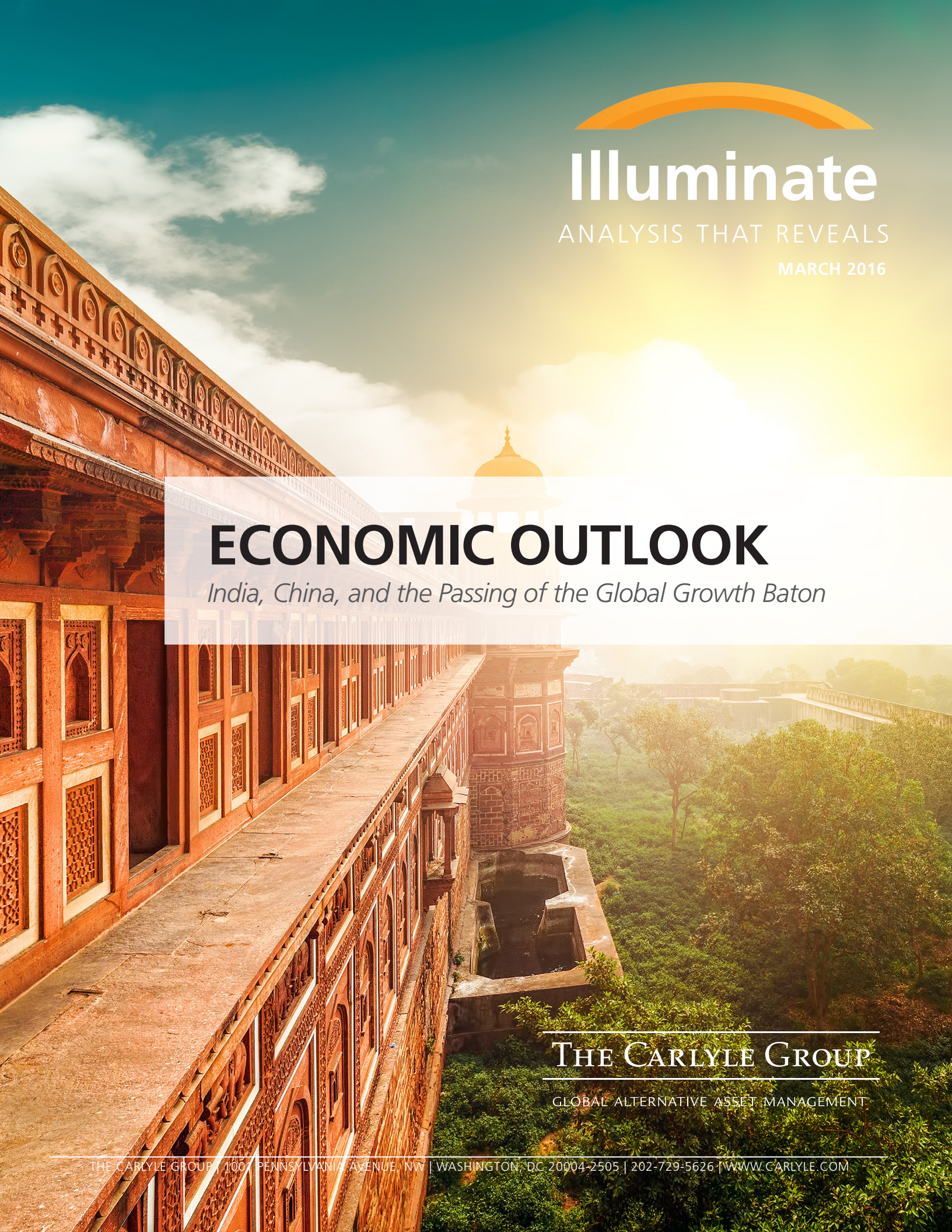

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ECONOMIC OUTLOOK

India, China, and the Passing of the Global Growth Baton

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India, China, and the Passing of the Global Growth Baton

