A PROSPEROUS ECONOMY IN WAITING

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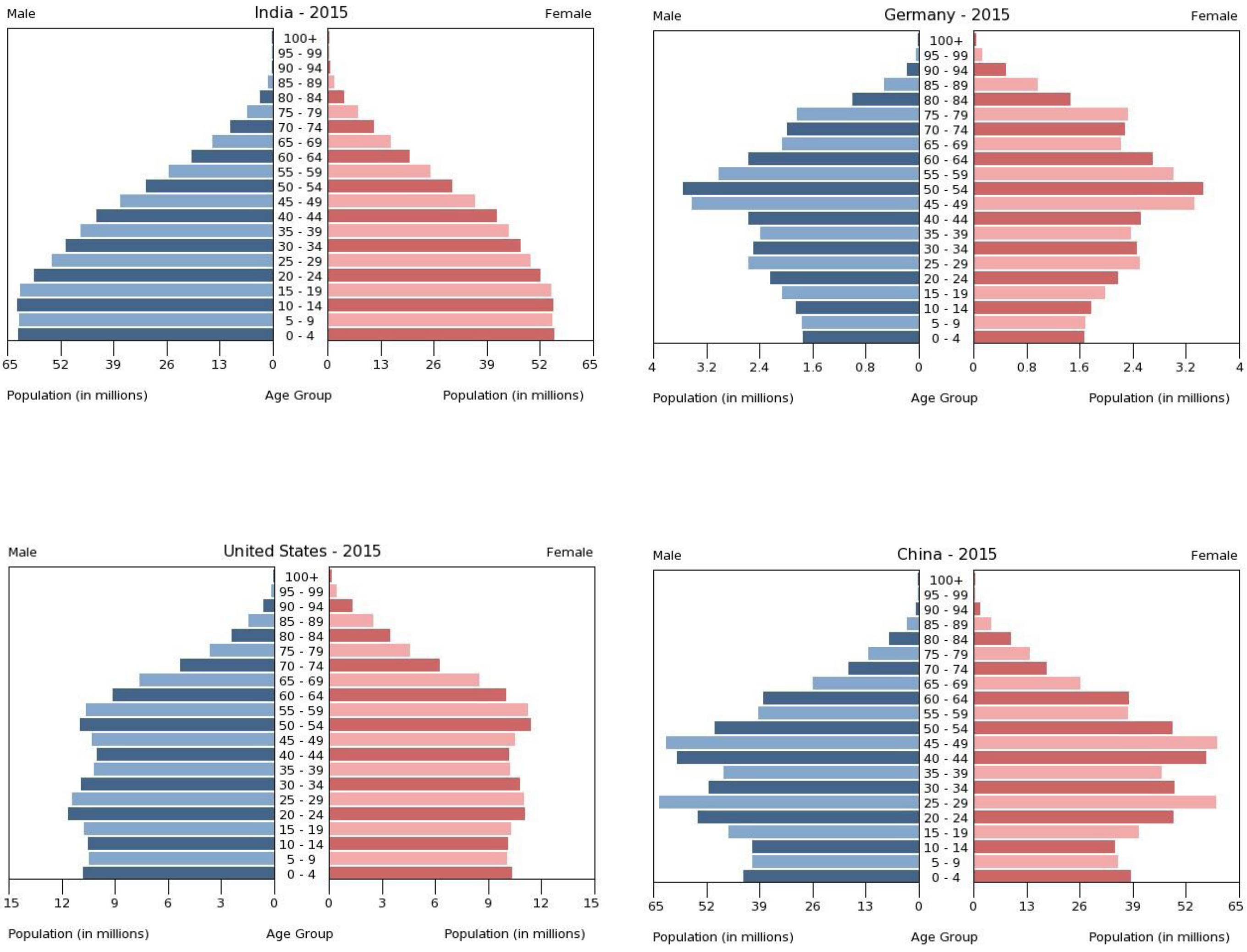
INDIA'S FAVOURABLE DEMOGRAPHICS

A large part of India's long term growth potential is driven by its youthful demographics, entrepreneurial culture and significant and growing labour force. This is particularly pertinent given weak global growth and rapidly aging labour force in many developed countries around the world today. Looking at the population pyramids below, the age distribution of India is heavily skewed towards the most productive part of population. This is likely to lead to higher consumption and expenditure and reduce the burden on the economy to fund social security required for the elderly.

