Special Topic 1

Asset Prices and Financial Stability

In recent years, both international and domestic asset prices have been, in general, on a rising trend. In particular, the real estate price and stock price have been rising at a quick pace, attracting people's attention.

Impact on Financial Stability Brought about by the Fluctuation in Asset Prices

Asset prices mainly refer to the prices of such major assets as stock, bonds, real estate, foreign exchange, and so on. Most studies on asset prices focus on the stock price and real estate price. Some fluctuations in asset prices are normal while others are not. To maintain financial stability, governments across the world devote their attention to abnormal fluctuations in asset prices. These abnormal fluctuations negatively affect financial stability at both the macro-level and the micro-level.

At the macro-level, the abnormal fluctuations in asset prices disrupt financial stability in the following ways: Firstly, they affect investment. The abnormal fluctuations will lead to the change in the expectation of asset return and change in asset demand, and this will result in fluctuations in corporate investment and financial activities. Secondly, they affect consumption. The abnormal fluctuations will lead to the changes in the financing of asset owners and those who demand assets and therefore will result in fluctuations in consumption. Thirdly, they affect the balance of international payments. In an open economy, the abnormal fluctuations in asset prices will affect such factors in the balance of international payments as the flow of funds, size of foreign debts, foreign exchange reserves and the exchange rate of the local currency. They will in turn create problems for the debt repayment capacity of enterprises and the government as well as the balance of international payments. Fourthly, they affect inflation. The abnormal fluctuations of asset prices will affect the inflation rate and will make it more difficult to formulate and implement the monetary policy.

At the micro-level, the abnormal fluctuations in asset prices disrupt financial stability in the following ways: Firstly, they affect enterprises' operation. The burst of asset prices will make the financing cost of enterprises higher and reduce their activities, production capacity, profits, debt repayment capacity and investment demand. Secondly, they affect individuals. The burst will reduce their wealth, debt repayment capacity and consumption demand. Thirdly, they affect the financial institutions' activities. The burst will increase non-performing assets, erode bank capital and lead to credit squeeze. Furthermore, the deterioration of bank assets may also result in the outflow of deposits and bank run. It may even lead to currency substitution, capital flight and drastic fluctuations in the economy.

The abnormal fluctuations in asset prices led to many occurrences of financial crisis and economic recession in the past. For instance, in the 1980s and 1990s, the abnormal fluctuations in asset prices severely disrupted the stability of Japan's financial system. The asset bubble in Japan emerged in the mid- to late-1980s and reached its peak during the 1987-1989 period. In 1990, the stock price and real estate price dropped in Japan by over 40% and 46% respectively. The burst of the asset bubble in Japan led to the drastic increase in non-performing loans and the unprecedented slump of the stock market. It negatively affected the confidence of enterprises and consumers and led to economic recession. For another example, in 1997, when the Asian Financial Crisis was at its height, some affected countries and regions witnessed drastic decrease in asset prices, which intensified the drop in bank deposits, loss in credit capital, devaluation of the local currency and the outflow of capital.

It should also be noted that the slump of the stock market only had a minor impact upon the overall economy. For instance, the NASDAQ Composite Index had been on a downward fall since March 2000, when it broke 5000 points to 2 471.9 points at the end of that year. However, the slump of the stock market and the burst of the bubble have not resulted in a financial crisis or any other major negative events upon economic entity. The main reason is that the US has a sound banking system and bonds market, which could resist the influence by the burst.

Global Asset Price Fluctuations and Global Financial Stability

Over the recent years, the world has witnessed a significant increase in asset prices. Some recent changes in asset prices in certain countries and regions have affected the global financial stability, becoming a concern of many countries.

