David Dodge: Fostering confidence

Speech by Mr David Dodge, Governor of the Bank of Canada, to the Vancouver Board of Trade, Vancouver, British Columbia, 10 September 2003.

* * *

Good afternoon. It's great to be back in Vancouver and to renew acquaintances at the Board of Trade. I'm going to spend some time today discussing the Bank of Canada's outlook for the Canadian economy and inflation, and how we are responding. But in order to understand the current economic situation, we need to look at some of the extraordinary events of the past year or so and how those events have affected the economy.

My last public speech here was almost exactly a year ago. You will recall that, at the time, markets were still in turmoil in the wake of Enron, WorldCom, and other corporate governance and accounting scandals of late 2001 and early 2002. In the United States and Canada - as well as in many other countries - corporations, regulators, and governments were beginning to respond with measures aimed at restoring and maintaining investor confidence.

Then came 2003 - which could well be named “The Year of the Shocks.” There was the war in Iraq, which is still being played out. The worldwide outbreak of severe acute respiratory syndrome (SARS) was a blow to Canada and to Asia. The human toll of SARS in Toronto was accompanied by a severe drop in Canada's tourism and travel industry. We also had an isolated case of mad-cow disease that blocked our exports of beef and cattle. Many of these export restrictions remain. And the forest fires in British Columbia have caused extensive financial and emotional pain. Meanwhile, the softwood lumber dispute with the United States has not been resolved. And recently, Ontario suffered through North America's biggest-ever power outage.

However, the good news is that Canadian consumers and businesses have been remarkably resilient through the past year or two in the face of all these shocks. But these kinds of shocks can have a significant impact on consumer and business confidence, especially when they happen in quick succession.

Today, I want to talk about the role that confidence plays in our economy and the measures that are being taken to strengthen it. Trust and confidence are essential if markets are to operate efficiently, so that businesses can finance themselves in good times and bad. And Canadians need to maintain confidence in the macroeconomic framework so that we can all reap the benefits of a smoothly functioning economy.

The role of confidence in monetary policy

At the Bank of Canada, we spend a lot of time thinking about confidence, because it is important to the conduct of monetary policy, which is focused on inflation targeting. We aim to keep the trend of inflation at the 2 per cent target midpoint of a 1 to 3 per cent range. When the trend strays away from that midpoint, either upwards or downwards, we take action to return it to 2 per cent over the medium term. We do that by adjusting our target for the overnight interest rate.

Over the past decade or so, we have successfully kept inflation at around 2 per cent, on average. Here's where the confidence factor enters into the equation: Canadians now expect that inflation will stay near the target - not just for the near term, but into the future. They believe that the value of their earnings and savings won't be eroded by inflation and that the real burden of their debt won't be increased by deflation.

That confidence has paid a real dividend in terms of monetary policy effectiveness. Inflation targeting works best when Canadians *believe* that it will work - in other words, when they have confidence that we will keep inflation near the 2 per cent target.

With this confidence, inflation and inflation expectations, as well as interest rates, have become more stable - and this benefits the whole economy.

How did we achieve this confidence dividend? By establishing a track record of credible, consistent monetary policy, together with greater accountability and transparency. Like many other major central banks, we have embraced the notion that monetary policy is more effective when people can understand what their central bank is doing and why. That is the motivation behind our semi-annual *Monetary Policy Reports* and *Updates*, our eight interest rate announcements every year, and our many public appearances and speeches.

Of course, monetary policy does not function in isolation. It works best when it is complemented by fiscal policies aimed at avoiding deficits and lightening government debt burdens. Reducing, and ultimately eliminating, the federal deficit in the 1990s helped Canada's international credibility, lowered the risk premium demanded by investors, and gave Canada more flexibility to adjust to changing economic circumstances. And continued fiscal prudence has given us the flexibility to weather the recent economic turmoil rather well.

Canadians have now seen the benefits of low, stable, and predictable inflation, and balanced budgets. And they expect that their central bank and their governments will continue to deliver those benefits through responsible monetary policy and prudent fiscal management.

Confidence in markets

So, good monetary and fiscal policies deliver a confidence dividend. But, of course, trust and transparency are crucial factors all across the economy and the financial system. We all know that a business will not last long if it squanders the confidence of its customers, suppliers, and investors.

The corporate finance and accounting scandals of 2001 and 2002 hurt more than just profits and portfolio gains. They also sideswiped the confidence of financial market participants. The problems that brought down Enron, WorldCom, and others were not limited to those companies. In fact, the international task force appointed by the International Federation of Accountants - and chaired by John Crow, a former Bank of Canada Governor - correctly notes that Enron was the event which, by its sheer size, awoke many to issues that had been significant for some time.

