Monetary Policy Report

Update

– August 2001 –

This text is a commentary of the Governing Council of the Bank of Canada. It includes information received up to the fixed announcement date on 17 July 2001 and updates the May 2001 Monetary Policy Report.

Overview

The Bank's outlook for inflation and overall economic activity in Canada to the end of 2002 has not changed fundamentally from that presented in the May *Monetary Policy Report*. The pace of economic expansion, after falling below the economy's growth potential in the first half of this year, is expected to begin to strengthen in the third and fourth quarters and to pick up further to slightly above potential growth in 2002.

Most of the factors supporting this outlook continue to be those discussed in the May *Report*—an expected strengthening in U.S. economic growth, substantial progress in adjusting inventory levels in key sectors of the economy, the easing that has taken place in domestic monetary conditions, and tax cuts boosting Canadian disposable incomes.

Since the spring, however, several important factors have changed relative to earlier expectations. In the United States, recently introduced tax cuts (which include rebates beginning in July) are expected to boost household spending and provide an offset to the weakness in capital investment that is now projected to last through year-end. In addition, economic conditions outside North America have weakened

Highlights

- The Bank lowered the overnight interest rate by 25 basis points on 17 July, following a similar cut on 29 May, bringing the target for the overnight rate down to 4.25 per cent.
- The cumulative 150-basis-point reduction in the policy interest rate this year is underpinning domestic economic growth in the face of weak conditions outside North America and uncertainty about the recovery of U.S. business investment spending.
- Economic growth in Canada is projected to pick up in the second half of this year and to make further gains in 2002.
- Core inflation is projected to fall to about 2 per cent in the second half of 2001 and stay close to 2 per cent through 2002.
- Total CPI inflation, which is currently above 3 per cent, is projected to move down to about 2 per cent by the end of 2001.

and the financial difficulties facing several emerging-market economies have intensified. The cumulative effects of policy actions taken in both Canada and the United States since the beginning of the year are working to counter spillover effects from abroad.

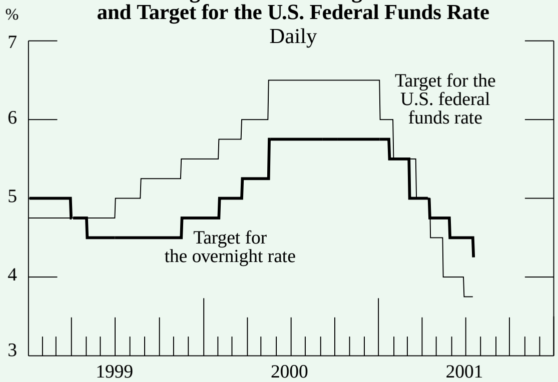
With the slowdown in the first half of 2001 easing pressures on capacity, core inflation is expected to decline to around 2 per cent in the second half of the year. It is then projected to steady out at that rate through 2002 as the pace of economic activity in Canada strengthens. Total CPI inflation is also expected to move down to about 2 per cent by the end of this year. Recent declines in the prices of gasoline, natural gas, and crude oil have reduced the risk that the high energy prices experienced earlier this year could have broader pass-through effects on Canadian consumer prices.

On 29 May, the Bank lowered its target for the overnight rate of interest by 25 basis points, and on 17 July it lowered the target by a further 25 basis points to 4.25 per cent, bringing the cumulative decline since the beginning of the year to 150 basis points (Chart 1). These decisions were judged to be consistent with keeping inflation close to the inflation-control target rate of 2 per cent over the medium term, thereby contributing to sustained economic and employment growth in Canada.

