BANK OF ENGLAND

Speech

The Role of the Transparency in the Development of Financial Markets

Speech given by

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“Transparency” has become a fashionable concept in the last few years. A steady stream of papers from the IMF, the OECD, the G7, the G20 and other international bodies recommends the adoption of transparency in one field of public policy or another, as if it were a miracle drug that could cure all economic illnesses.

Those who are not directly involved in the discussion may be forgiven for wondering exactly what all the fuss is about, and perhaps for wondering more particularly whether the people who are promoting transparency, apparently as a universal remedy, have ulterior motives which they have not disclosed.

My function today is to talk about the role of transparency in the development of financial markets. I hope to explain that transparency is a necessary condition if active financial markets are to develop, and that there are understandable reasons why this should be so. In fact, despite what may appear to be the case, transparency is by no means a new concept in financial markets – by contrast, it has a long history – and where financial markets have developed, transparency has played a very important role.

In his well-known book “Trust: the Social Virtues and the Creation of Prosperity”, the sociologist Francis Fukuyama distinguishes between low-trust and high-trust societies. In low-trust societies, there is a lack of what he calls “social capital” – the sense of community that leads people to trust each other enough to co-operate with each other in productive enterprises. The sense of community extends to family members but not generally beyond. Low-trust societies thus have large numbers of family businesses: they tend not to have large corporations. Unless low-trust societies find a way of overcoming their lack of social capital, their economic development is inhibited by their inability to build businesses beyond family size.

Financial markets are potentially one means through which small businesses can get bigger: that is the role that they have played historically, for example over long periods in Europe and in the United States.

In order to illuminate the importance of transparency, I shall review the various conditions that have to be met if financial markets are to develop successfully, and to discuss the role which transparency plays in each of them. These conditions are all about confidence. Investing in securities is a demonstration of confidence in the future – that the investment will return to the investor all that he or she expects. Without that confidence, the investment will not happen.

Precisely what kind of confidence is needed? I can identify four aspects of the financial infrastructure in which confidence is crucial for the development of markets:

(i) Confidence in the issuers of securities, whether they be corporate or government issuers.

(ii) Confidence in the currency, particularly in the case of bonds, which offer a return fixed in money values.

(iii) Confidence in the market structure – in the integrity of the intermediaries’ procedures and in market liquidity.

(iv) Confidence in the legal infrastructure.

Confidence in the issuers of securities is extremely important; and it is not easy to secure. This applies both to corporations and to government issuers. History is full of examples of corporate enterprises which have raised large amounts of money through issuing securities to investors, and have proved in the end to be worthless. One early example is the speculative mania in London in 1719 and 1720, when some 190 new joint stock companies were proposed. They expected to raise some £220 million from the investing public, which was convinced that the application of the joint stock form of company to all areas of the economy would bring untold riches to their shareholders. Most of them came to nothing [1].

A much more recent example is the Canadian company Bre-X Minerals Ltd, which was involved in gold exploration in Indonesia and claimed in 1996 to have discovered a gold deposit there of more than 30 million ounces (worth $8¼ billion at today’s prices). Shortly afterwards, its shares were listed on the Toronto Stock Exchange. During February and March 1997, doubts begin to emerge about the discovery, and in May that year, an independent consultant reported that the discovery was falsified “on a scale without precedent in mining history” [2].

It is not surprising that investors require reassurance about the corporate enterprises to which they commit their money. The Bre-X case shows that even now, institutions have not been developed which can guarantee investors against serious loss. Nevertheless investors have increasingly demanded that corporations disclose information about themselves, so that analysts can make a well-informed evaluation of their securities. The information they require includes financial information compiled and audited according to internationally-reorganised accounting standards. It also includes non-financial information, such as information about the range of activities in which the corporation is engaged, and the identity of major shareholders and of the directors. Corporations increasingly have come to realise that such

disclosure is in their own interests, as it is a necessary condition for access to the funds available from capital markets. Of course funds are available from banks as well as from capital markets, but banks are likely to demand just the same information as the capital markets.

To return to the title of this presentation, this is transparency. There is nothing new about it, and corporations regard the disclosure of information that it involves as being in their own interests.

