India – the rent-a-brain supermart

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India comprises about 9% of the MSCI AC Asia Index. Yet Australians appear to know far less about the industrial revolution occurring in India compared with our knowledge of China. This paper looks at why India was forced into economic reforms and what these reforms have so far achieved. It also addresses the performance of the Indian share market and opportunities for investors.

Introduction

Old-style India might best be glimpsed by its decision in the 1970s to force out Coca-Cola. The drive against the popular soft drink reflected the self-sufficiency or "swadeshi" mentality that pervaded the country's economic policies from independence in 1947.

During this time, policy-makers favoured central planning, kept out foreign investors and placed infrastructure, utilities, banking and other key industries under state control. The consequence was that India's economy stagnated at an annual growth rate of 3.5% from the 1950s to the 1970s. This was only equal to per capita growth of 1.5% per annum, a non-achievement that was derided as the "Hindu rate of growth".[1]

It was always going to take a shock to jolt India out of its economic mis-management and that duly arrived in 1990 when India faced a balance-of-payments crisis. Shortly after in 1991 when the problem had morphed into a currency crisis, the near-broke government turned for help to the World Bank and the International Monetary Fund. These bodies agreed to provide financial aid to India on condition the country made immediate free-market reforms.

The broad thrusts of the reforms were financial stability, outward-looking policies and deregulation. They consisted of two parts; immediate stabilisation steps and longer-term adjustments. The short-term medicine aimed to restore equilibrium in the foreign-exchange market by reducing demand, reforming trade policy, cutting the fiscal deficit and freeing capital flows. The value of the rupee was slashed to boost India's competitiveness.

The medium-term remedies included fiscal, exchange rate, trade and industrial reforms as well as policies to shake up the public sector, the financial industry and capital markets. These reforms included deregulating prices and investments, an overhaul of taxation and public expenditure, the sale of government assets and opening the Indian economy to the world.

India's industrial revolution is the outcome. Endless reforms since the 1990s have fanned impressive export and industrial growth that in turn have created a sense of optimism around the country -- and for good reason. India's economic performance in recent years has been among the best in the world. The

[1] *The Economist Intelligence Unit (EIU), Country Profile 2005, India*

long-term trend rate of India's economic growth has jumped and the country has recorded an average annual economic growth rate of 8.5% over the past four years, growing 9% in 2006 alone.[2]

Inflation of around 6% a year is much lower than the near double-digit annual results recorded between 1992 and 1996 thanks in part to good management by the Reserve Bank of India. Interest rates near their lowest in about three decades encourage investment and consumption. The country's net debt level and trade performances have improved vastly since the early 1990s due to foreign investment inflows and a better export performance.[3] India is getting better at exporting. India's exports totalled US$103 billion in 2005-06, nearly triple the amount recorded five years earlier.[4] About half of India's exports are textiles, cut gems and automobile components: but the real success story is IT services, which have soared in recent years.[5]

India's political structure

An economy needs some crucial foundations in place to prosper, including political stability. This is best achieved in a democratic system because checks and balances are generally in place that disperse power; an independent legal system secures property rights; a free media operates; the transparency involved limits corruption; and the system can better absorb stresses.

India can boast that it is the largest democracy in the world. The constitutional federal democracy of 28 states and seven union territories has held regular and largely free elections since independence for its two houses of parliament.

National elections are held every five years (earlier if leading parties lose majority), with universal adult suffrage for the lower house, or Lok Sabha, which appoints the prime minister. The country's constitution provides for an independent judiciary with high courts in every state and a Supreme Court in the capital of New Delhi.

India's inclusive politics has helped maintain social unity. A high level of political awareness and the sheer size of the electorate generally ensure that final election results reflect the wishes of the electorate. Since 2004, India has been ruled by a coalition led by Prime Minister Manmohan Singh. The size of the coalition and the fact that it includes Communist MPs slows policy making and implementation.