Figure 1: Population pyramids



Source: United Nations: Department of Economics and Social Affairs

In economics, the phenomenon where falling fertility rates and a young population result in the labour force growing faster than the population dependent on it, is known as a demographic dividend[1]. According to projections made by the International Labour Organisation (ILO), in the next 20 years the labour force is likely to decline by 4% in the industrialised world and 5% in China, while in India it is expected to increase by 32%. In fact by 2030, India's share of the global work force is expected to climb to as high as 30%.[2]

A country's per capita income grows more rapidly during this period and increases disposable income, leading to an increase in output and consumption. According to the IMF, it is expected that India will be the largest individual contributor to the global demographic transition in the coming years. Furthermore India's demographic dividend has the potential to add 2% per annum to per capita GDP growth over the next two decades. [3,4]

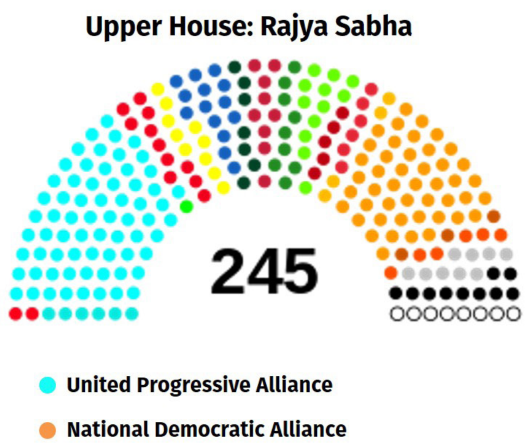
However, India's fortunate position does not assure it of guaranteed future growth. Whether India can translate its favourable demographics into economic growth depends on the institutional policies on areas such as the labour market, health and education. To drive these policies forward, broad based reforms, which are designed to eliminate barriers to growth and allow India to reach full potential, are required. The new BJP Government, led by Prime Minister, Narendra Modi, is focused on achieving just that.

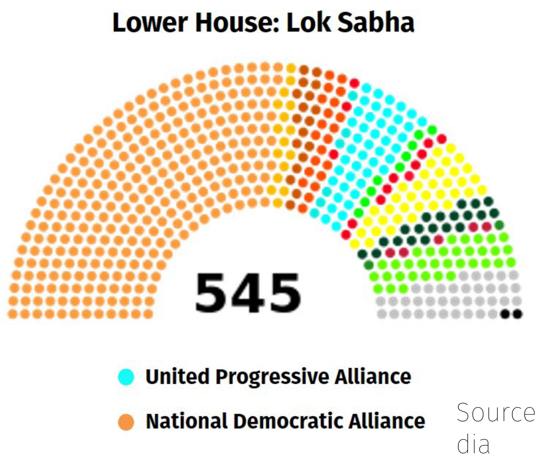
CURRENT POLITICAL ENVIRONMENT AND REFORM AGENDA

Prime Minister Modi's landslide victory in May 2014 has evoked a renewed sense of optimism for a country that is considered to have so much potential, but has previously been plagued by large bureaucratic, opaque policy and regulatory obstacles that inhibit its growth.

In India, the upper house is known as the Rajya Sabha with 245 seats and the lower house is known as the Lok Sabha with 545 seats. The two major coalitions are the United Progressive Alliance (UPA) and the National Democratic Alliance (NDA). The NDA has 34 parties and is led by Prime Minister Narendra Modi's Bharatiya Janata Party (BJP). The illustration below shows the composition of the UPA, NDA and other political parties in both houses. Despite the NDA holding a majority in the Lower House, it does not have the same power in the Upper House. It does however have a narrow majority coalition in the combined houses.