Chart 1

Target for the Overnight Rate and Target for the U.S. Federal Funds Rate

Daily



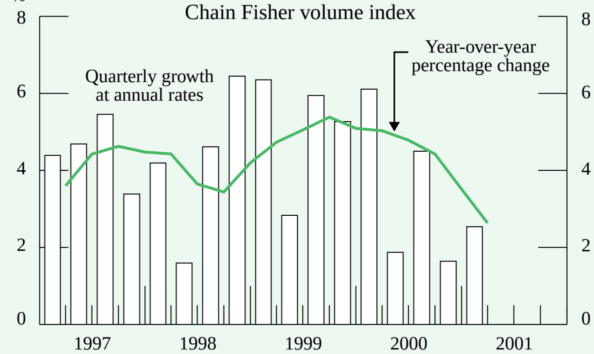
Recent Economic and Financial Developments

Real GDP growth in Canada averaged 2.1 per cent at an annual rate over the fourth quarter of last year and the first quarter of this year, compared with 4.2 per cent over the first three quarters of 2000 (Chart 2).[1] This marked slowdown resulted primarily from reduced U.S. demand for Canadian products, especially automobiles and telecommunications equipment, and from lower Canadian investment in machinery and equipment. Over the same period, activity in the oil and natural gas sector rose strongly, supported by high levels of profitability. In addition, household spending continued to show underlying momentum, sustained by further employment growth and by tax reductions by both the federal and provincial governments.

Chart 2

Real Gross Domestic Product in Canada

Chain Fisher volume index



Based on the latest available indicators, the same trends continued through the second quarter of the year, with GDP growth

1. The real GDP measure published by Statistics Canada is now based on estimates using the chain Fisher volume formula and also includes a change in the treatment of software spending by businesses and governments (see Technical Box 3 in the May *Report*). For more details on the changes to the measurement of real GDP, see Statistics Canada's Web site (www.statcan.ca) and the Bank of Canada's Web site (www.bankofcanada.ca). With these changes and other historical revisions, real GDP in 2000 is now estimated by Statistics Canada to have grown by 4.4 per cent on an annual average basis (instead of the previous estimate of 4.7 per cent, which valued output at 1992 prices).

estimated to have been in a range of 1 to 2 per cent (at an annual rate). While growth in household spending appears to have slowed, it has, nonetheless, remained relatively robust. Exports recovered somewhat, but reductions in inventory investment continued, and capital spending by businesses has remained weak.

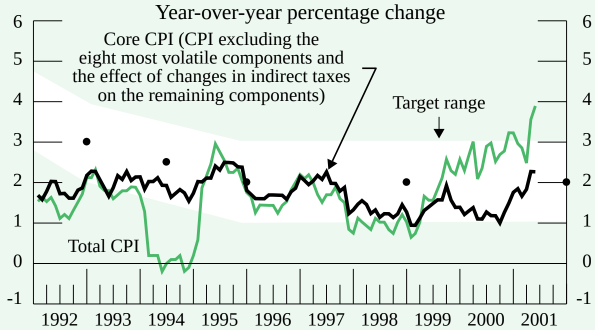
The slowdown in the pace of activity through mid-year has eased pressures on production capacity. It is estimated that the economy moved from a position of excess demand at the turn of the year to one of slight excess supply in the second quarter.

Core inflation was 2.3 per cent in May, up from 1.7 per cent in February and higher than had been expected in the May *Report* (Chart 3).[2] The rise in core inflation was associated with an economy operating at or above capacity at the end of 2000. Core inflation had been held down temporarily early this year as a result of increased price discounting by motor vehicle manufacturers and dealers and by a special provincial government credit program for electricity customers in British Columbia. Other statistical measures of the trend rate of inflation have been broadly in line with the Bank's core measure of inflation (Chart 4).