Since the collapse of the Soviet Union, India has built closer ties with the West including the US and has turned itself into a nuclear power. Tensions exist with neighbouring Pakistan, Bangladesh and China though these appear to be under control.

For investors, it is important to note that the numerous governments in power since the early 1990s have persisted with free-market reforms, albeit with different levels of enthusiasm, room to move and success.

India's upbeat economic outlook

An economy needs some advantages to flourish. As well as having favourable political and legal systems and a pro-business government, India's economy possesses three key advantages that augur well for its long-term economic growth; an expanding middle class, favourable demographics and a skilled workforce.

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[2] *rbi.org.in. Macroeconomic and Monetary Developments publication*
[3] *EIU ibid*
[4] *India Economic Survey on www.indiabudget.nic.in 2007*
[5]*EIU ibid*

Expanding middle class

A middle class has emerged in India that is set to boost and alter consumption within the country. The National Council for Applied Economic Research, a private non-profit economic research firm based in New Delhi, estimates that India's middle class has tripled to 300 million in the past 20 years thanks to the recent economic growth. Bloomberg quotes government estimates indicating that India's annual per-capita income has jumped 62% to 25,788 rupees (US$580) in the past six years.

If you assume that Indian consumption patterns will mirror those in Western countries as Indians become wealthier, there is vast potential for consumer sales because few Indians have what many in richer countries regard as essentials; a car, a TV, a PC and a mobile phone. There is also vast potential for smaller consumer items such as cosmetics, packaged food and alcohol, as the table shows.

The consulting firm McKinsey & Co. estimated in the McKinsey Quarterly publication in 2005 that India's market for consumer goods may expand to US$400 billion by 2010 from $250 billion in 2003. A surge in demand for services is mirroring the jump in demand for fast-moving consumer goods and durables. The financial services, media, entertainment and leisure sectors are expanding at a brisk pace.

Per-capita consumption Across Countries for Key FMCG Categories (US$/year/capita)

	US	UK	Russia	Brazil	China	India
Per-capita income	43,740	37,600	4,460	3,460	**1,740**	**720**
Bath products	15.4	20.2	5.3	6.2	**0.8**	**1.2**
Laundry care	33.1	45.1	9.5	13.7	**2.1**	**1.4**
Oral hygiene	16.1	19.7	5.2	8.3	**1.2**	**0.5**
Haircare	34.6	38.7	10.3	20.0	**1.7**	**0.8**
Colour cosmetics	28.4	32.9	6.7	6.3	**0.8**	**0.1**
Skincare	26.4	32.1	7.3	8.4	**2.7**	**0.3**
Packaged food	1,054.6	1,461.1	340.0	271.4	**42.7**	**8.8**
Beer	131.8	129.2	73.8	15.5	**9.1**	**1.0**
Wine	45.5	198.2	30.1	7.6	**2.1**	**0.03**
Spirits	66.2	92.1	79.4	5.7	**10.2**	**6.7**

Source: CLSA Asia Pacific Markets, 2006

Favourable demographics

India's population is a melting pot of languages, religions, castes and classes that overall possesses some demographic traits that are favourable for economic development. India's 1.1 billion population is young when compared with Western countries and even developing countries such as China, where a one-child-per-family policy has operated in much of the country for decade. About 30% of India's population is under 15.[6] When these youngsters move into the 15- to 49-year old age group they will be entering the age when they will be at their most productive and when they will consume their most. This aging process is likely to boost India's consumer base if enough people have risen out of poverty in the meantime.

As well, approximately 60% of Indians are 15 to 64 years old[7], a high percentage by international standards. This means India has a relatively low number of dependents in percentage terms of the population. It's generally accepted that as more people in an economy work to support fewer people, discretionary consumer spending is likely to jump. The effect on the national economy will be noticeable, if enough Indians have risen out of poverty to have money to spend on life's luxuries. India's dependency

[6] *Asian Development Bank and US Census Bureau*
[7] *Asian Development Bank and US Census Bureau*

ratio is expected to stay low well past 2035, unlike in many other developing countries where the population is aging, as the table shows.

