The Long Path to Restoring Faith in Financial Markets

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At the outset I would like to acknowledge the long-standing ties between the Swiss-American Chamber of Commerce and the Swiss National Bank. In the past, members of the Governing Board have been invited to speak before this select audience. It is a great pleasure and honor for me to continue this tradition.

My remarks today will focus on the present challenges faced by the global economy: a crisis in confidence which has pushed equity prices to unexpected lows and an economic recovery which does not seem to take the desired path. Nevertheless, I am convinced that the fundamentals are in place for a return to sustained growth. Inflation is low in almost all industrial countries, monetary policy is supporting the recovery, household consumption still plays a stabilizing role and public finances – despite short-term difficulties – are not far from equilibrium.

While numerous factors are responsible for the present economic uncertainty, the prolonged volatility witnessed in equity markets has hit investors particularly hard. In hindsight the stock market correction fits partially the classic story of fundamentals; one that is driven by a bubbles collapse in dotcom companies and the anticipated slowdown in economic activity. However, the increased volatility in equity markets has also been pronounced because of peculiar events: the integrity of financial analysts' recommendations and the increased spread of fraudulent accounting practices. It is the latter that has struck the financial markets particularly hard in recent months. U.S. firms, such as Enron, WorldCom, Global Crossing and Xerox, have become household names not because of their services and products but for their alleged accounting abuses. Investors in these firms undertook investment decisions based on apparently false information. The fear is that only the top of the iceberg has been revealed and more unpleasant news is expected to fill the front pages of the daily newspapers.

The fallout from the financial scandals has unearthed several dormant issues that twitch the nerves of financial markets. In turn, this has generated considerable discussion in the financial press, on the airwaves, and in the corridors of government buildings. While the issues are complex, the list of proposed solutions is long. This all suggests that consensus and reform will not be achieved overnight.

Trust as an Asset

As in all walks of life, trust is a valuable attribute. Central banks, as well, value the importance of credibility and trust. Allow me a few minutes to explain why these qualities are important to the National Bank. At the same time, they can provide a good illustration as to why these same qualities are equally important for the private sector.

Let me begin with what I mean by trust. Trust is a term that is closely related to confidence and credibility. Trust is understood to mean when individuals share a mutual understanding that the rules of conduct governing their network work well and make things better for everyone. Trust can therefore be thought of as a kind of social capital – a shared asset that benefits everyone. Just as we speak about trust between individuals and public institutions, the same is true for publicly traded firms that interact with markets. With trust, economic systems and networks are more efficient for less effort is spent on monitoring and checking. With the establishment of trust, confidence is developed. Over time, as trust is built up, confidence and credibility are developed.

Maintaining price stability is a key trust-building responsibility of the Swiss National Bank. Protracted changes in the price level, as a rule, stem from a malfunctioning of the monetary system. Price stability is important particularly because relative prices in our market economy govern the production and consumption of individual goods. Changes in the price level are liable to give misleading signals and lead to expensive mistakes in planning and investment.

Inflation has other dire consequences. For the less fortunate – those unable to protect themselves against price increases – inflation means an erosion in purchasing power. This is especially true for fixed income investments. In contrast, for those that can protect themselves against inflation, it means that considerable resources are squandered in trying to hedge against inflation. These efforts should be put to more productive use.

With price stability and trust in place, the list of economic benefits is long. In particular, the price development becomes more stable and predictable. This allows financial markets and businesses to operate more efficiently. As for the National Bank, it can conduct monetary policy more easily with expectations strongly anchored.

A key feature of trust is that it must be underpinned by transparency. We too have learned from past experience that Swiss monetary policy gains from increased transparency. Earlier than most 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, doing and why. Transparency also eliminates the doubts that the central bank is working with an informational advantage. Information asymmetries breed mistrust and skepticism.

It is much easier to instill trust in an institution if it is open about its goals and strategies. All this enhances the National Bank's accountability and reinforces the trust we have fostered.

What steps has the National Bank taken to improve the transparency of monetary policy? We have a long tradition of setting monetary targets, but since the announcement of our new monetary strategy more than two years ago, the discussion of monetary policy is even more clearly defined by norms, rules and procedures than before. The explicit definition of price stability gives Swiss citizens a yardstick for measuring how the central bank has performed. Changes to the target range for the policy instrument – the 3-month Libor – are commented by a press release. They are also discussed after each Quarterly Board Meeting, which are fixed in advance. At our biannual press conferences, we provide our assessment of the economic situation. At these occasions, we inform the public how we judge the risks facing the economy and present our inflation forecasts for the next three years. The forecast should guide the public in monitoring inflationary risks. Given all this, we have taken the extra step to publish the forecasting models that are used to generate our inflation forecasts.

