BANK OF CANADA

MONETARY POLICY REPORT

– April 2002 –

Summary

Overview

Canada's economic outlook has improved significantly since the November *Monetary Policy Report*. At that time, the uncertainties surrounding the global economic slowdown and the possible consequences of the September terrorist attacks dominated the outlook. But economic and geopolitical uncertainties have since diminished amid evidence that a robust recovery is underway in Canada. In fact, the optimistic scenario laid out last autumn—a rapid recovery of consumer confidence leading to early, strong growth—appears to have materialized.

In light of this, the Bank began to reduce the substantial amount of monetary stimulus in the economy, raising the target for the overnight rate of interest by 25 basis points to 2.25 per cent on 16 April.

Nonetheless, important risks and uncertainties remain. Household spending could be stronger than projected because of the monetary stimulus in place. But spending could also be weaker than anticipated if a greater-than-assumed share of the recent strength in spending was, in fact, borrowed from future expenditures. There is continuing uncertainty about the timing and strength of the recovery in business fixed investment. And there is increased uncertainty about how recent political developments in the Middle East could affect crude oil prices and the global economy.

Highlights

- **The outlook for the Canadian economy has improved significantly in the past several months, owing partly to the substantial amount of monetary stimulus provided during the past year.**
- **On 16 April, the Bank raised its target for the overnight rate of interest by 25 basis points to 2.25 per cent.**
- **Average annual growth for 2002 is expected to be in a range of 2 1/4 to 3 1/4 per cent, rising to between 3 and 4 per cent in 2003.**
- **The Bank projects that the level of production in the economy will return to full capacity in the second half of 2003. Inflation should be at the 2 per cent target by about the end of 2003. But there are risks to this projection, in both directions, from economic and political sources.**
- **As the economy approaches its capacity, the task for monetary policy is to gauge economic strength and the implications for future inflation. This means reducing the substantial amount of stimulus in place in a timely and measured manner.**

Recent Economic and Financial Developments

After contracting slightly in the third quarter of last year, the Canadian economy grew at an annualized rate of 2 per cent in the fourth quarter. Current estimates place real GDP growth in the first quarter of 2002 at an annualized rate of about 4 1/2 per cent. These figures are markedly stronger than the projections in the November *Report* and the January *Update*.

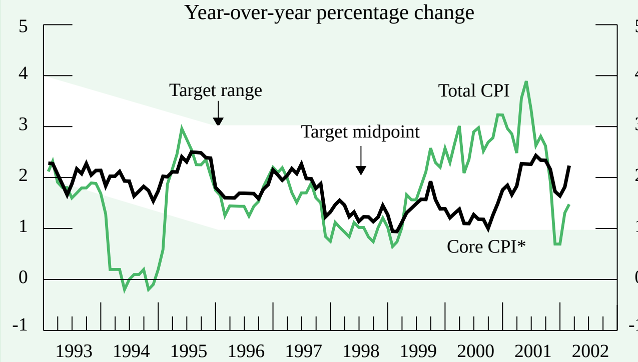
Several factors led to this outcome. The Bank eased monetary policy substantially during the year, which helped support domestic demand, particularly in the housing and automotive sectors. From January 2001 through January 2002, the Bank lowered its target for the overnight interest rate ten times, by a total of 375 basis points. The tax cuts implemented at the start of 2001, as well as spending on security after last September's terrorist attacks, also helped to boost consumer confidence. Motor vehicle dealers offered financing incentives, which stimulated consumer spending. And, with the U.S. economy recovering more quickly than expected, Canada's exports have been stronger than forecast.

With the slowdown last year, the economy moved into a position of excess supply. But with unexpectedly strong growth in the fourth quarter, the output gap is smaller than was anticipated in the November *Report*.

The Bank's conventional estimate suggests that the degree of economic slack was about 1 per cent of GDP at the end of 2001. After considering all indicators, the Bank's judgment is that the amount of slack was somewhat greater than this estimate would suggest. But with the economy expanding strongly in the first quarter of 2002, the amount of slack has begun to diminish.

Consumer Price Index

Year-over-year percentage change



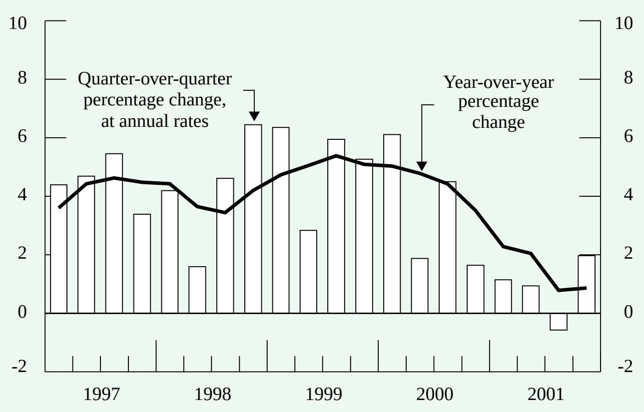
* CPI excluding the eight most volatile components and the effect of changes in indirect taxes on the remaining components

Core inflation fell below 2 per cent at the end of 2001. But at 2.2 per cent in February, it was somewhat higher than expected. Part of this surprise was the result of a change in the timing of some seasonal price increases and so should be reversed soon. The depreciation of the Canadian dollar over the past two years also had some effect on food prices. Total consumer price index (CPI) inflation moved down more sharply than core inflation at the end of last year, and remained below core inflation in early 2002, mainly because of last year's sizable decline in world oil and natural gas prices.

