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Sore heads to follow India's stock euphoria

By Kunal Kumar Kundu

BANGALORE - With the grand old party of India - the Congress - bagging more than 200 seats in the general election in India and the pre-poll alliance of UPA (United Progressive Alliance) coming tantalizingly close to the magical 272 mark (chalking up 260 seats), India, after a long time, voted decisively.

The market reacted with a "wow" on the first trading day after the election results were announced, on Monday. India's bellwether index, the Sensex, reacted as never before: up by more than 2,000 points and hitting two "circuit breakers" in about a minute (40 seconds in the first instance and 20 seconds after the market re-opened following a two-hour cooling off period) - the first time that trading has been halted after the Sensex breached a daily limit set by the market regulator.

That the market would open stronger was a foregone conclusion. The expectations prior to the election results were of a fractured mandate for the new government and nobody was expecting such a resounding verdict. All the exit polls, considered a close reflection of reality, indicated a neck-and-neck affair between the Congress-led UPA and the led by the National Democratic Alliance led by the Bharatiya Janata Party (BJP) - and both alliances were expected to come up far short of securing a parliamentary majority.

The dominant fear was that numerous regional parties, with their disruptive politics, would have to be enrolled into the government, with a deleterious impact on the economy. With that worry blown away, the bulls had a ball.

The question is, was the euphoria warranted? What actually changed so dramatically between Friday and Monday that warranted such a reaction? More importantly, is it backed by fundamentals?

The answer has to be "no". Sure, there's been some positive development, but nothing to warrant such a positive outlook.

The Sensex has now surged by more than 75% in two months nine days flat; it gained 17% on Monday alone. It is worth recalling that the Sensex tanked from its peak of 21,000-plus as the global financial crisis took root and there was a clear indication that the Indian economy was slowing from its annual 9% expansion over the preceding several years.

On one thing we should be clear: the worst for the global economy is yet to come. In the case of US, while the financial sector's problems are close to being played out, its transmission to the real economy has resulted in a gloomier scenario. Rising unemployment and falling retail sales have resulted in increased saving, thereby depriving the economy of its much-needed oxygen, that is, consumer spending.

In addition, the possibility of further financial trouble cannot be ruled out. According to a Wall Street Journal analysis, commercial real-estate loans could generate losses of US$100 billion by the end of next year at more than 900 small and midsize US banks if the economy's woes deepen. Such loans, which fund construction of shopping malls, office buildings, apartment complexes and hotels, could account for nearly half the losses at the banks analyzed by the Journal, consuming capital that is an essential cushion against bad loans.

Total losses at those banks could surpass $200 billion over that period, according to the Journal's analysis, which utilized the same worst-case scenario the federal government used in its recent stress tests of 19 large banks. Under that scenario, more than 600 small and midsize banks could see their capital shrink to levels that usually are considered worrisome by federal regulators. The potential losses could exceed revenue over that period at nearly all the banks analyzed by the Journal.

In Europe, things are hardly better, if not worse. And the less said about Japan the better. At this point, the US seems to be the country most poised, among developed economies, to come out of recession, but that's not going to happen soon. Clearly, more economic pain awaits the world.

In the case of India, growth in the financial year coming to an end on June 30 is expected to be less than 6.5%, and the country will be lucky to see expansion of 6% in the following 12 months. So domestically, nothing much has changed that points to an immediate turnaround in fortunes.

What has changed is the impending formation of a stable government. Indications are that punters placed a bet on this outcome prior to the elections and Monday's unprecedented rally was a culmination of this expectation. The basic expectation of a stable government is that the difficult parts of economic reforms will be carried through. However, if history and the previous performance of the UPA government is anything to go by, that expectation can be met only partially.

Populist policies were very much a part of the UPA's election manifesto. Hence there is a very real danger that the newly elected government will be obliged to go the populist way. Nor has the alliance covered itself with glory in its attitude towards reforms.

There are still some low-hanging fruits from the economic reform basket that can be taken advantage of, but major and politically sensitive reforms are likely to continue to struggle to see the light of the day.

The UPA is also crucially dependent on the Trinamool Congress and its shenanigans are now well known, even beyond India, given its decisive role in forcing Tata Motors to move its Nano car project out of West Bengal. The party is led by a person, Mamata Banerjee, who has also shown her sense of opportunism by aligning with different parties at different times (also true for many other allies of UPA), irrespective of the ideologies. This clearly brings to question the ideology of the party itself. On top of this, the lady delighted in carrying a resignation letter in her pocket (or wherever she can fit one in) whenever she was a minister, as a threat if things did not go her way.

To India's benefit, the communists, with their penchant for obstructionism, have been decimated in these elections. Yet it is doubtful whether the Trinamool Congress, which ousted the communists in West Bengal and supports the mainland Congress, offers a better alternative.

The country is in dire need of administrative reforms, since only these can ensure improvement of delivery mechanisms. While such steps would be easily accepted by the Indian populace, they remain little more than occasional lip service for political leaders.

Reforming the outdated labor laws is a case in point. Nor are subsidies going to be scrapped, specifically those on fuel, a majority government or otherwise. Such changes were not made before and look even more difficult to pursue now as they run counter to populism - by which Congress and its allies live and die.

Correcting the mess that is India's fiscal position is also not going to happen overnight, especially given the slowing economy and global recession. Wasteful government expenditure is not going to be reduced, particularly as subsidies are not going to decline. On the plus side, lower fuel prices will put less strain on government coffers, but that has nothing to do with the election or with the benefits of a stable government.

What is most likely to happen is more sales of government-owned enterprises, given that the communists (who relentlessly opposed disinvestment) are no longer part of the equation. That will help keep a check on the fiscal deficit, (including below-the-line items such as oil and fertilizer bonds) at present running at nearly 12%. Yet in some cases even this will not be easy.

Such government sell-offs will be the best way to fund intended development projects, which otherwise are unlikely to materialize, given the limited leeway the fiscal deficit gives the government.

The need of the hour will be to formulate a policy that will facilitate labor reforms, start administrative reforms in earnest, scrap controls on fuel prices to cut subsidy costs, increase long-stalled foreign direct investment, in insurance and pension funds and remove all barriers that are holding back road-building and expansion of power generation.

Populism, notably in the form of a waiver on farm loans, helped the UPA to retain power, but the new government led by Congress will have to go easy on such handouts. The government faces a widening deficit, slowing economic growth, falling exports and factory output, and huge expectations for fresh stimulus to protect growth and jobs. Whether the new government can deliver is a moot point - it probably can, albeit partially.

At this point, the stock market euphoria seems to be built too much on optimism rather than hard fundamentals. Some hope regarding India's future is valid; runaway optimism is not. Experience teaches that caution is justified.

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