MONETARY POLICY REPORT

– October 2003 –

Summary

Overview

In the April *Monetary Policy Report*, the Bank noted that inflation was well above its 2 per cent target and that short-term inflation expectations had edged up. Although inflation was being pushed up by special factors, particularly insurance premiums and energy costs, there were also signs that strong domestic demand was working to broaden price pressures. In April, we projected that Canadian economic growth would average 2 1/2 per cent in the first three quarters of the year and that core inflation would fall to 2 per cent by early 2004.

As it turns out, growth has been weaker than expected and is now likely to average just over 1 1/2 per cent in the first three quarters of the year. So the Bank now estimates that there is more slack in the economy than was projected in April. Moreover, the decline in core inflation occurred earlier, and has been more pronounced, than we had projected. As well, virtually all measures of inflation expectations have decreased since April.

This drop in core inflation reflected several unforeseen developments over the last six months. These include broad-based weakness in the prices of goods, such as automobiles and clothing, substantial reductions in the prices of tourism-related services owing to the outbreak of severe acute respiratory syndrome (SARS), and a slightly faster easing of pressures from insurance premiums. The substantial fall in the value of the U.S. dollar added to the weakness in goods prices in Canada. The Canadian dollar has averaged 72 1/2 cents U.S. since the July *Monetary Policy Report Update*, a sharp increase from the 69-cent level reached at the time of the April *Report*.

Highlights

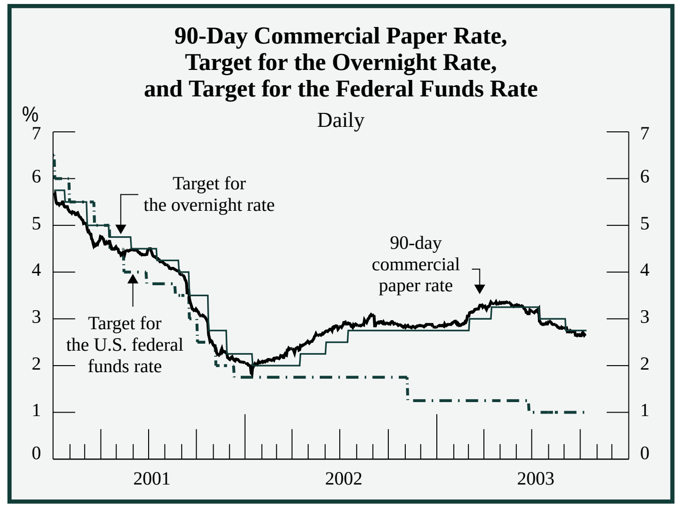
- **Inflation has fallen faster and further than expected and is projected to stay below the 2 per cent target until mid-2005.**
- **The Canadian economy should grow faster than capacity, relying primarily on solid domestic demand.**
- **Stronger growth abroad should boost foreign demand for Canadian products, although this will be dampened by the higher value of the Canadian dollar.**
- **The Bank will be closely monitoring and assessing the implications of global demand, price, and exchange rate adjustments for output and inflation in Canada.**

It now appears that core inflation will stay below 2 per cent until mid-2005, reflecting the excess supply in the economy, more moderate rises in insurance premiums, and the remaining impact of the past appreciation of the Canadian dollar.

Against this background, the Bank has reduced its target for the overnight rate by a total of 50 basis points since the April *Report*, bringing it to 2.75 per cent. This action was taken to support a return to levels of economic activity consistent with an overall balance between supply and demand, with the aim of bringing inflation back to the 2 per cent target over the medium term.

Despite a weak second quarter and additional third-quarter shocks, such as the power blackout in Ontario, there have been a number of encouraging developments. Growth in final domestic demand has remained robust, and the adverse effects of some of the recent shocks are beginning to dissipate. The inventory adjustment, which began earlier this year, is largely complete. Global economic conditions have improved since the April *Report*, and recent data indicate that the anticipated recovery in the United States is taking place earlier and will be stronger than previously expected. Financial conditions are also supportive of growth.

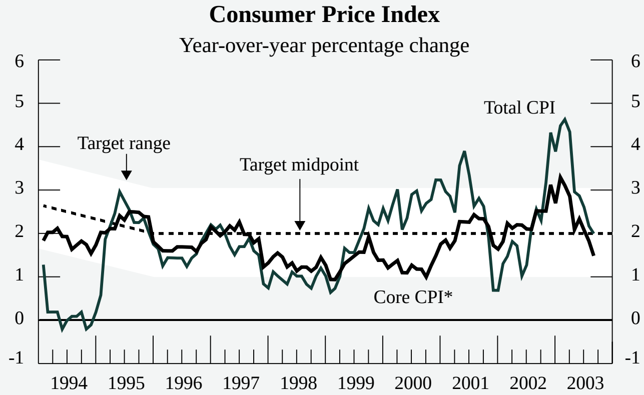
The Bank continues to expect growth in the Canadian economy to strengthen during the fourth quarter of 2003 and through 2004. On balance, this expansion should be above the rate of potential growth, relying primarily on solid household spending and increased business investment. Stronger economic growth abroad should also boost foreign demand for Canadian goods and services, but this source of strength will be dampened by the higher value of the Canadian dollar.



There are risks to this outlook related to the timing and magnitude of global demand, price, and exchange rate adjustments to economic imbalances. In particular, there is uncertainty both about the likely changes in key global exchange rates and about their effect on the Canadian economy. There is also uncertainty about the sustainability of U.S. growth beyond mid-2004. The Bank will closely monitor and assess the implications of all these global adjustments for output and inflation in Canada.

