# David Dodge: Trust, transparency and financial markets

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Greater Halifax Partnership, Halifax, Nova Scotia, 11 June 2002.

*   *   *

Thank you for the invitation to speak to you today. It is a pleasure to come to Halifax and see the exciting things happening in this city and this province. I'd like to congratulate the Greater Halifax Partnership for its role in community development. You have been recognized for your outstanding work in community economic growth, and your innovative approach makes this partnership a model for private and public sector co-operation.

### Financial market efficiency

My remarks today will concentrate on two themes. Later on, I want to talk a bit about the Bank of Canada's view of the economy.

But first, I would like to address an important subject; that is, how to promote the efficient operation of Canada's financial markets. Rather than approaching this topic in a detailed, technical way, I want to speak about two qualities that are essential to their efficient operation: trust and transparency.

Let me take a few minutes to describe why these qualities are important to the Bank. I think this can provide a good illustration as to why these same qualities are equally important for the private sector, particularly in light of Enron, and related questions about corporate practices.

I will start with a quick definition of what I mean by trust. It's a term that's closely related to two other very important words: confidence and credibility. Trust, as I will use the term today, is more than a simple belief in something or someone without supporting evidence. Trust is what develops when a group of people share an understanding that the rules for behaviour governing their system or society work well and make things better for everyone. With trust, less effort is expended in keeping tabs on others, so systems can run more efficiently. With trust, people can develop confidence that others will, in fact, do what they say they will do. And over time, as trust builds, so does the credibility of those who are trustworthy.

I can tell you from our own experience that trust is an important enabler for all of the Bank of Canada's key functions. And nowhere is this more true or more relevant than in the conduct of monetary policy. We have worked hard over the past decade or so to build up trust in our policy of explicit inflation targets. And this effort has been bolstered by our moves towards greater transparency.

### The economic benefits of establishing trust

During the 1970s and 1980s, the Bank of Canada had ample experience with operating in an environment where Canadians had significantly less confidence in the Bank's ability to safeguard the domestic value of the currency. Inflation was choppy and unpredictable, and the Bank of Canada was struggling to come up with an appropriate anchor for monetary policy. However, in recent years, Canadians have gained confidence that we will keep inflation low, stable, and predictable, thanks to our system of explicit inflation targets and our success in meeting them. This trust can be thought of as a kind of social capital—a shared asset that benefits everyone, including the central bank. This capital is very valuable and must not be squandered.

What does this have to do with efficiency? Quite a bit. If you think back to the 1970s and 1980s, people spent a great deal of time and effort trying to hedge against inflation. Resources that should have been put to more productive uses were spent devising ways to protect the value of savings.

Then, in 1991, the Government of Canada and the Bank agreed on a system of explicit inflation-control targets. As you may know, under the current agreement our target is the 2 per cent midpoint of a 1 to 3 per cent band for the total consumer price index. Since we adopted this inflation-control system we have been consistently successful in meeting the target. As a result, inflation expectations have fallen in line with the target and are now well anchored, not just for the near term, but well into the future.

With this trust in place, this social capital earned, the list of economic benefits for Canada is long indeed. Less time, energy, and money is being spent on protecting oneself against inflation. Labour and financial contracts have lengthened, while the amount of time lost to strikes and lockouts has dropped.

What is more, the dynamics of the inflation process have been changed, to the point that inflation itself has become much more stable and predictable. Inflation expectations are less vulnerable to swings in the external value of the Canadian dollar, and to changes in key energy prices.

All this allows the Bank to conduct monetary policy more easily. And it allows financial markets and businesses to operate more efficiently.

Of course, the economy has also undergone a number of other necessary changes, including a massive restructuring of the private sector and a restoration of fiscal health. Together, these changes have led to better economic performance.

**Transparency supports the system**

Before I move on, I want to say a few words about transparency. Like many other major central banks, we have embraced the notion that it is better for the conduct of monetary policy if people can understand what their central bank is thinking and why.

The Bank of Canada has dramatically increased the number of opportunities for updating Canadians on the economic outlook. We use our four Monetary Policy Reports and Updates, as well our eight fixed announcement dates each year, to share our thinking on the economy. We want Canadians to have a good grasp of what our goals are and of the framework we use to achieve those goals.

