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ECONOMY:SURGE IN FOREIGN INTEREST

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There has been a surge of interest of foreign institutional investors (FIIs) in the Indian stock markets despite the political uncertainty due to the dissolution of the Parliament and the calling of fresh elections, which are expected in September.

Generally, during such periods of uncertainty, the stock markets tend to turn sluggish, with the investors, particularly the FIIs, preferring to wait and watch till a new Government takes over and its economic policies become clear. This has not happened. On the contrary, the FIIs have been rushing to the Indian market, pushing up share prices.

The Bombay Stock Exchange Sensitive Index (Sensex) crossed the magical 4,000 point mark during the trading session on May 13 and has since remained above that level. Since the dissolution of the Parliament on April 26, the Index has risen by over 800 points. This has been the third highest rise in the history of the Bombay Stock Exchange (BSE).

During the first 13 days of May, FIIs poured US $ 276.20 million into the stock market. On May 13 alone, they bought shares worth US $ 65 million. As on May 13, the cumulative net FII investment in India amounted to US $ 9.399 billion.

There has been a significant improvement in foreign direct investment (FDI) too since the beginning of this year. During the first quarter, the FDI flow amounted to US $2.38 billion, as against a flow of US $ 3.3 billion during the whole of 1998.

It remains to be seen whether this surge is sustained. Even if it is not and proves ultimately to be short-lived, its significance will not be lessened. This significance arises from the following factors:

----It indicates a revival of foreign investor confidence in India despite the economic sanctions imposed by the US after the Pokhran II nuclear tests.

--- It also indicates the confidence of the foreign investors that whatever political combination comes to power in New Delhi, the economic reforms will remain largely on course with no back-pedaling.

---It is also a reflection of the confidence of the foreign investors that despite its faults, the Indian economic bureaucracy has managed the ups and downs in the economy fairly competently and that the Indian supervisory mechanism particularly in the banking sector, has been functioning well as compared to the failure of the mechanism in South-East and East Asia, which contributed to their economic collapse in 1997, and indications of its failure in China, which has contributed to increasing nervousness about China amongst overseas investors.

China's economic performance---at least statistically, provided the official statistics are acceptable-- is far, far superior to that of India--- a GDP growth rate of 7.8 per cent in 1998 (as against 5 plus in India), a cumulative FDI flow of US $ 271.7 billion since it opened its economy in 1979 (as against India's US$18 billion since it opened its in 1991), an FDI flow of US$ 45.6 billion last year (as against India's US$ 3.3 billion), a total foreign trade of US$98.85 billion during the first four months of this year alone despite a sharp drop (as against India's US$ 75.4 billion during the whole of the financial year 1998-99) and total foreign exchange reserves of US$146.5 billion (as against India's US$ 30 billion plus).

Despite this, since October last year, there has been growing uneasiness amongst foreign investors over the continuing prospects for the Chinese economy. "The China gold rush has come to an end," wrote the "Financial Times" on March 25,1999, and added: "The infatuation (of foreign investors) is starting to wane."

It quoted a German banker as saying that optimists on the Chinese economy were declining in number, while skeptics were increasing. The US-China Business Council reported in March that nearly 50 per cent of its members had decided to "reconsider, delay or even cancel intended investments."

The optimism of Chinese Prime Minister Zhu Rongji that China would be able to reach a GDP growth rate of 7 per cent this year has not been shared by foreign investors despite an 8.3 per cent growth in the first quarter of this year as compared with the first quarter of 1998.

The growing skepticism is reflected in comments such as the following:

----"For a small but growing number of companies, business conditions have prompted a painful retreat. A few recent examples: The Royal Bank of Canada has pulled out of China, worried about the health of the financial sector; South- Western Bell of the US has withdrawn from a planned telecommunications venture because of regulatory obstacles; and Fosters of Australia is selling its Chinese breweries after failing to turn a profit in China's oversupplied beer market. Marks & Spencer of the UK closed its Shanghai office recently, after shelving plans for a store there. Retrenchment is more common than retreat.

Companies such as Unilever and Motorola, the US telecom giant, have been cutting costs by replacing expensive expatriate employees with local staff.

Moreover, new projects have been put on hold. Last year, the value of foreign investment deals fell by 7 per cent, while the number of contracts signed was down to nearly half of what it was in 1995." ("Financial Times" of London of March 25,1999).

----"The news from China is not positive at all, even if it is not making waves. The economy is slowing, analysts say, pointing to indicators such as slow growth iin electricity consumption, falling exports and declining growth in retail sales.