Figure 2: Composition of political parties in both houses





Source: Wikipedia

[1]Demographic Dividend, Bill & Melinda Gates Institute for Population and Reproductive Health at the Johns Hopkins Bloomberg School of Public Health and the Population Reference Bureau, demographicdividend.org

[2]The International Labour Organisation (ILO)

[3]IMF Working Paper: The Demographic Dividend: Evidence From the Indian States

[4]IMF Working Paper: The Demographic Dividend: Evidence From the Indian States

One of the major challenges for the BJP in the future will be its ability to deal with a highly decentralised government and political opposition within the Upper House. However, it is worth noting that re-election for around a third of the members in the Upper House starts taking place from 2016 onwards, as various upper house members retire. Hence the BJP could make significant gains in the Upper House, if it can take control of several states holding elections over the next three years.

Nonetheless, Modi has been pragmatic and swift by making changes via executive orders and streamlining the Government at all levels. He has also boosted confidence and improved the foreign perception towards India, in an attempt to attract foreign capital.

Some of the changes and reforms to date include:

- FDI limits have been raised in railways, defence manufacturing, single brand retail, and insurance sectors etc.
- Higher fiscal autonomy has been accorded to state governments. Emphasis is on cooperative and competitive federalism. The Government will take a bigger role in Infrastructure spend. Increase in public investments towards highway construction and road development
- Key changes in direct taxes, such as the corporate tax rate to be lowered from 30% to 25%, over the next four years
- There has been a broader push towards a cashless economy, with stricter control over black money
- Social sector initiatives such as financial Inclusion, poverty reduction, job creations and housing for all
- Manufacturing push under the 'Make in India' initiative to increase manufacturing's share of GDP from 17% to 25% by 2025
- An initiative to create jobs and promote entrepreneurship under a multi-skill development programme called 'Skill India' It endeavours to establish an international equivalent of the Indian framework on skill development, creating workforce mobility and enhancing youth employability

INFRASTRUCTURE

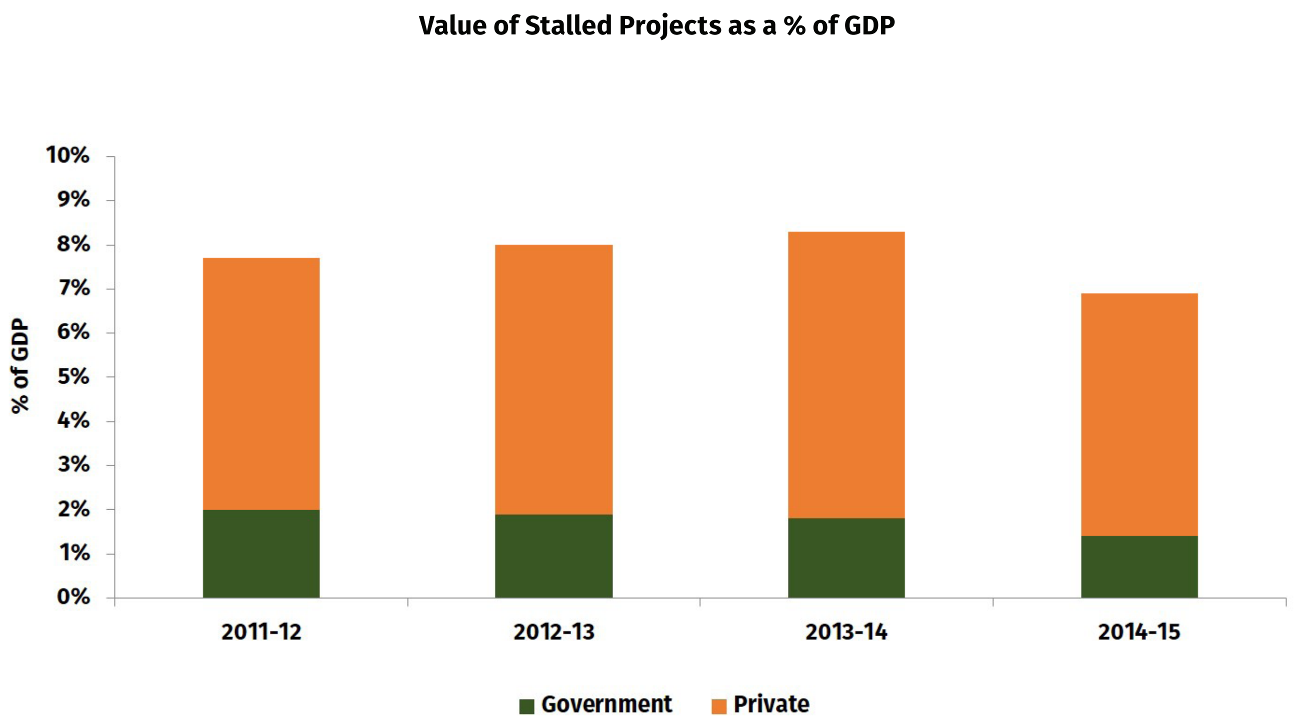
The current level of infrastructure is inadequate relative to the size and needs of the Indian population. This is particularly pronounced in transport and energy generation, where inefficiencies are created by government subsidies, foreign and private investor restrictions and regulated energy prices. These inefficiencies have left little room for investment spending to improve energy facilities and transport infrastructure, which directly impacts the cost of manufacturing and transporting of finished goods. Furthermore, there is a current backlog of infrastructure projects that have stalled due to inefficient incumbent policies and political red tape.