Prospects for Growth

With substantial monetary stimulus currently in place, household spending should continue to contribute to economic growth. Increasing exports and the reduced need for businesses to cut inventories should also act as supports, as will progressively smaller declines in business investment. Strong employment gains during the first quarter should lead to disposable income growth and underpin consumption. All told, growth in the first half of 2002 is expected to average between 3 1/2 and 4 1/2 per cent on an annualized basis.

Gross Domestic Product in Constant Dollars for Canada



The Bank expects that the economy will expand in the second half in a range of 3 to 4 per cent, above the rate of growth of potential output—estimated at about 3 per cent annually. Favourable developments thus far in the first half have raised business confidence and should lead to increased investment. Overall, the Bank projects average annual growth in 2002 of between 2 1/4 and 3 1/4 per cent, rising to between 3 and 4 per cent in 2003.

Also supporting the Canadian economy will be strengthening demand in the United States. U.S. economic growth is expected to be close to 4 per cent in the first half of this year, significantly stronger than projected in the November *Report*. Growth in the second half is projected to slow to 3 1/4 per cent. For the full year, the Bank expects average annual growth of about 2 1/2 per cent, up from the 1 per cent expected in the November *Report*. U.S. growth in 2003 is expected to be about 3 1/2 per cent.

The major European economies should see growth of close to 1 1/4 per cent on an average annual basis this year. This should reach 3 per cent in 2003 as the recovery gains momentum. Although continuing structural problems will likely cause the Japanese economy to shrink by about 1 1/2 per cent this year, growth should rebound to about 1 per cent in 2003, thanks to the U.S. recovery and easier monetary conditions. A number of emerging-market economies are also showing important signs of recovery.

The Outlook for Inflation

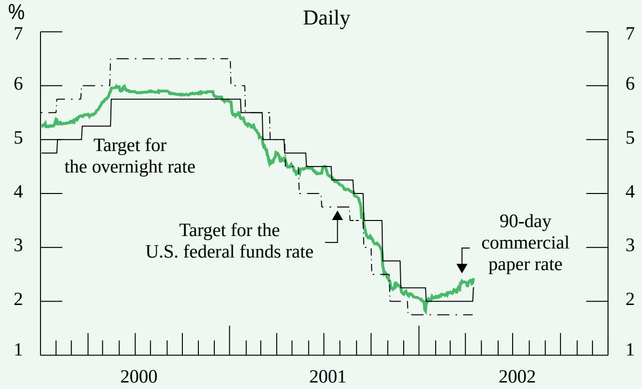
Overall, the Bank expects core inflation to average just under 2 per cent in the second half of this year and the first half of 2003, before moving back to the 2 per cent target midpoint of the Bank's inflation-control range by about the end of next year.

A modest amount of excess supply in the Canadian economy will put some downward pressure on core inflation throughout 2002 and in the first half of 2003. However, the unexpectedly strong growth of the past two quarters means that the output gap is smaller than previously thought and is currently narrowing. Thus, the excess supply in the economy will likely be eliminated in the second half of 2003—earlier than previously projected.

Other factors could put some modest upward pressure on core inflation in the period ahead. The depreciation of the Canadian dollar over the past two years could raise some prices, as could the effects of higher insurance and other security costs following last September's terrorist attacks.

Swings in oil and gas prices will continue to have a major impact on total CPI inflation. Recent political developments in the Middle East have created additional uncertainty about prices over the near term. If crude oil prices continue to average between US$22 and US$26 per barrel, total CPI inflation should stay below the core rate through mid-year. The Bank is projecting that total CPI inflation, like

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



core inflation, will be at 2 per cent by about the end of 2003.

Conclusions

With robust growth resuming in North America, the level of production in the Canadian economy should return to full capacity in the second half of 2003, and inflation will be at the Bank's 2 per cent target by about the end of 2003.

There are risks to this outlook. Given the amount of monetary stimulus in place, growth could be even stronger than projected. But it is also possible that household spending may be weaker than expected, if more of the recent spending than assumed was borrowed from future expenditures. Uncertainty still surrounds the timing and strength of the pickup in business investment and exports, mainly because of the fragility of global business confidence. And while geopolitical risks to the world economic outlook have declined since September, recent political developments in the Middle East could continue to affect crude oil prices, with possible repercussions for the global economy.

Given this background and the risks in both directions, the task for monetary policy will be to gauge the strength of the economy as it approaches its capacity to produce, and the implications for future inflation. This means reducing, in a timely and measured manner, the substantial amount of monetary stimulus now in place. The aim is to keep inflation close to the Bank's 2 per cent target, thereby helping to sustain economic growth at full capacity over the medium term.

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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