Chart 3

Consumer Price Index

Year-over-year percentage change



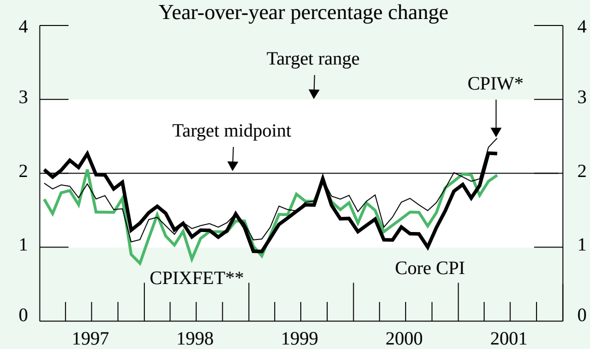
• Midpoint of the inflation-control target range

The 12-month rate of increase in the total CPI was 3.9 per cent in May, well above the rate of about 3 per cent experienced since the autumn of 2000. In addition to the factors affecting core inflation, the rate of increase in the total CPI was boosted by a jump in natural gas prices (resulting from continued tight supplies as well as the termination of an Alberta government assistance program), and by a temporary spike in gasoline prices.

Chart 4

Core CPI and Statistical Measures of the Trend Inflation Rate

Year-over-year percentage change



* CPIW adjusts each CPI basket weight by a factor that is inversely proportional to the component's variability.

** CPIXFET excludes food, energy, and the effect of changes in indirect taxes.

Despite broad-based increases in energy prices over the last two years, the estimated pass-through of higher energy prices to other components of the total CPI has been limited—less than 0.1 per cent over the past year.

In June, prices for gasoline fell back considerably. This is expected to be an important factor in bringing total CPI inflation for June down noticeably from May.[3] Moreover, spot and futures prices for both crude oil and natural gas have also fallen, pointing to lower consumer prices for energy products in coming months. The recent declines in the prices of gasoline, crude oil, and natural gas (Chart 5) reflect a better

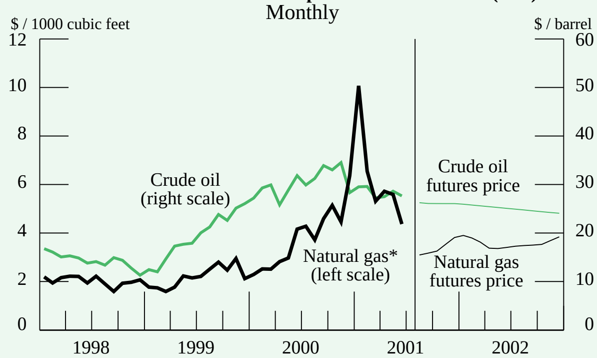
2. The core measure of CPI inflation excludes the eight most volatile components of the CPI, as well as the effect of changes in indirect taxes on the remaining components. The eight most volatile components are fruit, vegetables, gasoline, fuel oil, natural gas, intercity transportation, tobacco, and mortgage-interest costs. Information on the reasons why the Bank of Canada adopted this measure of core inflation is provided in the Bank's May 2001 publication, *Renewal of the Inflation-Control Target—Background Information*.

3. Expectations as of 17 July, prior to the release of the CPI on 20 July.

Chart 5

Crude Oil and Natural Gas: Spot and Futures Prices (US$)

Monthly



* Source: Canadian Enerdata Ltd., *Canadian Gas Price Reporter*

balance between supply and demand as softening demand has allowed stocks to build up again.

Although economic indicators have remained mixed, they have, on balance, been stronger than expected by financial markets and have led to a somewhat more positive sentiment regarding the outlook for the Canadian economy. In particular, concerns about a further substantial deterioration of the U.S. economy have lessened since the May *Report*. As a result, yields on medium-term Canadian bonds have increased since mid-April (Chart 6).

In the context of a slowing global economy, the continuing relative strength of Canada's economic fundamentals has contributed to a rise in the trade-weighted value of the Canadian dollar since early April. This has reflected primarily a rise against major currencies other than the U.S. dollar (Chart 7). More recently, uncertainties associated with developments in some emerging-market economies have led to increased volatility in exchange markets.