Since being in power, Modi has been focused on easing constraints on infrastructure projects and is considering privatising some of India's infrastructure assets. Some of the changes made include:

- Opening up the rail network to public-private partnerships (PPP);
- Pledging more spending on infrastructure (particularly roads) ; and
- Cleared stalled defence related projects and streamlined the process for new projects

Modi's commitments have already started to take effect, according to the Centre for Monitoring the Indian Economy (CMIE). Stalled projects have fallen from 8.3% to 6.9% of GDP as shown below.

Figure 3: Value of Stalled Projects



Source: CMIE, India Avenue

EASE OF DOING BUSINESS

Attracting foreign funds and businesses in India has been challenging for some time. According to the 'Ease of doing business Index' which ranks 189 countries in terms of business-friendliness[5], India ranks poorly. Whilst India has moved from 142 to 130 over the last couple of years, it is significantly worse than other major economies as seen below. However, the impending focus on improvement is likely to lead significant opportunities for growth of Industry, through foreign capital seeking growth.

Table 1: Ease of doing business index

EASE OF DOING BUSINESS INDEX	2015 RANK
UK	6
USA	7
AUSTRALIA	13
GERMANY	15
JAPAN	34
RUSSIA	51
CHINA	84
BRAZIL	116
INDIA	130

Source: World Bank, India Avenue

In order to facilitate continued foreign investment and business activity, Improving India's ranking is a key objective of the incumbent Government. Some of the progress that Modi has made in this area:

- The 'Make in India' initiative is likely to encourage more foreign and domestic investments over the next decade
- Promoted India as a business destination in countries including the US, Japan, UK and Australia
- Simplified the corporate tax structure and reduced the headline rate from 30% to 25% in a phased manner over the next four years
- Removed or increased the foreign investor limits on various sectors. For example, the foreign investor cap on the insurance sector has risen from 26% to 49%
- Strengthening of intellectual property rights and regulations to ensure higher volumes of FDI, thus protecting foreign investors
- New and Improved Foreign Trade Policy 2015-20, which is in sync with Government campaigns like 'Make in India'. The focus of the policy is to support services and exports along with improving the ease of doing business
- Operationalised an e-BIZ portal: Through eBiz portal, a business user can fill the eForms online/offline, upload the attachments, make payment online and submit the forms for processing to simply the business approval process

