MONETARY POLICY REPORT

– *April 2004* –

Summary

Overview

The Canadian economy continues to adjust to developments in the global economy. These include stronger world demand, higher commodity prices, the realignment of world currencies—including the Canadian dollar—and the intensified competition, together with new trading opportunities, coming from emerging-market economies, such as China and India.

These developments require shifts in activity among sectors and create a need for adjustments by many businesses. Monetary policy is facilitating these adjustments by supporting aggregate demand, with the goal of keeping the economy near its full potential and inflation on target.

At the end of 2003, the Canadian economy was operating at a lower level than the Bank had projected in the October *Monetary Policy Report*. Although growth rebounded in the fourth quarter of last year, real GDP growth in the third quarter was weaker than had been expected, and there was a downward revision to GDP in the second quarter. This came about despite stronger global economic activity, particularly in the United States but also in Japan and other Asian economies, and strong increases in commodity prices. Preliminary indications are that growth in the first quarter of 2004 was marginally below 3 per cent at annual rates. As expected, core inflation has generally been below the Bank's 2 per cent target since the October *Report*.

Against this backdrop, the Bank lowered its key policy rate by a total of 75 basis points, reducing it by 25 basis points on each of the last three fixed announcement dates, to bring it to 2 per cent.

Highlights

- **The Bank's outlook for economic growth and inflation is essentially unchanged from that of the January *Update*.**
- **Growth should accelerate in the second half of this year and early next year, returning the economy close to its production potential by the third quarter of 2005.**
- **Inflation is expected to return to the 2 per cent target by the end of next year.**
- **The Canadian economy continues to adjust to developments in the global economy.**
- **The risks to the outlook appear balanced.**

The Bank's outlook for economic growth and inflation in Canada is essentially unchanged from that of the January *Monetary Policy Report Update*. The Canadian economy is expected to grow at an annualized rate of about 2 3/4 per cent in 2004, picking up to about 3 3/4 per cent in 2005. Such growth would return the economy close to its production potential by the third quarter of next year. Core inflation is expected to average about 1 1/2 per cent for the rest of 2004 and to move back to the 2 per cent target by the end of next year.

The main uncertainty for the outlook continues to relate to how the Canadian economy adjusts to global developments. Overall, the risks to the outlook appear balanced.

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

Daily

Recent Developments

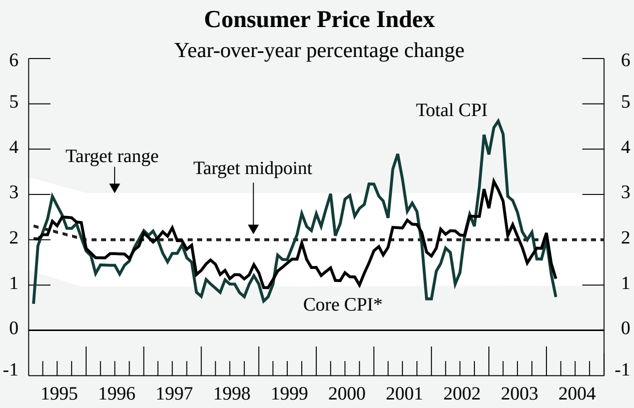
Despite the broadening of the global economic recovery, a number of shocks affected the Canadian economy in the third quarter of 2003, and growth ended up well below expectations at an annual rate of 1.3 per cent. The economy rebounded as expected in the fourth quarter, posting an annual growth rate of 3.8 per cent. Final domestic demand was slightly weaker than expected, however, and external demand was somewhat stronger than expected.

The resurgence in growth at year-end was supported by a pickup in inventory investment. As well, there was some recovery from the temporary shocks that had previously restrained activity. Other supporting factors were favourable financing conditions and stronger global demand. Exports rebounded substantially during the fourth quarter. Preliminary indications are that economic growth eased in the first quarter of 2004.

After appreciating against the U.S. dollar early this year and briefly approaching 79 cents U.S., the Canadian dollar has recently traded in a range of about 74 1/2 to 76 1/2 cents U.S.

While the economy grew at a faster rate than that of potential in the fourth quarter of 2003, the amount of excess supply in the economy at year-end was still somewhat larger than projected six months ago. It is the Bank's view that the economy is operating significantly below its potential, although with the shifts in economic activity brought on by global economic developments, there is more uncertainty than usual around estimates of potential output.

Inflation rates, both total and core, fell sharply in early 2004, as expected. This reflected the end of special factors, such as earlier substantial increases in auto insurance premiums. In addition, the stronger Canadian dollar has led to some lower food prices. Total inflation also fell because of lower prices for gasoline and fuel oil than a year ago, although oil prices have risen strongly since last October.



