The Sobering Disconnect Between a Soaring Sensex and Contractions in the Real Economy*

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As the Sensex hit the 50,000 mark this week for the first time ever, it is clear that the widening gulf between financial and the real sectors remains a matter of concern, both on grounds of the underlying inequities and the possibilities of a crisis in near future.

To trace the origin of the disparate levels of activities between the two sectors, attention needs to be drawn to the wide-ranging deregulation of financial markets in the US and the UK by the end of the last century. Regulations were loosened in the US with the scrapping of the Glass Steagall Act which enabled banks an entry to the security market. Similar measures to initiate universal banking followed in the UK in terms of the 'big bang'.

While these measures enabled banks to trade and invest in securities, their balance sheets got considerably exposed to risk-prone transactions in the uncertain market. The pace of financial flows revamped during globalisation with relaxed restrictions on capital flows. With activities in the financial sector subject to quick turnovers – which were mostly linked to short-term projects – financial assets continued to fetch higher returns compared to those relating to the sluggish real sector.

Exceptions included the few high growth economies in East Asia, and also India over a short spell of time.

A major factor behind the low growth in the real sector included the mindless application neo-liberal prescriptions for austerity in many countries. The pattern also marks the beginning of financialisation, with growth as well as the returns in the financial sphere continuing to exceed those in real sectors.

Divergences, however, have widened further in recent times with catastrophic downslides in production and employment during the pandemic-led lockdowns and related disruptions in economies. However, it remains a puzzle as to how the financial transactions reached further heights even in this period.

Looking first at India's real economy during the pandemic, GDP as per official estimates dropped by 23.1% during April-June (Q1) of 2020-21 when the COVID-19 crisis had just begun. The deceleration continued over the next quarter, with a negative growth rate of GDP at (-) 7.5%.

A similar decline officially predicted for 2020-21 as a whole puts GDP growth at (-) 7.5%. As for the financial sector, the contrasting performance is more than visible in the stock market. Thus the Sensex, the benchmark sensitivity index of the Bombay Stock Exchange, has been tracking an almost steady upward move, from 40,817 on January 8, 2020, to 48,569 on January 8, 2021.

The sharp downward slide in the market took place between February and March of 2020, which included reactions to the lockdown under the pandemic and other temporary disruptions later.

The jubilant strides in the major secondary markets for stocks, however, have continued, along with avenues open for fetching financial gains in the unregulated markets for real estate, gold and even commodities.

It is important to notice that profits on stocks booked in the secondary markets for stocks or other financial assets do not originate from productive activities in the real sector of the economy. This contrasts the floating of shares as initial primary offerings (IPOs) by enterprises which create capacity for additional production in the real economy.

The paradox in the continuing financial boom along with the real economy going through a stagnation is found in other emerging economies including Brazil and Argentina, as well as advanced economies like the US and UK.

Thus for Brazil and Argentina, experiencing the respective lows of GDP growth in the pandemic era at (-) 9.6% and (-) 16.0% in the second quarter of 2020, growth in finance continued to be robust. With Bovespa, the stock index in Brazil, the climb (subject to interim drops which were temporary) was from 6,000 to 12,000 between March 2020 and January 2021. It was similar in Argentina where the stock index, Mervel moved up from 22,105 to 52,180 over the same period. The story has been the same in the US, as can be seen from the upward trend of the US Nasdaq, from 7,006 to a level at 12,623 between March 2020 and January 2021. As for the US's GDP growth, it has been wavering within a low range between 2-3%. Not surprisingly, there has been a similar poor scenario with jobs growth, which were much less than what was needed.

Dissimilar patterns between the real and the financial sectors of economies impart a dissonance within the economy, with prosperous finance hardly relevant in the context of the stagnating real sector. To give an example, the bonanzas reaped from the unprecedented boom of the Indian stock market bears no testimony to the miseries of the uprooted migrants, the protesting farmers or the vast stream of the jobless in the country.

To understand a bit more, the magical prosperity which continues in the financial sector, we need to recognise the circuit of financial flows beyond the real economy. Such flows, having no counterpart in the productive sector, were identified, first by Karl Marx, as fictitious finance.

Despite the fact that flows of fictitious finance do not originate from the real economy, their accumulation leaves a mark by generating financial wealth for those having access to the financial circuit. Interestingly, financial assets, sold at higher prices fetching capital gains at higher prices generate a rise rather than a usual decline in demand. As for the dividends earned on stocks, the interest rate is used to discount the stream of those earnings – which in turn settles the level of stock price in the market. Evidently, possibilities of accumulating assets turn brighter with the high value assets used as collaterals, fetching credit for further business. As for the stock prices, reflected in the stream of dividends discounted by interest rates, lower rates can help pitch stock prices higher. We recall that cuts in interest rates are often preferred as tools under mainstream prescriptions limiting expansionary policies, which evidently helps stock prices.

Finally, the rise of finance as a major force in the power relations of economies goes with an evolving pattern of alliances between the ruling state and finance. It thus has been convenient to let banks make profits by entering the security market. For the non-bank financial institutions which were left outside the prevailing regulations, it turned out to be profitable business to procure leveraged securities and to convert them as assets. The bankruptcy of those units, not covered by the central bank as lender of last resort, led to contagion effects for banks exposed to the balance sheet of those units. That the state was in close proximity to big business in the financial sector is also evident with the state coming forward in times of financial crisis with measures to ensure financial stability. It speaks a lot of the pro-finance stance of the state as one that contrasts the benign neglect on its part in times of an upswing in the financial sector.

Possibilities of a sudden collapse of confidence in the financial sector, incurring financial losses borne by those holding such assets, go with social costs borne by the economy as a whole – a reality which cannot be ignored.

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