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In a Quest for Growth, The World Is Sending More Money to India

By VIKAS BAJAJ

MUMBAI, India -- Two years ago, when the crisis on Wall Street reached its pinnacle, the high-flying Indian stock market fell with a thud as foreign investors took nearly $5 billion out of the country.

The situation is very different today. In September, foreign investors poured $7.1 billion into Indian stocks and bonds -- a monthly record for foreign investment in India's securities market. The major stock indexes appear poised to breach the highs that they set in early 2008, when many analysts first argued that fast-growth developing countries were "decoupling" from the developed world.

Talk of decoupling is in the air again, especially here in India.

The United States, along with much of Europe and Japan, may stay in the economic doldrums for some time. But many economists and policy makers here say that the problems in developed economies could benefit emerging nations like India, as Western hedge funds, banks and other investors hunt for growth opportunities.

With an economic growth rate of nearly 9 percent and a stock market that is more open to foreign investors than mainland China's, India has become a destination of choice for financial investors. In the first nine months of the year, foreigners invested $28.5 billion in Indian stocks and bonds -- more than twice what they invested in the comparable period of 2009.

The Sensex index, India's equivalent of the Dow Jones industrial average, is up about 22 percent in the last 12 months and 114 percent since the end of 2008.

On Wednesday the index closed up 2.4 percent, to 20,687.88 points, and is now less than one percentage point away from the record high set in January 2008.

The Indian rupee has appreciated about 4 percent against the dollar so far this year.

"The rest of the world is starved for growth," said Manish Saini, an analyst and trader at Eastern Advisors, explaining why his New York-based hedge fund has increased investments in India and other emerging markets in the last year. "And India is still producing relatively high real rates of G.D.P. growth."

The strength of the market has been a boon for Indian companies, as well as the Indian government, which has been selling shares in state-owned firms. On Monday, it will start selling a 10 percent stake in Coal India, the world's largest coal-mining company, in an initial public offering. The sale could fetch up to $3.4 billion.

There are also plenty of skeptics, of course, who say that the Indian stock market may be getting dangerously frothy. And Indian individual investors, burned by the 2008 crash, have shown more wariness than foreign money managers.

But foreign investors are moving money to emerging markets in part to take advantage of a growing gap between near-zero interest rates in the United States and Japan, and rising rates in India, Brazil and elsewhere. A key benchmark rate set by the Reserve Bank of India stands at 6 percent, up 1.25 percent since March. As the difference between rates grow, traders can make more money by borrowing cheaply in dollars and yen and investing that money in higher yielding stocks and bonds in developing economies.

The Institute of International Finance, an association of financial firms, estimates that emerging markets will receive $825 billion in private capital flows this year, up from $581 billion in 2009.

Some analyst and policy makers are increasingly worried about the torrent of cash flowing from developed to developing countries.

In developed countries, the flows undercut the efforts of officials in Washington, Brussels and Tokyo to revive their economies by pumping money into the economy at low interest rates. And in developing countries, the flows threaten to raise the value of currencies, making their exports less competitive and potentially inflating bubbles in stock and real estate markets.

Some Indian analysts say they fear that the increasing bullishness about developing nations is sending stocks here to dizzying heights that may not be justified, even in light of the country's high growth rate, which some expect to slow somewhat in the coming months. Moreover, these people say investors appear to be ignoring the lessons of the recent financial crisis, which did not remain confined to the developed world.

"There are fairly serious risks of frothiness in equity markets escalating if capital continues to pour into India," said Eswar S. Prasad, an economics professor at Cornell. "We may be in the boom phase of a boom-bust cycle, with all the risks that entails."

Mr. Prasad, who has advised the Indian government on economic issues, says he worries that foreign investors in India could suddenly decide to withdraw their money, as they did in 2008, if the Indian economy slowed or if global markets were rattled by another crisis. That reversal could then pull down real economic growth in India by depriving the country of capital.

In 2008, for example, India's growth rate fell to 6.7 percent, from 9.2 percent, partly because foreign investors took billions of dollars out of Indian stocks and bonds and slowed down new investments. The slowdown severely hit real estate developers, airlines and other companies with large capital requirements.

One big concern today is that the majority of the foreign money flooding into India is going into the stock market, rather than into new projects and start-up companies. While flows into the stock market have more than doubled, foreign direct investment into India fell more than 24 percent in the first seven months of the year, to $12.5 billion, compared with the comparable period a year earlier.

Unlike holdings in the stock market, which can be sold quickly when traders in London or New York get nervous, direct investments in factories, stores and companies are harder to sell and are usually held for longer periods, economists say.

Still, Indian officials, bankers and economists say they do not worry much about a repeat of 2008. Their optimism appears to be based in part on the belief that investors are unlikely to find better opportunities elsewhere in the world.

India, these people say, is beginning a long period of high growth because its population is young and demanding more goods and services. The government is slowly beginning to improve infrastructure and further loosen control over the economy. And the financial system here is healthier than in Western countries, where banks still have many bad loans on their books.

"If you look at the Indian opportunity, most things are going in its favor," said Neeraj Swaroop, who heads Standard Chartered's operations in India and South Asia. "And there aren't too many real risks that we see around the corner."

Still, many Indians have become more cautious about the stock market. Individual investors, for instance, have not jumped at recent initial public offerings like that of SKS Microfinance, a lender to poor women that was very popular with institutional investors. By contrast, in early 2008, middle-class Indians clamored to buy public offerings like Reliance Power, an electricity firm that was relatively untested.

Surjit S. Bhalla, an economist and fund manager based in New Delhi, said he recently downgraded his bullish outlook on the global economy, because of the dour news coming out of the United States, Europe and Japan. He is more hopeful about the Indian economy but said he believed that its stock market could fall 10 percent to 15 percent.

"The Indian market rallied from last year on the expectations of broadly a V-shaped recovery, and it did obtain that," said Mr. Bhalla, who is managing director of Oxus Research and Investments. "But when the V-shaped recovery became the prospect of a double-dip recession, it hasn't corrected at all."

This is a more complete version of the story than the one that appeared in print.

PHOTO: The Bombay Stock Exchange in Mumbai. So far this year, foreigners have invested $28.5 billion in Indian stocks and bonds. (PHOTOGRAPH BY KUNI TAKAHASHI FOR THE NEW YORK TIMES)
CHART: Hot Spot for Foreign Investors (Sources: Securities and Exchange Board of India, via Haver; Bloomberg)