Monetary Policy Report

Update

– August 2000 –

This is a commentary of the Governing Council of the Bank of Canada. It includes information received to 4 August 2000 and updates the Monetary Policy Report *released on 11 May 2000.*

Information received since the last *Monetary Policy Report* continues to show solid economic growth in the United States, Europe, and the emerging markets. The Japanese economy has also shown signs of improvement. As the global economy continues to expand and oil producers maintain production quotas, the world price of crude oil and the North American price of natural gas have been higher than expected. In contrast, prices for most non-energy commodities have been below expectations.

In the United States, core inflation, which excludes energy and food prices, has continued to edge up. Recent data indicate that the pace of U.S. activity remains robust. However, there have been signs of slowing in interest-rate-sensitive sectors. Whether the slowing will be sufficient to reduce inflation pressures is not yet clear. Given the tight labour market, the balance of risks suggests continued upward pressure on U.S. core inflation.

In Canada, the growth of aggregate demand in the first quarter was at the top end of the Bank's expectations. Propelled by strong exports to the United States and by buoyant business investment, real GDP rose at an annual rate of 4.9 per cent. Based on available indicators, the Bank estimates that growth in the second quarter remained strong at between 3.50 and 4.25 per cent.

Highlights

- The Bank has revised up its projection of real GDP growth for this year to a range of 4.25 to 4.75 per cent, reflecting a strong first half in 2000 as well as upward revisions to output in the second half of 1999.
- Core inflation came in below expectations in the second quarter, suggesting that the economy's capacity limits had not yet been reached.
- For the second half of this year, the Bank continues to expect a slowing in the pace of economic activity, but to a rate that would still be above the growth of potential output.
- As a result, pressures in product and labour markets are still expected to emerge and to raise core inflation to about 2 per cent early in 2001.
- In light of these developments, the Bank will continue to pay close attention to the strength of aggregate demand in the Canadian economy and to a range of indicators of pressure on capacity.

Together with upward revisions to the level of economic activity in the second half of 1999, these figures have led the Bank to revise its projection of GDP growth for 2000 to between 4.25 and 4.75 per cent (on an annual average basis), up 0.25 percentage points from the projection in the May *Report*. For the remainder of this year, the Bank continues to project a pace of activity below that of the first half, but still somewhat above potential output growth.

Despite the stronger momentum in the first half, the rate of increase in Canada's core CPI (which excludes the volatile food and energy components, and the effects of changes in indirect taxes) remained unexpectedly low in the second quarter of this year. This suggests that demand may not yet have outstripped Canada's production capacity. However, excess capacity is being absorbed rapidly and pressures on capacity are expected to emerge as we progress through the year. Hence, core inflation is still projected to move close to the midpoint of the Bank's 1 to 3 per cent target range by early 2001. Because of higher energy prices, the increase in total CPI is now expected to remain above core inflation until some time in the first part of next year.

In terms of the risks to this outlook, developments since the last *Report* reinforce the uncertainties that the Bank has been highlighting for some time: the risk of a spillover of U.S. demand at a time of growing spending by Canadian consumers and businesses; the possibility of rising inflation pressures in the United States and the implications for Canada; and the uncertain balance between demand and supply in the Canadian economy, given some signs that the pressures on capacity have not been as intense as expected earlier.

The International Environment

Emerging-market economies

The performance of emerging-market economies has been better than expected. In the Asian economies, which posted solid export-led growth in 1999 after a slowdown caused by the financial crisis of 1997–98, growing domestic demand has contributed to continued strong expansion this year. The emerging markets of Latin America and Eastern Europe are also showing strength.

Europe and Japan

In Europe, the economic expansion remains solid. Strengthening employment and rising consumer and business confidence should stimulate domestic demand through the rest of the year. Tightening monetary conditions in the region should help to forestall inflationary pressures.

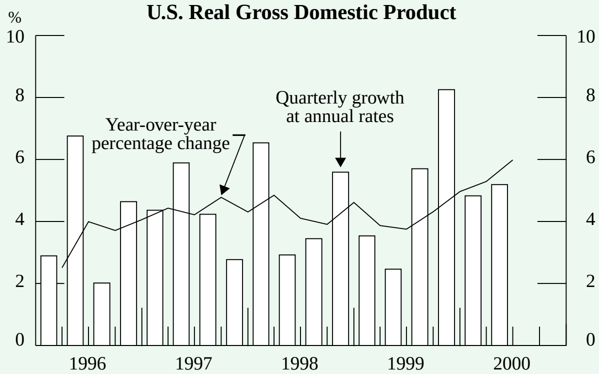
In Japan, there are signs that the economy is improving. Corporate profits, business investment, and production have all recently shown some strength. Nevertheless, the economy remains fragile: household spending is weak, and the financial sector requires further restructuring. This has led the Bank of Japan to maintain its policy of keeping the overnight interest rate at zero, for the time being.

