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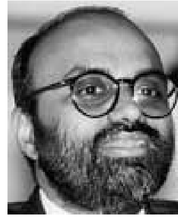
Stabilisation or socialisation?

GUEST COLUMN/ MARKET STABILISATION FUND

Jayanth R Varma / Ahmedabad June 21, 2004


Jayanth R Varma

The proposed market stabilisation fund would be a gigantic put option gifted by the government to stock market investors.

In their meeting with Finance Minister P Chidambaram in the beginning of this month, leading stock brokers are reported to have proposed that the government should set up a market stabilisation fund to support the stock market during periods of sharp declines.

It is very strange that stock brokers of all people should be making a proposal that runs counter to the fundamental reason why a stock market exists.

The function of the stock market is to allocate risk optimally among investors and thereby help in the optimal allocation of capital in the economy. The market stabilisation fund is an idea that harks back to the age when these functions were performed by the government.

For several decades prior to the reforms of 1991, risk was socialised and the government was the sole risk bearer in the economy. The ill effects of this socialisation of risk are still with us today.

As a nation, we still look up to the government to protect us from every risk that could befall on us. The result has been a huge burden of subsidies and market distortions that are impeding our economic growth today.

Interestingly, stock brokers are among the most vocal critics of these subsidies and distortions and are eager to embrace the idea that all other sections of the society must learn to live with the rules of market capitalism.

The proposal of the market stabilisation fund suggests that stock brokers do not wish to live by these rules themselves. When the shoe begins to pinch, everybody wants nanny government to replace market capitalism.

Proponents of the stabilisation fund point to parallels in other countries, particularly to the large purchases of stocks by the Hong Kong government during the Asian crisis in 1997.

Though Hong Kong did buy stocks, the objective was not to prop up the stock market, but to punish currency speculators. Hedge funds who were speculating against the Hong Kong dollar were shorting stocks to profit from the Interest rate hikes imposed by the currency board to defend the currency.

By buying stocks on a large scale, the government inflicted large losses on these hedge funds. This was not a stabilisation fund but one episode in a war between the government and currency speculators.

Let us not forget that a market stabilisation fund would involve a large subsidy from the government. At the end of the day, it is a gigantic put option gifted by the government to stock market investors.

The put option may be out of the money, but it does have a significant value and since the government does not charge an option premium for providing this put option, there is a large subsidy involved in this.

It is also interesting to note that though the term stabilisation is used, it is fundamentally asymmetric - it softens bear markets but does little to tame bull markets.

Sure, during the bull market, the stabilisation fund would sell the stocks acquired during the bear market, but that only returns the government to a neutral position.

A true stabilisation programme would require the government to take large naked short positions during a bull run and cover these short positions when prices retreat.

This analysis suggests that the proposed market stabilisation fund would in many ways be like the Food Corporation of India (FCI) - sitting on large buffer "stocks" financed with taxpayers' money.

There is delicious irony in the fact that many of those who favour the stabilisation fund would welcome a cut in the food subsidy.

After nearly 15 years of reform, the time has come for all of us to accept the rules of market capitalism. One of the first steps to be taken is the

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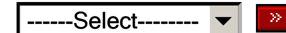

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de-socialisation of risk.

Financial markets, particularly derivative markets, provide fascinating ways to manage risk and allocate it to those most equipped to bear it.

Risk can be decomposed and traded in these markets quite efficiently. When risk is traded in transparent markets, it is also priced and this highlights the fact that protection from risk always comes at a price.

The cost of risk protection is obscured when a nanny state provides this protection, because the cost is now borne by taxpayers. Some people go to the extent of arguing that the state can bear risks easily because of its sovereign powers.

This argument is fallacious because it is the taxpayers who ultimately bear the risk and these taxpayers are ill equipped either to bear this risk or to hedge it.

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