Innealta CAPITAL

SPECIALISTS IN ACTIVE MANAGEMENT OF ETF PORTFOLIOS

BRIC Countries: How Are They Doing Today?
Part III - India

Key Takeaways:

- In its 70-year history as a country, India has transitioned from an extremely closed and stagnated economy, to the much more open-market economy that is driving increased growth.
- India's inflection point in its economic and political reformation happened in 1991, when the country began to address its unmanageable levels of public debt, currency overvaluation, and acute lack of competitiveness.
- Reining in public spending, allowing the currency to depreciate, easing previous restrictions on imports, privatizing some state-owned companies, and opening the country up for trade have proven to be decisive measures for India's last 25 years of sustained economic growth.
- India is currently one of the most promising economies worldwide: it is expected that its GDP growth rates will soon surpass those of China, and it is also on its way to becoming the largest country in terms of population size, with a rapidly growing middle class.

Exposure to emerging markets constitutes a significant strategic opportunity for U.S. investors. With any investment, the rewards and risks are directly related. In the case of those countries classified as Emerging Market, numerous economic and financial changes have occurred over the past decade. The financial crisis and the end of the commodities boom are two phenomena that affected emerging markets profoundly. In this series of papers, we focus our attention on the four most important emerging-market economies, considering both size and growth potential: Brazil, India, Russia, and China. Although Goldman Sachs initially bundled these countries together as the "BRICs" 16 years ago, the economic and equity market performance of each of these countries has been significantly different. Understanding the drivers of both the business cycle and market cycle is paramount to achieving investment success. Figure 1 shows the market volatility of the MSCI BRIC equity index. This market volatility provides the empirical evidence of the BRIC opportunity.

Our series on the BRIC countries continues with India, a nation that started a process of profound economic reform in the 1980s and, especially, the 1990s. Unlike Brazil and Russia, the country has enjoyed uninterrupted high economic growth rates since 2009. It is, in our opinion, one of the most promising economies in the developing world.

Figure 1

EQUITY MARKETS ACROSS BRIC COUNTRIES HAVE BEEN QUITE VOLATILE

Daily data between 12/31/07 and 12/29/16.

Source: Innealta Capital using data from Bloomberg.

1. A 2001 paper by Goldman Sachs coined the acronym BRIC for Brazil, Russia, India, and China. (Building Better Global Economic BRICs, Global Economics Paper No: 66, November 2001).

Overview

Of the four BRIC economies, India immediately stands out as the poorest. The differences with the other three BRIC countries are quite striking when looking at GDP per capita, be it measured in nominal or purchasing power parity (PPP) terms (see figure 2). However, there are many interesting trends that a simple static analysis would miss. The first one is demographic growth. When China began consistently growing at double-digit rates in the 1990s, its growth was deemed all the more important because of its population size. It would allow millions of people to join the ranks of the middle class, with all the positive spillovers that brings about. A powerful internal market was flourishing, and an abundant labor pool was there to keep attracting investors. But now we are getting closer and closer to the point at which, according to UN projections, India will become the largest country by population size (figure 3). The economic reforms that India has implemented are likely to have the same effect as those China introduced before. Millions of people have already been lifted out of poverty, turning the Indian market into a top target for many companies (e.g., car and phone makers).

Figure 2

INDIA'S NOMINAL GDP IS SIMILAR TO THAT OF BRAZIL AND RUSSIA, IN SPITE OF A MUCH LARGER POPULATION

Yearly data from 1987 to 2016, IMF forecasts for 2017-2022.

Source: Innealta Capital using data from Bloomberg.