By Jason M. Thomas

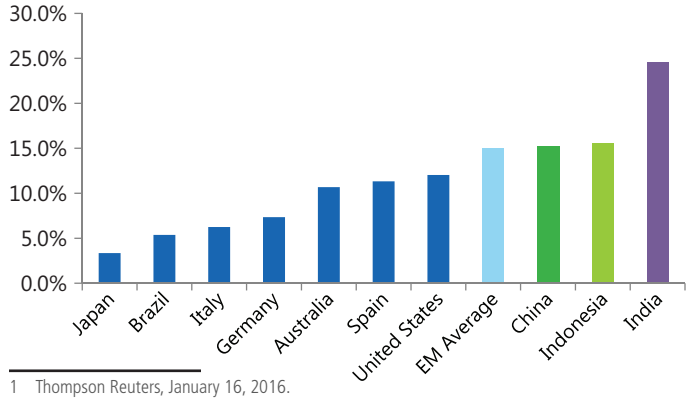
Last year marked an historic moment in international macroeconomics, as India assumed the mantle of the world's fastest-growing large economy from China. India's GDP grew by 7.3% in 2015, nearly half a percent more than China's. A survey of economic forecasts for 2016 suggests this was no fluke: the most optimistic forecast for 2016 GDP growth in China (7%) matches the most *pessimistic* forecast for India. Based on survey averages, India's economy is likely to grow about 1% faster than China's this year and this gap between the respective economies' growth rates is likely to widen over time.[1]

Year-to-year GDP forecasts are inherently speculative, but trend, or potential, growth estimates tend to be more reliable, as they depend on more persistent, supply-side factors. To produce more goods and services tomorrow, an economy (or business) must invest in additional productive capacity today. The change in the amount of goods and services produced between periods – i.e. the growth rate – depends on the amount of national income an economy invests and the rate of return it earns on that investment.[2]

India has the fastest-growing large economy in the world because it boasts the world's highest returns on investment. Thanks to India's large supply of low-cost labor, abundance of I.T. talent and entrepreneurs, favorable demographics, improved quality of public institutions, and small existing capital stock, the IMF expects returns on incremental capital in India to average 24.7% per year between 2016 and 2020. These returns are about 2x the global average of 12.5% and 1.7x faster than the 15% return forecast for Emerging Market economies on the whole (Figure 1). With an investment rate equal to roughly 30% of national income, Indian trend GDP growth is expected to average 7.5% annually through 2020.[3]

FIGURE 1

Expected Return on Incremental Capital for Select Economies, 2016-2020[4]



1 Thompson Reuters, January 16, 2016.

2 The "rate of return" is the incremental output-to-capital ratio, or the reciprocal of the incremental capital-to-output ratio as measured by the IMF World Economic Outlook database.

3 IMF, WEO Database, October 2015.

4 IMF, WEO Database, October 2015. Returns refers to the incremental output-to-capital ratio.

While growth at this pace is surely impressive in the context of global GDP growth of just 3%, there is no reason India should settle for "just" 7.5%. With effective wages one-tenth of the U.S. level, a capital stock one-third the size of China's, and a large pool of underemployed labor, India could absorb a significant increase in fixed investment with no diminution in returns (Figure 2).[5] Unlike in China, which suffers from industrial overcapacity and declining returns on incremental capital, India faces no similar constraints on future growth. Indeed, many of the same international observers warning of a slowdown in China have argued that Indian growth can and should accelerate from current rates.[6]

Rather than create excess capacity that depresses margins, new investments in India relax supply-side constraints and increase the yield of *existing* capital. For instance, it is estimated that electricity shortages depress Indian export growth by one-third relative to growth rates that would prevail in the absence of these constraints.[7] Investment in new generation capacity would allow existing businesses to produce more goods to sell abroad, which should increase domestic GDP and the return on existing business capital. Investment in technology aimed at creating a new digital infrastructure in financial services, health care diagnostics, and mobile e-commerce would likely yield similar results. IMF research finds that India could increase its annual investment rate by one-third (to 40% of GDP) and still maintain aggregate returns of nearly 24% per unit of incremental capital.[8] Investment at this rate would increase potential GDP growth from 7.5% to 9.5% per year.

Narendra Modi: Hitting the Growth Accelerator

Of course, boosting annual investment from 30% to 40% of national income is easier said than done, particularly in a pluralistic democracy like India's. To effectuate a sustained rise in investment, India requires structural reforms of the nation's institutions and regulatory landscape. Specifically, India would need to embrace: (1) fiscal reform to ensure fiscal deficits and inefficient revenue collection do not "crowd out" private investment; (2) an operational target for monetary policy to protect the value of the rupee (INR) and encourage households to channel savings to financial instruments instead of gold hoarding; (3) increases in infrastructure and energy investment to remove bottlenecks; and (4) and wholesale reform of the regulatory state to reduce bureaucratic intrusions and liberalize rules governing labor markets, zoning, market entry, and foreign investment.

