David Longworth: The crucial contribution of the financial system and monetary policy to economic development

Remarks by Mr David Longworth, Deputy Governor of the Bank of Canada, to the Conference of the Association des économistes québécois, Montréal, 5 May 2006.

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The panellists in the preceding workshop challenged us economists to be more lucid and convincing. I will do my best not to disappoint you with my speech today, especially since I am genuinely grateful for this opportunity to address a subject as interesting as the topic of this conference.

Over the past few days, you have examined some of the broad trends that have been observed in finance, as well as their implications for economic development. These are matters of great public importance.

I shall begin with a brief overview of what research has taught us regarding the contribution of the financial system to economic growth. Then I will discuss the particular role played by efficiency and regulation in the good functioning of markets, and draw on these theoretical elements to assess Canada's successes and how we can better rise to the challenges that await us.

In the second part of my speech, I will look at the specific contribution of monetary policy to economic development. These two parts of my presentation are closely linked since, as you know, the Bank of Canada uses financial markets as a channel for the transmission of monetary policy—which also strives to promote the well-being of Canadians.

What have we learned from research?

Many analysts have examined the relationship between the financial system and economic development. They have uncovered some interesting facts regarding the characteristics of the financial system—characteristics that contribute to the best possible allocation of savings to productive investments, which are themselves engines of economic growth. We know that in some countries, particularly those of continental Europe, a large part of the allocation of capital is provided by the banks, but that elsewhere, such as in North America, this task is performed primarily by financial markets. Now, we have learned from the research that a country's economic growth does not depend on any specific structure of the financial system. And yet, if not the structure, then what are the factors of success?

A more in-depth analysis sheds some light on the breadth and quality of financial services. The central issue is not to understand whether markets should replace intermediation by banks, but rather how banks and markets complement each other. As to the size of the financial sector, research reveals that it has a straightforward link with economic growth. Historically, we note that the share of this sector in the Canadian economy has expanded from 10 per cent of GDP after the Second World War to nearly 20 per cent today. The financial industry is also one of the most productive in Canada, if we consider its relatively modest share in total employment—barely 6 per cent.

A recent study by the OECD[1] emphasizes the quality of regulation of the financial system as a factor of economic growth. Its main conclusion is that ". . .regulatory settings that maintain excessively high barriers to competition in banking, or that provide too little protection for investors in securities markets, hamper the development of financial systems, resulting in weaker economic growth." Thus, a balance must be struck between competition and the protection of investors. This is of particular importance for firms that are growing rapidly and that depend on injections of outside capital, such as those specialized in information technology and biotechnology. This suggests that the quality of the financial sector is reflected in the industrial structure of an economy, and not only in its growth rate.

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1 OECD. 2006. "Regulation of Financial Systems and Economic Growth." In *Economic Policy.*

The efficiency and stability of the financial system

At the Bank of Canada, we have devoted considerable effort to promoting the efficiency and stability of the financial system. When speaking of the financial system, we are referring not exclusively to banks and markets, but rather to all financial institutions, their legal and regulatory framework, and their infrastructures, such as the payment, clearing, and settlement systems. We say that a financial system is functioning well when two conditions are met. First, agents have access to the information they need to allocate capital to the most productive investment projects. Second, risk is managed in such a way that it is assumed by those who are most prepared to do so. This type of financial system also contributes to reducing volatility in consumption and investment. It buffers the real economy from harmful shocks, making growth less volatile.

Asymmetries in the information available to lenders and borrowers are an example of frictions that undercut efficiency. Typically, the borrower has better information on the value and the risks associated with an investment project. Other examples of frictions are operational inefficiencies resulting from relatively weak competition among suppliers of financial services or from market distortions caused by poorly designed regulation. If we want to bolster economic growth, we need to expose and correct these inefficiencies. However, before sketching out a solution, it may be wise to recall the basic principles of sound regulation.

The efficiency resulting from good regulation

Let us begin with a basic axiom. Operational efficiency and the optimal allocation of resources in a market economy rely on a solid legal and regulatory framework. Fundamental legal principles, such as property rights, the rule of law, and respect for contracts, must be in place for market forces to play their role and create wealth.

Therefore, before a government agency considers imposing a new regulation, three tests must be passed: ensure that the regulation is targeted at correcting market failure; ascertain that the proposed solution is effective; and see to it that the cure isn't worse than the disease.

While satisfying these conditions, regulators can increase the efficiency of the financial system by acting on three complementary paths. The first is to foster competition in domestic and international markets. Competition stimulates innovation and efficiency. That does not mean, however, that authorities should simply get out of the way of market operators. Regulators can also promote efficiency by—and this is the second path—reducing informational asymmetries through the adoption of certain transparency requirements. Here, it is important to focus not only on the quantity of the information revealed, but also on its relevance, which, in turn, depends on the specific nature of the market and the preponderance of benefits over costs. For example, the optimal degree of transparency could differ between the bond and the stock markets.