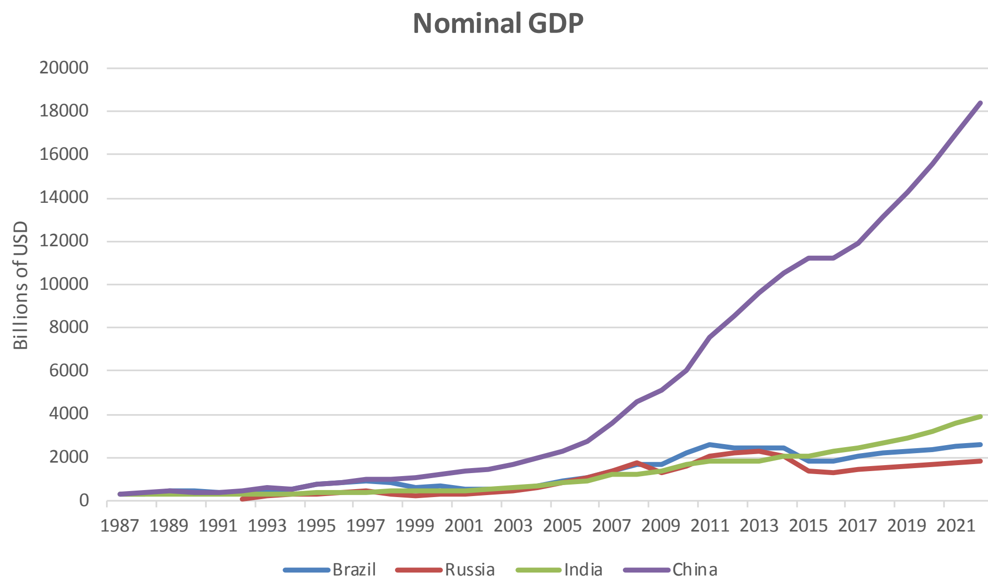
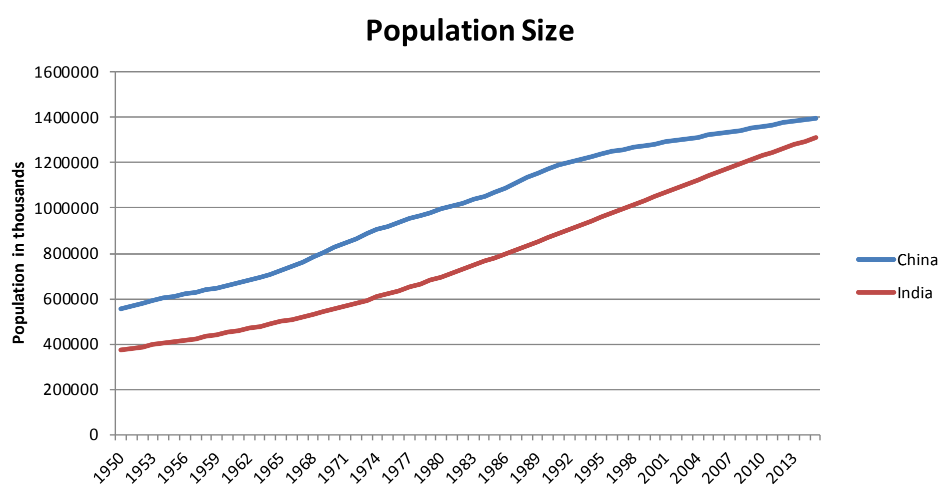


Figure 3

INDIA WILL BECOME THE MOST POPULATED COUNTRY ON EARTH WITHIN THE NEXT FIVE YEARS

Yearly data from 1950 to 2015.

Source: Innealta Capital using data from United Nations' Department of Economic and Social Affairs.