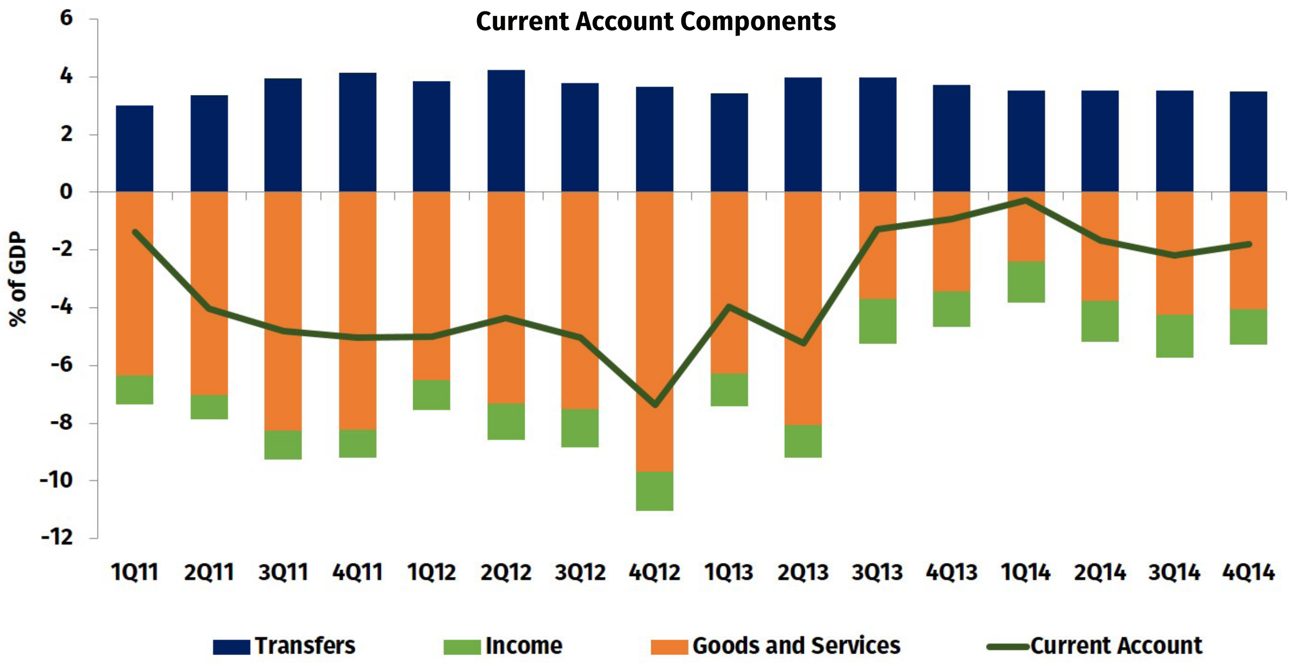
[1]World Bank Group: Doing Business, www.doingbusiness.org/rankings

INDIA'S EXTERNAL POSITION

India for the large part of the last 35 years has run a current account deficit. This is common amongst developing nations that require high levels of economic growth to sustain their economic expansion. It is important to understand the drivers of the deficit to determine if this is sustainable or not. For example, if the deficit reflects an excess of imports over exports, it may simply indicate competitiveness problems. However, if the deficit reflects low savings rather than high investment, it could be caused by a consumption binge, fuelled by high levels of indebtedness, which is not sustainable.

In India's case, the national savings ratios has been trending upwards from below 20% in the 1980's to currently around 30% of GDP[6], which is 5% higher than the rest of the world. In terms of debt consumption, currently India's private sector has a loan- to-GDP ratio at around 52%, which is very low compared to the rest of the world at 128% of GDP[7]. Public sector debt is at 66% compared to the US at 103% and the Euro area at 94%[8]. At a household level, the debt-to-asset ratios are 3.7% for urban India and 3.2% for rural India according to a survey run by the National Sample Survey Office[9], illustrating extremely low debt utilisation. Hence it is fair to to say that the deficit has been driven by a lack of export competitiveness. This is illustrated in the chart below which shows that the majority of the deficit has arisen from a negative trade balance (red bars), driven largely by imports of merchandise, and key commodities such as Gold and Oil. A more competitive currency, along with the government's campaign to increase manufacturing and exports with several incentives like duty drawback, duty remission schemes etc. for foreign trade.

