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Foreign investors are rejecting Indian stocks

A roaring economy is not enough to entice them

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HOW TO EXPLAIN the disparity? India's economy is growing astonishingly fast, Bangalore and Mumbai have become destinations for bosses of global financial firms and Narendra Modi trumpets the country's appeal in his electoral campaign. Given the enthusiasm, surely foreign money is flooding into the country.

Not quite. In April foreign investors dumped $1bn-worth of Indian shares. In May they dumped another $4.2bn. This is a sliver of the roughly $900bn of Indian shares in foreign hands, but it is a striking move given the mood music—and one that has pushed the share of the Indian stockmarket held by foreigners to just 18%, its lowest in a dozen years.

The usual explanations for the trend are unconvincing. India's election has prompted jitters, yet locals remain happy to enter the market and Mr Modi, who looks certain to win, is a sure-footed custodian of the economy. Indian companies are expensive, trading at double the level of both their accounting ("book") value and their Chinese competitors. Still, India's economy is on a tear, its firms offer superior returns on equity and they are deleveraging, meaning that they are producing more profits while taking less risk.

An alternative—more convincing—explanation rests on how India treats foreign investment. The country has never been a straightforward destination for international capital, owing to disclosure rules and taxes on capital gains and dividends. Until recently, however, such taxes could be avoided or minimised if the investing firm was registered in a country with which India has a tax treaty. The most popular such countries were Mauritius, which since 1983 has offered an escape route from Indian levies, and Singapore, which has

a treaty designed to mirror Mauritius's.

The first sign of change came in 2017 when India imposed its own tax regime on new funds registered in these countries. Then, in March, officials confirmed reports that tweaks to its treaties might put older funds at risk. They asserted that a fund must be located alongside a large portion of its operations, which would exclude many in Mauritius. Although ministers declined to provide details, investors are confronting the possibility of vast tax claims and the need to move businesses.

These changes are not entirely without cause. Local investors were annoyed that their foreign peers received better tax treatment; some channelled domestic investments via foreign funds to minimise tax bills. That, in turn, irked officials, since local investors were then able to avoid India's stringent disclosure requirements.

Moreover, the government planned to compensate for making investment tougher in this way by easing things in another. Nishith Desai, a lawyer, recalls a trip to Singapore in 2007 on behalf of the state of Gujarat, with its then chief minister, Mr Modi, who asked why India could not build its own Singapore-like financial hub. Today that is his signature project: the Gujarat International Financial Tec-City (GIFT City) sits within an hour of Ahmedabad, Gujarat's biggest city, and contains 19 modern glass buildings, which are home to 660 firms, as well as several hotels and schools. A new regulator, the International Financial Services Centres Authority, is intended to consolidate the usual Indian regulatory chaos into a single Singapore-style mechanism for efficient control.

Among the rush of laws drafted to support GIFT City are ones allowing investment funds to move from Mauritius without triggering the kind of liquidation and taxable event that such a move would normally entail. Dozens of fiddly little rule changes have been made to welcome reinsurance and aeroplane-finance firms that would run into ownership restrictions and other impediments elsewhere. Over a hundred local funds have registered in the city, drawn by provisions expanding the limited rights Indians have to invest overseas. Banks have been pushed to add workers.

For all this, GIFT City retains a Potemkin quality. New bank operations carry out work no different from that which they would have done in Mumbai, India's financial centre. The new regulator is, in theory, a big step; in reality, many approvals must still go through the central bank and securities authority, with disputes adjudicated by clogged courts. The rules applicable to equity investment remain half-formed and muddled. Foreign-denominated equity indices can be traded in GIFT City, but the underlying shares cannot. Funds established in GIFT City require a physical presence. Whereas Singapore offers efficient courts, low and well-administered taxes, and few operating demands, India's equivalent offers the opposite.

Perhaps these are growing pains. Among the rule changes are ones to allow securities listed on Mumbai's stock exchanges to trade on stock-exchange affiliates in GIFT City in dollars, which may offer a boost. Bureaucrats with ties to Mr Modi have been installed. Ironing out problems is said to be a post-election priority. But until things improve, foreign investors will see the messy situation and conclude that, for now, it is best to stay away. ■

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