Economic growth in Europe and in the emerging markets is firming, but the Japanese economy remains fragile.

United States

The U.S. economy continued to expand rapidly in the first half of 2000: GDP rose by 5 per cent (at an annual rate), following growth of 7 per cent in the second half of 1999 (Chart 1). This performance reflected particularly strong business investment throughout the period. Nevertheless, in recent months, there have been some signs of slowing in interest-rate-sensitive sectors. In particular, household and construction spending have slowed markedly from the very high levels seen earlier. The labour market remains tight, despite a moderation

Chart 1
U.S. Real Gross Domestic Product

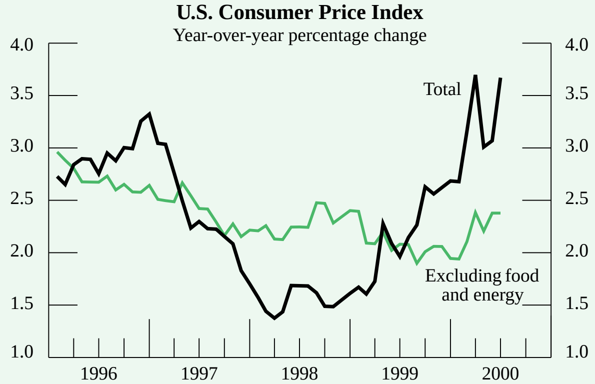


in employment growth. Continued strong productivity growth, however, has kept unit labour costs in check.

Despite some signs of slowing economic activity in the United States, the balance of risks continues to point to upward pressures on inflation.

Past increases in interest rates are expected to slow demand growth through 2000 and 2001. Nevertheless, the Federal Reserve may need to raise interest rates further if the high level of economic activity continues to put upward pressure on capacity and inflation (Chart 2). The degree of tightening expected by financial markets has been revised down significantly because of recent signs of slowing in some sectors.

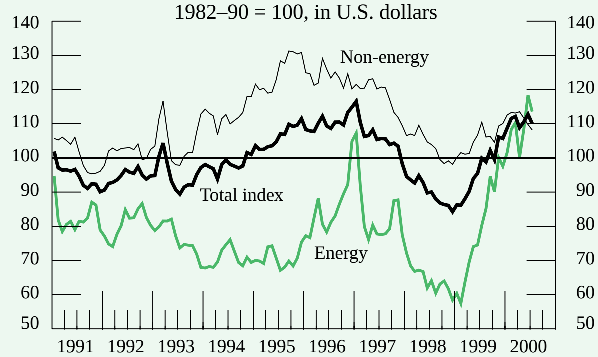
Chart 2
U.S. Consumer Price Index
Year-over-year percentage change



Commodity prices

The average U.S. dollar price of Canada's key primary commodities, as measured by the Bank of Canada's commodity price index, is down 1 per cent from its level at the end of April (Chart 3). While the price of crude oil has risen, prices for other primary commodities have fallen by about 5 per cent.

Chart 3
Bank of Canada Commodity Price Index
1982–90 = 100, in U.S. dollars



At the end of the second quarter, despite two increases in OPEC production quotas, the price of crude oil remained substantially above that suggested in the May *Report*. Even with the additional increase in output announced by Saudi Arabia in July, it is likely that retail prices of products derived from crude oil will be higher than expected through the summer. The price of natural gas has also risen because of low stocks—reflecting strongly growing demand.

Despite strong global economic expansion, non-energy commodity prices have eased. While some price declines can be attributed to temporary factors, declining lumber prices most likely resulted from slower-than-expected growth in U.S. construction.

