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Market swings & equity wealth effect

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Synopsis
Sharp fluctuations in asset prices can fuel expectations in a rather irrational way, which can cause systemic risks. **Should you invest in gold now?**

The markets are gyrating. The consequential change in demand (Pigovian wealth effect) that accompanies massive changes in wealth ��� realised / unrealised, real / illusory ��� from market valuations has upset the ���economic bliss��� (standard macro-economic identities). Macro-economic policy makers need to wake up to this reality and explore new policy parameters to restore and push up the ���economic bliss��� to higher levels.

Look at the figures. India���s GNP was Rs 41 trillion in 2006-07. The market value of equity portfolio is almost double that figure, however. More importantly, the market capitalisation increased by about Rs 38 trillion, almost the size of the GNP, in the first nine months of this fiscal. Add to this the rise in valuation of real estate and bullion (major asset portfolios, the latter particularly in India): welcome to the world of ���unearned��� income with both its real and illusory effects [wealth illusion, similar to the Patinkin ���money illusion���] that could trigger an age of much higher aggregate demand (consumption and investment) far in excess of the aggregate supply or income.

There are times in a market economy when the aggregate demand exceeds GNP. This happens when the portfolio owners perceive themselves to be richer due to an asset price boom of the kind that India experienced in 2007. Consequently they feel more comfortable and secure, and tend to spend more. Since the increase in wealth is ���unearned���, they may splurge a little. Or, at least the urge to add more to their portfolio reduces and they save less. A sharp decline in savings is, therefore, not uncommon in the economies where wealth is driven by higher equity valuations.

The very low rate savings in G7 countries in 1990s exemplifies this. The asset price boom reduces cost of capital, which coupled with higher consumption demand, pushes up investment demand. The portfolio owners are comfortable to bet on more investment. The combined increase in consumption and investment shifts aggregate demand function upwards because of the positive ���wealth effect���.

Higher the proportion of people who depend on passive income for livelihood, higher the average size of portfolios, higher the proportion of market-linked assets (securities, real estate, bullion, etc) in the portfolios, higher the elasticity of demand to changes in wealth, the higher is the magnitude of wealth effect. A sharp and lasting change in asset valuation could cause sharp and lasting wealth effect on the level of demand. Measuring the wealth elasticity of demand and modelling for the demand for changes in asset prices, however, is not an easy task as it is not amenable to the ceteris paribus assumption. But the effect, as revealed by many studies, is generally positive and would not be insignificant, more so, if size of ���unearned��� income is a multiple of the GNP.

Assume an economy which consumes 65% and saves 35% of its GNP and where investment is equal to savings. If it has an ���unearned��� income (increase in wealth from equity valuation) equal to GNP, it may consume about 5% of this leading to consumption rate of 70%. Probably this explains a part of the recent ���consumerism��� in India. It may also invest about 5% of the increase in wealth (investment demand of Rs 8 lakh crore in recent Reliance IPO did not come from current GNP) leading to investment rate of 40%. This onsets disequilibrium where aggregate demand (investment) exceeds GNP (savings) and inevitably drives up the economy through the ���multipliers��� and ���accelerators���. While these happen, the prices of other assets (non-equities) also go up, creating a ripple wealth effect from those assets also. As the movement approaches equilibrium, the resultant economic growth propels further higher valuations of equities putting a virtuous circle in motion.

Higher economic growth, generally though not necessarily, leads to higher valuation of equities. However, higher valuation of equities necessarily means higher wealth effect, aggregate demand and economic growth. The bull markets can, therefore, power the economies through wealth effect, while economic growth may not always propel a bull run.

The wealth effect reflecting relationship between aggregate demand and equity valuation is a double-edged sword. The poor equity valuations in bear markets can hurt economic growth particularly if the erosion in equity valuation in a day is as high as one-fourth of GNP as witnessed in the recent past. This may even lead to the withdrawal of public issues and consequently lower investment. In such cases, the aggregate demand would be much less than the supply to onset the disequilibrium. This would inevitably drive down the economy through ���multipliers��� and ���accelerators���. The stock market crash of 1929 caused sharp decline in wealth, reduced consumption sharply and contributed to depth of the Great Depression. The macroeconomic managers have to worry about the demand and the economy if the stock prices fall sharply from the exalted levels.

With globalisation, the economic agents of one economy hold assets in other economies. The variations in asset valuations in other economies have significant wealth effect in the host economy. Further, since the markets are linked globally, the valuations in one market have ripple effect on others. Time is not far off when the sharp gyrations in valuations of equity or other assets in any part of the world would contribute to divergence between aggregate demand and supply and can move the economies up or down depending on the degree of integration with the global economy and the direction and size of valuations.

As more people invest in market-linked assets and depend on markets for their income and wealth, asset price volatility anywhere in the world could have severe macroeconomic consequences and implications for monetary policy. A substantial rise in asset prices will increase ���unearned��� incomes and consequently aggregate demand and vice versa. This will amplify macroeconomic swings. Besides, sharp fluctuations in asset prices can fuel expectations in a rather irrational way which can cause systemic risks. This will increase the demand for effective regulation, backed by sound macro policies framed on the basis of these new realities.

(The authors are civil servants. Views are personal)