5 IMF, 2015 WEO Database, October 2015. Capital stock calculated based on perpetual inventory method.

6 C.f. Herd, R. and Dougherty, S. (2007), "Growth Prospects in China and India Compared," *The European Journal of Comparative Economics*. Whalen, C. (2015), "India vs. China: A 21st Century Economic Battle Royal," *The National Interest*.

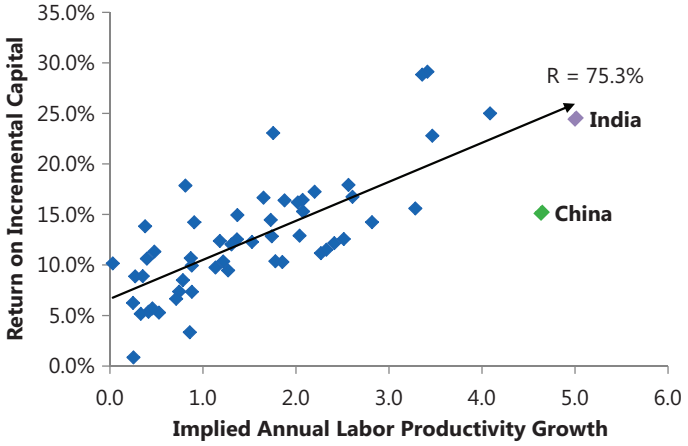
7 Raissi, M. and Tulin, V. (2015), "Price and Income Elasticity of Indian Exports—The Role of Supply-Side Bottlenecks," IMF Working Paper 15/161.

8 Mohan, R. and Kapur, M, (2015), "Pressing the Indian Growth Accelerator: Policy Imperatives," IMF Working Paper 15-53. They estimate an ICOR of 4.2, or an incremental output-to-capital ratio of 23.8%.

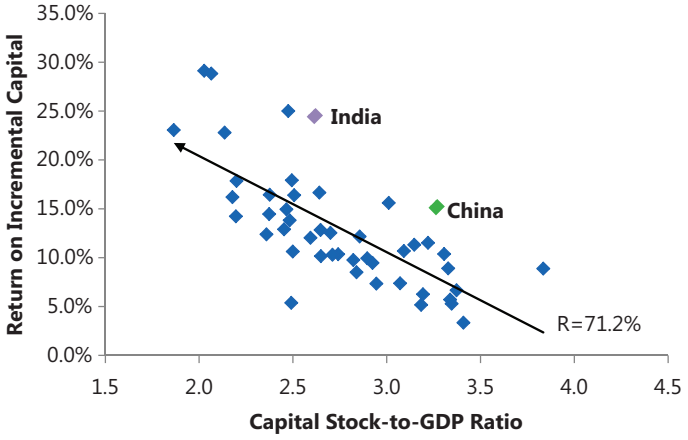
FIGURE 2

Determinants of the Return on Incremental Capital[9]

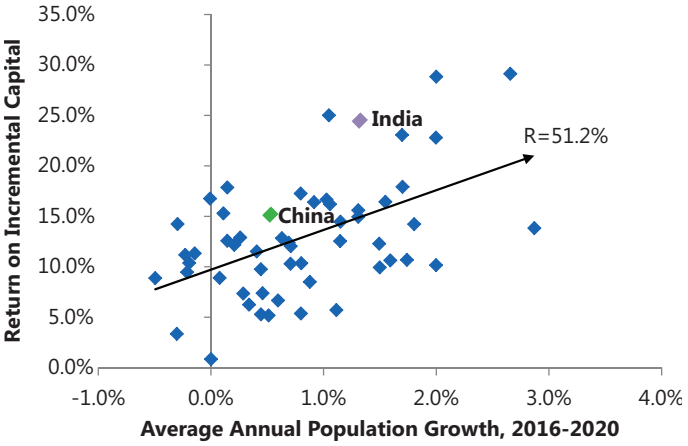
PANEL A: Labor Productivity Growth and Returns on Incremental Capital