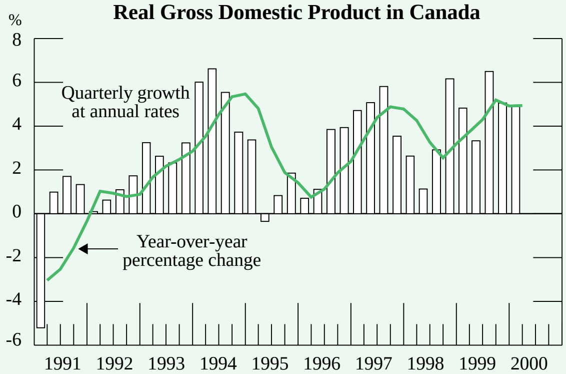
The Canadian Economy

Aggregate demand, output, and estimated pressures on capacity

Growth in the Canadian economy has been at the high end of the range projected in the May *Report*. Real GDP increased at an annual rate of 4.9 per cent in the first quarter of 2000 (Chart 4).[1] Export volumes rose considerably, chiefly because of very strong growth in U.S. demand. Business investment remained buoyant, supported by high levels of profitability and confidence. Substantial increases in household spending reflected marked gains in employment and real incomes. The growth of import volumes did ease somewhat, mainly reflecting lower inventory accumulation.

Chart 4

Real Gross Domestic Product in Canada



***In 2000, Canada's economy is now expected to grow somewhat more quickly than projected in the May* Report.**

Available information for the second quarter suggests that the economic expansion slowed but remained strong (and above the growth of potential output) at 3.50 to 4.25 per cent. Indicators of consumer spending and of investment in machinery and equipment remained firm. Data on exports showed further solid gains, with shipments of machinery and equipment up sharply in response to buoyant U.S. demand. There were, however, signs of an easing in household spending on interest-rate-sensitive items such as housing.[2] And employment gains also slowed in the second quarter.

Economic activity in 2000 is now expected to grow by between 4.25 and 4.75 per cent on an annual average basis, slightly more than envisaged in the May *Report*. This chiefly reflects the upward revision to Canada's GDP in the second half of 1999 and the strong first half of this year. For the rest of 2000 and for 2001, the Bank continues to project a slowing pace of activity, primarily reflecting an anticipated slowing in the U.S. economy.

Excess capacity is being rapidly absorbed.

The strong performance of the Canadian economy might have suggested that Canada moved into excess demand in the first half of 2000. However, several indicators suggest caution in making this judgment. Most important among these is core inflation, which remains below expectations. Nonetheless, it is clear that excess capacity is being rapidly absorbed, and with growth in demand expected to remain somewhat above that of potential output to the end of 2000, pressures on capacity are expected to increase.[3]

Prices and costs

The 12-month rate of increase in the core CPI in June, at 1.4 per cent, was down slightly from last March and below that projected in the May *Report* (Chart 5). In particular, prices

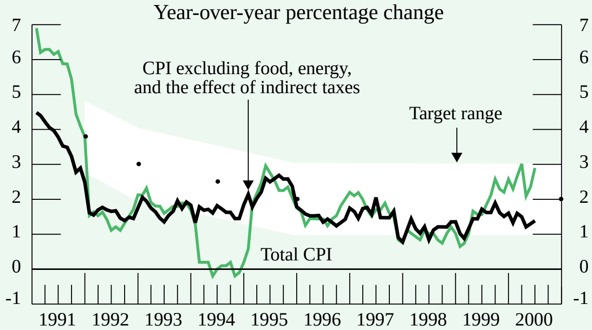
1. In the May *Report*, real growth in the first quarter was expected to be between 4 and 5 per cent.

2. The downturn in housing starts in the second quarter was exacerbated by a labour dispute in the Toronto area.

3. An update of the Bank's conventional measure of the output gap will be provided in the November *Report*.

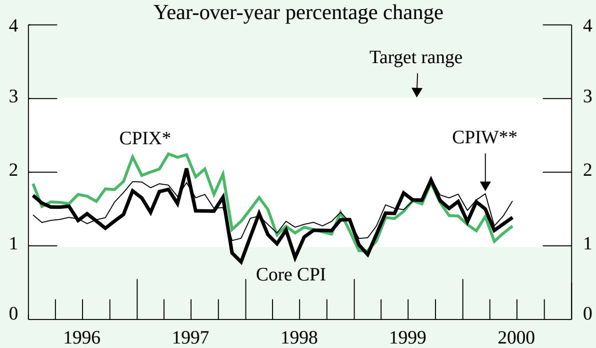
for both durable and semi-durable goods were weaker than anticipated, which may have partly reflected lower international prices. These surprises also suggest that there was still slack in product markets in the early part of the year. Other statistical measures of the trend rate of inflation were close to the core rate (Chart 6).

