The Bank of Canada Is Cautiously Optimistic

True to form at this time of year, the Bank of Canada today released its semi-annual monetary policy report.

**Highlights**

- The Bank of Canada has revised its economic growth forecast downward, bringing it more in line with the vision shared by most forecasters. As such, the Canadian economy should grow at an annualized rate of approximately 2.5% in the third quarter of 2003. Then, it should strengthen during the fourth quarter and through 2004 and exceed the rate of potential growth (estimated at approximately 3%). According to the Bank of Canada, the Canadian economy will grow 2% on average in 2003 and 3.25% in 2004.
- The Canadian economy should therefore gradually take up the slack in production capacity over the next few quarters. As a result, our economy could be operating at full capacity by early 2005.
- Inflation has fallen faster and further than projected in the Bank of Canada’s April report. This surprising and marked drop reflects several unforeseen developments such as broad-based weakness in the price of durable and semi-durable goods, the fallout of SARS and mad cow disease, a slightly faster reduction in the effect of one-off factors (including insurance premiums) and the impact of the sharp appreciation of the Canadian dollar.
- The slack in the economy will be a source of some downward pressure on inflation over the next few months. As well, the strong appreciation of the Canadian dollar during the past year should continue to put downward pressure on prices. However, the recent discounting in certain sectors should moderate over the coming months. As such, the Bank of Canada’s core inflation rate (CPIX), currently at 1.7%, could fall to just above 1% in early 2004. Then, the gradual take-up of economic slack and the reduction in certain one-off factors should bring the core rate of inflation back to 2% by mid-2005.
- A number of major risks are looming over this recovery scenario and could well affect the Bank of Canada’s future decisions. Among others, certain global imbalances are creating uncertainty in global demand, international prices and foreign exchange rates (including the value of the Canadian dollar vis-à-vis the U.S. greenback). As well, there is still some question as to whether the U.S. economic recovery can be sustained beyond the first half of 2004.

**Conclusion**

Lastly, Canadian monetary authorities do not appear overly concerned about the recent appreciation of the Canadian dollar. While their economic growth outlook is certainly based on the downturn in the foreign sector, solid domestic demand, including strong household consumption and a significant increase in corporate investments, should minimize the damage, and above all, maintain Canadian economic growth at over 3%. Under these circumstances, it is safe to assume that Canadian key policy rates will remain unchanged until the second half of 2004.

Clearly, today’s report says little about the past and especially the future of the Canadian dollar. It bears remembering that the Bank of Canada does not really have a target for the value of our currency. Indeed, Canadian monetary policy is exercised according to inflation, which must remain within a target range.

It is important to understand that the appreciation of our currency is inevitable and stems primarily from the weakness of the U.S. dollar. The Bank of Canada has few means at its disposal to deal with such a global trend. It can therefore only hope that the loony does not rise too sharply, necessitating a revision of its inflation and economic growth outlook.

Moreover, if our dollar should rise to between US$77.5 and US$80.0 for an extended period of time (i.e., a level that adversely affects our foreign sector), the Bank of Canada could be forced to reduce its key policy rates to relax monetary conditions in the country. But the monetary policy authorities would no doubt want to wait and see the adverse effects on the economy before reacting, which brings us to early 2004 before such a decision could be contemplated.