India's low elderly dependency ratio

	Elderly Dependency Ratio	
	2000 (%)	2035 (%)
China	10	30
India	8	16
Korea	10	39
Philippines	6	13
Singapore	10	53
Taiwan	9	n/a
Thailand	8	24
Vietnam	9	18
EU15	24	47
Japan	25	57
UK	24	37
US	19	32

Source: OECD, 2002

Skilled workforce

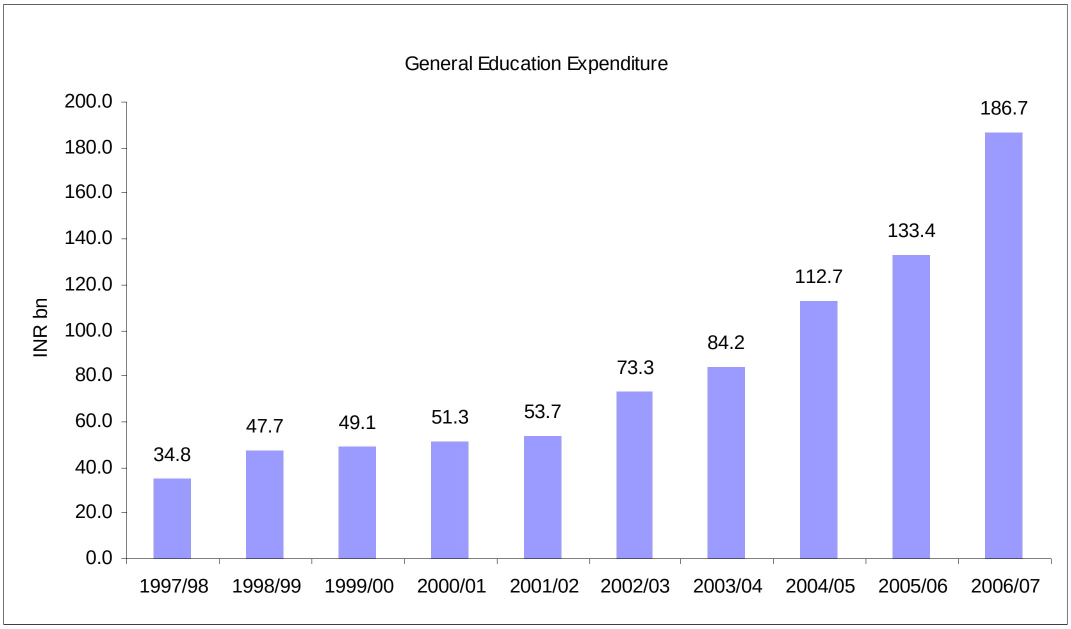
India's other big advantage is that many of its young workforce are highly skilled, even though it has a large number of uneducated people. (It has 17% of the world's population and 40% of the world's illiterates, according to the Economist Intelligence Unit).

India's large number of scientists, engineers, lawyers and financial managers are helping high-value industries succeed in India and are attracting foreign investment into the country. One of the key reasons foreign investors are attracted, of course, is that it is generally much cheaper for them to employ a well-qualified person in India than a person with similar skills in a Western country.

One of the skills of the Indian workforce is that English is widely spoken as a second language in a country with 15 official languages. The ability of many Indians to speak English is one of the reasons so many companies have outsourced call centres or set up IT operations in India. The workforce is skilled because the country decided more than 30 years ago to boost spending on education. The amount has doubled over the past three decades during which time the number of universities has trebled. (The chart below shows how spending on education in India has increased over the past decade or so.) At last count, the country boasted 225 universities, 6,800 affiliated colleges and 1,128 polytechnics, according to the Economist Intelligence Unit. However, the demand for skilled workers by industry has been rising faster than the supply. This has resulted in shortages and caused salary levels to rise in the past couple of years.