Chart 5
Consumer Price Index
Year-over-year percentage change



• Midpoint of the inflation-control target range

Chart 6
Core CPI and Statistical Measures of the Trend Inflation Rate
Year-over-year percentage change

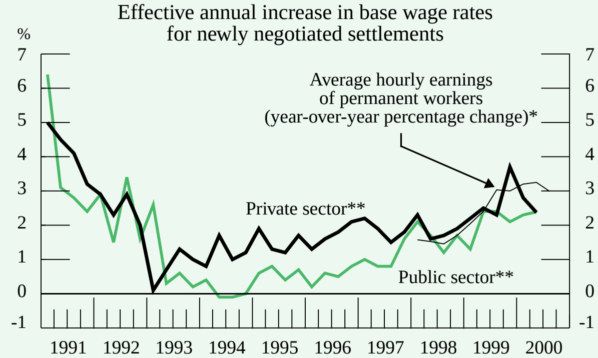


* CPIX excludes the eight most volatile components from the CPI as well as the effect of indirect taxes on the remaining components.
** CPIW adjusts each CPI basket weight by a factor that is inversely proportional to the component's variability.

The estimated effect on the core CPI of the substantial rise in energy prices since early 1999 continues to be small—less than 0.1 per cent. However, the 12-month rate of increase in the total CPI in June, at 2.9 per cent, remained well above core inflation, reflecting continued hikes in energy prices at the consumer level.

There has been little change in indicators of wage increases. The year-over-year increase in the average hourly wage (excluding overtime) for permanent workers, taken from Statistics Canada's *Labour Force Information*, was 3 per cent in July, down slightly from 3.2 per cent in the first half (Chart 7). The year-over-year rise in labour income per person-hour was still only 1.7 per cent in the first quarter (Chart 8). Finally, in the first five months of 2000, the average annual increase in wage settlements in the unionized private sector was 2.6 per cent, close to the average gain in 1999.

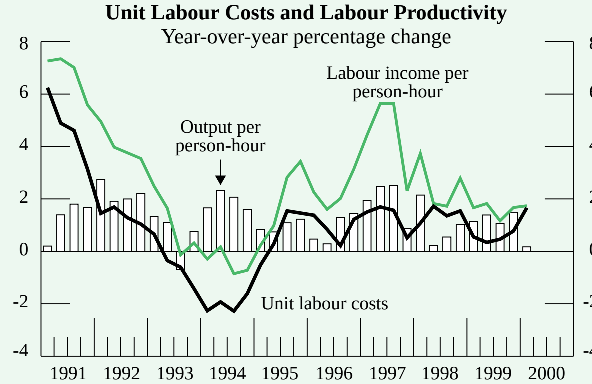
Chart 7
Wage Settlements and Average Hourly Earnings
Effective annual increase in base wage rates for newly negotiated settlements



* Source: *Labour Force Information*, last data point = July 2000
** Source: Human Resources Development Canada, last data point = April and May 2000

For the economy as a whole, the year-over-year rise in unit labour costs increased to 1.6 per cent in the first quarter, chiefly because of reduced growth in output per

Chart 8
Unit Labour Costs and Labour Productivity
Year-over-year percentage change



person-hour (Chart 8). The year-over-year increase in output per person-hour is expected to rebound considerably in the second quarter, however. As a result, the underlying year-over-year increase in unit labour costs should fall back. (This excludes the effect of the federal government pay-equity settlements, which could add up to 1.5 per cent to labour income in the second quarter.)

Asset prices tend to be sensitive to expectations of inflation and economic growth. In the late 1980s, for example, a surge in housing prices signalled the rise in core inflation. The housing market has tightened moderately since the beginning of 2000. The year-over-year rise in prices for existing homes (based on the Royal LePage index) was 6.4 per cent in the first quarter, up slightly from the rate observed in the preceding quarter. The year-over-year increase in new home prices has also risen, although it was only 2.4 per cent in May.

Core inflation is expected to rise gradually to about 2 per cent by early 2001.

Core inflation, while unexpectedly low in the second quarter, is still expected to rise gradually to about 2 per cent by early 2001. This reflects two factors: emerging pressures in product and labour markets as growth in demand continues to outpace growth in potential supply, and longer-term inflation expectations that are staying close to the midpoint of the Bank's target range. The resulting upward pressure on core inflation should be tempered somewhat by further reductions in import costs arising partly from the appreciation of the Canadian dollar since early 1999.

