Macroeconomic imbalances and financial market stability

BY NOR ZAHIDI ALIAS

Back in December 1996, then US Federal Reserve chairman Alan Greenspan expressed his anxiety over the sentiment in the US equity market, which he thought was overly bullish at the time. His famous market-roiling phrase was "irrational exuberance", which he used in one of his famous speeches.

However, he did not manage to deflate the equity market. No — the market swung back after a brief consolidation and climbed to its peak before bursting in 2000 during the dot-com bust. Fast-forward to June this year and Fed chair Janet Yellen has similar concerns about US equity prices. Greenspan, however, is more cautious about the bond market, saying that the real bubble now is not in equity prices. Indeed, he says the impact of further interest rate hikes on the bond market has not been discounted in the marketplace, so the financial markets are in for a surprise.

No matter who is right or wrong, it is comforting to hear prominent economists talk about the increasing risk in the financial markets. This is actually good news. It would be worrisome if everyone felt safe and optimistic about the future direction of global stocks and bonds. This is especially true when the size of the global financial markets — both stocks and bonds — has grown by leaps and bounds in the past few decades. In some emerging markets in Asia, for instance, massive portfolio inflows in recent years have bolstered foreign holdings of bonds and equities. Consider this. At the end of 2005, foreign holdings of Malaysian and Indonesian local currency denominated government bonds were about 5% and 7% of total government bonds outstanding respectively. By the end of 2016, they were 31% and 38% of the total outstanding.

History has shown how different economies respond to financial market risks. Generally, countries with macroeconomic imbalances tend to suffer more when the financial markets turn against them. The reason is quite clear — the so-called herd mentality plagues the vast majority of investors. In a country where serious economic imbalances already exist, investors' fears are normally magnified when the financial markets take a hit. In such a situation, human psychology plays an important role in making investors anticipate the worst possible outcomes. Thus, the intensity of a market downturn is stronger, leading to a self-fulfilling prophecy where currencies are hit and real economies seriously impacted. This vicious circle would not stop until some rationality emerges from the investor fraternity.

Take the Great Depression in the 1930s. Although a monetarist like Milton Friedman kept blaming the contraction in money supply for the economic catastrophe at that time, an economic imbalance, that is a property bubble, already existed in the early 1920s in the US. The bursting of this bubble in the late 1920s in places like Florida and Chicago made the impact of the stock market collapse in 1929 more severe than it would otherwise have been. Some studies indicated that in Chicago, property prices leapt by 150% between 1918 and 1926. In Miami, city lots were said to have been bought and sold as many as 10 times in a single day! When the property bubble finally burst, prices collapsed by more than 70% in some places and vacant lots were estimated to be in the millions. Foreclosures also surged, causing widespread misery until the great stock market collapse took place in 1929.

Similarly, the end of Japan's Economic Miracle in the late 1980s brought the Nikkei index down by half in the 1990s, after a period of over-exuberance. At the time, financial institutions took excessive risks in their lending practices. Being overly confident, investors pushed up real estate and equity prices to dizzying heights. Indeed, Tokyo real estate prices were said to be more than 300 times those of Manhattan, New York. A famous rumour going around was that the land on which the Tokyo Imperial Palace was sited was worth as much as the entire state of California! With this over-exuberance, the Nikkei index tripled within four years, reaching 39,000 before its eventual crash in 1990.

The story in Mexico sounds similar. Prior to the well-known Tequila Crisis in 1994 and1995, the economy rested on an exchange rate that was closely linked to the US dollar. That boosted confidence among foreign investors, who lent out massive amounts in the hopes of high returns. Some argued that prior to the crisis, investors were overly confident about the "new era" of Mexico following its inclusion in the North American Free Trade Agreement under President Carlos Salinas. Of course, there were signs of macroeconomic distress to some extent. In particular, Mexican current account balances were in deficit for several years. Eventually, reality set in and investors fled in droves, causing rapid currency depreciation and an equity market crash in December 1994.

In Thailand, prior to the baht's devaluation that preceded the Asian financial crisis in July 1997, an economic imbalance that emerged following inflows from abroad to unproductive sectors, such as real estate, made the financial

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market downturn more serious than expected. Prior to the downturn, foreign inflows poured in to capitalise on high interest rates and an exchange rate that was closely pegged to the US dollar. This led to a surge in the kingdom's external debt to around US$80 billion in March 1997, from just US$40 billion in 1992. The misallocation of resources was also evidenced by careless lending, especially to the property sector. It was reported that financial institution loans to property developers tripled between 1993 and 1996, and more than 700,000 housing units were built in Bangkok alone — twice the number planned by the government.

Of course, the financial market chaos in 2008 and 2009 was preceded by the US housing market bust. Again, over-exuberance over the prospects of the housing market led to the emergence of creative financial products that enabled subprime mortgage buyers to purchase properties they would not normally be able to afford. At the same time, the repeal of the Glass Steagall Act in 1999 (by the Gramm-Leach-Bliley Act), signed by the then President Bill Clinton, brought back the animal spirits among bankers who invested in risky financial products in the hopes of making huge financial gains.

These imbalances caused the financial markets to go wild by October 2007. As a result, the S&P 500 and Dow Jones indices plunged by more than 50% from their peaks by March 2009.

With all these in mind, it is not surprising to see China getting extremely cautious about its economic imbalances. Recent reports indicate that the government is taking various initiatives to ensure financial stability, which, if not properly guarded, will threaten the country's future economic growth. Excessive borrowing and speculation are being closely monitored to prevent the Japanese-style economic collapse of the late 1980s. Outbound investments are also closely scrutinised, leading to a sharp 55% drop in value in the first half of 2017 alone.

It is our hope that China succeeds in its mission, as our regional economies are closely intertwined with its economy. At the same time, regional economic imbalances should continue to be monitored. Being overly leveraged is risky as it leads to the underpricing of risks. Debt has to be contained, while massive short-term inflows into unproductive investments should be avoided. E

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