India Fever Overheats

Friday 29 June 2007, by BOWRING Philip (Date first published: 8 January 2007).

India's aspirations to overtake China economically are built on shaky foundations that could collapse disastrously.

There are several accidents waiting to happen in global financial markets. But the one that beats them all – even beats mainland Chinese bank fever – is India. Conditions are rapidly building for an accident that will not just devastate stock prices but strike a body blow at India's expectations of sustaining a faster growth pace than China. That in turn will prick the bubble of India's belief in its own arrival as a major player on the global economic stage.

If this were just a matter of inflated stock prices one would not – unless one were still a punter in this market – need to worry too much. But the coming price collapse will not be caused simply by a turn in the momentum but by a fundamental deterioration in economic circumstances. More than any emerging market, India's has been driven by global liquidity, the vast excess of dollars sloshing around the world courtesy of America's US$800 billion annual current account deficit. But worse, India has been driven by a steep drop in its private sector savings surplus, a drop that cannot continue much longer.

One could argue that the faith in India's long-term future, now held by foreigners as well as the newly emerged Indian upper middle income strata, is so strong that it will carry the nation – and stock prices even further ahead. Indeed, the Mumbai stock market has already overcome one short-term loss of confidence over the past year. Having reached 12,600 in May 2006, the index suffered a major bout of profit-taking as investors came to believe that the bull run was over.

The index fell to 8,900 in just five weeks before beginning a new advance which took it briefly over 14,000. It is still over 13,800. This is a very mature bull market which began in early 2003 and before the May setback had had only one significant retreat following the Bharatiya Janata Party's defeat in 2004.

The present BSE level is more than four times its 2003 low and five times the level in the 2001 bear market. It is more than double its previous bull-market high in February 2000 of 5,900.

The market now sells on a price-earnings ratio of over 20, although inflation and interest rates are well above those in developing Asian markets. Bullishness has been maintained despite a rise in interest rates and the Reserve Bank increasing banks' cash reserve ratios. For sure, earnings growth has been very strong. But return on capital, like interest rates, is a cyclical phenomenon and a combination of rising rates, slowing growth, a weaker currency and higher inflation could easily kill the earnings boom. So, at least for some, could be the over-investment hubris which killed the mid-1990s boom.

India's belief in itself has been very welcome after years of tending to agree with the negative views of most foreigners about its social and economic progress. One could forgive the crowing about the success of Indians overseas, such as the Mittal steel kings, and India's conquest of vast tracts of software territory. But while all that is to the good for both longer-term development and current morale, it cannot hide some nasty little numbers which help explain the recent bullishness and predict a coming crash.

The most striking is the surge in bank credit – up 28 percent in the past year and fuelled not so much by a rise in savings but a shift in bank assets from government securities to private sector loans. This would be unsustainable at the best of times. But these are not the best of times for India's external position. Having enjoyed several years of current near-balance, under the impact of rapid GDP growth and high energy prices the current account has deteriorated dramatically in recent months.

The July-September quarter showed a deficit of $6.9 billion, almost double that of a year ago. At this rate it is almost 4 percent of GDP and could well go higher, perhaps to $40 billion or 5 percent of GDP. The growth in earnings from software and remittances has slowed while merchandise imports have accelerated faster than exports. India's situation now stands in sharp contrast to the East Asian economies, which all continue to enjoy large current account surpluses. Nor is it easily rectified given that the merchandise deficit is now equal to 60 percent of exports.

The inflow of foreign cash into the Indian market has helped sentiment and partly offset the current account deterioration. The relatively large foreign exchange reserves that India accumulated in the past three years (now $168 billion) provide a cushion against any sudden loss of confidence in the currency. But overall financial conditions, let alone real returns to capital, in no way support the level of the stock market. Indeed there is some evidence that the relatively low cost of capital that India has been enjoying, despite massive public sector deficits, has led to a sharp decline in traditional high returns on capital.

It seems unlikely that the trade deterioration is a short term blip as firms have been gearing up for growth on the assumption that the 7-9 percent rate can be sustained. Meanwhile household savings patterns may also be changing as middle and higher income households spend more as consumer choice and expectations rise.

That may be a little speculative. What is not is that a current account deficit of 4-5 percent of GDP is enormous for a country which still does relatively little foreign trade, attracts only relatively small amounts of foreign direct investment and is historically averse to foreign debt. Some commentators boast that as Indian exports account for only about 15 percent of GDP it will not be too affected by a slowdown in US and global growth.

That would be true if the trade account was healthier but it looks like complacency given the persistent vulnerability of the Indian economy to external imbalances. Capital inflows have relied far too heavily on deposits by NRIs (non-resident Indians) and foreign financial capital rather than more permanent, less interest-and-currency-sensitive direct investment.

The external situation combined with a government deficit of 7 percent of GDP and relatively high (5 percent) inflation is going to mean higher interest and a squeeze on credit. Global liquidity and the continuing enthusiasm for things Indian may keep the stock bubble alive for a while yet but when it pops it will take with it expectations that sustained 8 percent growth is possible for India, and perhaps damage some of the liberalizing trends which have propelled India over the past 15 years.

What it must not do is divert energy and government money away from the things that India needs more badly than a buoyant stock market – better transportation, education and public health. It also needs an industrial sector that can compete with China and its Asian neighbors – still a distant prospect judging from the long list of exceptions to free trade that India is demanding of ASEAN in its current FTA talks. What that trade deficit is telling us is that India is falling behind in merchandise trade, relying instead on export of services and workers remittances. Useful though they are, they are no substitute for goods producing industries, particularly for a nation with a huge surplus of labor.

Perhaps a stock crash would be a good tonic, taking the gloss off the India of over-hyped achievement and focusing on the bigger India of under-achievement, social stagnation and unnecessary poverty.

P.S.

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