The confidence dividend in monetary policy

A stable and predictable rate of inflation at around the central bank's target rate of 2 percent creates a climate of confidence in monetary policy, Bank of Canada Governor David Dodge told the Vancouver Board of Trade in September. "Canadians," he says, "now expect that inflation will stay near the target not just for the near term, but into the future." There is now, he says, a confidence dividend in Canadian monetary policy. As for the crisis in corporate governance, the thematic of this issue of *Policy Options*, Dodge says "Only by reaffirming the integrity of individuals, corporations, and public institutions can we restore and maintain the confidence dividend."

Un taux d'inflation stable et prévisible avoisinant les 2 p. 100 crée un climat de confiance à l'endroit de la politique monétaire du pays, affirmait David Dodge, gouverneur de la Banque du Canada, en septembre dernier devant la Chambre de commerce de Vancouver. Les Canadiens, ajoutait-il, s'attendent maintenant à ce que l'inflation se maintienne à ce niveau, à court mais aussi à long terme. Notre politique monétaire récolte aujourd'hui les dividendes de ce climat de confiance. À propos de la crise de la gouvernance d'entreprise, notre thème mensuel, M. Dodge affirme qu'on ne pourra rétablir et maintenir les dividendes de la confiance qu'en réaffirmant l'intégrité des personnes, des entreprises et des institutions publiques.

The year 2003 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.

I want to discuss 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.

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 percent target midpoint of a 1-to-3 percent range. When the trend strays away from that midpoint, either upward or downward, we take action to return it to 2 percent 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 percent, 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 percent target.

With this confidence, inflation and inflation expectations, as

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Bank of Canada Governor David Dodge: "A confidence dividend" from predictability and success in the central bank meeting its anti-inflation targets.

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.

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 that, 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." Efforts are focused on four areas: First, improving financial reporting and disclosure; second, enhancing the quality of the audit process; third, strengthening corporate governance and management accountability; and fourth, 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.

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 the new "Corporate Governance Guidelines for Building High Performance Boards."

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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 BC 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.

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 US 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 US Financial Accounting Standards Board are co-operating 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 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.

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 we're working to make our financial systems more robust and efficient.

Adapted from an address by David Dodge, Governor of the Bank of Canada, to the Vancouver Board of Trade on September 10. For information on the central bank's policies and rate settings as well as exchange rates, visit the Bank Canada website at www.bankofcanada.ca