



Have the markets gone crazy? Or just regained sanity?

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Stock markets around the world have, until recently, experienced a significant run-up in prices. These appreciations, which started in 2003, have been particularly pronounced in Asia where many stock markets have been pushed to a series of historical highs.

While the booming economies in Asia have attracted massive capital inflows, there has been a corresponding increase in liquidity at the global level -- not just in Asia. It is conventional wisdom that the primary source of global liquidity has been the so-called "carry trade" which largely originates from Japan. This essentially refers to the ability of financial market participants to borrow from Japan where interest rates are very low (around 0.5 percent) and invest in the rest of Asia, the US and in other markets which offer higher returns.

If markets worked efficiently, such carry trade ought not to be profitable on a sustained basis - as in theory, the low-interest rate country ought to be compensated with a general expectation of currency appreciation (i.e. low yields and expected capital gains or high yields and expected capital losses). However, in the case of Japan, while interest rates have been kept low as the economy attempts to recover from its decade-long crisis in the 1990s, at the same time, there are concerns about allowing the yen to appreciate at the expense of a loss of export competitiveness. This simultaneous low interest rate policy coupled with the unwillingness of Japan's Ministry of Finance (MOF) to allow the yen to appreciate has made carry trade profitable. That said, it is fairly difficult to get an exact handle on the size of this carry trade.

In any event, the massive infusion of liquidity into Asia has led to a general upward pressure on regional currencies. While some currencies such as the Korean *won* have experienced a degree of currency appreciation, most Asian economies have been worried about concerns about export competitiveness. Accordingly central banks have intervened to prevent marked currency appreciations by selling more of their currency and accumulating foreign exchange reserves as a result of the intervention. The side-effect of this intervention has been the infusion of greater liquidity in the domestic economy.

While some of this new liquidity has been mopped up via tightening of domestic credit conditions, this so-called monetary sterilisation has not been complete or perfect, leading to the fuelling of asset price bubbles and, in some cases, even overall inflation. Cost-push pressures in some countries like India have further exacerbated inflationary concerns.

Increasingly, Asian central bankers have allowed a degree of deregulation of capital outflows to try to reduce upward pressures on their currencies, though results of this policy have been mixed at best. Some countries like Thailand attempted to impose controls on some capital inflows, but this policy was quickly reversed as the markets immediately displayed their acute disapproval of such dirigiste policies.

While central bankers in Asia have been concerned about the liquidity effects of such massive capital inflows, financial market investors have benefited significantly from sharp equity price appreciations. In spite of intermittent concerns over the speed and extent of price appreciation and the relative lack of volatility of the markets, very few market participants were willing to miss out on the apparent never-ending market boom.

The reserve build-up by Asian central banks as well as carry trade from Japan has led to a massive capital inflow into the US which in turn helped finance the widening US current account deficit and kept long-term interest rates low. Low long-term interest rates in the US in turn contributed to a sharp escalation in US real estate prices and a consequent decline in household savings as US households consumed out of their increased asset wealth. The domestic consumption boom in the US has in turn fuelled export demand from

Asia, leading to a seemingly virtuous cycle of growth and asset price appreciation globally (or at least Asia and the US).

Yet there remained an under-current of uncertainty as to how long the boom would continue. More specifically, the unaddressed concerns of policy makers and financial market participants were about what would happen if there was a negative shock to the system? What if the *yen* started to appreciate; what if the Bank of Japan raised interest rates sharply (both of which would lead to make carry trade unprofitable)? What would happen if the recent slowdown in US housing prices, which has led to a sharp downturn in the so-called "sub-prime" end of the mortgage market spreads to the rest of the mortgage industry? If the housing downturn became more widespread, would it fuel household bankruptcies and exacerbate the already slowing US economy? If this slowdown happens, what would it mean for the rest of Asia which remains dependent on the US as the export market of last resort? In a nutshell, while the global economy has been very robust in the last few years, one could argue that it has become highly leveraged.

A situation like this was ripe for a negative shock. Intermittent shocks did in fact occur, most notably in May-June 2006 as stock indexes across Asia --- particularly India -- fell following concerns about rising inflationary pressures and a slow down in the U.S. economy. However, these sell offs proved to be temporary and the markets bounced back and recorded new highs. What these episodes did suggest was that markets were jittery and a major negative shock could have a significant adverse impact.

One such major shock did occur on February 27, 2007 with the Chinese authorities announcing their intention to crack down heavily on illegal share offerings and take other steps to cool speculative activity, which were viewed as being partly responsible for the market's recent record increase. To be sure, the Shanghai Stock Exchange has, like its Asian counterparts, experienced an unprecedented bull run in prices in 2006 and early 2007, which has been a cause for concern for the Chinese government especially in view of the annual early March meeting of the all-important National People's Congress (NPC). These concerns sent Shanghai's benchmark index -- which had just the day before reached a record high -- sharply down by about 9 percent (its largest decline in a decade) and sparked a massive sell-off in the rest of Asia, with Indian, Southeast Asian and Australian markets also suffering major losses.

The Asian meltdown in turn led to negative spillovers in 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. Overall, the Dow crashed by over 400 points which in turn had negative ripple effects in Asian markets the following day. A self-reinforcing dynamic or vicious cycle was in place, with virtually all bourses globally being pummeled between February 27 and March 05, 2007. In the aftermath, concerns have been raised that the sell-off and reversal of global financial flows would negatively impact the global macro-economic system.

Clearly no one is quite sure where the markets are headed in the near term. 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. In their reckoning, all this represents a the start of an unwinding process as global liquidity tightens.

In contrast, the 'bulls' note that the decline is a temporary albeit sharp blip caused by knee-jerk reactions, but that significant buying opportunities remain. 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. If there are enough participants who take the latter view -- i.e. that this has only been a correction within an overall bull market trend -- and if there are no further near term negative shocks, financial markets could see a revival.

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