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AMP CAPITAL

India getting back on track

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Key points

> The resounding victory by the Bharatiya Janata Party (BJP) led alliance in Indian elections likely ushers in a period of significant economic reform in India.

> Reforms are likely to focus on improving the business environment, privatisation and reducing the budget deficit and support for inflation targeting.

> This should help boost India's growth potential back to around 8% pa, after a bout of stagflation in recent years.

> The reform process won't be smooth in the short term but is very positive for Indian assets over the long term.

Introduction

The overwhelming victory by the reform oriented BJP led alliance in India's recent election, has boosted hopes that the Indian economy will get India's growth story back on track. In the clearest election outcome since 1984, the BJP led alliance won 336 of 543 parliamentary seats giving it a clear majority, with the BJP alone getting a majority of 282 seats. The BJP led by Narendra Modi has received a clear mandate to push through with its reform program.

The Indian share market has, not surprisingly, taken this very positively having risen 3.5% since the election and being up 15% year to date, making it one of the world's strongest share markets this year as investors moved to position for a BJP win. But has it gone too far in the short term? What does the change of Government mean over the long term? And what does it mean for commodities and Australian exports?

India's growth potential is very high…

India's growth potential is well known. Its population is still growing rapidly, unlike say China's. By 2050 its population will likely exceed that of China. It has a highly educated workforce which has helped fuel growth in its services sector. Its urbanisation rate is low and has the potential to rise much further. Similarly its starting point of low per capita income (about one third of China's) also means plenty of potential. And being a relatively closed economy it's not as vulnerable as say Brazil to slower growth in China.

India compared to China

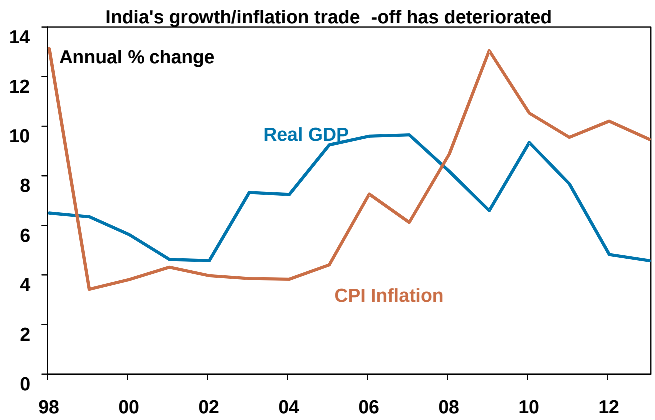
	India	China
Population, now	1.2 bn	1.4 bn
Population, 2050	1.6 bn	1.4 bn
Population growth, next 40 yrs, %pa	0.8	0.1
% urbanisation	31	54
Primary education completion rate, %	81	98
Days to start a business	89	41
Inflation rate, %	8.0	1.8
Current account balance, %GDP	-2.6	+1.7
Budget balance, %GDP	-5.2	-2.2

Source: AMP Capital

Through much of last decade this potential started to be unleashed as a result of economic reforms of the 1990s that de-regulated the economy and opened it up to investment. As a result the Indian economy performed spectacularly well, with growth averaging nearly 9% per annum over the five years to 2007 and increasing confidence that it was following in China's footsteps.

…but yet to be fully realised

However, starting late last decade it seemed the wheels started to fall of the Indian economy. As can be seen in the next chart, for the last five years inflation has pushed higher while growth has slowed leading to a significant deterioration in the growth/inflation trade-off.



Source: Bloomberg, AMP Capital

At the same time, the budget has remained in chronic deficit and is currently 5% of GDP and the current account has also remained in deficit.

Essentially the supply side of the economy did not keep pace with demand resulting in rising inflation and trade imbalances. Perhaps the biggest problem was that the Indian Government, run by the Congress Party, for various reasons failed to continue with the reform agenda in a meaningful way. As a result, privatisation has been slow, protection of domestic industries has been high, its labour market lacks flexibility and business is mired in red tape. It takes more than twice as long to start a business in India than it does in China. Compared to China, India also saves less and invests less in infrastructure.

As a result of its poor recent performance along with its dependence on foreign capital, India only a few months ago was being described as being one of the "Fragile Five" countries along with Turkey, Brazil, South Africa and Indonesia in terms of their vulnerability to the end of quantitative easing in the US.