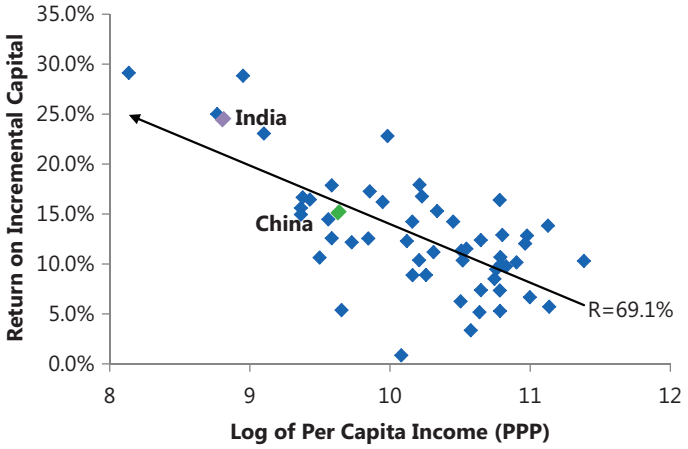
PANEL B: Existing Capital Stock and Returns on Incremental Capital



PANEL C: Demographics and Returns on Incremental Capital



PANEL D: Real Wages and Returns on Incremental Capital



Structural reform agendas of this sort often populate white papers and IMF and World Bank surveys and consultation documents. Rarely do they form the basis of actual public policy. That is why the election of Narendra Modi as Prime Minister in May 2014 spurred such excitement among foreign observers and multilateral institutions. With Modi, India elected a leader willing to make precisely these structural reforms the centerpiece of his domestic policy. As Finance Minister Arun Jaitley has said, being the fastest growing large economy is not good enough for India; its aspirations are set higher.[10]

While Modi's proposals have been on target, implementation has been incomplete. Modi's Bharatiya Janata Party (BJP) and its coalition partners command a large majority in the lower house of parliament, but the upper house remains in the hands of the political opposition. Key pieces of reform legislation have died in the upper house, including tax and land acquisition reforms critical to mobilizing savings and increasing domestic investment. Recent BJP losses in state elections have made the goal of taking the Upper House less probable in the near term, further undermining reform momentum.[11]

After flocking to India following Modi's election, foreign investors have recently become more lukewarm on the country's prospects. Broad Indian stock indexes rose by over 40% in the 12 months following the 2014 national election campaign, but have since fallen by nearly 20% from their 2015 highs.[12] Foreign investors sold nearly $1 billion of Indian debt and equities in January 2016, marking a third straight month of outflows.[13] Since August 2015, when the Goods and Services Tax (GST) reform bill was blocked in parliament, valuations in India have de-

9 IMF, 2015 WEO Database, October 2015.

10 "8-9% growth doable, says Arun Jaitley," Business Times, January 20, 2016.

11 "Narendra Modi Concedes BJP Election Defeat in India's Bihar State," *Wall Street Journal*, November 8, 2015

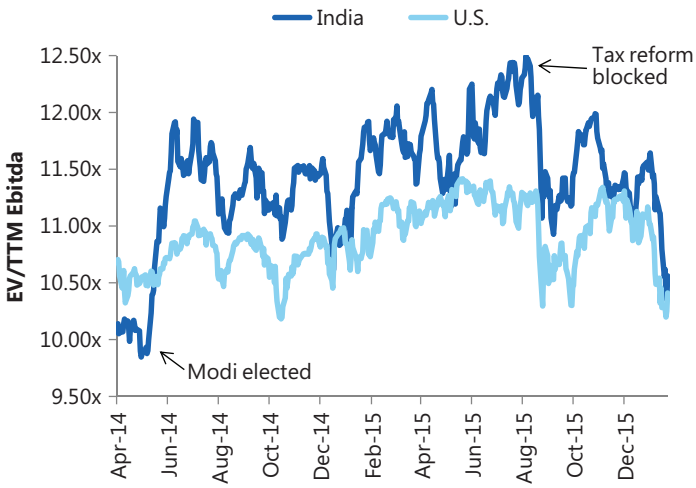
12 Bloomberg, January 22, 2016.