What's encouraging is that this awakening has happened quickly and that considerable effort is being made to address those issues and reinforce trust in the financial system. The Sarbanes-Oxley Act in the United States, for example, is aimed at restoring trust in corporate financial reporting. Other international efforts are underway to improve both reporting and monitoring of public companies.

In Canada, federal and provincial governments have been working with the private sector to review and improve the framework governing public companies and capital markets. These initiatives are summarized in a document entitled *Fostering Investor Confidence in Canadian Capital Markets*, which can be found on the Department of Finance's Web site.

Efforts are focused on four areas:

- improving financial reporting and disclosure;
- enhancing the quality of the audit process;
- strengthening corporate governance and management accountability; and
- toughening enforcement.

All of these efforts are aimed at building the confidence needed to allow markets to protect the interests of investors and creditors and to operate efficiently so that businesses can finance their operations at the lowest cost.

Steps to foster confidence

Let's look first at what's been done to date to improve financial reporting and disclosure. Our system, which has already worked quite well for Canadians, is being strengthened. The proposed new changes are aimed at building confidence while keeping compliance costs relatively low.

New guidelines on continuous disclosure obligations of public companies are being drafted by the Canadian Securities Administrators. The goal is to implement them by January 2004. There are also new guidelines from the Canadian Institute of Chartered Accountants (CICA) on stock options, financial guarantees, and off-balance-sheet arrangements. And the Investment Dealers Association (IDA) has developed new rules to promote the independence of financial analysts.

To improve the quality of the audit process, a new Canadian Public Accountability Board will oversee the practices of firms that audit publicly listed companies. Its chairman is Gordon Thiessen, my predecessor as Governor of the Bank of Canada. And David Scott, a senior partner with PricewaterhouseCoopers, was recently appointed as CEO. The Board will inspect audit firms and will make recommendations on accounting and assurance standards, rules of conduct, and governance practices. Its efforts are being augmented by the new Auditing and Assurance Standards Oversight Council, which is designed to provide perspectives from outside the accounting profession on the oversight and setting of corporate audit standards.

Critical initiatives to restore investor confidence are also being taken in the areas of corporate governance and management accountability. Most importantly, many companies have taken, or are taking, action on their own in this regard. Their efforts are being supported by the actions of provincial securities commissions. In January, the Office of the Superintendent of Financial Institutions released new guidelines on corporate governance for federally incorporated financial institutions. In last February's budget, the federal government announced a plan to strengthen the corporate governance standards in the Canada Business Corporations Act and the financial institutions statutes.

Institutional investors have also been pushing for better corporate governance practices and management accountability. They have established the Canadian Coalition for Good Governance, chaired by Michael Wilson, former Minister of Finance. The Coalition recently published new *Corporate Governance Guidelines for Building High Performance Boards*.

There has been a perception that the authorities have not been vigilant in enforcing the rules with respect to fraud and insider trading violations. Recent studies suggest that Canadian firms pay a penalty, in terms of their market valuations, as a result of this perception. That is why it is encouraging to see that steps have been taken to toughen enforcement. The B.C. government has draft legislation to increase fines, give more power to the provincial Securities Commission, and increase the rights of investors. Ontario and Quebec have passed legislation to increase penalties and to broaden the investigative powers of their securities commissions. New guidelines from the IDA include stiffer penalties for securities dealers that break IDA rules.

In last February's budget, the federal government announced stronger enforcement measures to combat fraud in capital markets. Amendments to the Criminal Code will make it easier to prosecute lawbreakers. More money will be dedicated to investigating serious cases of capital market fraud. And special teams of investigators, forensic accountants, and lawyers will be set up in key financial centres.

These are just some examples of the progress that has been made in Canada by companies, regulators, and governments to build investor confidence in our financial markets. Of course, these efforts also promote better corporate decision-making, greater efficiency, and stronger corporations. That is why it's in the interest of all of us that we make further progress.

What should we bear in mind as we continue to make these improvements? First, we must not be lulled into thinking that all the problems are behind us. Unless we remain vigilant and rigorous in our efforts, we risk squandering the good work done so far.

Second, while we must apply the same principles to all companies, they must be applied in ways that do not impose undue compliance costs, especially on smaller businesses.

Third, while our standards don't have to be identical to those in other countries, they must be seen to be as effective. Canadian and U.S. capital markets are already highly integrated and Canadians (and Americans) have benefited greatly from these open, transparent, and competitive markets.

Indeed, since world markets are increasingly integrated, there is a great benefit to having standards that are *globally* consistent. Right now, there appears to be willingness on the part of authorities in a number of countries to find a reasonable mix of principles and rules for accounting standards and securities regulation that could be applied globally. The International Accounting Standards Board and the U.S. Financial Accounting Standards Board are cooperating in such an undertaking, with the support of other countries, including Canada. It is important that Canada continue to work towards sensible global standards. We must identify how our practices should change to fit those standards in order to help our capital markets stay competitive in an increasingly global environment.