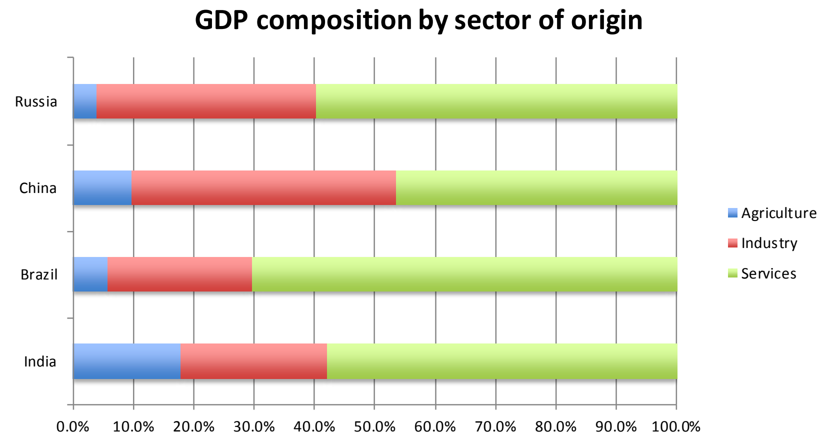
However, the transformation of India has not occurred at the same pace as in China, where reforms in the last part of the twentieth century were deeper. This is probably one of the reasons why the West has paid more attention to the latter. If we want to analyze the differences between them, going beyond disparities in macroeconomic statistics (which exist), the rural-urban migration patterns offer a stark contrast between the two countries. While China had more than 80% of its population living in rural areas in 1980 according to The World Bank, that share had been reduced to 44% in 2015. In India, however, 73% of the population still lives in rural areas today (Socio-Economic Caste Census, 2011). This is important given that, in developing nations, the economic circumstances of people in rural areas tend to be much worse than those of people in urban enclaves. And India is no exception to this rule: of people living in rural areas, less than 5% of them pay income tax, with 75% earning less than 5,000 rupees per month (approximately $77). Only 8% of rural households have their main earning member making more than 10,000 rupees per month (approximately $155). One of the main causes is the lack of salaried jobs for more than 90% of the rural population. (Casual manual labor is the principal income source for more than half of rural Indian households. Cultivation accounts for another 30%.) Moreover, 35% of the population there is illiterate (26% overall), which obviously places a tremendous constraint on future growth. The number of people living below poverty is a contested issue, given that the threshold used by the Indian government has been criticized as being extremely low. The government has estimated that 30% of its people live in poverty, while other estimates put that number closer to 50%.

Figure 4

INDIA'S LARGE RURAL POPULATION IS REFLECTED IN THE WEIGHT OF AGRICULTURE WITHIN THE ECONOMY

Data for 2014.

Source: Innealta Capital using data from CIA World Factbook.



Yet, in spite of the comparisons we can make with China, progress in India has been steady for the past 25 years. GDP growth has been strong, surpassing the $2 trillion mark in 2014. Progress can also be noted in the swelling size of the middle class, despite the vast numbers of Indians who still lag behind. For example, the number of people who own a two- or four-wheeled vehicle has increased sevenfold since 1991, according to the latest census. The Society of Indian Automobile Manufactures (SIAM) reported that the sales of passenger vehicles grew by more than 9% in the year ending in April of 2017. In rural areas, 71% of the people own a mobile phone, and the number of smartphones in the country has grown more than six times since 2012, becoming the second largest market for mobile services. The number of internet users is growing by 30% every year, and currently more than 430 million people can access the internet. Another area were there has been immense progress is building a modern digital infrastructure. Just a decade ago, around half the population was not even identified (with illiteracy playing a big role). India launched an ambitious program, Aadhar, which gave more than a billion people a 12-digit identification number. With it they have been able to access government and banking services, including cashless payments. Partly because of this, India's economy is becoming digitalized at a fast pace. Moreover, its world-class IT industry has revenues of $150 billion, accounting for 8% of GDP and 20% of exports. The country is now home to the third largest number of start-ups worldwide, leveraging on its highly qualified pool of engineers. Finally, India has the demographic advantage of a very young population: 60% of its labor force is under the age of 25.

However, to fully understand India's promising economic conditions, it is key to know more about its 70-year history as an independent country, where it has transitioned from an extremely closed and almost-stagnated economy, very close to socialism, to a much more liberal and fast-growing country. The parallels with China are striking, although, as we said before, the latter implemented deeper reforms first (regarding trade and foreign investment, e.g.), which gave it a considerable edge.