Of course, there are limits to transparency. Imagine a company whose prospects depend on a unique product which it has developed itself. Such a company cannot reasonably be expected to disclose to the public, including all its competitors, complete information about the product. To quote an example, the Coca Cola company has not been obliged by US securities laws to disclose its famous formula to the public. There is a potential conflict between the desirability of disclosing information to investors and creditors and the undesirability of disclosing commercially-sensitive information to competitors, but it is a conflict which it has generally been found possible to resolve in satisfactory ways. One of these ways is patents on process and product, which offer transparent information to all interested parties, while preserving and entrenching temporary monopoly rights.

Governments, as well as corporate bodies, issue securities in financial markets; and there has recently been extensive discussion of the appropriate disclosure of financial information by governments. When governments issue securities, they are nearly always bonds. The main uncertainty about bonds which governments issue in their own currency is about the future value of the currency, and I will discuss that a little later. Where governments issue bonds in foreign currencies, the main uncertainty is often their ability to service the debt.

It has for a long time been common practice for sovereign bond issues (like corporate bond issues) to be assigned ratings by commercial rating agencies, based on publicly available information. But investors' decisions to lend to sovereign borrowers have been influenced not only by the borrowers' ability to repay out of their own resources, but also by an assessment of the likelihood that the IMF or a group of industrial countries would, if necessary, provide emergency support to prevent a default – as for example happened after the Mexican crisis in 1994/95.

When lending decisions are influenced by largely political considerations in this kind of way, one predictable result is an excessive flow of lending – as is widely thought to have happened, for example, to Russia in the early part of 1998. Another predictable result is a reaction by the IMF and the industrial countries against the presumption that they should provide emergency assistance to prevent sovereign defaults. Thus the politics of the situation has changed, in that a substantial political constituency has emerged which is opposed to the presumption of sovereign bail-outs.

Because those who oppose the presumption in favour of bail-outs do not wish the flow of capital to sovereign borrowers to be unnecessarily curtailed, particularly in emerging markets, they are also encouraging sovereign governments to make available to the public a standard set of economic and financial data on the national economy. This is the origin of the IMF Special Data Dissemination Standard (SDDS) – which is one of the most important manifestations of the drive for greater transparency. As is the case with corporate disclosure, compliance with the SDDS is intended to be a matter of self-interest, rather than something to be undertaken as a gesture to the IMF or the so-called "international community".

As I have already indicated, one reason why transparency on the part of sovereign borrowers has been limited in the past was that investors assumed that the borrower might well be bailed out to prevent a default. Another reason, in some cases, was that governments felt that they should not be obliged to disclose to financial markets any more information than they would disclose to their own citizens. However, that left open the question why they did not disclose more information to their own citizens – a question about which I shall say more shortly. In practice, the additional disclosures that governments have made as a result of the SDDS and other transparency initiatives have been not only to financial institutions but to the world at large, including their own citizens.

I should add that the advance of technology, and above all the invention of the internet, has made communication of information much easier for both the sender and the recipient. Moreover, it is much easier than in the past to ensure that information is released simultaneously to all interested parties.

Investors in government securities – bills or bonds – denominated in domestic currency need to have confidence in the future value of the domestic currency, on which the return on their investment depends. There are many examples in history of investors in government securities being effectively wiped out by inflation: it happened after the First World War in Germany and it happened after the Second World War in France, Italy and, less spectacularly, in the United Kingdom. Investors need confidence that monetary policy will be conducted so as to secure and maintain stable prices.

There are strong grounds for believing that inflation is damaging to economic efficiency and economic growth in the long run. This is, perhaps, the main lesson of the disastrous experience of many industrial countries, including the United Kingdom, in the 1970s, when very high rates of inflation were accompanied by slow economic growth and steadily rising

unemployment. The core of the problem was the mistaken belief in a permanent trade-off between inflation and output – that is, the belief that governments could "buy" additional output and employment at the cost of a little additional inflation. The truth, as is now widely understood, is that attempts to stimulate output and employment in this way have only temporary effects: the longer-run result is higher inflation and no increase in output or employment – perhaps even a decrease. Nevertheless, it is prudent to assume that governments will always be tempted to indulge in a little bit of inflation, so as to generate a temporary short-run stimulus to output and employment, and to reduce the real value of their domestic-currency debts.

What is needed, therefore, is an institutional arrangement that prevents governments from yielding to the short-run temptations of inflationary policies in the interests of the long-run prosperity of the economy. Many industrial countries, including my own, have been struggling with these problems since the 1970s, and with some success, as you can see from the large reductions in inflation that have been achieved, without, I might add, any loss of output or employment.

