Urban Bäckström: In the wake of financial turmoil

Speech by Mr Urban Bäckström, Governor of Sveriges Riksbank, at the Conference on WorldCom and Enron - aftermath in the US and lessons for Sweden, held in Stockholm, 5 September 2002.

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Thank you for the invitation to discuss this interesting topic. The circumstances connected with WorldCom and Enron unquestionably raise some burning questions to do with the roles of the owners, the boards and the auditors, as well as with construction of the rule system. There is a risk, however, that a drive for quick solutions will result in hasty conclusions. Experience shows, in my opinion, that when dealing with complex problems, there is often much to be said for reflection and closer consideration. In many cases it is not until some time has passed, enabling us to gain a better understanding of what happened, that we are in a position to take the steps that are truly important and crucial.

My starting point here is that the events to do with WorldCom and Enron are a part of a broader context. In the first place they are, of course, directly connected with the recent years' stock-market bubble. But at a deeper level I believe they stem from two major processes and that, as so often happens when things go quickly, our current institutions - in a wide sense - have not quite kept up with the course of events.

- *One* major process that left its mark on the 1990s is the breakthrough in technology, above all for computers and telecommunications. This had been on the way for a number of decades and began to flourish in many parts of the world as it became increasingly clear what the microchip had to offer. It can be likened to the development of the steam engine in the late 18th century or the combustion engine and the electric motor a century later. As we know, those earlier technical breakthroughs had far-reaching consequences for the development and transformation of our society. The process is not - either then or today - a simple progression. But the setbacks are manageable and pave the way for new advances. Many of the setbacks originate in faulty expectations of the new technology's impact.
- The *other* major process has to do with the financial system's deregulation in recent decades. As a result, we now have a world where capital markets and capital flows are about as free as they were before the outbreak of World War One. With the Great Depression and World War Two, the idea of returning to a less restricted financial system failed to catch on. It was not until the 1980s that deregulation reached Sweden, after starting somewhat earlier in many other industrialised countries, including the United States. A free financial system is needed in order to promote the development of new technology and a genuine social transformation. But it does also entail a number of risks.

It was the new technology that provided the driving force behind companies such as WorldCom and Enron, just as it was the supply of capital from the deregulated financial system that enabled them to grow as they did. But these were not the only enterprises that exploited the new technology and benefited from the free capital market. It was the euphoria and even hysteria about many companies that led to the formation of a stock-market bubble. According to some measurements, the average levels that share prices reached in relation to more fundamental values in the late 1990s were higher than ever before. So it is hardly surprising that the falling trend in recent years has involved such large losses around the world. Share prices tend to return sooner or later to values that are a better reflection of fundamental factors.

A closer look at the recent stock-market bubble reveals a number of more specific features that call for special reflection. It looks as though share prices for IT and technology oriented companies were driven primarily by new and rather inexperienced investors, cheered on by managements in need of capital to cover current spending as well as by analysts from banks and investment companies that handled the share issues. Media around the world also seem to have lent their voice to this tendency.

Seen in this wider perspective, events in recent years raise a number of questions that I now want to consider briefly. How should we view financial bubbles, what causes them and what can we do about them? What drove the latest bubble, what can we learn from it and what is needed more generally to make stock markets function more efficient?

Nothing new about periods of undue optimism

One important lesson is that in a deregulated world, waves of excessive due optimism can arise and result in pronounced financial cycles. In the 1990s there were several periods of financial turbulence. One was Sweden's own bank and currency crisis about a decade ago. At the same time there were problems in other countries and turbulence in the European exchange rate mechanism (ERM). That was followed by the crises in Asia and Mexico, the problems with the major hedge fund Long Term Capital Management, Russia's suspension of payments, the IT bubble and, most recently, the difficulties in Latin America.

Further back, there have likewise been periods of excessive optimism and financial crises. Here, briefly, are the most spectacular items in Sweden's economic history.