In the beginning: economic stagnation

After India became independent in 1947, what followed were 30 years of economic stagnation. Heavily influenced by the USSR, the government intervened in areas that could otherwise have been left to the private sector. Moreover, India was not an open economy, yet it was still considered capitalist, nonetheless. India started implementing its Five-Year Plans in 1951, after the Planning Commission was set up to monitor their execution in 1950. (The twelfth plan is currently being implemented, although the orientations of it have changed dramatically. Even the Planning Commission itself was dissolved in 2014, and replaced by a policy institute.) A policy of import substitution, for example, was a major staple of the first plan. The second and third plans went further when it came to closing the economy, a policy emphasis that would remain in place until the 1980s. Many sectors were protected from foreign competition (e.g., by means of import licenses). Investment and consumption by the government grew at faster rates than those of the private sector. As expected, many problems arose from such stringent restrictions, with inflation being one of the worst. To make things worse, India was also involved in armed conflicts with China (1962) and Pakistan (1965).

The 1970s saw increased intervention, including the nationalization of 14 banks in 1971. However, exports started to grow (import substitution had been exhausted), something the government made an explicit goal. The government handed out subsidies to certain industries, but restrictions on imports (of inputs) made them less competitive. The authorities also invested heavily to spur the industrialization of the country. Inflation did not yield however, in part due to the fact that protectionism was still rampant. Government-sanctioned monopolies also contributed to this problem. Some authors have emphasized that the problem was not the government's involvement in the economy as much as its stifling of the private sector, a big difference with other Asian nations where the government was encouraging the private sector in spite of heavy intervention (e.g., South Korea).

Reforms

By 1980 it had become clear that liberalization was badly needed if the country wanted to spur economic growth. The 1980s saw the first reforms implemented, whereas the 1990s brought deeper and wider transformations. This meant, obviously, that the free market was given a far bigger role than it had previously enjoyed. In addition, the country became increasingly open to the rest of the world. We can trace India's economic boom back to these reforms. In the eighties, trade policy was liberalized, that is, more imports were allowed into the country. Also, exports were promoted. The depreciation of the currency was crucial for the latter (figure 5). On top of that, internal controls were eased (e.g., price controls), prompting more competition within the country. One of the main problems, however, was the level of public debt, with the government running big deficits throughout the decade (figure 6). This led to a balance of payments crisis in 1991, which left the government on the brink of default. The amount of foreign reserves reached dismally low levels.

Figure 5

THE INDIAN RUPEE'S OVERVALUATION IS ONE OF THE PROBLEMS THE COUNTRY HAS TACKLED

Monthly data from 11/1987 to 10/2017.

Source: Innealta Capital using data from Bloomberg.

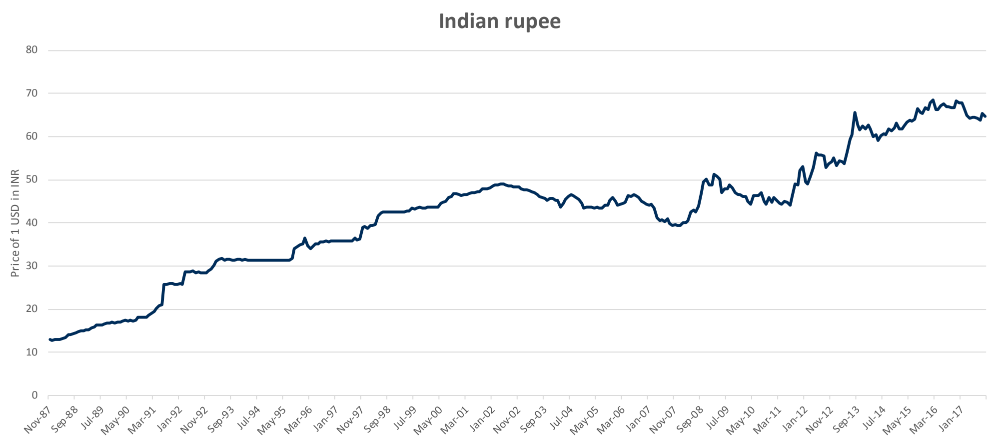
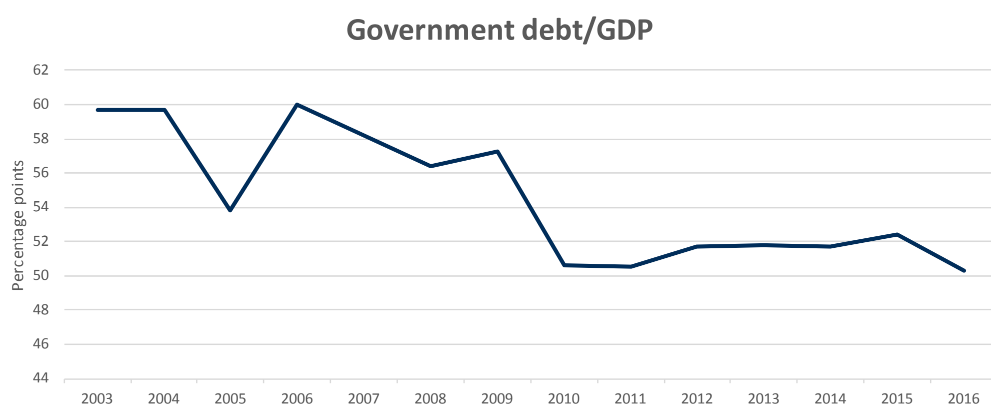