Our explicit inflation target gives Canadians a yardstick for measuring how their central bank is doing. In our view, the less flexible the yardstick, the better. It is one thing to have a goal of "low inflation" or "price stability." But the Bank and the Government of Canada agree that it is much more effective to have an explicit target for inflation so people know if we are meeting our commitment. So the result of all this effort at increased transparency is to give people a clear yardstick they can use to measure performance.

All of this enhances the Bank's accountability and reinforces the trust we have fostered through inflation targeting. After all, it's a lot easier to have trust in an institution if it is open about its goals and strategies, and if it offers a clear way to measure its performance.

**Trust and the private sector**

This is relevant not just to central banks but to the entire business and financial community. Trustworthy business standards are one of the most important forms of social capital. Trust is paramount to the efficient operation of financial markets. And financial markets are a key ingredient of a well-functioning economy.

This trust includes confidence in the players involved—the people who run the companies, and those who watch them. It also includes trust that the information required to make sound investment decisions is disclosed fully and accurately. Moreover, the disclosure must be fair—there must be confidence that insiders are not trading on information not available to everyone. Only when all these components of trust are in place can we have healthy, efficient financial markets that benefit everybody.

Generally speaking, these components are in place in Canada. But the Enron collapse in the United States reminds us here that we cannot be complacent about our own situation.

So what is lost when something like Enron occurs? Skepticism sets in about the truthfulness of routine financial disclosures. Companies find it more expensive to raise funds because once trust is broken, fewer investors are willing to participate, and those who remain demand a premium for the increased risk of being misled. A lack of reliable information also leads investors to make poor investment decisions, so capital is misallocated. In short, financial markets operate less efficiently, with fewer benefits for everyone.

Avoiding a widespread loss of trust requires a systematic and coordinated effort to fix the flaws and weaknesses that can undermine investor confidence.

It is important that there be a set of reasonable rules—so that chief executives, boards, and their auditors truly and fairly disclose the financial position of public companies—and that the investing public can rely on the truth, fairness, and completeness of that disclosure.

Now, in spite of the specific flaws that the Enron collapse has revealed, it has become clear that much of the public's confidence in the efficient operation of financial markets remains intact. But we must continue to be vigilant.

**Restoring confidence**

Financial statements form the foundation on which financial markets operate. I have already spoken of the way that a clear yardstick has helped the Bank improve its transparency. The same idea holds true for financial statements. Clear and accurate corporate reporting, together with other reliable information for investors, are essential. Equally importantly, information must be presented in a straightforward manner. Earnings reports should be used to disclose information, not bury it. We can't pretend that hundreds of complicated pages lead to the type of disclosure that facilitates efficiency.

Next, confidence must be constantly earned by corporate managers and directors, auditors, analysts and investment advisors, rating agencies and regulators. Reputations have been threatened by events like Enron, and by the suspicion that some insiders have been feathering their nests at the expense of shareholders. Obviously, it is wrong for analysts who actively own shares in a firm to use their assessments to promote that firm. But there can be more subtle conflicts of interest that don't involve illegal or fraudulent activity—for example, auditors who are not truly independent of the companies they audit.

Risk assessment is another issue that needs more attention, particularly by companies outside the financial sector. This involves more than just listing in a financial filing all the things that could go wrong. Companies need to tell investors how they are handling both the external risks that they face and the risks they have chosen to take on as part of their business strategy. After all, investors are required to sign a form that tells their broker about their risk tolerance before they buy a stock. Surely then, the company issuing that stock should be able to give those investors some honest disclosure of their assessment of the risks involved in that investment.

The fallout from Enron has prompted debate about the need for tougher financial market rules. If it is determined that new rules need to be written, they must not be picayune regulations that simply give the unscrupulous a roadmap to evade the spirit of the rules. It is the observance of the spirit as well as the letter of the regulations that we all must aspire to achieve.

And when unscrupulous market participants or practices are revealed, authorities must come down on them with full force. To do otherwise is to do markets a disservice. Only strict reprobation will restore and maintain confidence that the rules are being enforced.

