BANK OF CANADA

Monetary Policy Report

– October 2004 –

Summary

Overview

The Canadian economy continues to adjust to major global developments. These include a marked recovery in world economic growth and an associated increase in commodity prices; the growing global presence of major emerging-market economies, such as China and India; and a realignment of world currencies, including the Canadian dollar. Canadian monetary policy is facilitating the adjustment by aiming to keep inflation at its 2 per cent target and the economy operating near its production capacity.

Early in the year, with core inflation below target and excess supply in the economy, the Bank lowered its target for the overnight interest rate to 2 per cent to support growth in domestic demand. Given the appreciation of the Canadian dollar in 2003, the Bank did not expect net exports (the difference between exports and imports) to make a material contribution to growth in aggregate demand in 2004 and 2005. But, in fact, in the first half of this year, exports grew much more vigorously than anticipated. As a result, the Canadian economy has moved up near its production capacity sooner than was projected in either the April *Monetary Policy Report* or the July *Update*.

Recent developments have reinforced the continuing need for economic adjustments in Canada. Largely reflecting the strength of global demand, world oil prices have risen well above the Bank's earlier assumptions. The prices of non-energy commodities are at high levels, and the Canadian dollar has strengthened further, which places additional pressure on some sectors that are highly exposed to international trade.

Highlights

- **The Canadian economy has moved up near its production capacity sooner than was projected.**
- **The Canadian economy is projected to remain near its production capacity through to the end of 2006—growing by slightly less than 3 per cent in 2005 and by slightly more than 3 per cent in 2006.**
- **Core inflation is projected to move up to 2 per cent by the end of 2005.**
- **This base-case projection assumes further reduction of monetary stimulus over time to keep the economy near its production capacity and achieve the inflation target.**
- **There are significant risks and uncertainties around this base case related to the adjustment to global developments.**

Over the period to the end of 2006, the Bank's base-case projection is for aggregate demand for Canadian goods and services to expand, on average, at about the same rate as potential output, which is estimated at 3 per cent. Given the effects of higher oil prices and the past appreciation of the Canadian dollar, the Bank projects growth to be slightly less than 3 per cent in 2005 and slightly more than 3 per cent in 2006.

With the economy expected to remain near its production capacity throughout the projection period, core inflation is projected to move back up to 2 per cent by the end of 2005.

Against this background, the Bank moved to reduce the amount of monetary stimulus in the economy by raising its target for the overnight rate to 2.25 per cent on 8 September and to 2.50 per cent on 19 October. Further reduction of monetary stimulus will be required over time to keep inflation on target, with the pace of interest rate increases depending on the Bank's continuing assessment of the prospects for factors that affect pressures on capacity and, hence, inflation.

The outlook for Canadian exports and imports is of particular significance in this respect, given the uncertainty associated with the ongoing adjustments to changes in the global economy, including changes in commodity prices and exchange rates. The risks surrounding global economic prospects relate primarily to the evolution of oil prices, the pace of expansion in China, the way in which current account imbalances in the United States and East Asia will be resolved, and geopolitical developments.

Recent Developments

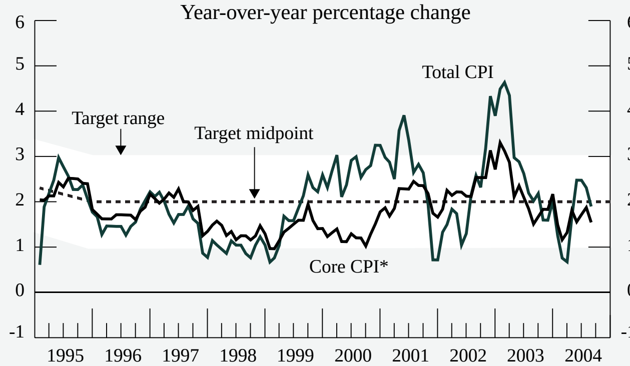
Canada's real GDP grew at an annual rate of 3.7 per cent in the first half of 2004. This was stronger than projected in the April *Report*. A key component of this growth was a surge in exports. This reflected the strengthening of global demand and a recovery from the unusually low level of exports seen in 2003. Household spending also grew vigorously, and business capital spending rose substantially. Recent indicators suggest that the economy grew at an annual rate of about 3 per cent in the third quarter of 2004.

Canadian firms have continued to adjust to developments in the global economy. There have been changes in the activity, employment, and capital spending plans of many companies, particularly those highly exposed to international competition. This adjustment process is still underway. Nonetheless, the Bank's autumn *Business Outlook Survey* suggests that, overall, Canadian firms have remained confident about their sales prospects, with firms in the West significantly more optimistic than those in Central and Eastern Canada. Investment intentions remain fairly high in most sectors, with manufacturing continuing to be an exception.

