

Date:15/03/2007 URL:

<http://www.thehindubusinessline.com/2007/03/15/stories/2007031503931500.htm>

Monday, March 26, 2007 Sensex , ACC LTD 734.55 -11.10+ BAJAJ AUTO 2,509.70

Fickle capital flows and equally fickle market psychology

D. Murali



WORRIED stockbrokers monitoring the falling Sensex as the BSE benchmark closed 453 points down in Mumbai on Wednesday. - Paul Noronha

Chennai March 14 The day's headlines are about Sensex tumbling over 453 points on funds selling, markets plunging, and global sell-off melting the indices. One also saw quite a few 'tanks', 'nosedives' and 'falls' in the market reports .

'Have the markets gone crazy? Or have they just regained sanity?' These are the questions that Mr Ramkishan S. Rajan, Associate Professor, School of Public Policy, George Mason University, poses as the title of a new paper posted on www.opinionasia.org. He discusses how the events of February 27 were a major shock, not only to Shanghai's benchmark index, which fell by about 9 per cent, 'its largest decline in a decade'. Markets in the rest of Asia, including India, felt the tremors.

"The Asian meltdown in turn led to negative spillovers to Europe as well as the US with the decline in the Dow Jones Industrial Average accelerating just before the close and after what seemed to be a computer glitch," narrates Mr Rajan, about the events at the end of last month.

"Overall the Dow crashed by over 400 points which in turn had negative ripple effects to Asia markets the following day. A self-reinforcing dynamic or vicious cycle was in place, with virtually all bourses globally being pummelled between February 27 and March 5."

At the time of writing, on Wednesday, the headlines speak of Dow thus: 'Dow plunges on subprime loan jitters' (*Newsday*), 'Asian stocks take a dive after Dow Jones selloff' (*Xinhua*), 'Dow drops more than 240 points' (*The Ledger*).

The situation has been 'ripe for a negative shock', notes Mr Rajan.

Where are the markets heading to in the near term? "No one is quite sure," says the paper. "The 'bears' argue that the global market meltdown was an accident waiting to happen. They opine that markets remain fundamentally over-priced and still have much more room to fall and we are

seeing the start of the unwinding as global liquidity tightens," writes Mr Rajan.

Okay, what do the `bulls' say? "That the decline is a temporary but sharp blip caused by knee-jerk reactions and that there are significant buying opportunities. They point to the fact that based on some commonly-used stock valuation methods (price-to-earning ratios, for instance), it is not apparent at all that Asian markets as a whole are over-inflated."

The author postulates that the financial markets could see a revival if the `bull' view found enough supporters, and `if there are no further near term negative shocks'. Weighty ifs, these are, but Mr Rajan is in no doubt that we are now in `a brave new world of increasingly synchronised global financial markets fuelled by fickle capital flows and equally fickle market psychology'. Take care, therefore.

"Intermittent shocks did in fact occur, most notably in May-June 2006 as stock indices across Asia - particularly India - fell following concerns about rising inflationary pressures and a slowdown in the US economy," he concedes. But these sell offs proved to be temporary and the markets bounced back and moved to new highs, he adds. "What these episodes did suggest was that markets were jittery and a major negative shock could have a significant adverse impact."

The paper traces the factors that lay behind the negative shock, which occurred only two weeks ago. Causes include: pronounced price appreciations since 2003, historical highs in the markets, and the so-called `carry trade' from Japan. For starters, the phrase `carry trade' refers to `the ability of financial market participants to borrow from Japan where interest rates are very low (around 0.5 per cent) and invest in the rest of Asia, the US and in other markets which offer higher returns.' Mr Rajan reasons how the simultaneous low interest rate policy and the unwillingness by Japan's Ministry of Finance to allow the yen to appreciate made carry trade profitable.

Capital inflows

Massive capital inflows into the US had set in motion `a seemingly virtuous cycle of growth and asset price appreciation globally (or at least Asia and the US)'. A rude jolt was what discerning economists feared as lying just under the apparent. To the lay, it may read like a thriller to know that `massive infusion of liquidity' led to `general upward pressure on regional currencies', even as the majority of central bankers `intervened to prevent marked currency appreciations by selling more of their currency and accumulating foreign exchange reserves'. But intervention too infused `greater liquidity in the domestic economy', which in turn, was sought to be mopped up by `tightening domestic credit'.

Since mopping up cannot be complete, one saw `asset price bubbles' and `overall inflation'. Cost-push pressures in some countries like India have further exacerbated inflationary concerns, observes Rajan.

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