- The first real financial crisis in Sweden occurred back in 1857. It mainly involved the real estate market and obliged the government to support the banking system for the second time in our history. The first occasion had been in 1668, when the Palmstruch Bank was taken over by parliament and ultimately became what we now call the Riksbank.
- Not long after, in the 1870s, the next wave of excessive optimism had to do with rapid industrial development, not least the construction of railways. Stockholms Enskilda Bank, for example, was in difficulties at the height of the crisis in 1878.
- Another serious setback for what was then the "new economy" occurred in 1907. The potential profits from hydroelectric power and electrification, forest industries and iron ore had been exaggerated.
- Then we have the undue optimism after the end of World War One, with a major investment boom and speculation in real estate and shares that peaked in 1921. It may be worth mentioning that measured in constant prices, it was not until the 1980s that turnover on the Stockholm stock exchange again reached the level in 1918. That says something about the strength of the speculation at that time.
- After that, as we all know, there was 1929 and the early 1930s, with a falling stock market, banking problems and the Kreuger crash as prominent events in Sweden.
- More than fifty years then passed before Sweden experienced another period of genuine financial turbulence in the late 1980s. The world, including Sweden, was hit by the stock market collapse in October 1987. A bubble developed in Sweden's real estate market and subsequently burst, severely damaging the financial system. Resolute action by the political system in the early 1990s did, however, prevent a financial meltdown that might have plunged our country into an even deeper crisis.

This brief review shows, I believe, that in periods with a heavily regulated financial system, the world economy has been somewhat less prone to generate pronounced financial cycles. It should be born in mind, however, that the regulations also created other problems which impeded long-term growth. Innovations and new enterprises are hardly stimulated when banks and markets are closely regulated. So it is symptomatic that the high growth in the 1950s and '60s came mainly from the rationalisation of existing firms rather than from new enterprises. When the deregulation of trade and of markets for goods and services got under way again in the decades after World War Two, attention was naturally drawn to the financial barriers that the tight regulations had set up against future growth. An awareness of the need for new, expanding companies and the emergence of new markets made it natural to promote this with a freer financial system.

While this financial deregulation was probably both natural and necessary, it also meant that the world economy again became vulnerable to the kind of exaggerated optimism, with the attendant risk of pronounced financial cycles, that had characterised the late 19th and early 20th centuries. Meanwhile, the institutions connected with the financial system had lagged behind. By "institutions" I mean everything in and around the financial system that affects its development. Examples are sets of rules, the banking system as such, the general public, the political system, the authorities and the media. The shortcomings took various forms. Important rules were wrongly formulated or non-existent. The banking system lacked the necessary know-how for risk management, both for its own institutions and for its clients. People had become used to credit being rationed and were now suddenly able to borrow large amounts. The political system, the authorities and professional economists all stressed the advantages of deregulating the financial system but were less clear about the risks. In their struggle for readers, listeners or viewers, the media sometimes forgot to question and scrutinise important elements of what was happening. Think how much advice about share transactions has been passed on airily in recent years without a careful scrutiny.

In the early 20th century these financial cycles and the risks of major crises were given a lot of thought by economists, not least those of the Austrian School. They pointed to the existence of transitory risks in the process of adjusting to a higher rate of productivity growth in connection with technological breakthroughs. At first there is a good circle: rising productivity tends to pull share prices up, making it easier to finance new investments. New investments and a growing capital stock lead through capital deepening to even higher productivity growth. When productivity goes on rising, however, expectations may become excessive and push share prices up still more. In certain cases, moreover, expectations of increased profits may lead to higher lending. All this can generate a vicious circle where a further increase in asset prices results in a continued expansion of credit.

With excessive euphoria, the expansion of the capital stock may go too far. Sizeable investments are made in sectors that will never yield the expected return. The subsequent adjustment accordingly involves a marked fall-off in investment activity and thus a weak development of demand. Both the excessive investment earlier and the inevitable correction of asset prices contribute to this. The setback can also lead to problems in the financial system in general.