The rate of increase in the total CPI is still expected to move down towards core inflation, with the pace determined partly by how quickly crude oil prices decline and feed through to retail prices. If crude oil prices average US$28 for West Texas Intermediate during the second half of the year, the year-to-year increase in the total CPI should decline to about 2 per cent some time in the first half of 2001.[4]

The monetary aggregates

Growth in the narrow monetary aggregates continues to be strong. On a year-over-year basis, M1 grew by about 17 per cent in June, while M1+ and M1++ were up some 12 per cent and 9 per cent, respectively. The pace of growth has been boosted by sharp increases in non-personal accounts. Part of the recent strength is due to an increase in the deposits of some financial intermediaries with banks. These deposits are distorting the information content of the narrow aggregates because accounts held by financial institutions would net out if the monetary aggregates were constructed on a fully consolidated basis. Our initial estimates suggest that when the data are adjusted to account for such distortions, the trend growth rate of the narrow aggregates is between 4 and 8 per cent.

When these data distortions are taken into account, the recent growth in narrow money suggests that real GDP will grow at a pace of about 3.5 per cent in the second half of 2000 (Chart 9). This is consistent with the Bank's overall projection of GDP growth. The growth in narrow money also suggests that core inflation will increase to about the midpoint of the target range by early 2001. This, too, is consistent with the Bank's projection.

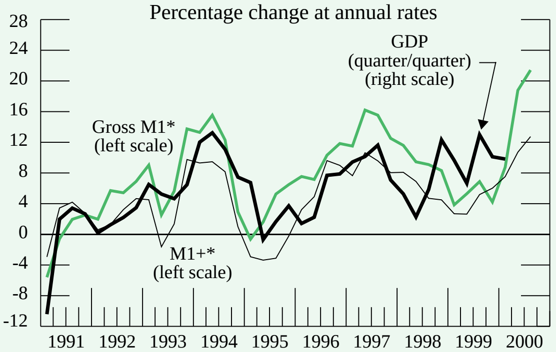
Growth in the broad monetary aggregate M2++ has increased since the beginning of the year, posting a 12-month gain of nearly 9 per cent in June (Chart 10). This increase largely reflects the acceleration in the narrow aggregates. Overall, growth in M2++ is consistent with the path for inflation implied by the growth in narrow money.

4. The average private sector forecast for the rate of increase in the total CPI is 2.4 per cent in 2000 and 2.1 per cent in 2001 (from the July issue of *Consensus Forecasts*).

Chart 9

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

Percentage change at annual rates

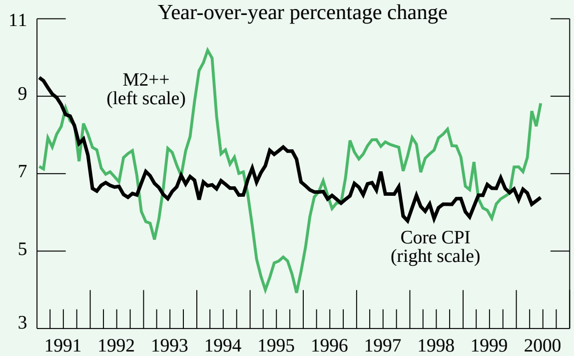


* Two-quarter moving average of growth in gross M1, M1+ (deflated by the core CPI), one quarter earlier

Chart 10

Core Inflation and Broad Money Growth

Year-over-year percentage change



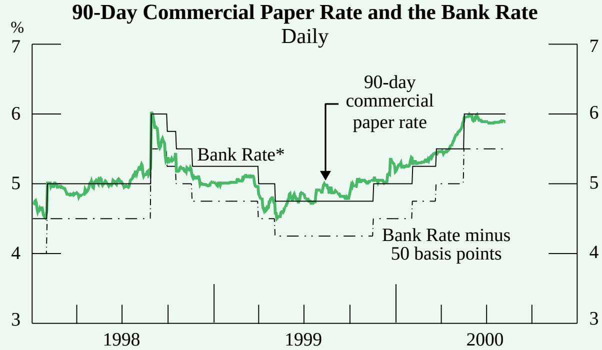
Monetary conditions and monetary policy operations

Concerns about future pressure on capacity limits arising from strong domestic spending and from the continued buoyancy of external demand for Canadian products prompted the Bank to raise the Bank Rate by 50 basis points on 17 May, soon after the publication of the May *Report* (Chart 11). This action, which took the Bank Rate to 6 per cent, followed a similar move by the Federal Reserve. The Federal Reserve's move highlighted the vigour of the U.S. economy and underscored the risk that U.S. demand and inflation pressures could spill over into Canada. Higher interest rates were deemed necessary to keep the future trend of inflation near the middle of the Bank's 1 to 3 per cent target range, thus contributing to sustained economic growth.