The Meaning of Faith in Financial Markets

Trust is relevant not just for central banks but also for 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, which is a key ingredient of a well-functioning economy. This trust includes confidence in the people who run the companies, and in those who watch them. It also means that the information required to make sound investment decisions is disclosed fully and accurately. The disclosure moreover must be fair. There must be confidence that insiders are not trading on information unavailable to everyone. Only when all these components of trust are in place do we have healthy, efficient financial markets where everyone benefits.

What is lost when accounting fraud and the abuse of management power occur? 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 rewards for everybody.

Avoiding a widespread loss of trust requires a systematic and co-ordinated effort to fix the flaws and weaknesses that can undermine investor confidence. It is important that there is a set of reasonable rules – so that chief executives, boards, and their auditors truly and fairly disclose the financial position of their companies and that investing public can rely on the truth, fairness, and completeness of that disclosure. Now, in spite of the specific flaws that several well-known firms have revealed, it has become clear that much of the public's confidence in the efficient operation of financial markets remains intact.

The recent events involving accounting fraud and abuse of management power remind us that we cannot be complacent even once it is felt that the current problems are behind us. Memories can fade quickly. Even if the worst is behind us, the responsibility lies in the market participants to apply the lessons of this particular period to stop its recurrence in the future. We must continue to be vigilant.

The Market's Response

The market participants have already reacted by themselves. We have seen much self-evaluation in recent months. I am 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.

But this is not enough. The apparent breakdown of the checks and balances that served us reasonably well in the past has prompted debate about the need for tougher financial market rules. Potentially new rules need to be written. 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 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.

Major firms, in response to those demands, are changing their corporate reporting methods. There is the clear recognition of the need to eliminate potential conflicts of interest – where auditors are able to offer additional services. This has raised other issues of rotation of auditors to prevent cozy relationships undermining the integrity of the audit. A periodic change of the firm might have led to more serious questioning of the accounts. Further, some US firms have announced plans to include, as an expense, the cost of executive stock options. The changes aim to more accurately describe the revenues and costs associated with companies' primary business. And Standard and Poor's has introduced new benchmarks for reporting corporate earnings.

These are all positive examples of participants working together to enforce the spirit of the rules under which financial markets operate.

What has been done recently in Switzerland to improve the transparency of Swiss financial markets? Some efforts have already started some time ago. Most notably, the Swiss Exchange and the Swiss Business Federation «economiesuisse» co-ordinated their efforts to develop two sets of rules which became effective on July 1, 2002: The «Swiss Code of Best Practice» and the «Directive Concerning Information on Corporate Governance». This will hopefully lift the standards for corporate governance and improve the level of transparency for the publicly traded firms in Switzerland. We have also seen political initiatives aiming at more transparency in remunerations.

Business Uncertainty

It would be shortsighted to believe that the recent stock market reaction has only been the result of misconduct and the lack of corporate governance. The world economy is still digesting the consequences from the deep retrenchment in capital spending, which started in 2000 in the high-tech and the telecommunications sectors. The investment climate was further muted by the terrorist attacks of last September, hitting hard other sectors such as air travel, tourism, and insurance. In short, there is considerable uncertainty surrounding the adjustment of investment spending and the dim prospects of corporate earnings.

While the worldwide weakness in business investment lies at the very heart of our present problems, at the same time the most recent signals from abroad reveal that new potential risks have emerged. The most recent economic indicators from the United States show that domestic demand is growing less strongly than anticipated. The confidence indices registered a decline for the months June and July. The labor market has recently shown increasing signs of weakness; both in terms of employment and hours worked.

These recent developments weigh heavily against household spending, which has been considered the lifeline of the U.S. economy. The fear is that many households are stretched, adding fears to the strength of household consumption and the resilience of the U.S. economy to withstand further shocks. U.S. households on average have low levels of savings and have begun to dip into housing wealth to maintain their consumption habits. While such savings imbalances do not support the crisis in investment, the recent signals from the labor market, should they deepen, bring new risks to consumption and the robustness of the U.S. economy.

