MONETARY POLICY REPORT

– April 2003 –

Summary

Overview

Since the Bank's last *Monetary Policy Report*, both core and total CPI inflation have been well above the 2 per cent inflation target. While one-off factors, particularly higher insurance premiums, and increased costs for some key product inputs have contributed importantly to high inflation, price pressures arising from strong domestic demand have also been at play. Indeed, although external demand for Canadian products has weakened, our economy has continued to operate close to full production capacity because of strong domestic demand. In this environment, inflation expectations have edged up.

In view of the domestic inflation situation and the underlying momentum of domestic demand, the Bank raised its target overnight rate on each of its last two policy announcement dates by 25 basis points, bringing it to 3.25 per cent.

Economic, financial, and geopolitical uncertainty has also figured prominently in the global economic picture over the past six months. Some of the geopolitical and financial uncertainty has lifted more recently, and the Bank expects that it will continue to recede. Global economic uncertainty remains important, however, especially over the near term.

Overall, the risks confronting the world economy now appear to be better balanced compared with last autumn, and by year-end, business and household confidence levels should be much higher. Thus, while global economic uncertainty will likely continue to dampen growth over the near term, activity should begin to strengthen towards the end of this year and through 2004, particularly in North America.

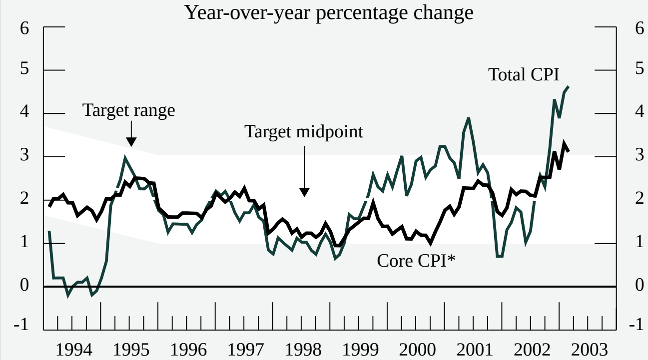
Highlights

- **Inflation has been well above the 2 per cent inflation target, and inflation expectations have edged up.**
- **In view of the domestic inflation situation and the underlying momentum of domestic demand, the Bank has raised its target overnight rate to 3.25 per cent.**
- **Global economic uncertainties will likely dampen near-term growth; however, the pace of activity should strengthen towards the end of this year and through 2004 as confidence levels improve.**
- **The Bank believes that further reductions in monetary stimulus over time will be necessary, but the timing and pace will depend on the evolution of inflation expectations and the strength of domestic and external demand.**

Given the underlying momentum of domestic demand, and an expectation that external demand for Canadian products will strengthen as uncertainties recede and confidence improves, the Bank continues to believe that further reductions in monetary stimulus will be necessary over time to return inflation to its 2 per cent target and to sustain output levels close to capacity. The timing and pace of further increases in policy interest rates will depend on the strength of domestic demand, the evolution of inflation expectations, and the pace of economic expansion in the United States and in overseas economies.

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

Recent Developments

After expanding at a vigorous pace in the first half of 2002, the Canadian economy grew at a more modest annualized rate of 2.6 per cent in the second half of last year. Reduced exports to the United States were one of the main reasons why economic growth in Canada slowed towards the end of 2002. But, at the same time, domestic demand continued to be strong, underpinned by stimulative monetary policy and significant gains in employment and real incomes.

These same factors continued to affect the economy during the first quarter of 2003. The Bank estimates that the economy grew at an annualized rate of around two per cent in that quarter. While this pace was below the estimated 3 per cent growth rate of the economy's potential, the Bank's conventional measure of potential suggests that the economy is still operating very close to its full production capacity.

Several economic indicators support this view. These include measures of capacity utilization, profits as a share of GDP, and the proportion of firms reporting labour shortages in the survey conducted by the Bank's regional offices. However, the marked rise in the labour force participation rate over the past year and the absence of upward pressure on wages indicate that there may be more slack in the economy than the conventional measure suggests.

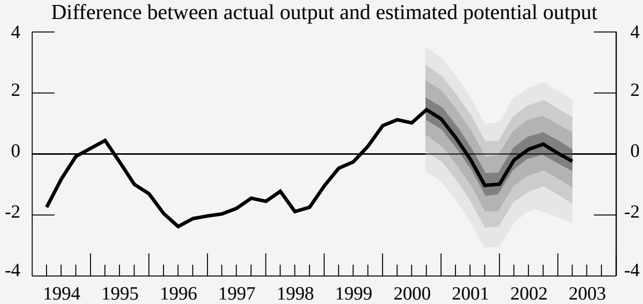
Overall, it is the Bank's view that the level of activity has been close to capacity since early 2002.

Canada's inflation rate has risen markedly since the October *Report*. Core inflation—a measure that focuses on the trend of inflation by stripping out the most volatile components of the consumer price index basket—was 3.1 per cent in February. This higher-than-expected core inflation reflects a combination of one-off factors, higher costs for certain inputs, and strong domestic demand.

The most conspicuous of the one-off factors is the rapid rise in insurance premiums, which reflects both higher claims and low returns on portfolio investments by the insurance industry. In a number of areas, higher prices for key inputs, such as energy and grains, are pushing up the prices of final goods and services. As well, with the economy operating close to capacity, there have been signs of price pressures in certain sectors such as shelter, personal care services, and some recreational services.

