Gyrations of Indian stock market point to future economic instability

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The wild fluctuations in Indian share prices over the past two months point to the increasing power foreign finance capital is exerting over Indian equity markets and indirectly the Indian economy.

After reaching an all-time high of 12,761 on May 11, the Bombay Stock Exchange (BSE) Sensitive Index (SENSEX), fell back sharply. By June 14, it had fallen some 30 percent, closing at 8,929—a loss of around $250 billion in a market whose total capitalisation is estimated at between $800 and $900 billion.

In the past three weeks, share prices have risen in fits and starts. On Thursday, the Sensex closed at 10,768 points, meaning share values have recovered about half of the losses they incurred between mid-May and mid-June.

Prior to this May's stock market plunge, India's business houses, political elite and corporate media were holding up the more than doubling in the value of India's premier stock market since May 2004 as proof of the "take-off" of India's economy.

Much, if not most, of this increase was due to the inflow of equity investments from Foreign Institutional Investors (FIIs) such as investment banks and hedge funds. A large portion of this investment came from the small Indian Ocean island and tax haven of Mauritius, where FIIs have set up paper companies that masquerade as Mauritius-based firms so they can take advantage of the double taxation treaty between Mauritius and India and escape paying taxes on their investment gains.

The biggest decline in the Sensex occurred May 22, when it plunged 1,111.70 points or more than 10 percent, triggering an automatic hour halt in trading. According to stock analysts, much of the fall on that and preceding days was due to sustained selling by FIIs, especially hedge funds. Such funds are notorious for borrowing massive amounts for speculative investments, which makes them vulnerable to margin calls (a demand for cash by lenders due to falling asset prices).

Following the May 22 plunge, Indian Finance Minister Chidambaram tried to exude calm: "There was certain nervousness in the market. My message to retail investors is to stay invested. FIIs are here to stay. There is no reason to panic.... [B]anks will provide money to those who want to provide margin calls."

Fearing that stock market losses might trigger a rash of suicides among ruined small investors, police in several cities, including Mumbai and Ahmedabad, were instructed to closely watch bridges and railway lines. Such suicides did occur in the 1990s when a speculative stock bubble burst.

According to estimates made in mid-June, the stock market sell-off has nearly halved the net foreign equity investment in India for this year to about $2.7 billion. By contrast, in 2005 there was a net inflow of foreign investment in Indian equities of $10 billion and in 2004 of $8.6 billion.

The share sell-off and associated withdrawal of foreign funds from India affected the exchange rate of the rupee. The rupee declined to a three-year low against the US dollar of Rs 46.57, but recovered somewhat after the Reserve Bank of India increased two key interest rates by 0.25 percent.

Ironically, the May 22 stock market plunge coincided with the second anniversary of the coming to power of the Congress Party-led United Progressive Alliance (UPA) government. During the campaign for the 2004 elections, the Congress made a calibrated appeal to popular anger over mounting economic insecurity and social inequality, while the Bharatiya Janata Party (BJP)-led National Democratic Alliance, reflecting the mood in the corporate elite and the most privileged sections of the middle class, sought re-election under the slogan "India shining."

Predictably, the Congress-led UPA, while continuing to spout pro-poor rhetoric, has pursued the same neo-liberal agenda as the BJP, seeking to make India a centre of cheap-labour IT engineering, business-processing, research, and manufacturing for the world market.

The dismantling of barriers to foreign investment in banking, retail and other sectors and government plans to gut restrictions on the layoff of workers and plant closures and divert state funds from income support and public services to developing energy and communication infrastructure have made India a magnet for foreign capital, helping fuel a quickening in the country's growth rate.

But the 7 percent-plus annual increases in GDP and sizeable per capita income increases of recent years have not translated into any improvement in the socio-economic well-being of the vast majority of Indians. On the contrary, the dismantling of India's nationally regulated economy, the associated cuts in social spending, including agricultural price supports, and the diversion of state investment away from agriculture towards the infrastructure projects wanted by Indian and foreign capital have produced mounting unemployment in the cities and severe distress in the countryside. According to a recent World Bank report, 35 percent of India's population live on less than a dollar a day.

Moreover, the claims of the corporate and political elite that India is on the fast track to becoming a world economic power are based on decades-long extrapolations of current growth rates.

By virtually any measure, and in all but a few sectors, India's economy remains small and backward. Although home to more than 15 percent of the world's population, India accounts for barely 1 percent of total world trade.

Just as importantly, the claims of India's irresistible rise ignore fundamental problems and imbalances in both the Indian and world economies.

The dilapidated state of India's infrastructure is increasingly cited by the information technology sector, a niche in which India has emerged as a significant global player, as a barrier to further investments.

Many economists estimate that for India to achieve an annual growth rate of 8.5 percent, it will require a yearly capital inflow of $50-$60 billion. Even this sum could be an underestimate, as Prime Minister Manmohan Singh told the 39th Annual Meeting of the Board of Governors of Asian Development Bank on May 5 that India's infrastructure requires an investment of more than $150 billion in the next few years.

With a view to attracting foreign infrastructure investment, the UPA, like the government before it, is planning to turn over key resources, like water, and key economic sectors, like power generation, to partial or even complete private sector control and ownership.

Yet, most of the foreign capital that India has attracted in recent years has been in the form of foreign institutional investment, rather than foreign direct investment. (In 2005, the ratio was 60 to 40 percent.) While the FII inflow has enabled Indian companies to raise additional capital through new share offerings or by raising loans based on the increase in their valuation, FII investments are by definition highly liquid, as financial institutions are in the business of profiting from short-term variations in share and currency values.

India's dependence on FII forms a marked contrast with China and Brazil, where FII investment accounted respectively for 26 percent and 30 percent of all foreign investment in 2005.

Should India's growth rate slacken, foreign investors grow impatient with the pace of neo-liberal reform, or international market conditions deteriorate, India could, as the recent stock market gyrations have shown, be sideswiped by a sudden withdrawal of FII and consequent rupee devaluation.

An article earlier this year on the *asiatimes.com* web site noted that the India's economy "faces significant risks arising from much higher international oil prices and the impact of higher energy prices on Indian inflation and global economic growth" and warned these risks could lead to the withdrawal of foreign funds from India's equity markets.

"In the past," continued the article, "emerging-markets investment performance that has lived by the accumulation of short-term foreign capital has also died because of sudden foreign capital flight. And India is very vulnerable to this syndrome."

India is running a substantial current account deficit. For the April-December 2005 period, the deficit was $13.5 billion, more than double the $5.9 billion deficit incurred in the corresponding period in 2004. The main reason for the increase in the current account deficit was the ballooning of the trade deficit, which totalled $39.6 billion for the nine months between April and December 2005.

On the fiscal front, both the central and state governments in India are mired in debts with up to 40 percent of revenue set aside for debt repayment. The huge debts are a direct consequence of successive rounds of tax cuts for business and the rich. With combined central and state government debt around 9 percent of GDP, international capital is insisting public spending must be sharply reduced.

In the long run, a confluence of factors beyond the control of the Indian elite could well bring about an economic crisis similar to the one that devastated Southeast Asia in 1997-1998.