Government incentives for businesses to further educate their staff and stepped-up government spending on education are expected to ensure that skill levels in India rise further.

India has boosted spending on education in the past decade



India's economic challenges

India faces pressure on its natural resources especially when considering that it is home to about 17% of the world's population yet they are only living on 2.4% of the world's surface. Also, being a developing country, resources need to be adequately exploited. As with any country, India faces challenges.

Poor infrastructure

India's biggest challenge may well be that infrastructure of all sorts is rudimentary and a hindrance to growth. With transport, the country has the world's most extensive rail network, at more than 63,000 kilometres of track, but it suffers from underinvestment and underpricing. India has only 65,000 kilometres of national highways compared with China's 1.8 million kilometers. The country's 12 major ports are inefficient and the airline system requires infrastructure upgrades.

Energy is another problem. India cannot produce enough power to satisfy demand and charges, on average, double what it costs in the US to provide power. Only 55% of Indian households have electricity. Importantly in an era when oil is fetching record prices, India is a net oil importer – a factor that has led to its current-account sliding into deficit since 2004-05.

The telecommunications system is modern even though the ratios of phones or mobile phones per 100 people are low by international standards. India is in fact the world's fastest growing mobile market. It is expected to have 300 million subscribers by 2009 from 77.6 million at the end of 2005.[8]

The government recognizes the need to improve infrastructure and progress is being made, albeit at a slow pace, and it is hoping to rely on foreign investors to help alleviate the problem. The Ministry of Finance estimates India has the "potential to absorb US$150 billion of foreign direct investment in the next

[8] *Gartner Inc., a US-based technology research company, as quoted by Bloomberg 28 February 2006*

five years in the infrastructure sector alone."[9]Morgan Stanley has estimated that India has earmarked about US$40 billion to spend on roads, ports, telecommunications, airports, railways and power by 2009.

Macro-economic concerns

India faces numerous, but surmountable, macro-economic challenges.

An overheating economy

After four years of economic boom, India has little spare capacity left. Many factories are operating at or close to full capacity and the country's roads, railways and ports are clogged. Demand is exceeding supply and excess demand is being met through imports. Imports in the first five months of 2007 surged 26% from a year earlier, while exports only grew 12.7%.[10]

The hyper economic activity is fanning the prices of goods, services, financial assets, real estate and wages. Producer price inflation rose 4.4% in the 12 months to 30 June 2007, just under the central bank's target of 4.5% to 5.5%. However, consumer price inflation, as measured by price rises for urban non-manual employees, jumped 5.69% in the 12 months ended 30 June 2007.[11]

To tame inflation, the Reserve Bank of India has increased its key repurchase rate six times in the past 18 months, ordered banks to curb lending three times so far in 2007 and slowed foreign currency purchased to bolster the rupee to make imports cheaper.

Hefty budget deficit

The federal government's deficit may well be India's biggest macro-economic challenge. The government's budget shortfall was equal to about 4.2% of output in fiscal year ended 31 March 2007[12]. The problem is seen as unsustainable and an impediment to growth because unproductive public spending is crowding out private investment.

The government's budget is structurally weak and many politically difficult issues would need to be tackled to fix it. These include reducing subsidies, cutting government employment, closing loss-making state businesses and raising the tax take by expanding the number paying income tax. (The Economist Intelligence Unit estimates that only two million people in India pay income tax.[13])

External constraints

A current-account deficit of about 1.5% of output for the December quarter of 2006 needs to be watched.[14] Export growth of 20% per year in recent years should help but exports only account for 11% of gross domestic product[15] compared with more than 100% in some more developed Asian countries such as Singapore and Taiwan. But to put India's export performance into perspective, India only accounted for 0.82% of world total exports as measured by merchandise trade in 2004 compared with China which accounted for 6.46% in the same year, according to the latest data available from the World Trade Organisation.[16]

