Monetary Policy Report

– October 2002 –

Summary

Overview

The Canadian economy has expanded strongly through 2002 and is now operating close to its full production capacity. Consumer price inflation has risen above the Bank's 2 per cent target and is expected to rise somewhat further before year-end because of a number of relative price movements—most importantly, higher insurance premiums and energy costs. What is important for monetary policy is that these effects not feed into price and wage inflation, but remain "one-off" influences on specific prices.

Against the background of a strengthening economy, the Bank of Canada began last spring to reduce the substantial amount of monetary stimulus provided in 2001.

While the Canadian economy has remained strong in recent months, an uncertain global economy and a reduced tolerance for risk in financial markets are working to dampen the outlook for Canadian economic growth in the near term. The Bank therefore decided on 4 September and 16 October to leave the target for the overnight rate of interest unchanged.

It remains the Bank's view, going forward, that further removal of monetary stimulus will be required to achieve the inflation target over the medium term. The timing and extent of policy tightening will depend on unfolding economic, financial, and geopolitical developments and on their implications for pressures on capacity and inflation in Canada. As well, the Bank will watch closely how well inflation expectations remain anchored, given the relative price movements noted above.

Highlights

- **The underlying momentum of the Canadian economy remains strong.**
- **However, the Bank has lowered its growth projection for Canada through 2003 because of the dampening influences of global economic, financial, and geopolitical developments.**
- **Inflation has been above the Bank's target rate, as well as above expected levels, largely reflecting a number of relative price movements.**
- **Given the projected balance of supply and demand in the economy, and provided that the relative price movements do not feed into price and wage inflation more generally, core inflation is expected to fall back to the 2 per cent target in the second half of next year.**
- **Going forward, further removal of monetary stimulus will be required, with the pace and extent of the tightening depending on unfolding developments and on their implications for pressures on capacity and inflation in Canada.**

Recent Economic and Financial Developments

The Canadian economy has outperformed virtually all other major industrial economies over the past year. Demand for housing and furnishings has been particularly strong. Investment in both inventories and fixed capital has also been stronger than anticipated. As a result, the economy expanded at a faster pace in the first three quarters of this year than expected at the time of the April *Monetary Policy Report*.

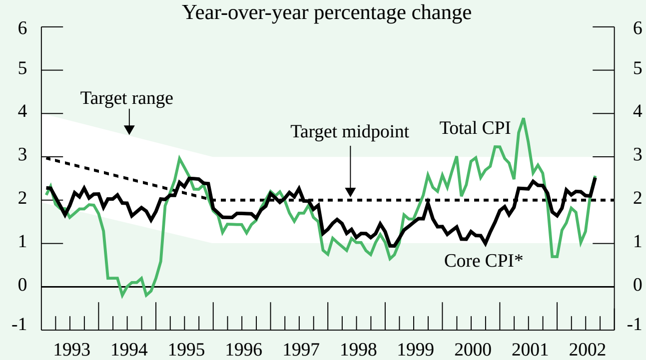
Growth elsewhere in the world has been slower than expected. Among the factors that have held back the global economy are a delayed rebound in investment, a decline in equity prices, rising risk premiums, concerns about corporate governance and financial reporting (coming mainly from the United States), geopolitical developments, and the situation in several Latin American countries. These factors have created uncertainties in the global economy, reduced risk tolerance, and resulted in volatile financial markets.

Canada's economy posted annualized growth of 5.2 per cent in the first half of 2002, well above the growth rate of the economy's production capacity. The Bank estimates that Canada's economy grew at an annualized rate of 4 per cent in the third quarter. So, the economy has moved towards its production capacity more quickly than expected and is now operating close to that level.

Since the April *Report*, the Bank of Canada has removed some of the substantial monetary stimulus in the economy. The Bank raised its target for the overnight rate of interest by 25 basis points on 16 April, 4 June, and 16 July to its current level of 2.75 per cent. But with the uncertainties and weaker global outlook likely to dampen growth in aggregate demand for Canadian output in the near term, the Bank left its overnight rate target unchanged on 4 September and on 16 October.

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

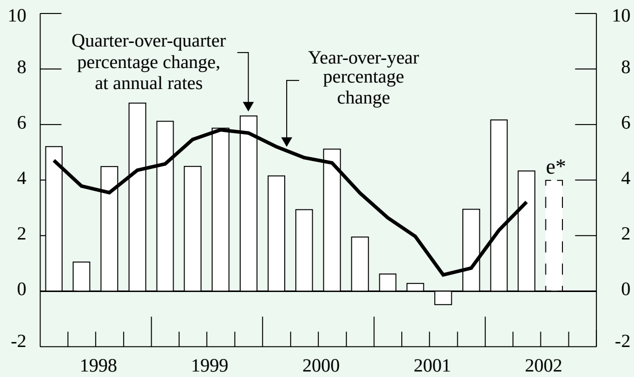
The Bank's core measure of inflation has been running above earlier projections. Several factors, which should affect inflation only temporarily, have been behind this move. Home and auto insurance premiums have jumped substantially, partly because of higher claims against insurance companies. As well, the hot summer weather in Ontario led to a sharp increase in electricity prices. Core inflation has also been boosted by a strong demand for housing and furnishings.