Figure 6

PUBLIC DEBT BECAME UNBEARABLE IN 1991, BUT IT IS NOW AT MUCH HEALTHIER LEVELS

Yearly data from 2003 to 2016.

Source: Innealta Capital using data from Bloomberg.



To avoid the worst, the government signed an agreement with the IMF, by which it committed to major fiscal, monetary, and exchange-rate reforms, in exchange for an emergency loan. Further measures included liberalizing the financial sector and encouraging foreign direct investment, even in areas that had been monopolized by the state up until that point, like telecommunications. This crisis ended up being the major turning point for modern India. GDP almost doubled within the next decade, with exports and imports multiplying by factors of 2.5 and 2, respectively. The services industry grew to become 40% of the economy, whereas agriculture stopped being the main driver (yet to this day it employs an overwhelming majority of the population). A major reduction in poverty levels was another legacy of the 1990s. In the end, India averaged an annual GDP growth rate of 6.2% from 1980 until 2007, a powerful testimony to the value of economic reform.

Today's picture

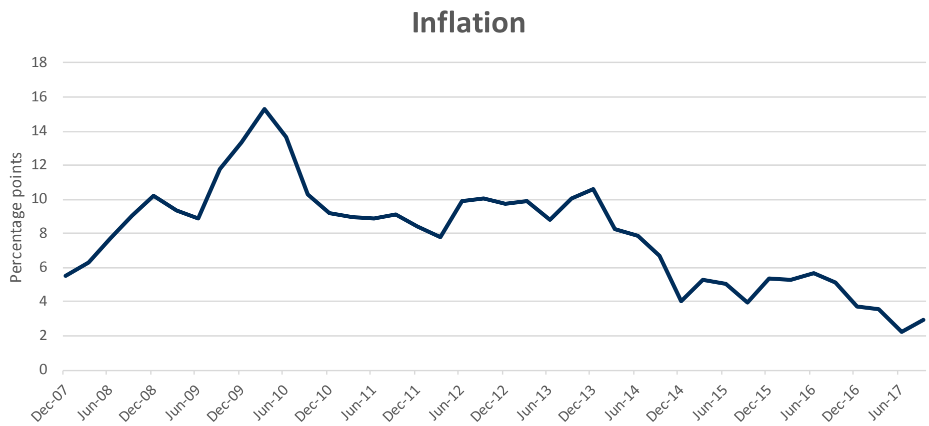
India was not as badly hit, at least directly, by the 2008 financial crisis. Its financial system was not as integrated to the rest of the world as those of other nations. Of course, the economic slowdown that followed the crisis did affect the country. However, GDP growth has been solid after 2008, and even that year it was 3.8%. Unlike Brazil and Russia, India has not experienced recessions as the ones those countries suffered in recent years. In 2015, GDP growth was even higher than China's, something that had not happened since 1999. This is another major legacy of the reforms we described before: India stopped depending on commodities, which allowed the country to avoid the negative consequences that Russia and Brazil faced when the commodities boom came to an end a few years ago. To the contrary, India actually benefitted from this, for it allowed to tame inflationary pressures. In fact, inflation seems now under control (figure 7). This was a problem that persisted long after the 1991 reforms, being at or close to double digits until 2013. Prudent macroeconomic policies have played a key role in this (e.g., the debt-to-GDP ratio has been decreasing). The government does not spend more money than it collects. The huge deficits that led to the 1991 crisis seem a thing of the past. Finally, the economy continues to become more and more open. As an example, India is currently negotiating a free trade agreement with the European Union.

