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IS INDIA REALLY THE WORLD'S MOST ATTRACTIVE ECONOMY FOR INVESTORS?

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HOW FUNDAMENTAL STRENGTHS, MODI'S REFORMS, AND CLEARING OUT DEADWOOD PROPELLED INDIA TO THE TOP OF THE BPI.

Two years ago, India was an unhappy member of Morgan Stanley's "Fragile Five[1]," a handful of emerging economies judged most vulnerable to tighter Federal Reserve policy and rising global bond yields. Since then, India's oil bill has dropped, inflation has eased, gold imports have been curtailed, the trade deficit has narrowed -- and in last year's national elections, Narendra Modi's Bharatiya Janata Party (BJP) romped to victory, becoming the first single party to win a majority in the lower house of parliament for 30 years.

No longer known for its fragility, India now enjoys a happier economic distinction. According to the International Monetary Fund (IMF), it will grow by 7.5 percent[2] this fiscal year (which ends March 2016), faster than China over a similar period. If the forecasts are fulfilled, India's economy can claim to be growing faster than any economy that's bigger, and to be bigger than any economy growing faster.

This growth is underpinned by several macroeconomic virtues, which India's ministers can typically recite by heart. India's national saving and investment rates (over 30 percent[3] of gross domestic product) are sadly lower than they were during its pre-crisis boom, but IMF figures show that they are still higher than those of many emerging markets, such as the Philippines, Thailand, Brazil, South Africa, or Turkey. As inflation has eased, more of that saving is returning to the financial system, which some households had abandoned in favor of gold and other physical hedges against rising prices. And India's demographics boggle the mind: According to projections by the World Bank[4], its working-age population will grow by almost 60 million people over the rest of this decade, close to the United Kingdom's entire population.

The country can also boast some institutional strengths. Its electoral traditions and its central bank, the Reserve Bank of India (RBI), have offered a measure of political and financial stability: India has been spared the coups and banking collapses that plague so many other emerging

[1] Morgan Stanley Global Outlook Research Paper "FX Pulse – Preparing for volatility", 1 August 2013
[2] International Monetary Fund's World Economic Outlook Database, April 2015 Edition http://bit.ly/1IpArzR
[3] International Monetary Fund's World Economic Outlook Database, April 2015 Edition http://www.imf.org/external/pubs/ft/weo/2015/01/weodata/index.aspx
[4] The World Bank's Population Estimates and Projections http://datatopics.worldbank.org/hnp/popestimates

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economies. It is no stranger to bouts of inflation and imprudent borrowing. But helped by the drop in global oil prices, the RBI appears to have succeeded in breaking the inflationary psychology that gripped India after the global financial crisis, when it was condemned to a period of stagflation. Modi's government has contributed to this macroeconomic stability by liberalizing the cost of diesel and mandating only modest rises[5] in the minimum prices that India pays for rice and other major crops.

Although India's recent inflationary spell raised local prices, the rupee also weakened, leaving the economy's international competitiveness largely intact. Its real exchange rate, which takes account of both the rate of inflation and the fluctuations of the rupee, has cheapened by over 10 percent since 2010, according to the Bank for International Settlements[6]. Over the same period, China has become almost 30 percent[6] more expensive.

Indeed, India's goods and services remain remarkably cheap by global standards. According to the IMF's figures[7], India's price levels average only about 28 percent of America's when converted into dollars at market exchange rates. As a consequence, a dollar stretches about 3.6 times further in India than it does in the United States. Over time that gap should narrow, according to textbook economics, as India's prices rise faster than America's and the rupee strengthens against the dollar. This slow progress toward "purchasing-power parity," as economists call it, may benefit long-term foreign investors, as reflected in successive editions[8] of the Baseline Profitability Index. Intrepid foreigners can invest today in Indian ventures that will be selling goods at higher prices and a stronger exchange rate years from now.

Although this underlying economic logic remains attractive to many investors, India's partisan politics and obtrusive bureaucracy are considerably less so. India's taxmen, for example, do not traditionally raise much money -- the central government's tax revenues[9] amounted to less than 10 percent of GDP last fiscal year -- but they do inspire a lot of fear. Foreign multinationals in particular were upset by the previous government's effort to impose taxes retrospectively on past transactions. In Washington, D.C. last week, Arun Jaitley, India's current finance minister, described it as "an ultra-aggressive tax policy which didn't bring us any revenue, but just scared people away from investing."