13 Sensex falls to 2014 levels on global economy woes, Times of India, January 20, 2016.

clined by 15%, pushing trailing twelve month (TTM) Ebitda multiples below U.S. levels for the first time in nearly 20 months (Figure 3).

FIGURE 3

Public Equity Valuations, U.S. and India[14]



Placing Political Setbacks into Perspective

Foreign investors in India's stock market seem to have overestimated the speed at which structural reforms could be implemented. Yet, the pessimism implied by recent outflows seems out-of-step with underlying fundamentals. Even with the parliamentary setbacks, it is not an overstatement to suggest that Modi has fundamentally changed the business climate in India. Modi has reduced subsidies for fuel and reallocated budgetary savings for infrastructure[15]; opened 15 sectors to foreign investment; eliminated layers of bureaucracy and the vestigial remnants of India's central planning commission; and used the grant of a Presidential Assent to allow state reforms of labor markets as part of a "Make in India" regulatory reform campaign.[16]

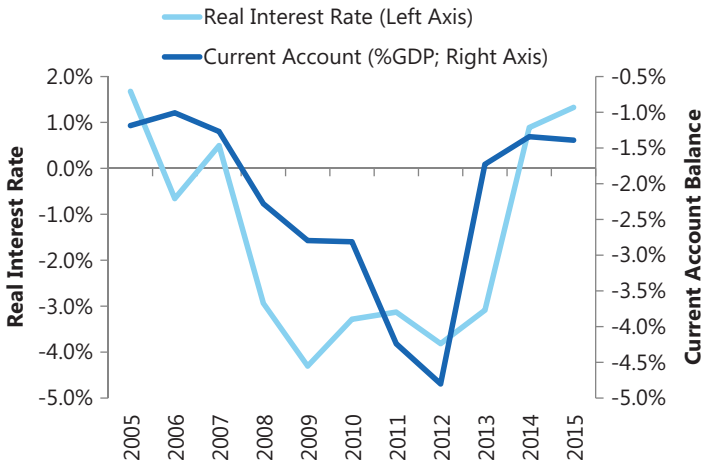
Most significantly, the Modi reform agenda has generated a sense of confidence among business leaders lacking in much of the rest of the world. A January 2016 PWC survey of global CEOs ranked India as one of the top five "most promising" overseas markets. In addition, 64% of Indian CEOs were "very confident" about their companies' near-term revenue growth, the most optimistic assessment in the world and 10 percentage points above the nearest economy, Spain, where 54% of CEOs expressed near-term optimism about their home market.[17]

There is also reason to believe reforms are not *blocked* so much as *delayed* due to the kind of political posturing and horse-trading inherent to democratic government. GST tax reform, for example, is a commonsense tax initiative that would remove fiscal barriers between states, create one common market to enhance business efficiency, and provide a mechanism to reduce fiscal deficits without compromising growth. But since it would subsume indirect taxes at the state and central level, it would reorient the locus of fiscal policy decision-making in a manner that can generate frictions that delay reform without proving fatal. The opposition party has formally embraced GST tax reform in the past and its leader, Ghulam Nabi Azad, suggested that his party would ensure that it is passed with some amendments.[18]

Moreover, it is worth reemphasizing that the structural reform agenda aims to accelerate growth from an already healthy baseline. Even in the absence of full reform implementation, India is likely to achieve 7.5% annualized growth for the foreseeable future.[19] India has been relatively insulated from global economic weakness. In 2015, India still managed 7.3% growth despite unusually weak external demand, which caused Indian goods exports to decline for 13 consecutive months.[20] As the world's third largest importer of crude oil, India is also a major beneficiary from the decline in global oil prices, which has offset the decline in goods exports and reduced domestic production costs.[21]

FIGURE 4

Real Interest Rate and the Current Account Balance[22]



Since the 1990s economic liberalization, whenever growth in India has stalled, it has been as a result of fiscal and monetary mismanagement. When inflation rises above nominal interest rates (real interest rates turn negative), Indian households are very quick to diversify into gold, which deprives businesses of savings, increases the current account deficit, and often triggers sharp devaluation of the currency. This cycle is largely what was observed

14 S&P Capital IQ Database, January 15, 2016. Value-weighted aggregate of all public companies with enterprise value greater than $100 million.

