Warnings issued over share market surge

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Wall Street has continued to surge, with the three major market indexes reaching new record highs yesterday, despite the continuing impact of the coronavirus outbreak on the world economy and indications that it will affect the US as well.

The effects on the Chinese economy were underscored by a report this week that the country's consumption of oil is expected to plunge 25 percent this month. The expected fall in consumption is predicted to be 3.2 million barrels a day throughout February, an amount equivalent to 3 percent of global consumption.

South Asian authorities are becoming increasingly concerned about the economic fallout from China. The Thai central bank earlier this week cut interest rates to a record low and warned the economy would expand at "a much lower rate" this year than it had previously forecast.

Singapore authorities have indicated there may be a need for a currency depreciation to counter the effects of the China slowdown with a major Malaysian bank lowering its annual growth forecast for the island state from the already low rate of 1.8 percent to 1.1 percent.

Oxford Economics has said that the effects of the virus could cut between 0.1 and 0.2 percentage points from US gross domestic product but the main impact will be in China and economies in the Asian region.

"The intensifying coronavirus outbreak constitutes a large negative shock to China that will ripple through the global economy," Kathy Bostjancic, chief financial economist at the group, stated. It was "too early at this stage to rule out either a less severe or more serious and long-lasting impact."

At this point, US markets have discounted any significant effects of the virus, confident they will be offset by the continuing cheap money policy of the Federal Reserve and intervention by Chinese authorities to prevent a slide in its share markets.

Since the fall on Wall Street last Friday, when the Dow dropped by 600 points, markets have risen every day. So far this week, the Dow is up by 4 percent, the S&P 500 by 3.7 percent, with the Nasdaq gaining 4.5 percent.

But amid the continued rise, there are warnings that the divergence between asset and equity prices and developments in the global economy are unsustainable in the longer term.

The well-known financial analyst Mohamed El-Erian wrote a comment in the *Financial Times* earlier this week in which he pointed to a "tug of war" between "favourable sentiment and mounting longer-term economic uncertainties."

He warned that the "virtual economic stoppage" of economic activity in China was "cascading" throughout the world's second-largest economy and fundamentally "weakening the country's services sector, at a time of considerable challenges for manufacturing."

This was a particular problem for Europe, he noted, as the European Central Bank was "effectively out of productive ammunition" and governments had yet to implement a comprehensive pro-growth package.

The ECB has kept its interest rates in negative territory and has resumed its program of asset purchases, neither of which has stimulated economic growth. Euro zone growth in the fourth quarter of 2019 was just 0.1 percent after unexpected contractions in both the French and Italian economies.

According to El-Erian, the markets have been underpinned "by the belief that central banks were always willing and able to suppress volatility and boost asset prices. That fueled investors' fear of missing out on a seemingly never-ending rally."

But the coronavirus had the "potential to constitute a structural break for markets" and, given that it had yet to be sufficiently absorbed, this created "equity and liquidity risk."

Speaking to the business channel CNBC following his *Financial Times* comment piece, El-Erian said liquidity could be decoupled from economic fundamentals for a "very long time" but a point may arrive where central banks were "not only ineffective but counter-productive."

This theme was taken up in an address to the National Press Club in Canberra on Wednesday by the Reserve Bank of Australia governor Philip Lowe. He noted that the world economy might be reaching a "crossover point" in which low interest rates might be "too much of a good thing."

Lowe said the central bank was paying particular attention to the use of increased debt both in Australia and internationally as house prices and corporate debt rose higher.

"Higher asset prices and a willingness to take on more risk can be good for the global economy, especially if they lead to more investment, not just more borrowing." If they just led to "more borrowing then we are going to have more problems."

During question time, he acknowledged that the three rate cuts carried out by the RBA last year had not lifted private investment, adding he did not expect them to do so in the short-term.

But the international experience is that they have not done so in the long-term either. Since the global financial crisis in 2008, interest rates around the world, and above all in the major economies, have been at historically record lows but investment continues to remain at levels lower than in any previous recovery phase in the post-war era.

Lowe said there was a risk that low interest rates encourage too much borrowing and drive excessive asset valuations.

"There is a concern that we could be getting close to a crossover point where what has been a good thing may not be such a good thing in the future. There is no precise point for that crossover, we are just trying to judge it carefully both here and overseas."

Asked a question as to whether he expected a greater fiscal response by governments, Lowe's comments indicated that behind the reassurances they have the situation under control, central bankers and other financial authorities really have little idea about what to do about the dangers that at least some of them clearly recognize.

"The standard way of thinking for the past 20 years has been that monetary policy really is the stabiliser, deals with the economic cycle, and fiscal policy just deals with the structural issues. But with interest rates as low as they are there is limited scope in the future, probably, for monetary policy to play exactly the same role that it used to play."

He posed the question of whether there was something fiscal policy could do if monetary policy could not or "are there so many problems using fiscal policy that it's just too hard to do?"

He said this was a discussion taking place between the RBA and the treasurer in the Australian government as well as in international forums and "it's something we talk about a lot."

Meanwhile, as the talk continues, the policies pursued by central banks around the world, and the belief they are willing and able to come to the rescue of the financial oligarchy as they have in the past, are widening the divergence between financial markets and the underlying economy.