Chart 6

Term Structure of Interest Rates in Canada

Yields on treasury bills, government bonds, commercial paper, and corporate bonds

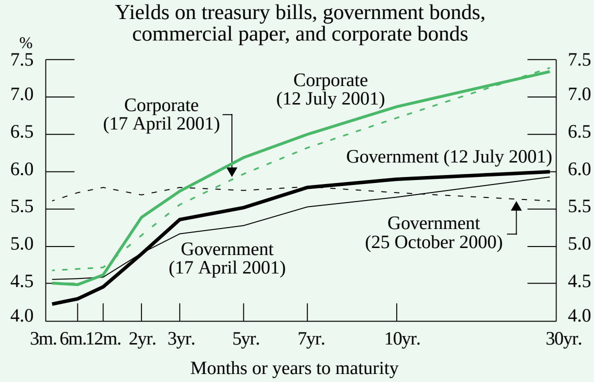
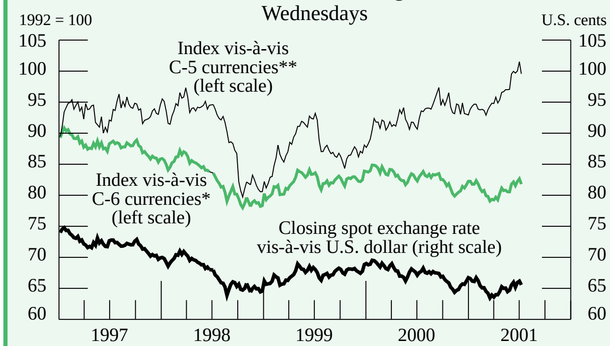


Chart 7

Canadian Dollar Exchange Rate

Wednesdays



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

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

The Outlook

The Bank's outlook for economic growth in Canada in 2001 and 2002 remains very close to that of the May *Report*. Real GDP growth in 2001 is still expected to be in a range between 2 and 3 per cent. Following moderate growth in the first and second quarters, real GDP is expected to rise at an annual rate of between 2.5 and 3.5 per cent in the second half of 2001. In 2002, the pace of Canada's economic expansion will likely be slightly higher than the Bank's estimate for potential output growth of about 3 per cent.

The Bank's outlook for economic growth in Canada in 2001 and 2002 remains very close to that of the May* Report*, with real GDP growth in 2001 still expected to be in a range between 2 and 3 per cent.

The factors that support this outlook continue to include: substantial progress in adjusting inventory levels, a turnaround in business investment (including continued high levels of investment in the energy sector), the easing in domestic monetary conditions, domestic tax cuts, and the expectation of a modest recovery in U.S. economic growth. Employment growth, however, is likely to lag the pickup in activity, and thus job gains are likely to be modest through the summer months.

The U.S. economy is still expected to strengthen in the second half of 2001.

The U.S. economy is still expected to strengthen in the second half of 2001 as a result of the significant declines in interest rates, the impact of announced tax cuts (which include rebates beginning in July), and a reduced rate of inventory liquidation. Although business investment (especially in telecommunications technology) is now expected to remain weak for a longer period than was anticipated at the time of the May *Report*, consumption is projected to be stronger, owing to the introduction of the tax reductions and associated rebates. Together with the slightly stronger-than-anticipated momentum at the beginning of the year (Chart 8), which was bolstered by automobile purchases, these factors should support U.S. economic growth for 2001 in the upper half of the 1 to 2 per cent range indicated in the May *Report*. In 2002, growth is projected to average 2.5 to 3.5 per cent (the same as in the May *Report*).

The outlook for economic growth in the overseas economies has, however, weakened from earlier expectations, in part because of adverse spillover effects from the slowdown in the U.S. economy. Growth in the European economies has softened, while Japan's situation has deteriorated further, reflecting in part the structural problems facing that economy. The near-term outlook for emerging-market economies has also weakened, and uncertainties persist around the situations in Argentina and Turkey.

The outlook for economic growth in the overseas economies has, however, weakened from earlier expectations.

In response to the slowdown in world economic growth, the U.S.-dollar price of non-energy commodities is projected to ease over the remainder of the year (Chart 9). The surge in lumber prices, which boosted the Bank of Canada's index in the second quarter, has partially reversed in response to inventories returning to more normal levels. However, lumber prices are likely to remain volatile.