15 IMF Applauds India for Cutting Fuel Subsidy, The Economic Times (India), January 18, 2015.

16 Center for Strategic and International Studies, The Modi Government's Reform Program: A Scorecard.

17 PwC Global Survey, January 20, 2016.

18 Congress hits back: 'BJP, Modi blocked GST all these years," Indian Express, August 12, 2015.

19 Based on IMF, WEO Database, October 2015.

20 "December exports fall 14.75% in 13th straight month of declines," January 25, 2015.

21 Energy Information Administration, International Energy Statistics, Accessed January 20, 2016.

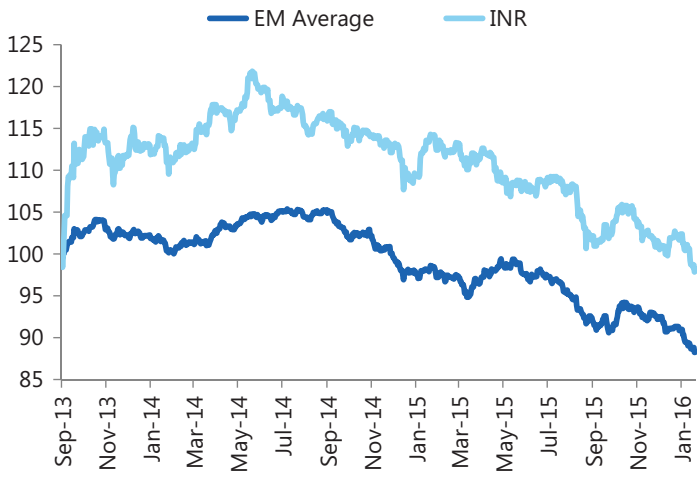
22 IMF, WEO Database, October 2015.

between 2011-2013 when growth slowed to 6%, on average, the current account deficit widened to 4%, due to gold imports of 3% of GDP, and the currency fell by 25% against the U.S. dollar (Figure 4).

A re-run of the 2011-2013 experience is highly unlikely given the policy reforms implemented by Reserve Bank of India Governor Raghuram Rajan. Rajan has established an inflation target of less than 6% and a real interest rate target of 1.5% to 2% on base treasury bills.[23] The enhanced monetary credibility from clear operational targets have stabilized the currency, increased household savings, and allowed growth to return to trend. Since Rajan was appointed RBI Governor in August 2013, the rupee has been roughly flat against the dollar, even as the dollar has appreciated by 23% on a trade-weighted basis and by more than 15% against EM peers (Figure 5).

FIGURE 5

Rupee (INR) and EM Average Relative to USD Since September 2013[24]



While the central government fiscal deficit is likely to remain close to 4% of GDP in 2016, the government has wisely prioritized infrastructure investments over spending cuts. The central government provided seed funding for the National Investment and Infrastructure Fund, a sovereign wealth fund designed to operate at arms' length from the government and focus on Greenfield and stalled infrastructure projects.[25] With nominal GDP growth well in excess of funding costs, India's debt-to-GDP ratio is expected to decline steadily even with deficits above the 3% of GDP target.[26]

Conclusion

In 2015, India formally assumed the mantle of the world's fastest-growing large economy thanks to returns on investment that are 2.5x the global average. While baseline growth of 7.5% per year is extremely attractive given current global realities, India could realistically add two percentage points to annualized GDP growth rates without generating any of the overcapacity or investment excesses that have caused Chinese growth to slow. The Modi government has offered a structural reform agenda to achieve precisely this acceleration, but implementation has been incomplete.

The messiness of democratic politics should not distract investors from the strength of the Indian economy's underlying momentum. In a world of high valuations and low growth, India offers the world's highest expected returns on incremental capital in the context of valuations on par with those of the U.S. The reform agenda proceeds, albeit at a slower pace than many observers initially contemplated, and new monetary policy targets have reduced the risk of a confidence-sapping rise in inflation that hits financial savings and the currency. India's hour on the global macroeconomic stage has arrived. Investors should take notice.

23 Transcript of Reserve Bank of India's Post Policy Conference Call with Media, September 29, 2015

24 S&P Capital IQ. The MSCI EM Currency Index (USD) includes the INR. Excluding the INR from the calculation yields a cumulative decline of 15%.

25 NIIF, India's sovereign fund, to start by year-end," India Express, August 1, 2015.

26 IMF, WEO Database, October 2015.

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