BANK OF CANADA

FOR IMMEDIATE RELEASE
22 October 2003

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Bank of Canada releases *Monetary Policy Report*

OTTAWA B Since the April *Monetary Policy Report*, the Canadian economy has been hit by a number of unusual shocks: SARS, BSE, the Ontario electricity blackout, and the severe forest fires in British Columbia. Inflation has also fallen faster and further than expected. This drop in core inflation reflected several unforeseen developments. These include a broad-based weakness in the prices of goods, substantial reductions in the prices of tourism-related services because of SARS, and a slightly faster easing of pressures from insurance premiums. The substantial fall in the value of the U.S. dollar added to the weakness in goods prices. The Bank now estimates that there is more slack in the economy than was projected in April.

The prospects for near-term growth in the global economy have improved since April, and geopolitical uncertainty has continued to decrease. The near-term outlook for the U.S. economy is much improved. The economy in the euro area is still weak, but prospects for Asia look bright, led by China and India. The Japanese economy is performing better than anticipated.

The Bank expects growth in the Canadian economy to strengthen during the fourth quarter and through 2004. On balance, the expansion should be above the rate of potential growth, relying primarily on solid household spending and increased business investment. Stronger growth abroad should boost foreign demand for Canadian products, but this will be dampened by the higher value of the Canadian dollar. Growth is expected to average a little over 3 per cent in the second half of 2003 and 3 ¼ per cent in 2004. With growth above potential, the slack in the economy should be absorbed by early 2005.

The Bank expects core inflation to average just over 1.5 per cent for the rest of 2003, and to fall to just above 1 per cent in early 2004, as the effects of earlier increases in insurance premiums dissipate. Core inflation should return to 2 per cent by mid-2005, as economic slack is taken up. Total CPI inflation will continue to be importantly affected by swings in the price of crude oil. If prices ease to US$27 per barrel next year, total CPI inflation would likely fall below core inflation in 2004.

However, there are significant risks to this outlook. These risks relate to the timing and magnitude of global demand, price, and exchange rate adjustments to economic imbalances. In particular, there is uncertainty both about the likely changes in key global exchange rates and their effect on the Canadian economy. There is also uncertainty about the sustainability of U.S. growth beyond mid-2004.

We continue to assess the implications of all these developments—both past and future—for output and inflation in Canada, and what this means for monetary policy.