It is estimated that some slack emerged in the Canadian economy by the second quarter of 2001. This should lead core inflation to decline from 2.3 per cent in May to about 2 per cent in the second half of 2001, in line with long-term inflation expectations. With

Chart 8
U.S. Real Gross Domestic Product

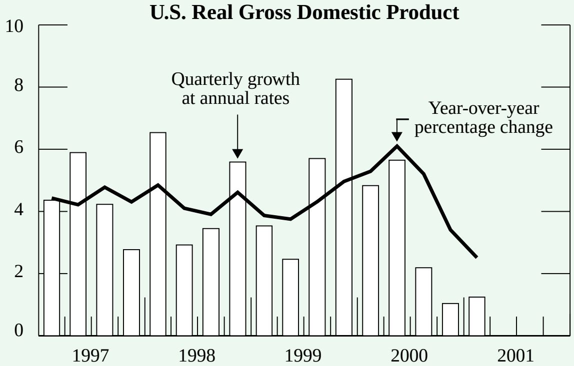
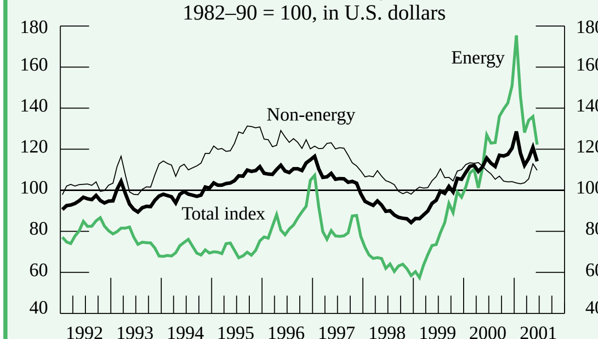


Chart 9
Bank of Canada Commodity Price Index
1982–90 = 100, in U.S. dollars



the economy expected to expand next year at a rate slightly above its growth potential, slack should be eliminated and core inflation should steady out at around 2 per cent through 2002.

Core inflation is expected to decline to about 2 per cent in the second half of 2001 and remain around that level through 2002.

With the prices of many energy commodities down significantly from earlier peaks, the year-to-year rise in consumer energy prices should fall through the autumn. As a result, total CPI inflation should move down to about 2 per cent by the end of 2001.

* * *

Detailed Indicators

In preparing its outlook for inflation, the Bank examined the recent behaviour of the monetary and credit aggregates, as well as other indicators of pressure on inflation and production capacity.

Monetary and Credit Aggregates

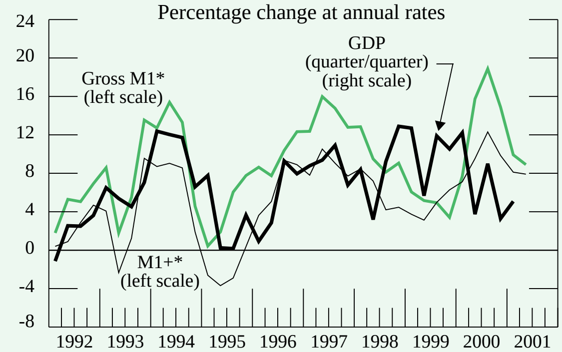
The monetary aggregates continue to suggest a stronger outlook for growth and somewhat higher inflation than the Bank's overall projection. Growth in the narrow aggregates has been greater than expected since February but remains well below the rates experienced at the end of 2000 (Chart 10).

Part of the recent strength in the narrow aggregates likely reflects a temporary increase in the precautionary demand for money. In the face of stock market uncertainty and concerns over future income, firms and individuals may be choosing to hold a higher level of liquid deposits. To the extent that this increase in deposits will be

Chart 10

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

used to purchase savings vehicles once uncertainty is reduced, it should not lead to inflationary pressures.