Figure 7

INFLATION HAS RECEDED IN THE LAST FEW YEARS, LONG AFTER THE 1991 REFORMS

Quarterly year-over-year data from 12/2007 to 9/2017.

Source: Innealta Capital using data from Bloomberg.



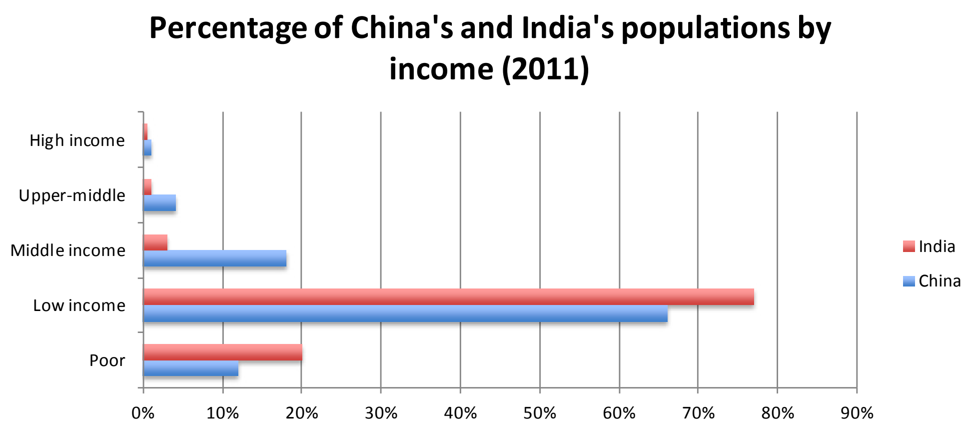
On the negative side, income distribution is still very unequal (figure 8). This is probably India's biggest challenge in the near future. At least one-third of the population lives in extreme poverty. On the other hand, we can expect this abundance of cheap labor in India to continue to be a great boon for foreign investment. Corruption is also still a challenge, although a less overarching government has reduced the areas where corruption can fester.

Figure 8

WHILE A STRONG MIDDLE CLASS HAS EMERGED IN CHINA, INDIA IS JUST STARTING TO SEE THE SAME

Data for 2011. Thresholds for each category are $2, $10, $20, and $50 per day.

Source: Innealta Capital using data from Pew Research Center.



Conclusion

Despite persisting high levels of poverty and institutions that still need to be made stronger, India looks like the most promising of the BRIC countries today. With a population that is on course to becoming the largest worldwide, and growth rates that may soon be greater than those of China, the potential of the Indian economy looks very strong. We expect that foreign investment will be a tremendous driver of future economic growth, just as it was in China. For example, India has both large numbers of high- and low-skilled workers, making it very attractive for investors in a wide range of industries. Its internal market is also growing very fast, with a middle class that is shoring up demand for a number of consumer goods. As the ranks of the middle class continue to grow in the next decades, India will become a focal point for companies worldwide.

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The MSCI BRIC Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance across the following 4 Emerging Markets country indexes: Brazil, Russia, India and China.

It is not possible to invest directly in an index.

Diversification does not protect against loss in declining markets.

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