Another round of reforms

However, the resounding BJP victory means that the reform process will likely get underway again. Narendra Modi's pro-development track record in Gujarat state where he has been Chief Minister for the last decade has been impressive, resulting in 10% pa growth over the last five years. The BJP and Modi ran their campaign with a pro-business and pro-reform policy agenda, which they now have a mandate to deliver upon. Based in large part on the BJP's economic agenda, key reforms are likely to include:

- cutting subsidies and price controls;
- implementing the GST;
- increasing infrastructure spending over current spending;
- reducing the budget deficit;
- faster privatisation;
- commencing a high speed rail network;
- boosting urbanisation and low cost housing;
- cutting red tape;
- simplifying labour laws; and
- support for inflation targeting by the central bank.

The BJP led alliance found support from all social classes and regions (with the exception of Muslims) indicating that the electorate is supportive of the reform agenda.

These reforms should help to boost India's average growth rate back up to around 8% pa in the years ahead. That there are some signs of slowing inflation and a stabilisation/revival in growth indicators may mean that the task may be a bit easier in that at least some of the hard work in getting inflation down has already been undertaken by the Reserve Bank of India.

Short term challenges

Of course, Modi and the BJP alliance will face a number of short term challenges worth keeping an eye on:

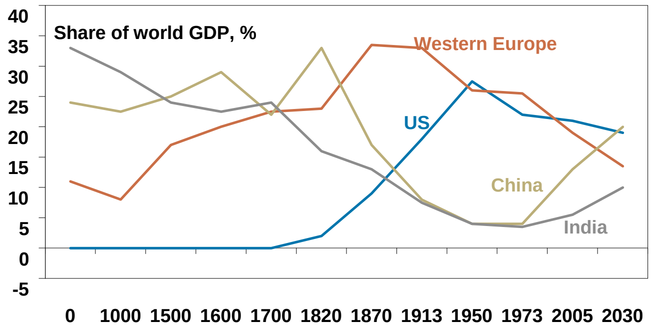
- First, the BJP alliance does not have a majority in the upper house and support from the states will be required. There are potentially ways around the upper house though using joint sessions, although this will take time. And un-cooperative states will be under pressure as they will lose out to states that go down the reform path.
- Second, there's a lot to fix.
- Third, past experience with economic reforms indicates that economic conditions can get worse before they get better.
- Finally, there are some concerns that the BJP's victory will fuel tensions with Muslims. A counter though is that at the end of the day Modi and the BJP are pro-development and pragmatic.

The scale of the BJP led alliance's mandate combined with a five year reform friendly electoral cycle means the BJP has a good chance of success over the medium term, but it won't necessarily be smooth sailing in the short term.

Implications for the world & Australia

A reformed India combined with its large and strongly growing population will put it back on the path to (again) becoming the world's biggest economy – probably by the end of the current century (but after China gets there first).

India's share of world GDP is following China back up (again)



Source: Angus Madison (2001, 2005), AMP Capital

Like China, India will become an increasingly important driver of global economic growth, it will add to commodity demand and its abundant cheap labour and cost advantages will see India play an ever increasing role in world trade adding to downwards pressure on global inflation. In terms of commodity demand, the following table highlights the potential. India's per capita consumption of commodities is a long way behind that of China, let alone developed countries.

Annual commodity "consumption" per person

	Copper (kilograms)	Aluminium (kilograms)	Oil (barrels)
US	7.0	23.0	23.0
China	3.0	6.0	2.6
India	0.5	0.9	1.1

Source: Bank Credit Analyst, AMP Capital

India has a long way to go though. Its per capita real GDP is about where China's was in 2000 and its commodity demand is only around 15% of that of China. So, it's a long way from being able to fill any gap in commodity demand should China have a short term setback. However, its long term demand for commodities will be large and over time this will provide a strong source of growth for Australian exports. India is now Australia's 4th largest export market, having risen rapidly from 7th largest in 2007 and 15th in 2001.

What about the Indian share market?

On most metrics the Indian share market is expensive. Its price to earnings ratio and its price to book value ratio is above that in other emerging countries and the world average and its dividend yield is far lower.

Indian shares overvalued short term

Country	Forward PE ratio	Price to book value ratio	Dividend yield, %	Return on equity, %
India	15.4	2.5	1.6	16.9
Asia ex Japan	11.8	1.5	3.2	12.4
Emerging mkts	10.8	1.4	2.9	12.9
China	7.9	1.2	4.0	14.5
US	15.2	2.4	2.0	14.2
World	14.1	1.9	2.6	12.6
Australia	14.2	2.0	4.6	13.6

Source: MSCI, AMP Capital

A higher return on equity does provide some support for richer valuations, but having risen so rapidly this year to record highs and relative to other markets Indian shares are at risk of a short term set back. This could be triggered by short term uncertainties or setbacks regarding the reform process.

However, with the election ushering in a business friendly reform Government, which should be very positive for long term Indian growth, any short term set back should be seen as a buying opportunity. Over the long term Indian shares are likely to be relative outperformers globally.

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