Finally, efficiency is bolstered by promoting financial stability in general. When well-designed rules give rise to systemic stability, resources are freed up that can then be devoted to more productive ends. To a large extent, this is the purpose of the international standards in Basel II, which sets banks' regulatory capital requirements as a function of the individual risks assumed. The current Basel I standards are not that sophisticated.

The Canadian record

Now that we have established the principles for the well functioning of the financial system on the basis of research and of some elements of the theory, we can take a look at the Canadian record.

To gain a broader perspective, let us step back in time to the Porter Commission. In 1964, this Royal Commission on Banking and Finance recommended increasing competition, liberalizing markets, and creating a regulatory framework conducive to greater efficiency. These proposals may seem mundane today, but in postwar Canada the government retained a considerable presence in the economy and so they were quite avant-garde.

The Royal Commission won the day, and Canada radically amended some of its laws. The banks reacted to the new competitive environment by innovating and improving their efficiency. Canadian institutions became global leaders while foreign banks lagged, bound by more restrictive and less efficient regulatory regimes. For a full 30 years, Canada maintained its lead on the world stage. Recall that subsequent revisions to the law allowed greater competition between traditional pillars of finance, i.e., banking, insurance, brokerage, and trusts, thus driving down costs and increasing efficiency.

Over the course of the past decade, efforts have focused on improving prudential regulation, which seeks to stabilize institutions and the financial system as a whole. In 1987, the federal government created the Office of the Superintendent of Financial Institutions and the Financial Institutions Supervisory Committee. The purpose of the latter is to facilitate the exchange of information between various federal bodies involved with financial stability, including the Bank of Canada.

At the Bank, one of our less well-known mandates is to oversee payments infrastructures, especially the Large Value Transfer System. The LVTS is an electronic system launched in 1999 and operated by the Canadian Payments Association. It meets or exceeds the highest international standards in matters of risk management, and does so at a fraction of the cost. Experience has shown that a solid and comprehensive infrastructure contributes greatly to the robustness of a financial system. Allow me to take advantage of this occasion to draw your attention to another less-recognized contribution of the Bank: its *Financial System Review*. In it, the Bank presents its current analysis of systemic risks, along with articles that tap into the wealth of research that we conduct into financial markets.

In other matters, the restructuring of Canadian stock exchanges at the end of the 1990s allowed specialization and solidified our market position. Since that time, the Montréal and Toronto stock exchanges, and the TSX Venture Exchange have experienced remarkable expansion. It remains to be seen how the inchoate movement to consolidate markets elsewhere in the world will affect us here, and the new challenges it will pose to Canadian stock exchanges. Also, even though North American financial markets are more integrated than ever before, their regulation has not always kept pace, and non-tariff barriers, which one would have expected to disappear in an era of free trade, persist. In particular, I am thinking of the constraints imposed on small U.S. investors wishing to buy Canadian stock.

All in all, even though the Canadian financial system has continued to develop since the Porter report, it is clear that a number of countries have now caught up to us, and some might even say that they have surpassed us.

Challenges for the future

The competitive capacity of the Canadian economy depends largely on the ability of its financial sector to compete on the world stage. Canada needs to follow best practices in regulation. But this does not mean blindly importing any and all flavours of the month in terms of innovations, not even those originating with its principal trading partner.

A telling example will allow me to illustrate several principles. Enron, along with a number of other similar scandals, drove the U.S. Congress to rush into legislating the Sarbanes-Oxley Act (SOX). This law regarding corporate governance reflects some sound principles, and several equivalent provisions have been enacted in Canada. However, after careful consideration, Canadian Securities Administrators recently opted not to require external audits of the internal controls of publicly traded companies, as under SOX. Of course, large Canadian corporations that draw on U.S. capital will continue to comply with this law, but Canadian companies with more modest capitalizations—which, we should recall, are considerably smaller than their U.S. equivalents—will not have to bear this very heavy burden.

What conclusions can we draw from all of this? That it is essential that the Canadian regulatory framework be guided by principles that are at least as good as, if not better than, those of other countries. However, our rules, and their implementation, must be adapted to domestic requirements and reflect the diversity in size and complexity of our publicly traded companies. So "yes!" to regulatory requirements that vary with size, but "no!" to regulatory requirements that vary by province. At this time, I would like to welcome and encourage the harmonization efforts that are ongoing among provincial securities commissions, including Quebec's Autorité des marchés financiers.