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[9] *Economic Survey 2005-2006. India's Ministry of Finance website finmin.nic.in*
[10] *Bloomberg. India May Trade Gap Widens to US$6.2 billion. 2 July 2007*
[11] *Bloomberg. India's June inflation for industrial workers slows to 5.69%.31 July 2007*
[12] *Budget speech 2007. India's Ministry of Finance website finmin.nic.in April 2007*
[13] *EIU, ibid*
[14] *Bloomberg. Global Economic Watch*
[15] *CLSA, CLSA Estimates, September 2005*
[16] *Country profiles of India and China found on wto.org 2006*

On the import side, oil is a problem for India. The balance-of-payments crisis of 1990 was triggered when oil prices jumped after Iraq invaded Kuwait. Some analysts say that India would be able to attract cheaper capital if the rupee was fully convertible. Since 1993, India has operated a managed-float exchange-rate regime. Under this system, where the current account is fully convertible, the Reserve Bank of India influences the value of the rupee by selling or purchasing dollars from banks.

Sector-level challenges

India's growth is still subject to the quality of the monsoons. Agriculture employs about 60% of India's workforce, according to the Economist Intelligence Unit[17], and any crop failures due to a lack, or abundance, of rain can hamper output and growth in rural areas. Another problem for agriculture is that it is still subject to skewed government incentives for wheat and rice. These schemes encourage the overproduction of these crops and the underproduction of others that could even be sold for export.

Heavy industries in India such as steel, shipbuilding, engineering and chemicals are dominated by inefficient state-owned enterprises. The government has pledged to reduce ownership in non-strategic public-sector businesses to boost efficiency and accountability. But political opposition has hampered this proposal. Burdensome labour laws, a lack of finance and a lack of will tied to public ownership have prevented many heavy industries reaching their potential.

For service industries such as retail, the shortage of good-quality urban real estate is dampening prospects. India's property market is fragmented because it specifies land use based on 1930s British views of what a city should look like.

Investing in India

Sustainable economic growth is the first prerequisite to a thriving share market. If an economy is doing well, then companies will generally be able to increase their sales and earnings.

That said, investors need to gain confidence in the infrastructure surrounding a stock market before they invest. They will want comfort on its disclosure requirements, the level of transparency and even its day-to-day capacity to operate efficiently.

Developed market

India is home to 23 stock exchanges including Asia's oldest. The longest-running exchange is the Bombay Stock Exchange (BSE), which was set up in 1875, three years before the Tokyo Stock Exchange was formed.

While India has multiple stock exchanges, more than 99% of total trading volume is handled at the BSE and the National Stock Exchange (NSE). The BSE boasts more than 4,700 listings, second only to the New York Stock Exchange, a number that reflects the Indian entrepreneurial spirit. The top 100 companies on the BSE account for about 70% of the total market capitalisation. The NSE was set up in 1994 and introduced online trading to India. It has more recently overtaken the BSE to become the busiest exchange in India, handling more than twice the number of transactions than the BSE, and a derivative market in which it has a virtual monopoly.

[17] *EIU, ibid*

India's stock market is on a par with developed market exchanges around the world. The introduction of a modern index and stock options and futures in 2000 has spawned one of the most vibrant derivatives markets in Asia. Modern trading and settlements systems have been introduced. All trading is electronic and more than 70% of outstanding shares are held electronically.

Many multi-national listings

India has a large number of US and European multinational company listings. Some of these multinationals include AstraZeneca Pharmaceuticals, Colgate-Palmolive, GlaxoSmithKline Pharmaceuticals, Gillette, Hero Honda Motors, Hindustan Lever and Siemens India Ltd.

Reference to individual companies does not constitute a recommendation or necessarily reflect a stock-holding status of any kind.

Expanding industry selection

India's stock market boasts an ever-expanding number of industries and its market capitalisation has soared in recent years. While part of the growth in the market cap has been due to rising stock prices, there has been a steady stream of equity issuance such as IPOs and follow-on issues. This number of issues is expected to increase because the government is privatising enterprises and smaller companies are turning to the stock exchange to raise capital.