The Canadian dollar has exhibited significant movements since the April *Report* and is currently about 7 per cent stronger against the U.S. dollar than it was then. Some of the factors contributing to the appreciation of the Canadian dollar during this period include faster-than-expected economic growth in Canada, slower-than-expected growth in the United States, and firm prices for many commodities.

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

With stronger growth in the first half of 2004 and with some upward revisions to GDP data for 2003, the Bank's conventional measure of the output gap suggests that the Canadian economy had moved up near its production capacity by the middle of this year—earlier than had been anticipated in the last *Report*.

There is a wide confidence band around this measure. While some indicators are pointing to greater pressure on capacity, others suggest that there may be more economic slack than implied by the conventional measure. Overall, the Bank judges that this measure is giving a balanced view of how close the economy is to its production capacity.

Capacity utilization varies across industries and regions, and some of these differences may well become more pronounced in the future as a result of the ongoing adjustment process. However, there is currently little excess supply in the Canadian economy as a whole.

The excess supply in the economy in 2003 and early 2004 contributed to keeping the core rate of inflation below target through the first eight months of this year. In August, core inflation was 1.5 per cent, broadly in line with expectations set out in the April *Report*.

Total consumer price inflation rose sharply above core CPI, mainly because of higher prices for gasoline and fuel oil. These, in turn, reflect movements in the world price of crude oil, which has risen well above the levels projected in either the April *Report* or the July *Update*, because of strong global demand and concerns about supply disruptions.

Prospects for Growth and Inflation

The global economy performed better than expected in the first half of 2004, and prospects remain positive as we look ahead. However, the recent sharp increase in oil prices is expected to dampen world economic growth. Assuming that oil prices average about US$50 per barrel next year and US$44 per barrel in 2006, as suggested by prices in futures markets, the Bank's base-case projection calls for U.S. economic growth to moderate from about 4 1/2 per cent in 2004 to about 3 3/4 per cent in 2005, before rising to around 4 per cent in 2006.

The U.S.-dollar prices of non-energy commodities are expected to remain at a relatively high level over the next two years as a result of the global economic expansion, but they are likely to ease over time as new sources of supply are developed.

There are risks to the Bank's base-case projection for the global economy. For 2005, there are both upside and downside risks to growth in the United States and China. As we look further ahead, the main uncertainties relate to the resolution of global imbalances, notably the current account imbalances in the United States and Asia, and to the timing and extent of fiscal consolidation in many industrial countries.

For Canada, the base-case outlook is for continued, though more moderate, expansion of exports. Ongoing strong growth in final domestic demand is expected to help support a solid economic expansion through 2006. Business investment is projected to strengthen further, and gains in real incomes should support consumer spending. Housing investment is expected to stabilize at current high levels. Import growth is likely to pick up, reflecting strong domestic demand and the continued adjustment to the appreciation of the Canadian dollar. However, given the various forces at play in the global economy, there are risks around our projections for imports and exports, and for business investment.

The aggregate impact of higher oil prices on the Canadian economy is expected to be slightly positive over the medium term, since the associated reduction in manufacturing exports and consumer spending should be offset by increased output and capital investment by energy-producing firms. But given the time necessary for regulatory approval in many cases, and the potential for shortages of materials and labour, the positive impact of higher oil prices on energy-producing firms is likely to be limited in the short term. Thus, the Bank projects that high oil prices will be a small net drag on the economy in 2005.

Overall, the Bank expects the Canadian economy to grow, on average, at the 3 per cent annual growth rate of potential through to the end of 2006. Given the effects of higher oil prices and the past appreciation of the Canadian dollar, the Bank projects growth to be slightly less than 3 per cent in 2005 and slightly more than 3 per cent in 2006. This base-case scenario assumes further reduction of monetary stimulus over time to keep the economy near its production potential and achieve the inflation target.

With the economy operating near potential over the projection period, we expect core inflation to move up from about 1 1/2 per cent in the fourth quarter of 2004 to the 2 per cent target by the end of 2005 and to stay there through 2006. The past appreciation of the Canadian dollar is expected to continue to exert slight downward pressure on core inflation through 2005.

Movements in crude oil prices will continue to dominate the outlook for total CPI inflation. Based on the assumption that prices will follow the path currently embedded in oil futures, the Bank projects that total inflation will rise to the top of the 1 to 3 per cent target range in the first half of 2005, before falling slightly below core inflation in early 2006.

This is a summary of the Monetary Policy Report *of the Governing Council of the Bank of Canada. The* Report *is based on information received up to the fixed announcement date on 19 October 2004.*

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

Telephone: (613) 782-8248; e-mail: publications@bankofcanada.ca
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