Overview and reason of the rise in global asset prices

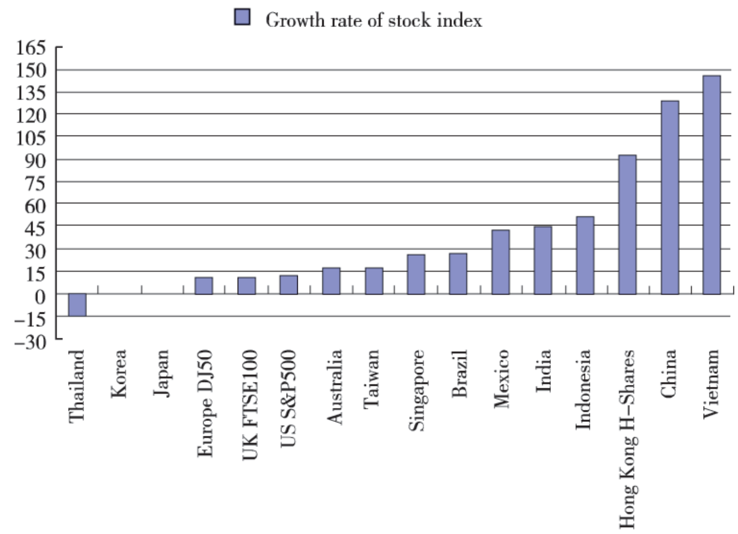
With economic globalization, trade and investment have linked different economies even closer. Assets are now allocated across the world, and the change of asset prices tends to be more synchronized throughout the world. Recently, global asset prices have been growing. Most stock markets have witnessed considerable increase, the house prices of some countries have been rising high, and so has been the growth rate in the prices of primary raw materials. In 2006, the growth rates of stock indexes in Vietnam, China, Indonesia, India, and Mexico, among others, were all above 40% (Figure A1.1).

The house prices of some countries also witnessed a rapid increase. Over the past 10 years, the asset prices in the UK, Australia, Spain, Sweden, the Netherlands, Belgium, France, Luxemburg, Italy, and the US have been increasing at varying degrees. Compared to the level 10 years before, the house prices in the US and the UK doubled and tripled respectively in September 2006 (Figure A1.2).

Since 2003, the prices of resources across the world have been increasing rapidly, which is supported by IMF Energy and Non-energy Commodities Price Indexes (Figure A1.3). In December 2006, the prices of British Brent

Figure A1.1 Growth Rate of Stock Indexes across the World in 2006

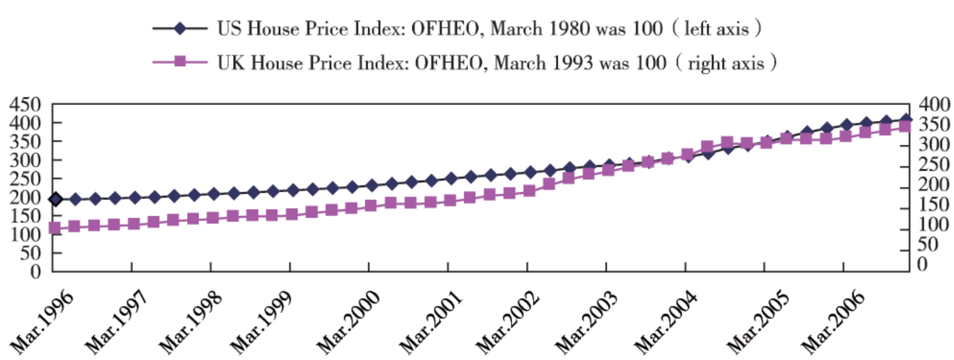
(*percent*)



Note: China's figure represents that of the Shanghai and Shenzhen 300 Index.

Source: Bloomberg, BNP Paribas.

Figure A1.2 Changes in House Prices in the US and the UK over the Past 10 Years

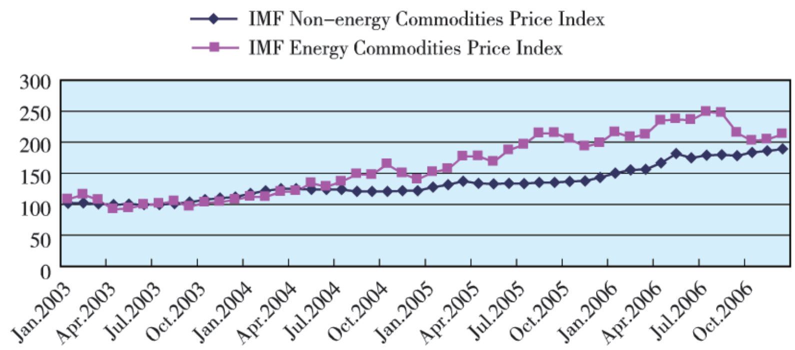


Source: CEIC.

crude, Brazilian iron ore, Canadian aluminum and British copper rose by 41%, 19%, 54%, and 111% respectively as compared with the level in January 2005 (Figure A1.4).

