Great Dream of Prosperity*

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Over much of the last decade and more, the stock market had provided advocates of reform a convenient indicator of economic health. This was because there were long periods during that decade when real economic growth tallied with stock market performance. The high growth era, 2004-08 and the post-crisis recovery years, 2010-11 were also the ones in which the stock market was buoyant or boomed. But more recently this comfortable synchrony appears to be breaking down. Since crisis year 2008-09, GDP numbers turned volatile and the official national accounts with 2004-05 as base suggested that growth was stalling. But the stock market has experienced an almost continuous bull run despite occasional bearishness attributed to 'market correction", or the internal correction of excessive exuberance. So the Sensex was the preferred indicator for those talking up the economy.

However, all of a sudden now, the era of synchronous movements in the two indices has come to an end. Moreover, the tables have turned. With the release of the new GDP series (with 2011-12 as base), the numbers now considered official suggest that GDP growth has not only been robust in recent times but is on the rise. The most recent cause for celebration was the provisional GDP growth figure for 2014-15, which at 7.3 per cent is almost equal to the 7.4 per cent growth projected in the advance estimates available thus far. Moreover, despite the fact that GDP growth has been revised downwards in both agriculture (to 0.2 per cent from 1.1 per cent) and services (10.1 per cent as opposed to 10.6 per cent), manufacturing has done better than expected (4.8 against 4.5 per cent). As a result, GDP growth is now computed to have risen from (a revised) 5.1 per cent in 2012-13 to 6.9 per cent in 2013-14 and 7.3 per cent in 2014-15. What is more, the fourth quarter numbers for 2014-15 are being quoted as evidence that India has overtaken China in the GDP growth race.

As expected, despite early scepticism, those wanting to make the case that India is the next potential growth 'miracle' are regularly citing the new GDP numbers. But in this "new growth scenario", the GDP numbers seem to be an exception. Industry, even according to many insiders, is not performing well. The month-on-month industrial growth rate as measured by the index of industrial production collapsed from a positive 5.9 per cent to a negative 5.6 per cent between May and October 2014. Though it recovered to 4.7 per cent in November (helped by a low base in the corresponding month of the previous year), more recent signs are of continued deceleration with the rate placed at 2.2 per cent according to the provisional figure for March 2015.

The performance of agriculture is even worse. According to the official third advance estimate for food grain production for crop year (July to June) 2014-15, output is likely to fall by 5.3 per cent. With food grain production having been indifferent in the previous two years, this outcome is close to disastrous. Thus alternative indicators of growth in the commodity-producing sectors seem to offer a completely different picture of real economic performance.

What is more, the comforting GDP numbers have been released at a time when uncertainty about global interest rates and a desire to exit emerging markets has gripped foreign investors. As a result a mood of bearishness has overcome Indian

equity and debt markets, which seems to be reversing what has been a long bull run in India's stock markets over the last three years or more. In early May, the BSE Sensex closed at 26,500. Though high relative to where the Sensex stood even at the beginning of January 2014 (for example), the fall received much attention because the climb in the Sensex had been so rapid earlier, that even the relatively early May level reflected a more than 10 per cent decline from a peak of close to 30,000 realised just three months earlier. It is in this period that the earlier relationship between stock market performance and GDP growth broke down. Not only has the synchronous movements in the two ended, but the stock market had been performing remarkably even as GDP growth slowed.

What needs to be noted, however, is that (to the surprise of most) before the new GDP figures were released it was the GDP growth rate that had been volatile and playing truant. On the other hand the stock market, as noted, experienced a long term rise with two booms of different intensities spliced together. One ran from 2011 to 2013, in which the Sensex rose from around 16,000 in May 2012 to a little more than 21,000 by the end of 2013. That was a 30 per cent rise over a year and a half. But this boom was marred by considerable volatility, including the downturn induced by the taper tantrum. The second boom stretched from the beginning of 2014 till about the beginning of 2015, when the Sensex rose, with far less fluctuation, from just above 20,000 to touch 30,000 about a year later. That was a remarkable rise of close to 50 per cent with a much lower degree of volatility. However, the investor exuberance that delivered this second boom occurred in a period when growth as measure by the then official GDP numbers was slowing. In sum, the recent stock market uncertainty when GDP growth numbers seemed robust was a significant turnaround in the relationship between the two.

The point to note is that the correspondence between GDP growth and market buoyancy during the 2004-08 period seemed credible because of a third factor—the surge in capital flows into India. There is little disagreement that the bull run, which began in late 2012 when the Sensex was hovering just above 16,000, was driven by the appetite of foreign institutional investors for emerging market paper induced by access to cheap liquidity.

The liquidity increase that followed the conversion of hard currency funds to rupees by foreign investors triggered a credit splurge. Banks flush with funds enhanced lending so that the ratio of scheduled bank credit to GDP, which averaged between 20 and 22 per cent during the 1990s, rose sharply during the first decade of this century to touch 56 per cent in 2011-12. This explosion in bank credit financed a huge increase in debt financed private expenditure, which more than compensated for the contraction in demand that the reform-led decline in debt financed public expenditure induced. This explained the spurt in GDP growth during the years between 2003-04 and 2009-10. With hindsight it is now clear that the form that boom took was not all too positive. The credit boom brought in sub-prime clients into the universe of borrowers, resulting in a rise in the proportion of defaulting loans. The result has been a growing reluctance of banks to lend to certain sectors and to restrict lending even to the best customers. The contraction in credit that implied reduced the stimulus to growth that debt-financed private spending provided. This explains in large part the slow down in growth the Indian economy has been experiencing.

However, the downturn in growth did not result in any significant decline in foreign capital inflows. In fact, there had been a resurgence in foreign investor interest in India, after the brief period of the “taper tantrum” starting May 2013, when investors responded to the fear that the Fed would sharply unwind its quantitative easing or bond buying programme and send interest rates soaring, by pulling out of ‘emerging markets’. But since there has been no revival in debt-financed private spending, there was little impact on growth. In essence, the link between growth (if actual) and stock market performance had been broken.

This explains the emphasis now on the GDP growth numbers. If the fear that the US Federal Reserve would be forced to raise the currently near-zero interest rates does end the stock market boom, then the government would only have its new GDP numbers to declare that all is well. But given the divergence of those numbers from other indicators, few would give them any credibility. GDP as of now just seems a great dream of prosperity.

* **This article was originally published in the Frontline, Print edition: June 26, 2015.**