Much of what the Austrian School had done was forgotten during the half-century of regulation from the crisis in the 1930s to the 1970s. Political economy was dominated instead by Keynesianism. It may also be the case that the efficient market hypothesis has been interpreted too freely. This theory largely amounts to a warning that the market is basically the best judge of a share's real value. Under normal conditions that is probably true. When a bubble has got under way, however, the market's normal information processing tends to be disrupted and prices are driven instead by impenetrable forces of a psychological nature.

In many respects the financial turbulence in the 1980s and '90s was a rude awakening for many economists, decision makers in economic policy, authorities, representatives of the business and banking communities and people in general. I find it important to underscore how broad was this lack of insight into how financial problems arise. One cannot single out a person or group as being solely responsible for how things took a turn for the worse. Perhaps a society has to undergo a learning process on a broad front so that earlier mistakes yield new insights.

Economic policy decision-makers like myself are, of course, no exception here. But as financial turbulence does not inevitably lead to a serious crisis in the real economy, we need to ask why it is that in certain cases output and employment do suffer severe setbacks and the attendant deflation. Much will have been gained if we can learn to tell whether or not an extensive share price fall, for example, besides being troublesome enough for many people, is likely to result in a situation with general deflation, rapidly falling output and rising unemployment. An answer to that question was suggested in the summer of 1999 by the Federal Reserve chairman, Alan Greenspan:

> *While bubbles that burst are scarcely benign, the consequences need not be catastrophic for the economy. The bursting of the Japanese bubble a decade ago did not lead immediately to sharp contractions in output or a significant rise in unemployment. Arguably, it was the subsequent failure to address the damage to the financial system in a timely manner that caused Japan's current economic problems. Likewise, while the stock market crash of 1929 was destabilising, most analysts attribute the Great Depression to the ensuing failures of Policy.*

Most things indicate that when banks run into trouble on account of financial turbulence, the supply of credit may dry up and the payment system cease to function. It is under such circumstances that output and employment have tended to suffer severely, leading to actual deflation. That, of course, is what prompted the Swedish political system's resolute intervention at the time of the bank crisis here about a decade ago. It was a matter, not of protecting the banks as such or their owners from losses, but of safeguarding the banks' central function in our economy. Maintaining a modern market economy would be virtually impossible/ without an efficient credit supply and payment system. In the present context it is positive that the banking sector is functioning well even though stock markets around the world have fallen steeply in recent years. There are also many signs that the banking sector has learnt a good deal from the financial problems in the last few decades.

As regards general economic policy, we know that focusing on low and stable inflation creates a better and securer environment for economic policy decisions on the whole. A credible long-term commitment to low inflation does away with some of the uncertainty about future income streams, which are what ultimately determine the fundamental value of various kinds of asset. Such a commitment should also provide better conditions for financial decisions. But there is more to it than that. As representatives of the Austrian School pointed out, business cycles are not exactly alike. As a result of exaggerated euphoria, a basis for risks that may lead to future instability can be created even before the threat of inflation becomes more visible. In the event of rapidly rising asset prices, with the associated risk of financial instability, a central bank should therefore keep a watchful eye on credit expansion in the economy. Under such circumstances the central bank may need to intervene in the interests of financial stability. In my opinion, interest rate adjustments should certainly not be ruled out if they are judged to be effective. In other contexts I have mentioned the desirability of such a “flexible inflation targeting policy” and believe that support for action of this type is to be found in current legislation. The recent share price bubble was not accompanied by any undue expansion of credit. This was no doubt partly because the Swedish bank crisis is still so fresh in people’s minds and banks here have made the process of providing credit much more rigorous.

The IT and telecom bubble in the 1990s

So much for financial bubbles in general and what general economic policy can do. There is, however, more to learn from WorldCom, Enron and the whole of the IT and telecom bubble.

American studies suggest that the new technology which enabled people to do their own share trading on the Internet attracted many people who were unfamiliar with saving in shares. These new and less experienced players concentrated in particular on shares that are quoted on the technology oriented Nasdaq exchange, which greatly influenced the pricing of similar shares around the world. While more professional and institutional investors accounted for 90 per cent of trading on the New York exchange, during the stock market boom around half of Nasdaq’s turnover came from private individuals.

