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India May Pay Dearly for the War Scare

Foreign investors are fleeing – and might not return for a while

Now that war fever has begun to abate between India and Pakistan, investors are starting to ask some pointed questions. How much have the tensions damaged India's economy? And how long will it be before the nation is seen as a safe destination for foreign investment again?

The answer is that the economy has taken a beating from which it may not soon recover. In the three weeks after mid-May, when Pakistani militants attacked an Indian army camp in hotly contested Kashmir, foreign institutional investors pulled an estimated $48 million out of the Bombay Stock Exchange, helping knock the bourse down 10% (chart). The $8 billion software industry is hurting, too, with visits of foreign clients being canceled. Also hard hit is the garment export industry, which fears loss of business in seasons ahead.

Long accustomed to living in a volatile region, Indians have a hard time understanding foreign jitters. Last week, the Confederation of Indian Industry likened British and U.S. travel warnings to "unofficial economic sanctions, [which are] unjustified and should be reversed." But the truth, says Ajay Sondhi, country chief of UBS Warburg in Bombay, is that "India's perceived risk profile has been heightened and may not be lowered in a hurry."

Investors can be forgiven for seeing India as a risky bet these days. Even as relations with Pakistan began to boil, communal violence in the industrial state of Gujarat in February rocked the nation. A $200 million fraud in India's cooperative banks showed the dangers lurking in the financial system. Adding to the pain is the recent decision by Morgan Stanley Dean Witter & Co. to change its widely followed MSCI emerging-markets index of recommended weighting for portfolios. India's weighting was reduced from 7.5% to about 3.5%. All this makes for an unappetizing stew for the firangi, as foreigners are called.

Hardest hit is India's vaunted software industry. "September 11 delayed the industry's recovery," says Infosys Technologies Ltd. Chief Operating Officer S. Gopalkrishnan. "This will delay it further." Ditto India's plans to become the back office and call center to the world. Foreign investors in India's telecom sector say the tension will make them loath to commit new funds.

It's not just tech and telecom, either. South Korean auto maker Hyundai Motor Co., which has invested $700 million in India since 1997, figures a dull stock market could depress consumer demand by 10% to 15% in coming months, meaning fewer cars sold. "The feel-good factor could disappear," says Hyundai India President B.V.R. Subbu.

The tensions with Pakistan came just as India was climbing out of a trough. The markets were looking up for the first time since September 11, there had been an uptick in auto and cement sales, a housing boom was under way, and the software sector appeared to have bottomed out. Even the country's languid privatization program had gained momentum. Business hub Bombay was buzzing again. And investors had been looking forward to a dozen public issues this year—a bonanza in a market that hosted just six since 2000.

The move back from the brink is having some positive impact. On June 11, I-Flex Solutions Ltd., a subsidiary of Citibank India that makes banking software, went ahead and floated 10% of its shares. The issue was oversubscribed by three times and the company raised $43 million. There are contrarian bulls in the crowd, too. They believe a historic moment of opportunity has arrived for India and Pakistan to bury their differences—and that the market is undervalued. Samir Arora, head of Asian emerging markets at Alliance Capital Management in Singapore, says he has been "buying like mad"—up to $5 million a day of such stocks as auto maker Telco and refiner Hindustan Petroleum Corp., which is due to be privatized this year. **Jon Thorn of the $15 million India Capital Fund has been buying from departing foreign investors. "They're just scaredy cats," he says.**

Maybe so. But most investors prize stability, and India, at least from a distance, doesn't have much. Analysts say what's needed to counteract the war scare is an acceleration in the tempo of economic liberalization. Then, says UBS Warburg's Sondhi, "when the war clouds finally lift, India will again be seen as a good investment destination." Unless, of course, some new crisis intervenes.

By Manjeet Kripalani in Bombay

Enclosure 2