Figure 4: Current Account Components



Source: RBI, India Avenue

[6]World Bank Open data catalogue: National Savings as a % of GDP

[7]World Bank Open data catalogue: Private Sector Debt to GDP

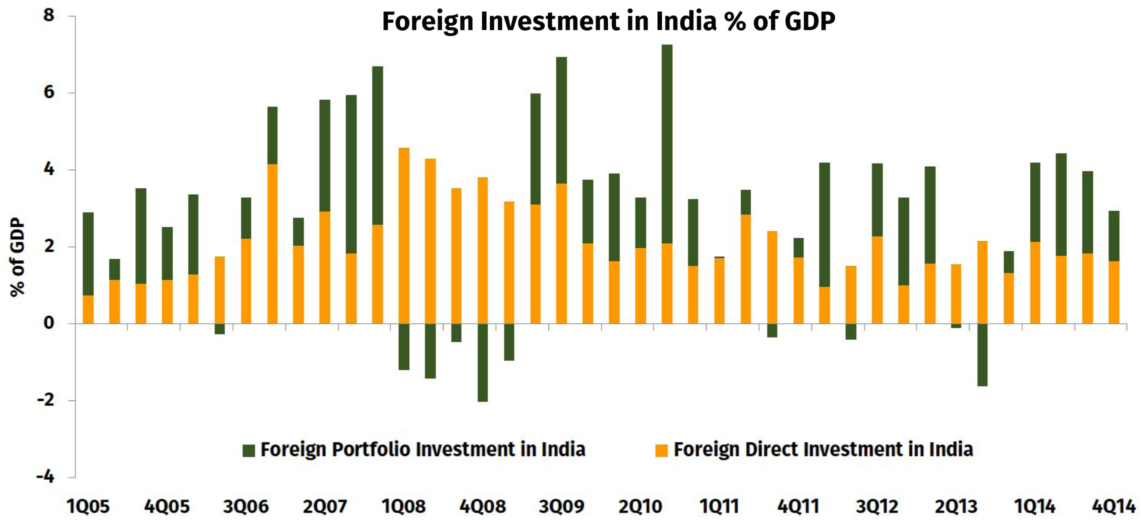
[8]http://www.tradingeconomics.com/country-list/government-debt-to-gdp

[9]Government of India, Ministry of Statistics and Programme Implementation, National Sample Survey Office, Key indicators of debt and investment in India, www.mospi.nic.in

A legitimate worry with India financing part of its current account deficit with foreign funding is that it is vulnerable to a sudden reversal in foreign portfolio capital. Such a reversal can be highly disruptive because marginal private consumption, investment and government expenditure must be curtailed when foreign financing is no longer readily available or requires a higher return on investment. This can have a negative consequence on India's capital markets and in particular increase the volatility of its currency as foreign capital is withdrawn.

The vulnerability to a reversal in capital is partially mitigated by a greater composition of capital flows from foreign direct investment (FDI) than portfolio Investment. This is because FDI is a longer-term and much more stable investment compared to more volatile short-term investment flows (e.g. into and out of equities and bonds). The chart below depicts the composition of foreign investment between FDI and Portfolio Investment.

Figure 5: Foreign Investment in India



Source: RBI, India Avenue

With political campaigns like 'Make in India', lifting of foreign investor restrictions and the recent currency declines, the countries competitiveness has been restored, particularly against other emerging economies, which are competing for the same foreign capital pool. This has and will continue to make India an important destination for foreign direct investment.

SUMMARY

Despite the potential for a strong GDP windfall for India's economy, a translation of this into strong equity market returns is not guaranteed. However, we feel that there are many macro and microeconomic factors at play in India, which increase the probability of healthy long-term returns for investors into India's capital markets in the future. As discussed in this piece, we feel that the following factors are paramount to translating into returns for investors in India's equity markets in particular:

- The improving political environment;
- Reduction in inefficiencies caused by political red tape;
- The Prime Minister's reform agendas to simplify doing business, promote business activity and encourage FDI and manufacturing; and
- Improving India's external position to encourage stable foreign investment and trade

In our next piece, we articulate from a microeconomic perspective, some of the key sectors that are likely to benefit from the evolving macroeconomic landscape. Furthermore, it will provide some examples of the companies that are most levered to India's growth story and thus likely to realise significant profit through higher volume growth and higher operating margins.

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