Studies also indicate that companies, analysts and banks had incentives to use somewhat questionable means of attracting inexperienced investors to buy shares in new enterprises. Lacking an adequate cash flow, many new technology companies were dependent on raising money from new share issues to pay their employees and procure equipment. That in turn called for a high share valuation. This gave managements an inducement to “doctor” reports and statements about their company’s future performance. The disclosures about WorldCom and Enron clearly show how an environment developed in which managements also stood to gain from stretching the accounting regulations in order to meet market expectations. It also looks as though the same environment left its mark on the large corporations’ auditors, who likewise needed to modify the extent and direction of their services in order to generate income and profits and survive in the new economy. In certain respects it amounted to breaking the law. In other instances it was the law that was not sufficiently clear or extensive.

Analysts and investment banks that earned money by arranging share issues evidently lacked an incentive to make a critical appraisal of corporate reports and statements. This deprived the inexperienced investors of the necessary help and support. A look at, for example, the advice that was provided before stock markets began to fall tells the same tale: recommendations to sell made up less than one per cent of all advice.

The media latched onto the stock market boom with reports of rapidly rising share prices. Instead of taking a critical look at what was happening, the notion that the new economy offered chances of earning a quick profit became the conventional wisdom. The part played by human psychology for herd behaviour in financial markets has in fact given rise to a new school of financial knowledge, known as Behavioural Finance. Two key concepts in this analysis are just conventional wisdom and wishful thinking. There’s nothing odd about that. When people make investment decisions they function in much as the way as in other contexts. A familiar example is our reluctance to enter a restaurant that is empty - we generally prefer one that already has many guests, particularly if there is a long queue outside. We simply rely on the good judgement of others and assume that all those inside have made the right choice. By arriving at a better understanding of how people behave, we can certainly do a good deal to prevent unduly large mistakes in market pricing and perhaps ultimately reduce the occurrence of financial bubbles.

Functional institutions are crucial for economic development

Today as well as earlier, the financial turbulence is an additional inducement to create better conditions in many parts of the economy for the institutions involved in the financial system and corporate management. It would be wrong to suppose, however, that regulations and other measures are capable of eliminating financial turbulence altogether. Like the business cycle in the real economy, cyclical movements in the financial world cannot be excluded as long as a market oriented distribution of saving and investment is considered desirable. The learning process in which we are all involved does at least help us to understand the mistakes that have been made and what they can teach us.

The focus at present is very much on the roles and actions of the owners, boards and managements of listed companies. Self-preservation alone will no doubt lead to much being done to restore investor confidence in these corporations. Auditors around the world are presumably also devoting a good deal of thought to their various functions. Accounting issues are very much on the agenda. Many banks are also considering ways of providing clients with better analytical advice about share investment. A one-sided producer oriented approach, with the emphasis on getting clients to buy the bank's products, is unlikely to work in the longer run. Bank managements are tending to look instead at how to make their approach more consumer oriented. What is good for the client is presumably good for the bank as well. The structure of internal incentives also needs to be adapted to encourage a long-term relationship. It seems reasonable to suppose that some newspaper managements are likewise thinking about how their readers' interests can best be served.

Without in any way claiming to be exhaustive, these examples illustrate the major forces that are at work in many parts of our society with a view to making things function better than they did in the recent stock market boom. In addition there are of course the deliberations of economic policy decision-makers, authorities and international institutions.

The message I want to put across today is primarily that there are no simple solutions that would prevent a repetition of what we have been through. We must also realise that the spontaneous healing mechanisms in a market economy can take time to work. They probably need the support of better institutional rule systems, for example in accounting practice. At the same time, I would be cautious about intervening too much, for instance by complicating matters with rule systems or unduly detailed supervision by authorities. It is a question of striking a balance so that the sound forces in the economy are free to act while tendencies that may develop into a crisis are held in check. How this is to be achieved is something that market players and the competent authorities continuously have to consider and try out in the light of experience.