Better corporate governance

Recent initiatives by the Securities & Exchange Board of India have improved corporate governance, particularly since 2001. Studies now rate India third in corporate governance in Asia, behind Singapore and Hong Kong. [18]

A long-term view is essential

But investors should be aware that India is a long-term investment option. As an emerging market, India's stock market lacks depth and liquidity. Market capitalisation as a percentage of gross domestic product remains low, and only a relatively small number of companies are actively traded. Therefore, capital inflows tend to trigger large price movements.

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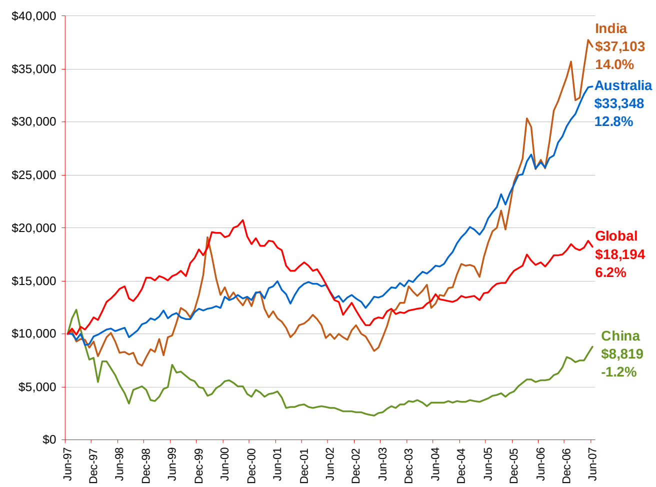
[18] *Asian Corporate Governance Association, 2004*

India's recent share market performance

(All figures and charts in this section are based on data to 30 June 2007 and are in Australian dollars. All returns are shown in AUD terms (assuming currency exposure is unhedged) and assume dividends are reinvested. Returns are average annual returns over the periods shown. Indicies used are: Australian shares: S&P/ASX 200 Accumulation Index (All Ordinaries Accumulation Index before 1/4/2000), Global shares: MSCI World Index, Chinese shares MSCI China Index, Indian shares: MSCI India Index.

Growth

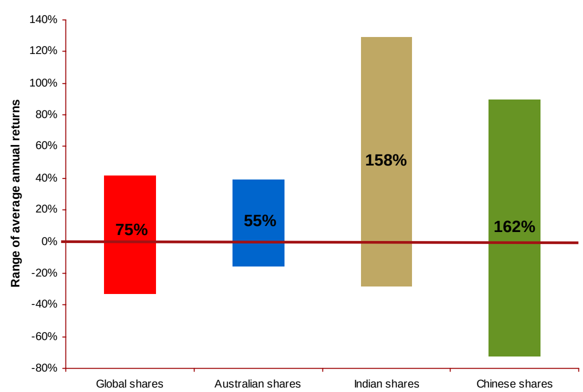
Over the past 10 years, India's share markets have performed exceptionally well. The first chart below shows the returns generated from Indian shares over the past 10 years compared with Australian, Chinese and Global shares. India's average annual growth rate over that time was 14%.



