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The Stock Market Turmoil and Implications for India

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The Hong Kong and the Shanghai indexes recovered by 2% in early trading on 25 August 2015, after a free fall a day earlier that dragged down indices all over the world. The stock markets in China appeared to continue on a downward trend subsequently that day. The opening (3004) was lower than the closing numbers (3209), but there has been a correction by 28 August. The correction indicates that there is still value in the stocks that are being traded, and that valuations over a one-year as well as a five-year time-frame are still positive. The index was 2217 on 30 August 2014, and 3080 in early trading on 25 August 2015, a gain of over 40%. It is true that the index had reached 5166 on 12 June, a growth of 150%, and has lost substantially since then: but the inherent strength of the Chinese economy is evident from the fact the index is substantially higher than at this point last year.

This should help the doomsayers to pause, step back and look at what appears to be happening in the Chinese markets, and in the rest of the world.

First, there is clearly excess capacity in many manufacturing sectors in China. Iron, steel, tyre, and input producers are dumping products in all markets, including India, affecting local

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production and sales. The United States, Brazil, and Indonesia are some of the countries that have resorted to anti-dumping duties against Chinese products. As the domestic consumption patterns fail to meet the expectations of policy makers in China, and faced with an uncertain global export market, there is an overhang of production capacities and consequential debt burdens, which are spilling out into the global economy.

This is exacerbated by the fall in commodity prices. While the softening of oil prices is caused by excess production capacities, and with the revenue needs of Middle East economies to keep pumping oil to meet their expenditure requirements, the reductions in imports by the US, as well as the slowing down of the European Union's and Russian economies, are affecting demand growth globally. Other commodities like coal, copper and other minerals are affected by the China factor. As China moves away from coal-based power generation into nuclear and solar options, it is likely that the coal prices will remain soft in the medium-term. Copper and other commodity prices are suffering due to heavy stockpiling by China in the past, and these need to be unwound for prices to stabilise again.

China has been trying to boost internal consumption as an alternative to export-led growth, and it is clear that its success has been mixed, with some regions responding faster than others. The policy-interventions of supporting equity markets, allowing greater leverage in trading, and most recently, exposing pension funds to equity markets for up to 30% of their asset base, appear to be knee-jerk reactions, which the global markets are discounting as bad policy.

There is evidence of US economic recovery, but as its economy is most integrated with the rest of the world, the problems in China are compounded with the continuing crisis in Greece, the decline of Gross Domestic Product (GDP) in Japan, the slowing down of the commodity-based Australian economy and the political tensions in Korea. It is to be expected that markets there will be jittery, but perhaps it is not due to the China factor alone, but a combination of events happening simultaneously across the globe.

Stepping back into the context of India and South Asia, there has been little change in the Karachi and Dhaka indices, though they are insignificant global traders. The Bombay Stock Exchange in India recovered by 28 August, after a fall of over 1600 points on 24 August.

India's Finance Minister and Governor of the Reserve Bank of India (RBI) have attempted to allay anxieties, both saying that the fundamentals are strong. This needs to be examined.

The Foreign Institutional Investment (FII) sales on 24 August were of the order of Rs 5,000 crore, less than a billion US dollars, and the sales on 21 August were around Rs 2,500 crore, about half that amount. Yet the rupee fell against the dollar by a whole rupee. This indicates the volatility of the reserves that India is holding, and how prone it is to short-term fluctuations. Anxieties about the 'hot money' holdings have resurfaced. It is fortuitous that crude prices have softened and the current account deficit is under control, even though exports have been performing dismally.

However, the fundamentals of foreign exchange management in India appear to be more worrisome than the authorities make out to be. It is also clear that the stock market valuations are shallow, based on FII inflows, rather than retail and local institutional investors; this perhaps is a significant distinction between the Chinese and Indian markets.

While South Asia appears to be relatively calm, the signals from the markets on 24 August are important for India to pick up and learn from. Most importantly, it is clear that there need to be some change in the fundamentals of economic growth parameters in the Indian economy. There is no evidence of fresh capital formation (though the construction sector is seeing some signs of recovery). The quarterly results of important corporates indicate flattening sales, and margins are held only due to reduced input prices. Capacity utilisation in major industries like steel, cement, automobiles and its ancillaries is lower than what it was one year ago. The nationalised banks have deposited close to Rs 70,000 crores (around US$ 12 billion) back with the RBI, as there is little appetite for fresh industrial loans and for lending.

Prime Minister Narendra Modi's statement on 24 August that he would announce some reforms aimed at reviving growth appear to be a recognition of the need for policy-interventions. The announcement that there would be an acceleration of public expenditure is a welcome one, for it would infuse much-needed liquidity in the economy.

It is important to note that while stock markets in China are continuing to fall, markets in India have recovered by 28 August – further evidence of the strength of the Indian economy.

There are several green shoots. There is a strong revival in the technology sector, especially start-ups that are based on information technology. There has been significant funding in the last six months. The digital retailing space has exploded; growth in logistics, warehousing and distribution is very visible. Retail sales in urban areas are still robust, though the picture in Tier-2 and -3 cities is somewhat subdued. A poor monsoon would dampen spending in rural areas, and sales of motorcycles, tractors, fertilisers and irrigation equipment could get affected. However, there is a healthy growth in the consumption of petroleum products, and petrochemicals and plastics, as well as in the pharmaceutical industry.

A growth rate of over 7% of GDP still appears feasible and real. These are due to *sui generis* factors indicated above, and the Government needs to do its bit in stabilising growth through policy- as well as implementation-interventions.

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