While money growth has been a little stronger than expected, growth in business credit—particularly short-term credit—was weaker than expected. The slowing partly reflects a tightening in credit conditions for certain sectors, especially telecommunications. Household credit has continued to grow at a moderate pace.

Indicators of Pressure on Inflation and Capacity

Several indicators have been consistent with the view that pressures on production capacity eased in the first half of 2001. The ratio of unfilled orders to shipments in the manufacturing sector (excluding the aerospace industry) has decreased over the past year, and manufacturers' inventories have risen considerably relative to sales. Moreover, while the unemployment rate has risen only slightly since mid-2000, the recent decline in the help-wanted index indicates an easing in the labour market. The Bank's most recent survey of firms also suggests that capacity pressures and labour shortages were less intense than at the end of 2000.

Other indicators, however, suggest that capacity pressures in product and labour markets persisted into the early part of this year. In labour markets, certain areas, notably health services and trades, continued to experience pressures. Based on the average hourly earnings of permanent workers, the underlying rate of increase in labour compensation moved up slightly to a range of 3.5 to 4.0 per cent in the second quarter of 2001 from a range of 3.25 to 3.75 per cent in the second half of 2000 (Chart 11).

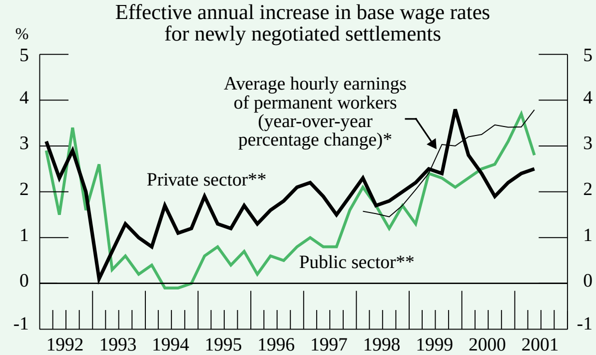
In addition, Statistics Canada's measured rate of capacity utilization for the non-farm, goods-producing sector in the first quarter of 2001 was still well above normal levels, although it had eased since mid-2000. Vacancy rates in the commercial real estate sector were also at very low levels in the first quarter of 2001.

Between the first quarter of 2000 and the first quarter of 2001, output per person-hour in the business sector fell 0.2 per cent, and unit labour costs rose 1.9 per cent (Chart 12). While productivity growth is expected to rise as the economy gains momentum, increases in unit labour costs are likely to remain in the 2 to 3 per cent range over the near term.

Chart 11

Wage Settlements and Average Hourly Earnings

Effective annual increase in base wage rates
for newly negotiated settlements

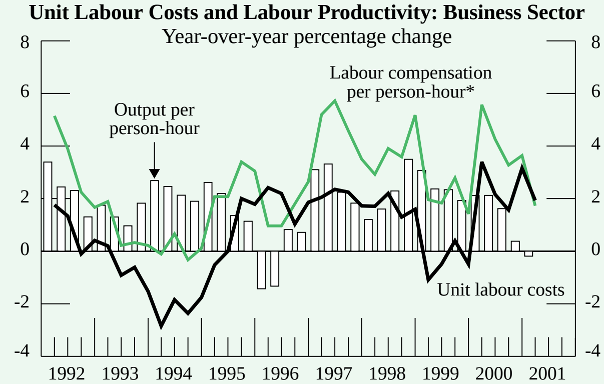


* Source: *Labour Force Information*
** Source: Human Resources Development Canada,
last data point plotted = April 2001

Chart 12

Unit Labour Costs and Labour Productivity: Business Sector

Year-over-year percentage change



* Labour compensation includes the labour income of paid workers,
plus imputed labour income for self-employed workers.
Source: Statistics Canada *Daily*

The Bank of Canada's *Monetary Policy Report* is published semi-annually in May and November. Regular *Updates* are published in August and February. Copies may be obtained from:

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