Source: RIMES

Volatility

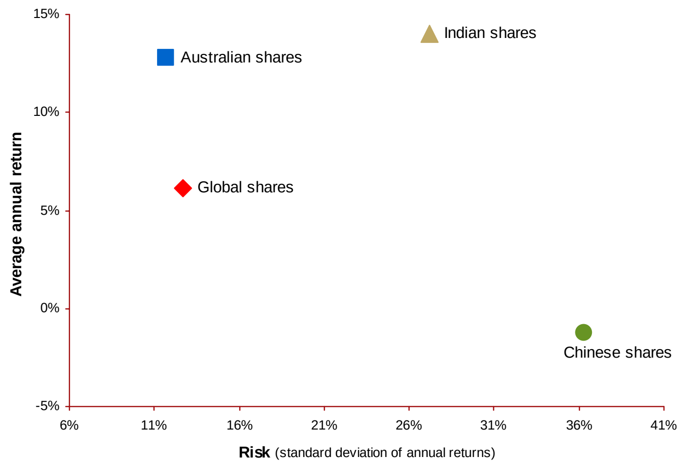
Volatility on India's share markets has also been high. The next chart compares the spread between the best and worst one-year return in each of these markets over the past 10 years (based on rolling month ends). For India, there was a spread of 158% between the highest and lowest one-year returns achieved, which was less than China's result but well ahead of the gaps on more developed markets.



Source: RIMES

Risk/return

Putting this information together, the chart below shows a risk/return picture for the past 10 years in each of these markets. While Indian shares have achieved the highest average annual return over the last 10 years, they have also experienced high volatility (measured as standard deviation).



Source: RIMES

Correlation

Indian shares have the potential to add diversification benefits to a share portfolio. The table below outlines the correlation of returns between these four share markets over the past 10 years. Indian shares have had a relatively low correlation with global, Australian and Chinese shares over this period, meaning that they can add diversification to a portfolio.

	Indian shares	Global shares	Australian shares	Chinese shares
Indian shares	1.00			
Global shares	0.31	1.00		
Australian shares	0.29	0.53	1.00	
Chinese shares	0.17	0.25	0.33	1.00

Source: RIMES

Accessing Indian shares

There are limited opportunities for retail investors to gain exposure to Indian shares in Australia. In fact, at time of writing the Fidelity India Fund is the only country-specific managed fund available to retail investors via platforms in Australia. Exposure can also be gained via regional managed funds such as emerging markets funds (which typically include China, India, Brazil, Russia, Mexico, Korea, Eastern Europe, Latin America) or via some Asian share funds (although not all include India).

Summary

One issue that our industry still needs to grapple with is where India funds (and indeed emerging Asia and even stand-alone China funds) fit within well-diversified portfolios. Fidelity believes more focus should be given to this question. Most Australian investors have little exposure to Indian equities because most invest in global equities through products benchmarked against an MSCI World Index.

India generally only comprises about 0.55% of this index, well below its 6% share of the world economy when compared on a purchasing-power parity basis.[19] At Fidelity, we expect that India's markets will continue to rise in absolute and relative terms. The current gap between India's share-market weighting and its share of global economic output is part of a normal delayed reaction. It generally takes time for investors, especially foreign investors, to gain confidence in developing economies. Why? Because investors want to see political stability, a legal system that enshrines property rights, a sound investment infrastructure, and evidence that a country's economic growth is sustainable.

This paper has attempted to show that India is scoring better all the time on these measures, even if there is some way to go. India's greatest advantage is that its development is "bottom-up". Its people are driven and innovative. They have created world-class companies and modern financial markets, including a liquid bond market and flourishing stock markets. All it took was for them to be unleashed from state control. India's political system delivers stability. The rule of law applies, which means that property and intellectual property rights are secure. People are encouraged to invent solutions because they can benefit from them financially, and not see their countrymen steal their ideas and wealth. The media is unfettered, which means the greater availability of information creates more certainty for businesses to invest. The country's demography will aid economic development. As education is valued, there is a swelling pool of English speakers and professionals to staff local and foreign businesses. These people are cheap to employ by global comparison.

As an added bonus, China's remarkable rise is creating competition between the two neighbours that will, no doubt, help both become economic powerhouses at some point before this century is too old. Over time, therefore, we believe the economic muscle of India will be better reflected in its share-market weighting in the MSCI World Index. If asset allocators are as convinced about India as Fidelity is, then now could be the time to overweight the country so investors can benefit from the industrial revolutions underway on the sub-continent -- where Coca-Cola and every other type of business can thrive.

[19] *www.imf.org*