Here in Europe, although the economic picture is slightly different, the economic prospects are not brighter. Economic hopes pinned on exports and consumption, do not appear to be resilient across Europe. The potential for further stimulus on the fiscal and the monetary front appears to be limited. On the one hand, the stability pact does not allow for further fiscal stimulus. On the other hand, the European Central Bank is unwilling to provide the same amount of monetary stimulus as its U.S. counterpart. The reason is simple. Inflationary pressures in the Eurozone continue to be a stumbling block for lower interest rates.

The recent deterioration of the international business sentiment and the prolonged uncertainty witnessed in the financial markets has also influenced negatively the growth prospects in Switzerland. Our view at the beginning of 2002 was that economic growth for the current year would be moderate. Our GDP forecast was 1% growth for 2002. Other institutions were more optimistic. All in all, however, there was considerable agreement among forecasters that Swiss household consumption would register moderate but stable growth and that the economy would experience a recovery in the second half of this year. The recovery was to be underpinned by strong growth in exports.

The economic information that stemmed from the first quarter of this year was consistent with the scenario just described. First quarter real GDP came in slightly stronger than expected. Although real GDP growth was only 0.6% in the first quarter, an important consideration was the upward dynamics after gloom had set in the second half of 2002. As anticipated, real growth was supported by private consumption. Confidence indices and leading indicators were all pointing up, reinforcing the view that the economy was on track.

As is the case abroad, the most recent economic figures question whether the recovery scenario for 2002 remains valid. Information from various economic indicators is painting a consensus picture of weak growth. The negative numbers cover the broad contours of the

Swiss economy. These sectors include construction, investment, tourism, financial services, and export-oriented industries.

None of this means that the Swiss economy is not able to stay afloat. But those that have steered a ship know: it is not enough to have water under the rudder, one needs to plot continuously a course that will safeguard the vessel. The first rule of caution in seamanship and in monetary policy – is to keep away from situations in which adverse shocks will lead to trouble. With the recent interest rate reductions in the target range, we have tried to steer a prudent course that seeks to offset potential adverse shocks that would jeopardize economic recovery in Switzerland.

On May the 2nd, we lowered the target range for the three-month Libor by 0.5 percentage points to 0.75% to 1.75%. With this step, we reacted to the rapid appreciation of the Swiss franc against the major currencies, which led to an undesirable tightening of monetary conditions in Switzerland, thereby threatening the economic recovery.

We reduced the interest rate range by a further 50 basis points on July 26th. The current target range lies between 0.25% and 1.25%. We reacted to the increasing signs from Switzerland and abroad that point to a delay in the economic recovery and slower-than-anticipated economic growth in 2002. We now forecast the average growth rate for real GDP to fall clearly short of 1% in 2002. In addition, the further appreciation of the Swiss franc tightened the monetary conditions, which were regarded to be undesirable under the current environment.

Concluding Remarks

It is more than one year that we are in this difficult economic situation. The loss in business confidence began with the downturn in economic activity lead by a sharp correction in capital spending. The path to economic recovery has been recently overshadowed by the loss in investor confidence, which found its origins in the highly publicized scandals involving fraudulent balance sheets. This setback in investor confidence undermined the required trust in financial markets that the right rules are in place and that those rules are being enforced.

Although I am confident that stronger rules will merge to restore trust in financial markets, consensus will not be achieved overnight. Corporations must continue to build on the social capital that is entrusted in them by investors. They should promote the efficient operation of financial matters, and optimize the benefits that markets can bring to everyone in society. However, as long as the rules of the game prize short-term gain over long-term earnings stability, the temptation to cheat by manipulating the market will remain strong. Reforms cannot remove risk from investment, but firms can do more to promote transparency and ensure that their risks are properly disclosed. It is thus vital for firms – not just politicians and the public – to determine if there are weaknesses in legislation or regulation so that they too can correct and begin their part of the process of rebuilding investor confidence.

But the present challenges are not only those of better regulation. The global economy is also facing a crisis of confidence, which interferes with investment decisions and dampens activity. Against this international backdrop, we have reacted swiftly to the changing winds that bring new risks to the domestic economy. The latest reductions in the target range are aimed at injecting further monetary stimulus in our economy. These actions are undertaken with an eye on keeping price stability in check. This is the best contribution the Swiss National Bank can make to restore confidence in the economy and promote a strong and sustainable recovery.