In order to secure an institutional structure which "locks in" low inflation, the first requirement is a sufficient political consensus that price stability is indeed the proper objective of monetary policy. If that consensus is not there, investors, and the general public, will not believe that the objectives of monetary policy will remain unchanged.

The technical strategies that countries have used in their monetary policies have varied. Some have fixed their exchange rates against the currencies of other countries, while others have adopted monetary policies directed at domestic objectives. They have, however, mostly had in common a high degree of transparency, including in many cases the following features:

(v) A publicly-announced monetary policy objective – for example, a fixed exchange rate or inflation target.

(vi) A central bank with sufficient technical expertise and autonomy from the government to adjust monetary policy instruments, such as interest rates, in pursuit of its monetary policy objective.

(vii) A requirement that the central bank explains its actions publicly.

In some countries at least, including the United Kingdom, this degree of consensus on the objectives of monetary policy, and the associated transparency, are new features of monetary policy, and their effects have thus far been entirely beneficial. In the UK, they have dispelled the suspicions that had previously always been present in financial markets that the true objectives of monetary policy were not the same as those that had been declared, or that the objectives might suddenly be changed without any prior warning. Inflationary expectations have thus stabilised at a low level, consistent with the inflation target, and bond yields have fallen to their lowest level for over 30 years.

The third condition for the development of financial markets that I identified earlier is confidence in the market structure – the integrity of the intermediaries and procedures, and market liquidity. This, too, is a big subject. Many regulators have published codes of conduct setting minimum standards of behaviour to be followed by intermediaries when dealing with investors. This provides reassurance to investors about how they can expect to be treated by the intermediaries, and provides them with a statement of minimum standards in case they wish to make a complaint against an intermediary. They also set minimum capital standards for intermediaries. Such measures are in the interests of both the market and the intermediaries, since they are likely to make people feel more confident about dealing. It is also important that when there are complaints by investors against intermediaries, they are investigated thoroughly, impartially, and transparently.

Among the most important aspects of securities market procedures are the arrangements for disclosing new information about issuers. Investors will not feel confident about participating in financial markets if they believe that others are trading with the benefit of unpublished information. It is essential that new information is disclosed to all investors at the same time, and that those who have access to the information before it is published (eg company directors and employees) are not able to deal in the relevant securities until after the information is public. Markets in which there is widespread abuse of insider information quickly acquire a bad reputation and lose business as a result. A vital part of transparency is discipline in the release of information.

Market liquidity refers to the willingness of market participants to buy or sell a particular security. It depends above all on how widespread are the investors with an interest in that particular security, and how willing they are to trade. There is an on-going debate about whether real-time disclosure of trading activity has a positive or negative effect on liquidity. Such disclosure could involve either publication of bids and offers before trading takes place (pre-trade transparency), or just publication of information about trades after they have been completed (post-trade transparency). In neither case need the names of the parties involved be published. The debate is unresolved. In general, the market makers who make a living by buying and selling securities, and thus provide liquidity to the market, oppose greater transparency because it would reduce the value to them of the information inherent in the flow of orders from their customers, so that they would find it harder to provide liquidity to the market. Others, however, claim that more transparency of this kind would make investors feel more confident about participating in the market, so that liquidity would increase.

The final condition that I identified for the successful development of financial markets is confidence in the legal infrastructure. This is a very big issue, and I have no time to do more than mention it. It is clear why it matters for investors in financial markets. They need to feel confident that in the event of a dispute going to court, the law will not be unreasonably biased against them and that the court will be impartial, and that there are sufficient penalties for transgression and perjury. In order for them to have that confidence, a high degree of transparency about the law and about legal processes is needed.

In my remarks, I have tried to persuade you that transparency in the disclosure of information is very often in the interest of the person or body undertaking the disclosure. Transparency is a kind of general cultural development, rather than something confined to financial markets, or monetary policy, or finance. Transparency is, however, emphatically not an objective in itself: it is a means to an end, to be adopted in a pragmatic way. It can perhaps be seen as a device for helping to overcome the lack of trust which Francis Fukuyama sees as inhibiting development and prosperity in countries which, to whatever extent, are lacking in what he calls social capital.