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

Prospects for Growth and Inflation

Even though there are indications of marginally slower growth in the first quarter, the Bank's outlook remains essentially unchanged from that of the January *Update*. Economic activity should accelerate in the second half of this year and early 2005.

The international outlook is quite positive. Prospects for a strong expansion in the global economy over the next year or so have improved. The Bank expects U.S. economic growth of about 5 per cent for 2004 as a whole, and 4 1/2 per cent in 2005. In addition, Japan may be experiencing a sustained recovery. Near-term prospects for the euro area are subdued, but the longer-term outlook is improving. Among emerging-market economies, prospects are favourable, particularly for China and India. This strong world demand should support Canadian exports and help maintain high commodity prices.

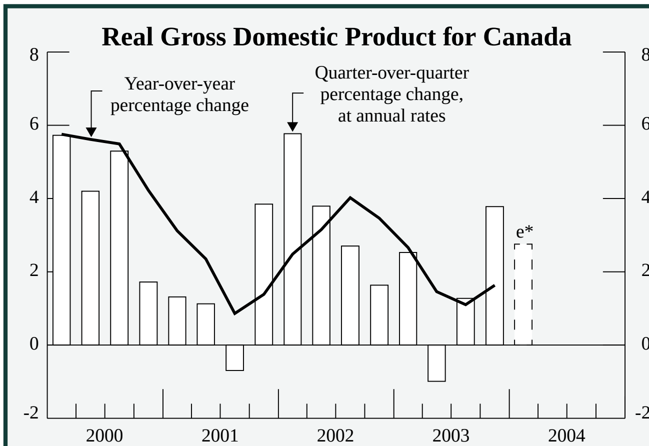
While the external outlook is bright over the near term, it does contain some downside risks, especially as we look further out. Higher oil prices, should they persist, could dampen growth prospects, particularly in the United States. More broadly, there are uncertainties about whether current account imbalances and fiscal deficits in many industrial economies will be resolved in a way that maintains growth.

The Bank expects economic growth in Canada this year and next to come primarily from private domestic demand, reflecting the monetary stimulus in the economy and high levels of business and consumer confidence. Monetary aggregates are consistent with an increase in economic growth.

The Bank's most recent survey of businesses, completed in March, suggests that companies are somewhat more confident in their ability to adjust to the appreciation of the Canadian dollar.

Capital spending by businesses should grow robustly, supported by stronger world demand, high commodity prices, favourable financial conditions, and the lower cost of imported machinery and equipment.

Despite some softening at the end of 2003, household spending is projected to grow solidly, helped by projected stronger gains in real incomes. Government spending is projected to rise moderately this year and next.



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

Solid foreign demand should support exports this year, although the stronger Canadian dollar will continue to dampen export growth and boost imports. Overall, net exports are not projected to contribute to growth in 2004 and 2005.

All told, the Bank expects real GDP to expand at an annualized rate of about 2 3/4 per cent in the first half of this year. In the second half, growth should pick up to about 3 1/2 per cent. Such a result implies real GDP growth of 2 3/4 per cent for 2004 on an average annual basis.

With growth projected to peak at about 4 per cent in the first half of 2005, the Bank expects average growth of 3 3/4 per cent next year. Under this scenario, there would be little change in the amount of excess supply in the economy in 2004, but the economy should move back close to its potential by the third quarter of 2005.

With the persistence of excess supply through 2004, core inflation should average 1 1/2 per cent over the remainder of the year. The past appreciation of the Canadian dollar may also put some modest downward pressure on core inflation through 2004. But as excess supply diminishes, core inflation is projected to move back to 2 per cent by the end of 2005. Total CPI inflation will be heavily influenced by developments in the markets for crude oil.

Projection for Core and Total CPI Inflation
Year-over-year percentage change*

	2004				2005	
	Q1	Q2	Q3	Q4	H1	H2
Core inflation	**1.3** *(1.3)*	**1.4** *(1.6)*	**1.6** *(1.6)*	**1.6** *(1.6)*	**1.7** *(1.7)*	**1.9** *(1.9)*
Total CPI	**0.9** *(0.9)*	**1.7** *(1.5)*	**1.7** *(1.5)*	**1.7** *(1.5)*	**1.6** *(1.4)*	**1.7** *(1.7)*
Assumption for the Price of West Texas Intermediate Crude Oil (US$ per barrel)						
WTI (level)	**35** *(33)*	**33** *(31)*	**32** *(30)*	**32** *(30)*	**32** *(28)*	**30** *(28)*

* Figures in parentheses are from the January *Monetary Policy Report Update*.

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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