Regulatory and supervisory bodies around the globe have begun to deal with the fallout from Enron and other high-profile bankruptcies. In the United States, the Financial Accounting Standards Board is looking at proposals to determine when so-called "special-purpose entities" should be consolidated on company balance sheets. The Securities and Exchange Commission has proposed new rules for more detailed and timely corporate disclosure.

Here at home, the Canadian Institute of Chartered Accountants (CICA) has asked its Accounting Standards Oversight Council to closely monitor the accounting and financial reporting issues raised by Enron. The CICA is also looking at ways to boost auditor independence. I am also aware that the accounting profession and its regulators are working to develop an oversight body to promote high-quality audits of public companies. The Toronto Stock Exchange has made changes to its guidelines for effective corporate governance. Parliamentary committees such as the Senate Banking, Trade and Commerce Committee have also launched their own investigations into the Canadian market post-Enron.

**The market is responding**

We have seen much self-evaluation by market participants in recent months. I am very encouraged by how seriously these issues are being taken. The market is enforcing its own discipline. Corporate boards are re-examining their roles and taking a closer look at what is being done in their companies.

Investors are demanding greater reconciliation between pro forma financial statements and generally accepted accounting principles.

Major firms, in response to those demands, are changing their corporate reporting methods. For example, some firms have announced plans to include, as an expense, the cost of executive stock options. And Standard and Poor's has introduced new benchmarks for reporting corporate earnings. Those changes aim to more accurately describe the revenues and costs associated with companies' primary businesses.

We feel steps like these are helpful in advancing the debate about the most fair and accurate methods for reporting a company's true financial state. These are all positive examples of participants working together to enforce the spirit—not just the letter—of the rules under which financial markets operate.

In the end, everyone needs to have trust in the financial markets—to know that the right rules are in place and that those rules are being enforced. We must continue to build on that social capital, to promote the efficient operation of financial markets, and the benefits that those markets can bring to everyone in society.

**The current outlook for the economy**

Now, I would like to say a few words on the Nova Scotia economy. Like the rest of Canada, Nova Scotia's economy has proven to be stronger than expected over the past year. Indeed, Statistics Canada reported last week that the province's employment rate has returned to an all-time high in May. Nova Scotia was buoyed by strong offshore oil and gas production last year. The study commissioned by the Greater Halifax Partnership paints an exciting picture of the future impact of offshore development.

The province has also been making important strides in building other sectors to diversify its economy, and this bodes well for the future. We've seen tremendous expansion in the information technology and life sciences sectors. That includes commercializing some of the excellent research being done at Nova Scotia universities and fostering technology companies to capitalize on the province's telecommunications infrastructure.

Turning to the outlook for Canada as a whole, the economy has been growing robustly—expanding at an annual rate of 6 per cent in the first quarter—well above expectations. And this has been reflected in the extraordinary number of jobs created since the beginning of the year. Employment has grown by almost a quarter of a million jobs in the past five months.

Canada is demonstrating clear economic momentum. Consumer spending, particularly on interest-sensitive items, continues to show strength. Business investment is no longer acting as a drag on growth, and there are signs of the beginnings of a recovery in investment in machinery and equipment. Corporate profits are rebounding, which should continue to support business investment.

While this domestic performance bodes well, geopolitical uncertainties and weaker profits among large multinational firms may inhibit a strong rebound in investment around the world for a period of time.

Let me sum up. Canada's economy is growing at a faster pace, and is operating at a higher level, than had been anticipated. And this means that it is moving towards full production capacity more quickly than we had expected. Core inflation has also been running slightly higher than we anticipated, at 2.2 per cent in April.

Against this backdrop, last week, the Bank raised its target for the overnight rate by 25 basis points to 2.50 per cent. This was the second increase in the target rate, aimed at withdrawing some of the substantial amount of monetary stimulus in the economy. With the domestic economy showing strong momentum, the Bank will take whatever action is necessary to keep inflation near its 2 per cent target over the medium term. And that is the best contribution the Bank of Canada can make to promoting a strong, sustainable economy for all of Canada.