Other energy prices, which are not part of the Bank's core inflation measure, have also increased. These increases, partly related to fears of disruptions in crude oil supplies in the event of a war in the Middle East, pushed the total consumer price index above the core rate sooner than had been expected. Higher tobacco taxes have also contributed to the rise in total CPI inflation.

Prospects for Growth

After a very strong performance in the first three quarters of this year, economic growth in Canada is expected to slow somewhat in the fourth quarter and in the first half of 2003. The level of U.S. economic activity has been revised downwards, and the projection for U.S. economic growth has been scaled back slightly. This implies slower growth in Canadian export volumes. Fixed

Real Gross Domestic Product for Canada



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

investment by Canadian businesses is also expected to be slightly weaker than previously thought, as global uncertainties lead to spending delays.

Over the next three quarters, growth in Canada is expected to average slightly less than the economy's 3 per cent growth potential. But with the U.S. economy projected to gain momentum through next year and global financial conditions assumed to improve, real GDP growth in Canada is expected to pick up to above 3 per cent in the second half of 2003.

This outlook implies average annual growth in Canada of about 3 1/2 per cent in 2002 and in a range of 2 3/4 to 3 3/4 per cent in 2003. The midpoint of this range is slightly below the average of private sector forecasts for 2003.

In the United States, real GDP growth over the fourth quarter of 2002 and the first two quarters of 2003 is expected to average close to 3 per cent — slightly lower than that economy's potential growth rate. While financial market developments are restraining growth, U.S. monetary policy remains very stimulative, with the Federal Reserve holding its policy rate steady at 1.75 per cent. Above-potential growth in the United States should resume and begin to take up economic slack in the second half of next year, assuming that the effects of recent financial market developments dissipate. This would result in average annual growth of 2 1/2 per cent in 2002 and 3 1/4 per cent in 2003, which is slightly less than forecast in the April *Report*.

Elsewhere in the world, growth is still expected to pick up, although at a slower pace. Europe should see 1 per cent growth in 2002 and 2 1/2 per cent in 2003. But Japan's economy is expected to shrink by 1 per cent in 2002 and to grow by only 1/2 per cent in 2003.

The Outlook for Inflation

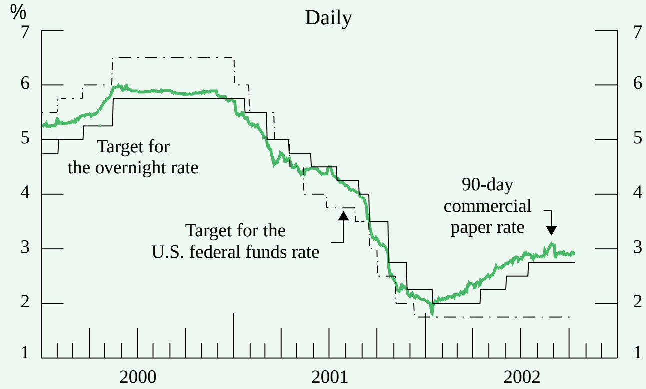
The strong growth in Canada's economy so far this year has narrowed the gap between its actual and its potential output.

Conventional estimates of economic slack suggest that the output gap had essentially closed by the end of the summer. But several other indicators point to less pressure on capacity. On balance, it is the Bank's judgment that the economy is currently operating with somewhat more slack than the conventional measures suggest.

The Bank's current outlook suggests that, with monetary stimulus being removed in a timely and measured way, the Canadian economy will continue to operate close to capacity. While a small amount of excess supply will remain over the near term, it is expected to be taken up as output growth moves above potential growth in the second half of 2003. But with the output gap expected to remain small, judgments about the degree of slack will need to be carefully assessed as developments unfold.

This profile for the output gap implies little demand-driven pressure on inflation, either upwards or downwards, over the projection horizon. Nevertheless, both core and total CPI inflation are expected to rise further in the near term and to remain above

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



earlier expectations well into 2003, because of the relative price movements mentioned earlier.

Core inflation is expected to rise to a peak of about 3 per cent by the end of the year. But as the one-off price influences fade in 2003, and with aggregate supply and demand in balance, core inflation is expected to drop back to the Bank's 2 per cent target in the second half of 2003.

The total consumer price index will continue to be affected by swings in crude oil prices. If tensions in the Middle East keep crude oil prices near US$30 per barrel, CPI inflation is likely to peak at around 4 per cent by the end of 2002. In 2003, total CPI inflation is expected to move back in line with core inflation, but the pace will depend on the behaviour of oil prices.

Recent experience suggests that the pass-through of temporary oil-price movements to the prices of other goods and services is relatively small. Thus, while the behaviour of total CPI inflation could be dramatically affected by the near-term behaviour of oil prices, volatile oil prices are not expected to have much of an impact on core inflation.

Risks to the Outlook

Two risks will require close monitoring over the next few months. First, global developments may have a more persistent dampening influence on the Canadian economy than assumed. Second, with the Canadian economy now operating close to capacity and with inflation expected to rise further in the near term, inflation trends and expectations will need to be carefully monitored against the projection that inflation will return to its 2 per cent target in the second half of 2003.

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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