Analysts don't believe China's report that its economy grew 7.8 per cent last year. "That is not even close," said Nicholas Lardy, a China economic specialist and senior fellow at the Brookings Institution in Washington. At the same time, foreign investment in the form of loans, bonds and stock sales seems to be declining. Mr. Lardy adds that "the environment has never been worse for China in the raising of capital in foreign markets…" Analysts think the catalyst (for a devaluation of the Chinese currency) would be a deterioration in China's balance of payments. Mr.Lardy argues that this deterioration could already be under way because of the loss of foreign credit and the slowdown in the Chinese economy." ("The International Herald Tribune" of March 1,1999)

Amongst the factors contributing to the skepticism about the Chinese economy are:

----Continuing reports of the difficulties of the banking sector due to reckless borrowing and lending as had happened in Thailand, Indonesia and South Korea before the collapse of 1997. Officially, the non-performing loans of the banks have been estimated at 20 per cent of the total loans, but unofficial estimates, including one by Moody's, estimate that this could be as high as 33 per cent. The figures relating to the Guangdong International Trust Investment Company (GITIC), which collapsed in October last, have brought out the disturbing state of the finances of such companies, which borrowed offshore money for financing investments. In January, a liquidation committee headed by the Bank of China had estimated its total available assets at 59 per cent of its liabilities, but on April 22, the committee revised its estimates downward and said that its assets amounted to only 16 per cent of its liabilities. Foreign lenders, who had lent money to GITIC under the impression that all their loans stood guaranteed by the State which would undertake the responsibility for their repayment, have been shocked to find that this was not so. This would mean that for every dollar lent by them to GITIC, they might get back only 16 cents. The expectations of the foreign creditors that they would be given preference while settling the repayment problem have been belied. The Chinese authorities do not want to face a problem similar to what Indonesia had faced under IMF pressure, when Jakarta had given preference to the settlement of the claims of overseas creditors. The consequent anger of the Indonesian depositors, who lost their money, partly contributed to the social unrest of last year, which ultimately led to the exit of Suharto. 20,000 middle class and lower middle class Chinese had deposited their savings of Rmb780 million (one US$ ==8.2 Rmbs) in the GITIC. A number of other financial institutions have been facing similar difficulties. Personal deposits held by Chinese citizens in the banks and other financial institutions amounted to US$655.88 billion in January, an increase of 16.7 per cent from a year ago. Urban Chinese, who constitute 30 per cent of the total population of the country, hold 70 per cent of these deposits. Any apprehension that their savings might be in danger could lead to a run on the banks as happened in Indonesia in 1997, leading to an economic collapse and urban social unrest. To preempt this danger, the Government has embarked on a two-pronged policy of setting up asset management companies and starting a deposit insurance scheme to reassure overseas creditors as well as local depositors.

----As a result of the nervousness caused by the bad debt problem, international bank lending to China has fallen sharply. Before exchange rate adjustment, international bank credit to China slipped to US$ 81 billion at the end of September last, from US$90 billion in December, 1997. Even Japanese banks have reduced their lendings for Chinese banks and other financial institutions.

The "Far Eastern Economic Review" of Hong Kong reported as follows on May 6,1999: "There are signs that some are reducing their exposure to China. Syndicated loans to Chinese entities amounted to US$577 million in the first quarter,down by nearly two-thirds from a year earlier, according to Thomson Financial Securities Data. And bankers suspect that a large portion of the US$30 billion in short-term loans that will fall due this year won't be renewed. This may be due to the country's economic slowdown as well as the banks 'heightened perception of credit risks."

---- There are also some misgivings about the real state of China's foreign exchange reserves, with a gnawing suspicion that the actual available reserves might be less than the claimed figure of US$146.5 billion. The State Administration of Foreign Exchange (SAFE), which manages the reserves, has reassured the public that it maintains stringent internal controls and keeps the country's holdings on international markets in high quality, high liquidity investment.

Despite this, analysts have been voicing the suspicion that some of these reserves have been used to help out banks and State-owned Enterprises in difficulty. The "Financial Times" of March 24,1999, has quoted an unidentified Chinese, who is stated to be familiar with the management of the reserves, stated as follows: "The actual, useable foreign reserves for market operations are significantly less than that number (US$ 146.5 billion). They have made policy loans (from the reserves), but they have not been extended to a wide range of clients. Nobody knows how much is really manageable money." A similar concealment of the depletion of the reserves had contributed to the collapse of the baht in Thailand in 1997.

---- The Chinese exports, which had registered a robust growth year after year for 15 years, grew by only 0.5 per cent last year and declined by 7.9 per cent during the first quarter of this year as compared to the first quarter of 1998.

The nervousness caused by these factors has led to foreign investors being more cautious about economic prospects in China. This has led to a 9.5 per cent decline in FDI flows in the first two months of this year and a 14 per cent drop in the value of the red chip stocks of mainland backed companies listed in the Hong Kong market through their subsidiaries.

The consequent decline of the "feel good factor" about China should at least partly account for the surge in the interest of foreign investors in India. It remains to be seen whether this interest is sustained. This would depend on the success of the Chinese authorities in rigorously enforcing corrective measures and avoiding a collapse of more banks and a devaluation of their currency. If they succeed, it is doubtful whether this surge of interest in India would be sustained to any significant degree, unless India goes further forward on the road to reforms.

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