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The most surprising aspect of China's recent stock market crisis was not the plunge itself, but the spasmodic overreaction by global financial markets. After all, it had long been known that Chinese equities were trading at implausible levels, driven in part by inexperienced local retail investors. Similarly, it was not exactly a secret that China's economy has arrived at a crucial moment in its development: Growth rates must come down significantly at the same that Beijing tries to implement major structural reforms. And perhaps less commonly known, but still relevant, is the fact that China's stock markets are far too small to be an accurate gauge of the country's underlying economic health.

Why, then, did the Dow drop by more than 1,000 points just minutes after opening on August 24, 2015 — dubbed by the Chinese media as the country's own Black Monday — with similar losses recorded worldwide? Did new information, in the form of Beijing's widely derided inability to intervene in its stock markets and allegedly bungled currency devaluation, suddenly expose hitherto unknown incompetence? Perhaps, but virtually all reputable China experts immediately and categorically dismissed the possibility of a Chinese financial meltdown. Was it that financial markets are much less efficient than commonly assumed, and prone to wild exaggeration? Although there is obviously some truth to that as well, Western stock markets are dominated by institutional investors who had plenty of time and access to the information needed to make intelligent investment decisions.

A closer look reveals the root cause of the rippling crisis: The volume of financial capital available for investing far exceeds what is needed in the real economy. In other words, the world's supply of financial savings is much larger than what is demanded for investment in economic activities, creating an enormous pool of excess liquidity sloshing around global financial markets in search of higher returns anywhere they can be found.

At first blush, that may sound like a wonderful problem to have; who wouldn't like to have more money than they know what to do with? And although that may be true for individuals, the story is entirely different at the level of the aggregate economy. There, excess capital can create significant problems that not only distort and destabilize the financial system, but also spill over into the real economy, hurting investors and non-investors alike.

Excess capital initially results in the partial decoupling of returns from their underlying fundamentals, as investors and especially financial intermediaries start profiting more from trading highly liquid short-term securities among themselves than underwriting long-term investments in labor, capital stock, or productivity im-

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provements. This in turn creates enormous pressure on growth for growth's sake, and makes investors' success as much a function of the ability to react almost instantaneously to new information and outsmart other investors as accurately assessing the long-term value of economic activities. For example, professional investors may knowingly invest into a bubble, hoping that they'll be able to pull out the very second things start to look bad (and despite the volatility this generates).

In addition, excess capital encourages the creation of new financial products that carve up and repackage previously raised capital into increasingly complex and opaque securities. As the global financial crisis of 2008 made painfully clear, it can become nearly impossible to accurately assess the underlying risk of such securities. Because no new capital is injected into the real economy, no incremental value is actually created, other than, of course, redistributing wealth from one investor to another.

None of this is a problem per se, as long as the amount of excess capital is relatively small and the potential negative impact can be contained within the financial system itself. However, that clearly is not the case today. In fact, the amount of excess capital is now arguably large enough to hold down interest rates, potentially leading to dangerous asset price bubbles. (Ben Bernanke has written about the related implications of a so-called savings glut.) It can also result in long-term secular stagnation, as Larry Summers has argued, in economies that are already suffering from weak domestic demand.

The combination of low domestic demand and near-zero interest rates forces investors to look for growth elsewhere — for example, in emerging markets, such as China and India, and countries in Southeast Asia and Africa. That is fine in principal. Capital should flow to where it is most needed and can earn the highest returns. However, such inflows may lead to widespread corruption by the political elite in emerging markets with weak institutions. More important, large in- and outflows of foreign "hot money" can overwhelm emerging markets' current accounts and destabilize their financial systems and economies.

Finally, the resulting increase in volatility is encouraging both countries and firms to preemptively hoard cash in case of another crisis (they are hedging against disaster risk, as Harvard's Kenneth Rogoff has noted). And the increased likelihood of such crises has spawned new regulations that force financial institutions to hold more government securities, creating a positive feedback loop that makes the excess capital problem even worse. Excess capital creates a disconnect between return and underlying values, leading to a focus on trading versus investing and increasingly risky and volatile markets, which, in turn, lead to even more excess capital through cash hoarding and other safety buffers.

If the financial system is a train speeding down the tracks, how can we decelerate and avoid derailment? Monetary policy becomes ineffective when real interest rates are driven down to zero or below and, for example, the historically inverse relationship between unemployment and inflation breaks down. The high degree of interconnectedness of the global financial system is further limiting central banks' degrees of decision-making freedom. For example, the U.S. Federal Reserve recently declined to raise interest rates, not for domestic reasons, but due to fears of another taper tantrum elsewhere.

Fiscal policy could be helpful, if directed toward much-needed investments in areas such as infrastructure and education. However, deficit spending has become a difficult proposition in developed countries, not only for economic reasons such as high government debt levels and perhaps limited availability of worthwhile investment projects, but also because the topic has simply become far too politicized to generate effective policies.

Are there other ways of increasing demand to suck up excess capital? The world as a whole actually isn't exactly short of investment demand; infrastructure development needs in Southeast Asia alone may amount to as much as US$750 billion a year between 2010 and 2020, according to a 2009 study by the Asian Development Bank. However, such investments won't be easy for foreigners. The financial markets in many emerging economies aren't sufficiently advanced, and the alternative, foreign direct investment (FDI), is risky, highly illiquid, and often subject to various local restrictions. Nevertheless, creating new financial instruments for making such investments could be a win-win for developed and developing countries alike.

Perhaps in the absence of adequate monetary or fiscal measures it may be prudent to, in the words of Nobel laureate James Tobin (published in the *Eastern Economic Journal* in 1978), "throw some sand in the wheels of our excessively efficient international money markets" — for example, through Tobin's own financial transactions tax and various forms of cross-border capital controls. However, it remains an open question whether such "two steps forward, one step back" proposals are truly desirable, or even feasible.

Whatever the right answer may be, it is imperative that we act soon. Until we do, real and imagined financial crises such as that caused by China's stock market crash will continue to happen — with ever-greater reach and impact. +

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