HOW CAN THE WORLD ECONOMY REGAIN CONFIDENCE ?

(Madrid 11 March 2003)

Before trying to answer that question, one needs to understand the basic reasons for the loss in confidence that we are now witnessing.

1. The basic reasons for the loss in confidence

If one leaves aside the geopolitical uncertainties of today, one can observe that these basic reasons all go back to the past excesses of the asset markets.

Stock exchanges have gone up by a factor of 4 from the early 90's to mid-2000. The bubble then burst and the markets have fallen by 50 % over the last 2 1/2 years to a level close to that of the end of 1997.

a) Those years of boom have led to a set of events that explain today's gloom :

- the years of boom appeared endless because of the widespread and misconceived belief-fanned by what one can only call intense "propaganda"- that a "new economy", a "new paradigm" was born that would outlive the classical cycle ;
- this boom led to extremely high returns on equity investment, thus attracting new and increasing funds to the equity markets ;
- analysts made investors and companies believe that shareholder value could continuously increase by 15 % per year.

b) But those years of boom, followed by the burst of the bubble, brought significant consequences which have impaired global confidence :

- Theory became more and more distant from reality. Markets were so happy to see the boom of asset prices continue that they were inclined to believe that corporate profitability had structurally improved. In fact, this was not the case. Due in part to intense competition, margins have been low and it was only in services that there was some pricing power left. Labor productivity has certainly increased in the US but not as dramatically as had been heralded.

- In order to keep up with the "15 % growth" in shareholder value, a large number of companies have bought back their shares massively. This equity destruction was only made possible by a dramatic increase in corporate indebtedness[1].

- Some companies have been tempted to go beyond and to transgress accounting rules. The cases are well known : a few managers, surveyed by weak auditors and helped by imaginative advisers, tried to boost artificially their revenues.

- Investors have been living for the last three years with a bear market. Many "new" investors have lost more than 50 % of their investment. Up to now, the impact on consumption through the wealth effect has been limited. But distrust is growing. Pension funds and saving schemes have been victims of the equity market meltdown. Managerial behaviors (stock options abuse) and accounting scandals have given a negative image of the corporate world[2].

2. How can confidence return ?

a) It is, of course, normal and, but only to some extent, advisable to tighten regulation after such an exuberant and irrational behavior :

- Whilst it is widely accepted that the "Enron-type cases" are criminal exceptions, regulators are multiplying new rules as if those cases were not so "exceptional". This approach carries some ambiguity. Surely regulators consider that new and tighter rules will deter unlawful practices. But one can also note that the proliferation of new rules does not necessarily lead to more virtuous behaviors. No "perfect" system will, by itself, eliminate fraud.

- Perhaps more important than tightening, is the need -in an integrated world- to harmonize worldwide basic accounting rules and regulations as well as governance best practices. This objective has not attracted much interest up to now. What we see is the multiplication of adhoc new regulations from country to country. This is not clarifying the matter and is not conducive to increased confidence. It is indeed absolutely necessary to converge and make compatible those regulations[3].

[1] From 1997 to 2002, the US non farm non financial corporate business "lost" some 500 Billion dollars in equity whilst its increase in debt was close to 2000 BN dollars.

[2] Usually, 10 % of US corporates revise their financial statements. This percentage has increased five times in 2002. The average life of a CEO in his functions has shifted from 12 to 3 years over the lasts decade.

[3] How can the general public understand, for example, that, due to the existing differences in definitions, a French company listed in the US can show that its board includes 50 % of independent directors according to the French MEDEF-AFEP recommendations, 22 % under the Sarbanes-Oxley and 64 % according to the NYSE rules ?

b) <u>The adjustment is probably not yet over :</u>

- ❖ After the fall in asset prices, experts tend to calculate that PERs have become "more normal". The long term ratio between US market capitalization and macroeconomic profit trends has been on average 17.5 over the period 1955-2003. It went up to 45 at the peak of the bubble and is now back to 17.5. But after speculative bubbles, this ratio has a tendency to overshoot downwards. <u>So, further asset price declines are not to be ruled out</u>.

- ❖ Banks tend to become <u>more risk-adverse</u>, more selective and, rightly so, more price-driven in their lending. Although no global credit crunch is observed (the world corporate sector is highly liquid and the banks at large are in a strong financial position) some areas (small and medium size enterprises) are starting to be constrained.

- ❖ Bank's internal credit assessment models are often correlated to market equity values. This compounds the <u>pro-cyclicality</u> of bank lending and its volatility. A number of IAS 39 regulations go in the same direction. In this respect, it would be, for example, a major mistake, especially in Europe where the economy still relies so much on bank intermediation to adopt the fair value accounting rules as proposed by the IAS Board for derivative hedging.

- ❖ Past euphoria has led to <u>expensive acquisitions</u> that have now to be written down. In the United States, 700 B$ of goodwill have been written down in 2002. The figures in the European Telecom industry are also dramatic. For sure, these exceptional provisions clean up the balance sheets, but the debt that was incurred to pay for those acquisitions remains and has become the focal concern of analysts and rating agencies.

- ❖ Given the <u>massive misallocation of resources</u> brought about by easy monetary conditions and by the consequent bubble, <u>the economy is in a situation of significant overcapacity</u>. This does not augur well for a strong upsurge in business investment.

- ❖ <u>Households and consumers</u>, which have been the pillars of world growth over the past years, have yet to be convinced that things are improving.

- will they wish to save more given the uncertainties and their pension retirement concerns?
- will they be reassured that corporations are sound and investing again ?

- or will they be depressed by the ongoing adjustments (layoffs) that are taking place in the overindebted and overstretched (capacity wise) corporate sector ?
- how long will the indispensable "mending" of balance sheets take to unfold ?

ooo

Those are indeed some basic questions that will take some time to receive answers but seem more crucial than any "smart" regulatory devices that one can think of.

In the background of course, loom the real but too often unaddressed fundamental issues : the large macroeconomic uncertainties linked to the US current account deficit and to the dollar, the sagging Europe and its lack of reforms, the loss of confidence suffered by emerging markets, the Japanese unsolved problems,…. And on top of all that, the geopolitical uncertainties….

To address these issues in a way that can reassure investors and consumers, the world needs healthy and steady growth and thus a strong collective economic policy leadership from the G7 and the multilateral institutions.

* *