BANK OF CANADA

Opening Statement by
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Banking, Trade and Commerce
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I welcome this opportunity to meet with you to discuss macroeconomic policy. I would like to start by reviewing the objective of monetary policy and our inflation-control targets. I will also talk briefly about the Bank's views on current economic developments and prospects for the Canadian economy.

The objective to which monetary policy will continue to be directed over time is to achieve and maintain price stability. This objective was reaffirmed in the joint statement issued by the government and the Bank of Canada at the time of my appointment in December, a statement to which I attach great importance. Let me quote from that statement. "High levels of economic growth and employment on a sustained basis are the primary objectives of monetary and fiscal policies. The best contribution that monetary policy can make to these objectives is to preserve confidence in the value of money by achieving and maintaining price stability."

As you will recall, in 1991 the government and the Bank laid out a path for inflation reduction. The December statement begins from that path and extends the target band of 1 to 3 per cent (which is to be achieved by the end of 1995) for three more years, out to the end of 1998. By 1998 a decision will be made as to the rate of change in the consumer price index (CPI) that would be consistent with price stability. As was the case in 1991, the targets continue to be expressed as bands rather than a specific inflation rate because it is impossible to control inflation precisely.

I would now like to spend a moment on the way in which the Bank will react to movements in the CPI. How we react will depend on whether or not a change in measured inflation is associated with a shift in the momentum, or underlying trend, of inflation.

If momentum develops which is likely to result in a trend rate of inflation outside the target bands, the Bank will take timely action. For example, suppose that strong spending pressures were accumulating and were likely to push inflation through the top of the band. Because it takes time for monetary policy to have its effects, the Bank would have to take actions to contain the pressures before inflation had gone through the top of the band. Similarly, the Bank would respond if it appeared that momentum were developing to push the underlying rate of inflation through the bottom of the band.

However, not every movement in the consumer price index represents a change in underlying inflation. For example, changes in indirect taxes can push the consumer price index up or down without necessarily generating further cost and price responses. That is, tax changes can have first-round effects on the price level, without having ongoing effects on the process of inflation. As long as such changes do not result in a shift in the momentum of inflation, the Bank does not need to respond to them, either on the upside or on the downside.

In line with this approach, let me be explicit about the Bank's response to the recent reductions in tobacco taxes. These tax changes caused a decline in the level of the consumer price index in February and will lead to a rate of change in the CPI (for the current month compared to the same month a year ago) that will be very low for some months. But this change in the CPI will not be a good indicator of the underlying rate of inflation. A year from now, the effects of the tax cuts will drop out of the measured rate of change in the CPI. The cuts will not have a more lasting impact on the CPI unless they change expectations of inflation in the future and result in second-round effects on prices and costs. Only if the tax cuts have such effects will the Bank need to take offsetting monetary policy actions. In assessing what is happening to the underlying rate of inflation, the Bank will monitor closely changes in the consumer price index excluding the volatile food and energy components and excluding the estimated effect of indirect taxes.

Accommodating the initial effect on the price level of a tax change but not any ongoing inflation effects was the approach set out with the February 1991 inflation-reduction targets and reiterated in the December 1993 agreement.

I would like to turn now to recent economic developments.

The recovery from the 1990-91 recession has been slower than typical of past recoveries. A number of factors have been limiting demand and growth. We are still dealing with some of the after-effects of the inflationary distortions that developed during the boom of the late 1980s. As well, commodity prices have been low and external markets have for the most part been weak. In addition, increasing international competition and changes in technology have led to widespread industrial restructuring in Canada to improve productivity and to lower costs. This has meant that employment has not kept pace with production. And the resulting uncertainty about employment prospects has dampened consumer confidence and restrained household spending.

More recently, our economic situation has become more favourable. The economic expansion in the United States has been developing a good head of steam. More fundamentally, the industrial restructuring has been successful in raising productivity and our performance in controlling cost and price inflation has greatly improved.

The 12-month increase in the consumer price index in February, excluding food and energy and adjusted for tax changes, was 1.9 per cent. And current trends suggest that the underlying rate of inflation is likely to remain in the lower part of our target band in the near future. And along with lower inflation has come an improvement in expectations of future inflation.

We are already seeing the benefits of lower inflation and inflation expectations. Interest rates, despite some recent backup, are near their lowest levels in many years. For households, the decline in interest rates has greatly eased the burden of servicing what is still a large debt load. Lower interest rates have also made housing more affordable than it has been for years.

The decline in interest rates has also facilitated investment in machinery and equipment by businesses as part of the ongoing process of restructuring to improve productivity and competitiveness. Moreover, with low inflation, firms have been keeping their costs under firmer control. In fact with recent productivity increases, unit labour costs have actually fallen. This good cost performance has helped Canadian firms to take advantage of the depreciation of the Canadian dollar to improve their ability to compete both at home and abroad. One result has been a strong export performance.

The recent favourable developments in inflation, interest rates, cost control, productivity and international competitiveness have not yet been reflected in growth and employment to the extent we would have liked to see. However, the signs are that strong foundations are being laid for a sustainable expansion of our economy.

In conclusion I would like to say a word about recent events in financial markets. International financial markets have been volatile and interest rates have risen, particularly for longer maturities. As a result of these pressures and some uncertainties about future developments in Canada, markets here have also undergone some sharp movements. Since early February, the Canadian dollar has declined while both money market interest rates and yields in the bond market have risen. As in similar circumstances in the past, Bank of Canada actions have been directed to helping markets find trading ranges where borrowers and lenders feel there is good value in Canadian financial assets. However, I believe it is also important to focus on the fundamental economic situation, for that is what will determine the value of those assets over longer periods. As I have already said, those fundamentals are good: low inflation, a monetary policy committed to price stability and an economy with rising productivity and improving competitiveness. These should provide a firm base of support for investor confidence into the future.