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 first quarter of 2003 is based on a projected rise in output of 2 per cent (at annual rates) for the quarter.

The overall annual CPI inflation rate reached a peak of 4.6 per cent in February, well above the 2 per cent inflation target. One important factor behind the jump in total inflation has been the sharp rise in the prices of gasoline, fuel oil, and natural gas. Fears of supply disruptions in the Middle East and elsewhere pushed energy costs higher, as did unusually cold weather in North America.

Measures of near-term inflation expectations have edged up. These include data from the survey of firms conducted by the Bank's regional offices and the average private sector consensus forecast. However, measures of longer-term inflation expectations continue to be centred around 2 per cent.

In light of the weakening global economic situation and economic, financial, and geopolitical uncertainties, the Bank of Canada kept its key interest rate unchanged on its October and December 2002 fixed announcement dates. The key policy rate was left unchanged again in January, although the Bank noted that higher-than-expected inflation could be a sign that the Canadian economy was closer to its level of full capacity than previously believed. On both the March and April announcement dates, the Bank raised its key policy rate by 25 basis points, bringing it to 3.25 per cent. These decisions were taken against the backdrop of persistently high inflation rates, the expectation that the economy would remain near its capacity, and the stimulative stance of monetary policy.

Prospects for Growth and Inflation

The global economy continues to expand, but at a slower pace than projected in the October *Report* and the January *Update*. Given that economic uncertainty remains an important factor, global economic growth will likely remain subdued over the near term. But with geopolitical uncertainty lessening, world oil prices significantly lower, and financial conditions improving, the risks confronting the world economy are now better balanced.

The Bank's analysis and projections continue to be based on the assumption that global confidence will improve significantly by the end of the year. So, while growth in the United States is expected to be below the growth rate of that economy's potential over the first three quarters of 2003, it is projected to rise above potential towards the end of the year and through 2004. Improved confidence levels, along with stimulative monetary policy, tax cuts, and increased defence spending, should support activity. All told, the Bank expects that U.S. economic growth, on an annual average basis, will be about 2 1/2 per cent in 2003 and about 4 per cent in 2004.

The recovery is less certain in other industrialized countries, where weak domestic demand is a concern.

The possible spread of Severe Acute Respiratory Syndrome (SARS) has also increased uncertainty.

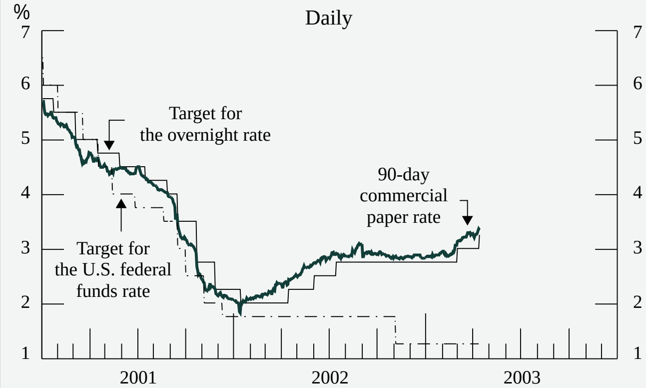
Canadian economic growth should average near 2 1/2 per cent over the first three quarters of this year. But with a pickup in economic activity in the United States, growth in Canada should accelerate towards the end of the year and through 2004. Exports, which declined in late 2002 and early 2003, should recover, while government spending on goods and services is expected to increase solidly. With a further improvement in financial conditions, investment spending should also pick up. In addition, conventional drilling by the oil and gas sector should increase, in response to high prices for crude oil and natural gas. Household spending is expected to grow at a healthy rate, although this will be moderated somewhat by the withdrawal of monetary stimulus.

Average annual growth in Canada is expected to be about 2 1/2 per cent in 2003. Over the course of 2004, the Bank projects growth above the economy's 3 per cent growth of potential. This implies that most of the small amount of economic slack that is likely to open up over the first two or three quarters of this year will have closed by the end of 2004.

With domestic demand remaining strong and given the expected pickup in U.S. activity towards year-end and into 2004, the Bank continues to see the need for further removal of monetary stimulus over time to return inflation to its 2 per cent target and to maintain output levels close to capacity.

Core inflation is expected to remain near 3 per cent through mid-2003. However, the combined effect of one-off factors should decrease

90-Day Commercial Paper Rate, Target for the Overnight Rate, and Target for the Federal Funds Rate



significantly in the second half of this year and will likely have run its course by early 2004. In addition, the balance of aggregate demand and supply in the economy should be a source of slight downward pressure on inflation over the projection horizon. The Bank expects core CPI inflation to fall to about 2 1/2 per cent in the second half of this year, and to about 2 per cent by early 2004.

Total CPI inflation will continue to be importantly affected by swings in crude oil prices. If oil prices were to average about US$28 per barrel in coming months, total CPI inflation would be expected to ease to about 3 3/4 per cent in the second quarter. If crude oil prices were then to settle down at about US$25 per barrel by mid-2003, consistent with futures prices, and the Canadian dollar were to stay close to current levels, total CPI inflation would likely fall temporarily below the core rate in the first half of next year, before steadying out at a rate close to core inflation.

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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