Chart 11

90-Day Commercial Paper Rate and the Bank Rate

Daily



* The Bank Rate is the upper limit of the 50-basis-point operating band for the overnight rate.

The timing and magnitude of the Bank Rate increase were largely anticipated by financial markets. Most of the rise in the 90-day commercial paper rate occurred prior to the rate hike, as the financial community became increasingly convinced that the Bank would take such an action. The Bank's move, therefore, had only a small impact on money market rates. The U.S. money market behaved in a similar fashion, with most of the rise in market rates occurring ahead of the Federal Reserve's action. More recently, expectations of further increases in U.S. official interest rates over the balance of 2000 receded, as market participants began to see signs of a possible slowing in the U.S. economy.

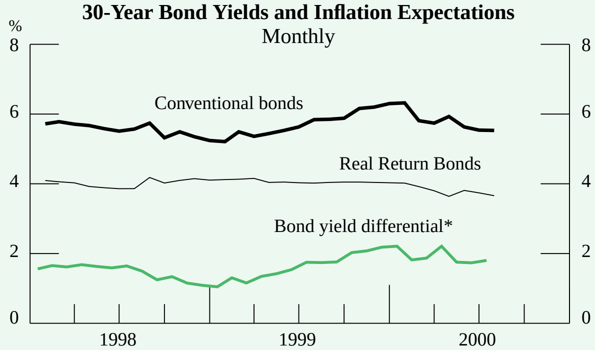
North American money market rates have increased as a result of central bank tightening.

North American bond yields drifted lower in the weeks following the central bank moves, as tighter monetary conditions reduced the perceived risk of a significant medium-term buildup in the trend of

Chart 12

30-Year Bond Yields and Inflation Expectations

Monthly



* This differential is calculated using the compound interest formula.

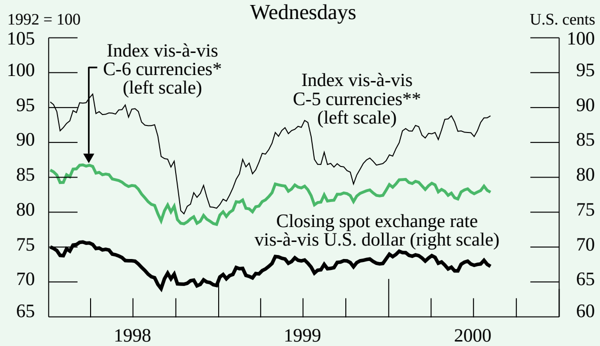
inflation (Chart 12). These yields continue to be affected by the relatively small issuance of long-term government bonds. Combined with investors' continuing demand, this reduced supply has resulted in an inverted yield curve for longer government maturities.

Since the completion of the May *Report*, the Canadian dollar has been affected by shifts in the expectations of financial markets concerning the relative robustness of the Canadian and U.S. economic expansions. The Canada / U.S. dollar exchange rate (Chart 13) fluctuated between a low of 66.04 cents (US) and a high of 68.36 cents (US) over the period. The Canadian dollar weakened in mid-May because market participants felt that the Canadian economy would grow more slowly than the U.S. economy. Subsequently, the Canadian dollar strengthened against the U.S. dollar when signs of a moderation in the U.S. economic expansion began to emerge. Fluctuations in the Canada / U.S. dollar exchange rate were largely paralleled by those of the Canadian dollar trade-weighted exchange rate. Economic fundamentals continue to support the Canadian dollar, since growth remains robust, and the current account has moved into surplus. The Bank's monetary conditions index has fluctuated between -5.7 and -4.8 since mid-May.

Chart 13

Canadian Dollar Exchange Rate

Wednesdays



* C-6 currencies: U.S. dollar, euro, yen, U.K. pound, Swedish krona, and Swiss franc

** C-5: excludes U.S. dollar

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