Markets work more efficiently when they all operate under clear, transparent, and reasonable rules and principles - both internationally, and also within Canada. That is why we at the Bank of Canada encourage efforts to achieve uniform securities law, regulation, and enforcement across this country.

Finally, as we set new rules to promote confidence, we must be careful to avoid creating a regime that stifles financial market innovation. We need to create a framework that balances the necessity for effective and enforceable rules to promote confidence with the need to facilitate new and innovative methods of corporate financing to improve the allocation of capital.

This type of framework is the best support we can provide for the efficient operation and continued growth of our financial markets. But it won't do the whole job. A sound legal and regulatory framework must be combined with strong and widespread ethical standards. CEOs and other corporate officers must take it upon themselves to communicate with investors clearly, openly, and fairly. Investors, for their part, have a responsibility to take into account all available information. And regulators, politicians, and public servants must all perform their functions in a way that reinforces trust. We all benefit when everyone plays by the rules. Only by reaffirming the integrity of individuals, corporations, and public institutions can we restore and maintain the confidence dividend.

Indeed, as I said at the outset, the resiliency of Canadian consumers, investors, and businesses has helped us weather recent economic shocks. Confidence will be critical to strengthening our economy in the months ahead and to a sustained expansion over the medium term. So let me now briefly discuss the Bank's views on the economy and inflation.

The current economic situation

Since our *Monetary Policy Report Update* in July, inflation pressures in Canada have continued to ease. Part of the recent decline in inflation has come from an increase in the amount of slack in the economy. The pace of growth in the second quarter of this year was interrupted by a number of near-term factors, especially SARS and trade restrictions on Canadian exports of cattle and beef because of an isolated case of bovine spongiform encephalopathy (BSE). Growth in the third quarter will also likely remain below the economy's potential because of the remaining trade restrictions on beef and cattle, as well as the effects of the power blackout in Ontario and of forest fires in Western Canada.

The prices of some services have been temporarily depressed by SARS. In addition, there has been a greater-than-anticipated reduction in the prices of a number of goods, such as motor vehicles, clothing, and household furniture and appliances. We had expected our core rate of inflation - which strips out the eight most volatile components of the consumer price index, as well as the effect of changes in indirect taxes on the remaining components - to decline below the 2 per cent target. In fact, that happened earlier than the Bank had anticipated. Our core inflation measure is likely to decline somewhat further in the next few months. And we see the trend of inflation remaining below the 2 per cent target for some time.

As I've said, part of this lower trend in inflation is a result of the slack in the economy that has opened up in 2003. In addition, prices of many traded goods have fallen worldwide because of excess supply. The rise in the Canadian dollar earlier this year pulled down the price of imported goods, and some retailers have passed on these savings to consumers. As well, vendors are lowering prices to clear their inventory, especially in the automobile sector. Price pressures that we saw from higher insurance premiums earlier this year appear to be dissipating as the year progresses.

The total CPI inflation rate has come down from 4.6 per cent in February to 2.2 per cent recently, because of the decline in core inflation and because of smaller increases in energy prices. Swings in energy prices remain a risk to our total inflation outlook in the months ahead, although we assume oil prices of about US$27 per barrel in 2004.

Notwithstanding the temporary factors that have affected the economy in the second and third quarters of this year, we see indications that the conditions are in place for stronger economic growth. Here's why. Growth of final domestic demand has remained robust, and the adverse effects of the shocks that I just mentioned are beginning to dissipate. The economic rebound in the United States began earlier, and will be stronger, than previously expected. More robust consumer demand and strengthening business investment in the United States should augur well for Canadian exports. We are also seeing a strengthening trend in Asia. As well, the tone of capital markets remains favourable.

So, despite current weakness, the accumulation of economic evidence to date reinforces the Bank's view that growth in the Canadian economy will strengthen towards the end of 2003 and through 2004.

Last week, we lowered our target for the overnight rate by one-quarter of one percentage point, to 2 3/4 per cent. With this decision, policy interest rates will support the return to levels of economic activity that are consistent with an overall balance between supply and demand in the economy. Achieving that balance will work to return inflation to the target over the medium term.

Conclusion

Canadians have been through a lot this year. But each shock also represented an opportunity - to learn, to improve our ability to handle a crisis, and to strengthen our sense of community.

No one can predict what kind of shocks our economy will face in the future, but we know that shocks will occur. What's important is that we have a robust economic and financial framework that allows us to deal with those disturbances and to seize opportunities as they arise. It is that strong framework that gives businesses and investors the confidence to take risks and to innovate.

We are making progress in building the framework that supports the confidence dividend. During the 1990s, we improved our fiscal and monetary policies. Now, as I have described, we're working to make our financial systems more robust and efficient.

These continuing efforts promote confidence. They improve our ability to withstand all types of economic shocks and to capitalize on opportunities.