Enron gave rise to the adoption of Sarbanes-Oxley in the United States. On a smaller scale, the Portus, Norshield, and Norbourg affairs force us to look at ways to strengthen the application of the law in Canada. I do not deny the need to foster the development of a culture of compliance and the implementation of appropriate internal controls within financial institutions. Unfortunately, this is not always enough. Some research suggests than insider trading is not prosecuted with the same vigour here as in the United States, tainting the reputation of Canadian financial markets. It can even be argued that this less- than-stellar reputation results in higher financing costs for our firms.

Thus, it is necessary that the behaviour of market operators be monitored and that violators be prosecuted and appropriately punished. A regulatory framework that ensures strict application of the law and that punishes dishonest players will reinforce the credibility of markets and investor confidence.

Rising to this challenge will involve complementary and sustained action by several bodies at both levels of government: securities commissions, police forces, prosecutors, and the courts. It will also require that all stakeholders develop a solid expertise. Integrated Market Enforcement Teams (IMETs), which unite various law-enforcement forces, are a step in the right direction. However, we must push for greater co-operation, since only in that way will we be able to mobilize the complementary expertise of all participants.

The Canadian economy faces stiff international competition. To continue to prosper, it must be able to count on the support of an efficient financial system under a modern regulatory framework. The Porter Commission provides good advice for legislators and regulators: The future of our financial system remains ever and always dependent on competition and innovation.

From monetary policy to economic development

What is the role of monetary policy in all of this? In a narrow sense, monetary policy is a user of the financial system. It targets the overnight rate, but relies on efficient markets to transmit its impact throughout the economy. This explains the strong interest of the Bank of Canada in the issues that I have discussed earlier. At the same time, solid monetary policy reduces costs and volatility in credit markets. It's a matter of give and take, so to speak. More generally, we can further assert that good monetary policy, like an efficient financial system, yields considerable benefits to a country's economy. We observe a positive feedback mechanism. In short, the Bank of Canada believes that by keeping inflation low, stable, and predictable, it maximizes its contribution to the well-being of Canadians. Let us look at that in greater detail.

The adoption of an inflation-targeting regime in 1991 stabilized inflation at approximately 2 per cent and provided an anchor for medium- and long-term expectations. Together with the restoration of fiscal health, this stability permitted a decline in both the level and the volatility of interest rates. Over the past 15 years or so, we have all witnessed a sharp drop in short- and long-term interest rates, at times to levels lower than U.S. rates—which in the past would have been unthinkable. However, what is less obvious is the decline in volatility: The standard deviation of the variability of 10-year rates has fallen by half since the early 1990s, to below U.S. levels. These results have certainly benefited Canadian borrowers and, by extension, investments.

The reduced uncertainty of all economic agents has paved the way for loans with longer terms to maturity. The ratio of long-term debt to total business debt has risen from 45 per cent in 1981 to over 70 per cent. Also, the benefits extend far beyond financial markets. For example, the duration of union contracts has increased, with typical maturities having risen from approximately 25 months at the end of the 1970s to nearly 40 months in recent years.

The manner in which monetary policy responds to fluctuations in the business cycle also promotes greater stability in the economy, which then runs closer to its full capacity. For example, if a negative demand shock drives inflation below the 2 per cent target, interest rates are cut or held at lower levels than they would otherwise be, so as to bring economic activity back to production potential. Naturally, the Bank's actions are symmetric, and interest rates will typically rise when an overheating economy threatens to drive inflation above target.

Having a credible monetary policy also makes it possible to abstain from reacting to most relative price shocks. For example, if a sudden jump in the world price of oil translates into a greater-than-expected rise in the CPI, the fact that we are focusing on inflation 18 to 24 months down the road means that we can ignore this effect, since it will likely have no impact on inflation expectations.

Finally, monetary policy facilitates the structural adjustments required of the Canadian economy in two ways. First, high and variable inflation masks the strong economic signals conveyed by changes in relative prices. With inflation under control in Canada, firms and individuals are better able to understand what rising energy prices and the appreciating Canadian dollar mean for them, and in this way, they can make better informed decisions. Second, resources released by sunset industries can more easily migrate to growth sectors when the economy is running at full capacity. This is our monetary policy strategy for the current period of significant change. Fortunately, the adjustment seems to be unfolding relatively smoothly, despite the real difficulties encountered by some firms and their employees.

Conclusion

Let me conclude. I hope that my remarks today have helped to emphasize that behind the abstract concept of financial system efficiency lies a very important factor for the competitiveness of the Canadian economy.

What can be done to improve things? I submit to you that our financial system does not need a comprehensive, dramatic reform. There is, however, a genuine need for tenacious efforts from all financial system participants to bring about a long series of ongoing improvements—especially in the area of enforcement, competition, and innovation.

As good economists, we at the Bank of Canada will continue to advocate efficiency. And, as for monetary policy, rest assured that control of inflation will help markets function as efficiently as possible. All of these efforts will strengthen our economy and its ability to generate a high standard of living for our fellow citizens.