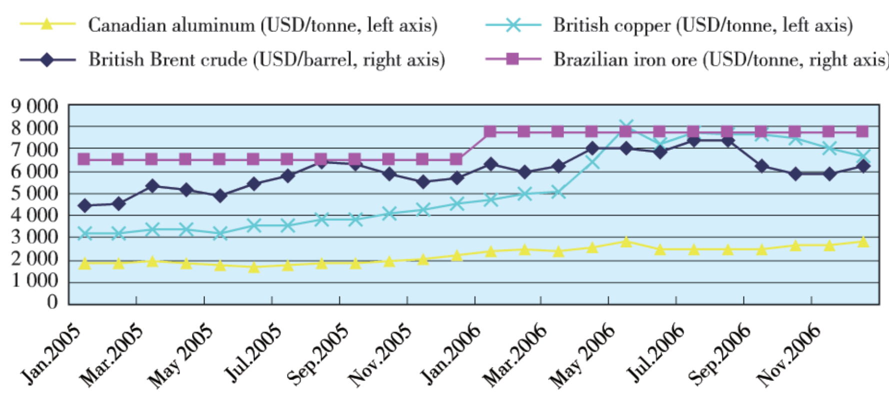
The major factors contributing to the rise of asset prices over the past few years are as follows:

Figure A1. 3 IMF Energy and Non-energy Commodities Price Indexes since 2003



Source: International Financial Statistics.

Figure A1. 4 Changes in the Prices of Commodities in the World since 2005



Source: International Financial Statistics.

Global economic recovery and relative political stability. Over the past five years, the world economy has been growing rapidly at an annual rate of over 4%. The economic growth has boosted the demand for assets. Despite such uncertainties as the Iraq War, oil supply and hurricane strikes, the overall global political landscape has been relatively stable, which has provided a favorable environment for economic development.

Drastic increase in cross border capital flow. Such factors as the yen carry trade and cross border M&A have increased the capital flow, boosting the asset prices.

Excess liquidity worldwide. The major monetary authorities have maintained a loose monetary policy for a long time. Furthermore, the deposit level in Asian countries and OPEC countries has been high. These have resulted in a surplus of liquidity worldwide. Investors with large sums of money are willing to take higher risks in their portfolio.

Rapid development of the financial derivatives market. The worldwide financial innovation and the growth of private equity investment funds have led to the rapid development of the securitization of assets and the capital market. The financial derivatives not only offer risk-aversion function for some economic entities, but also provide a platform for the surplus liquidity to seek the global assets. As a result, the liquidity of assets has been growing and the asset prices have been rising.

Growth of household borrowing. Over the past 20 years, the interest rate and inflation rate have been low and the household debts increased significantly. The growing demand for assets by individual investors has also boosted asset prices.

Optimization of the economic and financial policies and the acceleration of globalization. The economic and financial policies throughout the world become sounder and the fiscal deficits have been drastically declining. High growth and low inflation have been achieved. In the meantime, thanks to the globalization process of the emerging market, the world has benefited from a huge pool of low-cost labor and products, and these not only boosted the sustained economic growth worldwide, but reduced inflation pressure also. These factors, to a certain degree, have enforced investors' optimistic expectations on the increase in asset prices and have led to such increase.

Risks of the excessive fluctuations in global asset prices and the impact on global financial stability

Although the rapid increase in global asset prices over the past few years is somewhat rational, asset price bubbles and traces of adjustment can be discerned in some countries, leading to widespread concern on global financial stability.

A sound economic and financial environment is the key to support the increase in asset prices. The economic history of many countries shows that a sustained economic growth and a low inflation level will boost optimistic expectations, reduce risk premium, attract capital to the asset market, increase asset prices, and even give rise to asset price bubbles.

Furthermore, more and more retirees in developed countries are adjusting their financial asset allocation—they are reducing their financial assets and increasing their cash holding to meet retirement needs. This has created a pressure to lower asset prices. Recently, the risk of the adjustment in asset prices has been taking place.

The abnormal fluctuations in asset prices often lead to the fluctuations in investment and consumption, which in turn leads to the fluctuations in the economy. Furthermore, these fluctuations disrupt financial stability by affecting the behaviour of the enterprises, individuals and financial institutions. They also increase the difficulty in formulating and implementing the economic and financial policies worldwide. The decision makers across the world should work hard to strike a difficult balance between maintaining high growth and low inflation as well as preventing the abnormal fluctuations in asset prices and overheating.

The fluctuation in asset prices in China is mainly reflected in the real estate sector and the stock price. Experts have not reached a consensus yet as to whether the rise in asset prices is still rational. From the perspective of financial stability, we should focus more on the changes in asset prices. We should raise investors' risk awareness, and protect investors' rights and interests. Furthermore, due to low ratio of direct financing, corporate financing has been largely dependent upon the banking sector. The financial risk is largely remained in the banking sector. We should, therefore, pay special attention to the soundness of the banking sector during the fluctuations of the stock prices and prevent systemic risks.

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