as a point of reference.

through 2004. However, the extent of the pass-through of exchange rate movements to consumer prices is expected to be limited, based on the experience here in Canada and in other countries with low and stable inflation.

The outlook for the 12-month rate of increase in the total CPI continues to be importantly affected by developments in the markets for crude oil. If oil prices ease to about US$30 per barrel in the second half of 2004 and US$28 in 2005, as suggested by forward contracts, total CPI inflation should remain below core inflation through 2005.

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

Telephone: (613) 782-8248; e-mail: publications@bankofcanada.ca
Web site: http://www.bankofcanada.ca