Do ‘Markets’ talk sense?

C. P. Chandrasekhar

As the state election results trickled in on December 11, to the surprise of many, the Sensex after a hiccup rose and closed 190 points above its previous end-of-day level. The following day too, the Sensex moved upwards. This was a surprise to many, since the impression had spread that influential players in the market favoured a return of a Modi government in 2019. To the extent that the defeat of the BJP in three important states was a signal of a possible defeat next year, they expected investors to walk out, triggering a market collapse. That did not happen.

This could be interpreted as the ‘markets’ turning sensible. In fact, having gone wrong, some observers argued that their prediction did not prove right only because the markets had already made the necessary “correction” for a possible 2019 BJP defeat by their response to the exit polls, which too had suggested that the BJP may not fare too well. Not only had the Sensex fallen by 7 per cent on the Monday following the Friday evening when the results of the exit polls were revealed, but the shares that took a beating included those of companies from the Ambani and Adani stables—two industrialists who are alleged favourites of the leaders of the current government. So, the buoyant trend in the market after the announcement of the poll results was a surprise only because those who expected a downturn had not taken account of the fact that the markets had already factored in the political uncertainty that an unfavourable result for the BJP gives rise to.

This explanation is a bit bizarre. It suggests that the market is so perfect that a one shot ‘correction’ can take care of the current political uncertainty. The Sensex, it is being claimed, fell 714 points between the close of trade on Friday and that on Monday to ‘factor in’ the uncertainty arising from the current government’s political vulnerability signalled by the exit polls. Once that was done it could return to ‘normal’ behaviour. And in this case, with global oil prices easing and signs that the Federal Reserve would hold back on raising interest rates further, which would stall the exit of foreign portfolio investors from emerging markets like India, the Sensex must normally rebound, which it did on the day the actual results were coming in.

Reasoning of this kind is driven by the need to make market movements, termed ‘behaviour’, sensible. Investment advisors, market observers and journalists are not the only ones prone to such blind faith in the intelligence of markets. Viral Acharya, the Reserve Bank of India’s Deputy Governor, and a Professor of repute at New York University’s Stern School of Business, who one would think should know better, is also a member of the club. Incensed by

the political leadership's interference in the affairs of the central bank, which he believes should be independent, Acharya lashed out at the government, warning it of invoking the wrath of markets if it persists. "Governments that do not respect central bank independence will sooner or later incur the wrath of financial markets, ignite economic fire, and come to rue the day they undermined an important regulatory institution," he said, in a lecture delivered late October.

In fact, Acharya went even further. He placed the markets above even the central bank he implicitly privileges relative to the government. In his view, "the presence of this third player – the market – in the back and forth between a government and the central bank (more generally, regulatory institutions) is an important feedback mechanism. The market can discipline the government not to erode central bank independence, and it can also make the government pay for its transgressions. Interestingly, the market also forces central banks to remain accountable and independent when it is under government pressure."

However, the markets have not obliged Acharya either. On December 10, clearly disturbed by the demands an intransigent government were making of him, RBI Governor Urijit Patel, who had gone along even with the demonetisation decision, chose to resign, days before the next meeting of the Monetary Policy Committee of the central bank. The government did not bat an eyelid, just accepted his resignation, and very soon appointed retired finance ministry bureaucrat Shaktikanta Das, among whose claims to fame was that he (mis)managed demonetisation, as the new Governor for three years. If Acharya was right, this clear signal that the Modi government has no time for talk about central bank independence should have riled markets, even if the uncertainty about 2019 spurred by the assembly elections had been factored in. Markets should have collapsed. Instead the Sensex rose. Going by the expectations of those who swear by the 'market', this behaviour did not amount to talking sense.

The fact of the matter is that a range of factors influence investors' decisions and their portfolio choices. But for all such investors, so long as there is money to be parked, investment decisions cannot be avoided. The only choices are the markets and the instruments in which investments are made. None of these decisions are necessarily "rational". They are reasoned bets based on guesstimates of how the market would move, which together actually influence the way markets move. There is no reason whatsoever why the guesses and the outcome should match. To see sense in this cacophony is to drop all reason.

Taking a longer view there is only one consistent signal that markets globally have been sending out in recent years: if there is money available in the system and it is going cheap, market players would use it to speculate. And when they do, the market, for a time, behaves as if there is only one direction in which it

can move, which is ‘up’. Till the bubble bursts. Even during the years following the global financial crisis, when the real economy in the advanced countries was performing poorly, the ‘markets’ were booming, because of the large volumes of cheap money injected into the system through the policy of “quantitative easing” adopted in response to the crisis.

In fact, ever since the early 2000s there has been a lot money—or liquidity as they call it—in the system, injected by ‘independent’ central bankers. Before the 2008 crisis the likes of Federal Reserve Governor Alan Greenspan did it because inflation was not a threat, and only when that was the case did they see a need to rein in money supply and raise interest rates. Since governments in the advanced nations had embraced austerity and were spending less, demand was on average depressed. Simultaneously, capacity was being relocated to low wage locations like China, reducing costs of production and prices. For these reasons, inflation, occasionally triggered by rising oil and commodity prices, was generally subdued. So feeding the system with cheap money became a habit. The speculative boom this triggered and the hideous forms it took finally gave, precipitating the 2008 crisis. But after a short period, speculation once again raised its head, driven this time by the cheap money delivered to address the crisis.

Since in a globalised world capital is freely mobile, it does not stay in the countries where the liquidity is generated. It flows across borders, including to “emerging markets” like India. So asset markets globally experience a speculative boom. And when the boom gives way to a crash, this affects all markets. There is a strong tendency to synchronisation of market movements worldwide, which makes domestic factors like election results or a spat between the government and the central bank less determining.

In recent times, fears that the financial boom that has been underway since 2009 cannot be sustained have hounded global markets. Central banks in the advanced countries were being forced to recognise that their cheap money policies had set off asset market bubbles the world over. So the pressure to unwind quantitative easing raise interest rates from their near-zero levels has increased. The prospect of losing access to cheap money is forcing speculators rethink their game. But there is no clear or consistent trend in markets. Central banks are not independent of markets. They fear that if they wind down the easy money regime too fast, markets would collapse. This has made the retreat from what are euphemistically called “unconventional monetary policies” slow and halting.

The net result is that, with some small change, the regime of easy money continues. So, in the markets, the game is still on, though played with less intensity. While the intensity of the speculative boom has weakened and volatility has increased because the weight of fear in decision-making has risen,

markets themselves are yet to unwind. Their vulnerability is reflected in their volatility, so that short term movements defy explanation. To look for a disciplining force in such markets is without basis. Essentially, markets never were nor can be “rational”, so they cannot be sensible enough to discipline governments and central banks to do the right thing. Rather, they have in recent decades forced central banks to adopt measures that fuel speculation, and are therefore patently wrong.

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