# Paulson in India Defends Hedge Funds

by Ramtanu Maitra

Representing an economically weakening United States, Treasury Secretary Henry Paulson arrived in New Delhi on Oct. 29, on his first official visit to India. Upon his arrival, he called for India to open its economy further to international investors, and said that recent moves to limit capital inflows could hurt competitiveness.

Paulson's visit to India was designed to nudge New Delhi to carry out more economic and labor "reforms," and to integrate India's regulated financial sector with the globalized free market system. As a part of the deal, Paulson also made a pitch urging the Indians to help complete the Doha Round of negotiations to usher in the World Trade Organization's globalization and economic liberalization plans. But Paulson's push to defend his Wall Street investor friends was too much even for some of the best friends of the Bush Administration in the present Manmohan Singh-led government.

The reason is the following. Near the end of October, the Securities and Exchange Board of India (SEBI) proposed a ban on the issuance of participatory notes, causing a 1,700 point one-day plunge of the Bombay Stock Exchange's (BSE's) benchmark Sensex index. Unregistered foreign investors will need to wind up positions through participatory notes over the next 18 months, SEBI chairman M. Damodaran said. SEBI measures followed the sharp rise in the flow of foreign capital from unregistered hedge fund and derivative operators into the BSE, which fueled a dramatic rise in domestic stock prices, analysts said.

Participatory notes (P-notes) are part of relaxed restrictions on foreign investment in India, providing overseas investors who are not registered with SEBI with a way to invest in Indian securities. Foreign institutional investors authorized to trade in India, and Indian brokerages will buy Indian securities and sell participatory notes based on them to foreign investors. SEBI was aware that P-notes were being used by offshore hedge funds to park liquidity in the Indian stock exchanges, to make a quick profit, and that they had sufficient leverage to destabilize the market.

As an Indian financial commentator pointed out, the biggest beneficiaries of P-notes are foreign banks and intermediaries who earn hefty fees for channeling this money through appropriate vehicles while concealing true ownership. Hedge funds are unregulated in most markets, completely non-transparent about their investors as well as their fee structure, and many of them have questionable investment practices. "Giving them a free run of our market mocks domestic investors who have to adhere to strict disclosure norms and know-your-customer rules," she said.

Referring to the 1997 Asian market collapse, when the well-protected Indian market was lauded by Asian nations for being the "island of stability, Dr. Y.V. Reddy, governor of the Reserve Bank of India (RBI), India's central bank, told the Indian daily *Business Line*, on Oct. 30, that "after ten years, if similar global turbulence happens, our objective is to ensure that India will be an island of stability." He said this after announcing the mid-term review of Monetary Policy, which had "liquidity management" as its main thrust.

## What Paulson Did Not Like

"We do not know what will happen globally, but there are strange things that are happening globally, unusual things. How it will affect us, we don't know. It will have less impact than on most other countries. But if it is such an unprecedented global shock, the policy has to be all placed together and we should be in readiness," Dr. Reddy said.

Reserve Bank of India

*Reserve Bank of India governor Dr. Y.V. Reddy warned Secretary Paulson that in view of "strange things that are happening globally," and in case of an "unprecedented global shock," Indian officials have to have a policy in readiness. Here, Reddy (right) is shown with Prime Minister Manmohan Singh, inaugurating the Centre for Advanced Financial Learning in 2006.*

What Reddy was referring to as "strange things," is the new injection of liquidity engineered by the U.S. Federal Reserve, the European Central Bank, and the Bank of England. The yet-to-be-unfolded implications of the U.S. subprime mortgage crisis and its supposed antidote—injection of liquidity for a longer period than usual—have forced the RBI to adopt measures which could help protect domestic investors by slowing down the inflow of dirty money.

RBI's concern rose from the fact that the portfolio flow, according to the bank's July 31 credit policy announcement, amounted to $8.4 billion during 2007-08, up to July 13, while gross Foreign Direct Investment (FDI) inflows during April 2007 were placed at $1.6 billion against $0.7 billion a year ago. This does not include external commercial borrowings.

"These pools of capital, which are private, often opaque, highly leveraged, and largely unregulated, have the potential for heightening risk to the domestic financial system," the RBI said in its bi-annual review of monetary policy.

But Paulson will have none of it. Accompanied by Indian Finance Minister Palaniappan Chidambaram, a Harvard-trained darling of Wall Street because of his unmitigated commitment to free market economy, former Goldman Sachs chief executive Paulson told the Indian CEOs, at a conference in Mumbai: "Administrative restrictions of capital flows are blunt instruments and can have unintended consequences. They tend to inhibit efficiency and lose their effectiveness over time."

## Another Cruel Joke

What is particularly ironic, in light of the collapsing dollar, bottomless U.S. debt, hundreds of billions of dollars in trade deficit every year, and a huge liquidity crunch hanging over the U.S. economy like the sword of Damocles, is the groveling before Paulson by Chidambaram and the Indian industrialists, begging for U.S. investment in India's ramshackle infrastructure.

One of the items addressed at the conference attended by Paulson and his team—which included William B. Harrison, former chairman and CEO of JPMorgan Chase; Emil Henry, managing director of Lehman Brothers; and Tracy Wolstencroft, managing director and head of global infrastructure and municipal finance at Goldman Sachs—was how to increase investment in India's infrastructure, such as roads, ports, and power, for which the Indian government reportedly estimates it will need close to $500 billion over the next five years.

Chidambaram said India needed to change the rules on investments by pension funds and insurance funds, so they could be used to fund infrastructure growth. Paulson piped up: To attract international investors to sectors like infrastructure, India needs to develop transparent systems run by independent regulators. The country also needs a stronger legal system, so that investors have the assurance that their contracts will be enforced, he told reporters.