BANK OF CANADA

Opening Statement by
Gordon G. Thiessen
Governor of the Bank of Canada
before the Standing Senate Committee on
Banking, Trade and Commerce
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I am pleased to appear before you again this year to explain the Bank of Canada's monetary policy and to give you our assessment of current economic and financial conditions. The release of our annual report provides a good occasion to present an account of our management of monetary policy.

Let me begin with our monetary policy objectives. The agreement between the Government of Canada and the Bank of Canada is to hold inflation within a target range of 1 to 3 per cent from the end of 1995 through to the end of 1998. By then, the Government and the Bank are committed to decide on a future target range that will be consistent with price stability.

I cannot emphasize too often that price stability is a means to an end, not an end in itself. Price stability is the appropriate objective for monetary policy because it contributes to a more productive and more stable Canadian economy.

As we point out in the report, the Bank has again met its inflation-control target. And following four years of good inflation performance, Canada is establishing a reputation as a low-inflation country. I believe that this reputation has been helpful as we have coped with fluctuations in international financial markets, concerns about the budgetary situation in Canada and uncertainty surrounding the Quebec referendum campaign.

In judging inflation performance, it is important to focus on the underlying trend rather than the month-to-month fluctuations in the Consumer Price Index (CPI). We use the year-over-year change in the CPI, excluding the volatile food and energy components and indirect tax effects, as an indicator of the trend. This measure of inflation declined through the second half of 1995 and, at 1.6 per cent, is now in the lower half of our target range.

The inflation-control targets for monetary policy operate as a built-in stabilizer for the economy. When the economy is expanding at an unsustainable pace that will lead to price pressures which are likely to push inflation through the upper limit of our range, the Bank will act to tighten monetary conditions in order to slow the pace of economic activity and ease price pressures. Similarly, a weak economy that implies a downward trend of inflation, with the risk of going below the lower limit of our range, will lead the Bank to ease monetary conditions in order to stimulate economic activity. In line with this approach, the Bank has been acting since the autumn to lower short-term interest rates in Canada. Our most recent action took place last week when we lowered our Bank Rate and our operating band for the overnight rate by 1/4 of a percentage point.

The Canadian economy struggled through much of 1995 as the U.S. economy slowed and Canadians had to cope with the sharp rise in interest rates early in the year following the Mexican currency crisis and market nervousness about the Canadian fiscal situation. Prospects for 1996 look more promising. The U.S. economy appears to be on a sustainable, low-inflation growth path, and easier monetary conditions in Canada are providing substantial support for economic activity.

However, economic confidence among Canadian households remains weak. The recent rise in mortgage rates will not have helped. That rise reflected pressures on our bond yields coming from U.S. financial markets, following some strong economic data in that country. External shocks like that are bound to hit us from time to time. This time, however, the response in Canada was more muted than we have seen in the recent past -- the Canadian dollar remained firm, differentials between longer-term U.S. and Canadian bond yields tended to narrow, and money market conditions stayed favourable for the move by the Bank of Canada to lower short-term rates.

I believe that the improvement in our fiscal situation over the last couple of years and our low inflation record are important factors contributing to this greater market stability. I hope we will see a further narrowing of medium and long-term interest rate spreads through the year.

The Canadian export sector has performed well and should continue to do so. This is reflected in the encouraging recent increases in employment. Better employment prospects and more stable financial markets should together be helpful for household confidence and for a recovery in the housing market and in consumer spending during the coming year.

I should also draw your attention to the information in the annual report on the Bank's other activities. Like many other public sector institutions, the Bank has undertaken a major reassessment of its operations and is implementing initiatives aimed at improving the effectiveness of its operations and lowering costs.