Recent Developments

It now appears that during the first quarter of 2003, the Canadian economy was operating just below its full production capacity. Statistics Canada has estimated that the economy shrank at an annual rate of 0.3 per cent in the second quarter, mainly reflecting a sharp drop in inventory investment and the effects of SARS, as well as the effects of an isolated case of bovine spongiform encephalopathy (BSE or mad-cow disease) on exports. While the impact of SARS began to fade in the third quarter, the effects of BSE continued to be felt, and activity was further reduced by a power blackout in



* CPI excluding the eight most volatile components and the effect of changes in indirect taxes on the remaining components

Ontario. The Bank expects growth in the third quarter to be about 2 1/2 per cent on an annual basis. All told, the economy is now operating with somewhat more slack than had been anticipated earlier in the year.

The Canadian dollar, which had risen to around 69 cents U.S. by April, has continued to appreciate over the last six months. This movement was largely the result of continuing broad-based weakness in the U.S. dollar but also reflected rising commodity prices and the relatively smaller amount of excess capacity in Canada.

In April, core and total inflation were well above the 2 per cent target. But both measures have fallen faster and further than projected in either the April *Report* or the July *Update*. Other measures of the trend of inflation have decreased over the same period and are very close to the core rate.

The drop in core inflation reflected several factors. Most important was the unexpected weakness in many goods prices, which stemmed partly from efforts by retailers to reduce undesired inventories. Downward pressure on goods prices also came from the substantial rise in the Canadian dollar and from declining world prices for many goods. Auto insurance premiums have risen slightly less quickly than expected over the last six months. Prices of tourism-related services have fallen because of SARS, and beef prices have fallen because of BSE.

Total CPI inflation has come down even more rapidly than core inflation. The pace of annual increases in energy costs has eased with a reduction in the world price of crude oil, even though oil prices have not declined as much as had been assumed in April.

Prospects for Growth and Inflation

On balance, the prospects for near-term growth in the global economy have improved since the release of the April *Report*, and geopolitical uncertainty has decreased. However, as noted above, there are risks posed by imbalances in the global economy.

The near-term outlook for the U.S. economy is much improved. There have been clear signs of strength in the household and business sectors, as well as in defence spending. Continued stimulative monetary and fiscal policies will support activity in 2004. The Bank forecasts U.S. growth of about 2 3/4 per cent on an average annual basis in 2003 and about 4 per cent in 2004.

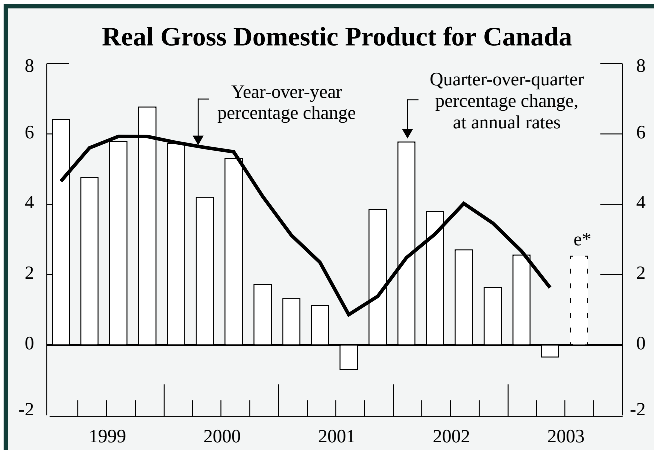
The economy in the euro area is still weak, but economic prospects for Asia look particularly bright, led by China and India. Japan's economy is also performing better than anticipated.

For Canada, recent indicators of domestic spending have been stronger than anticipated, with the housing sector remaining particularly vibrant. The effects of SARS should continue to reverse, leading to some rebound of activity in the affected sectors. Business investment should continue to grow, supported by the recent improvement in financial conditions. Stronger U.S. growth will also boost the Canadian economy. However, the gains in exports will be dampened by the appreciation of the Canadian dollar.

All told, we expect growth in Canada to average a little over 3 per cent in the second half of 2003, and about 2 per cent for the year as a whole. During 2004, the economy should grow above its 3 per cent rate of potential growth, returning to its level of full capacity by early 2005. That would imply growth at 3 1/4 per cent on an average annual basis in 2004.

In the meantime, the slack in the economy will be a source of some downward pressure on inflation. Other factors will also be working to restrain inflation. The impact of earlier large increases in auto insurance premiums is expected to continue to diminish. The recent substantial appreciation of the Canadian dollar should continue to put downward pressure on both core and total inflation through the end of 2004, although how much of an effect this will have on core consumer prices is uncertain.

On the other hand, recent discounting in those industries affected by SARS should moderate over the coming months. And with the expected completion of the inventory correction, some of the downward pressure on goods prices should ease.



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

The Bank expects core inflation to average just over 1.5 per cent for the rest of 2003 and to fall to just above 1 per cent in early 2004 as the effects of earlier increases in insurance premiums dissipate. As economic slack is taken up, the core rate of inflation should return to 2 per cent by mid-2005. Core inflation could be somewhat lower over the next several quarters, if some of the previous increases in auto insurance premiums are reversed.

Total CPI inflation will continue to be importantly affected by swings in the price of crude oil. If oil prices follow the path indicated by futures markets, easing to US$27 per barrel next year, total CPI inflation would likely fall below core inflation in 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.

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