Yet even under his watch, taxation has spooked foreign investors. Earlier this year, the country's taxmen decided to act on a long neglected ruling that allowed them to collect 20 percent tax from foreign institutional investors on their past capital gains. To mollify investors, the government has waived the tax from this year onwards and appointed a panel[10] to clarify who owes how much from the past. The finance minister described the affair as a "legacy issue" that stemmed from a judge's verdict rather than the government's own

[5] Source: Bloomberg, "Modi Boosts Odds Of India Rate Cut With Curbs on Crop Prices" article, 18 June 2015
[6] Bank For International Settlements (BIS) statistic on "effective exchange rate indices,16 June 2015 https://www.bis.org/statistics/eer/index.htm?m=6%7C187
[7] International Monetary Fund's World Economic Outlook Database, April 2015 Edition http://www.imf.org/external/pubs/ft/weo/2015/01/weodata/weorept.aspx?pr.x=47&pr.y=6&sy=2014&ey=2014&scsm=1&ssd=1&sort=country&ds=.&br=1&c=534&s=PPPEX&grp=0&a=
[8] Foreign Policy article, "Where to Invest around the world 2014", 29 May 2014
[9] Statement I – Consolidated Fund of India – Revenue Account – Receipts http://indiabudget.nic.in/ub2015-16/afs/afs1.pdf
[10] Press Information Bureau, Government of India, Ministry of Finance, 26 May 2015 http://pib.nic.in/newsite/PrintRelease.aspx?relid=122034

initiative. But even if his ministry did not initiate the latest tax scare, he did not succeed in preventing it either.

On issues like taxation, subsidies, labor regulations, and privatization, India's most ambitious reformers had hoped the new government would mark a cleaner break with the compromises of the past. They imagined the new government shared their economic vision and would use its unexpected majority to impose it on the country. In the past year, however, they have discovered what they should always have known: Modi is a charismatic campaigner and energetic administrator who will keep ministers on their toes, but he is a political pragmatist -- not a liberalizing radical. And even if he were, he could not impose wholesale reforms on a country that is still deeply ambivalent about the looser regulation of land, capital, and labor that many entrepreneurs hoped to see.

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Instead, India's government has forsworn "big-bang" reforms in favor of what its chief economic advisor calls "persistent incrementalism." Modi will provide the benefits of brisk administration but not perhaps the thrill of bold reform. To use a cricketing analogy, he will run well between the wickets, picking up singles where he can, even if he cannot score many boundaries, piercing the outfield at will.

The distinction between these two styles of reform is clear in Modi's approach to India's onerous labor laws. Rewriting these laws is fiendishly difficult, as the BJP government knows well. However the text of the legislation is often less important than the way it is enforced -- and streamlining the administration of these laws may be politically easier than amending them. For example, the government last year launched the Shram Suvidha online portal[11], which allows firms to file a single compliance report for 16 central-government labor laws (out of 44). Computers will randomly dispatch labor inspectors to firms and oblige them to upload their report within 72 hours, with the aim of preventing officials from preying on particular firms for bribes.

Similar piecemeal reforms over the past couple of years have lifted India's position on the Baseline Profitability Index. Property rights have improved slightly, perceptions of corruption have lessened, and protection for minority shareholders has strengthened considerably, thanks largely to the Companies Act of 2013[12], passed by the previous government. Together with the potential for the real exchange rate to appreciate, these factors pushed India to the top of the table.

But will persistent incrementalism be enough to sustain 7 or 8 percent growth over the next few years? Many foreign investors have their doubts. They compare India, with its conspicuous displays of poverty and disorganization, unfavorably to China, with its intimidating displays of spectacular infrastructure. But India's economy is sometimes better than it looks to the naked eye -- and China's is often worse. India's moldering buildings often contain vibrant entrepreneurial businesses, while China's gleaming cityscapes sometimes house nothing but local-government hubris and inefficiency.

[11] http://efilelabourreturn.gov.in/home
[12] The Companies Act, 2013, India,30 August 2013

Besides, India is a much poorer country than its bigger northern neighbor. Its GDP per person is only about a fifth[13] of China's when compared at market exchange rates. That gives it tremendous scope to grow before it has to worry about matching China's current levels of productivity. It could grow by 8 percent for years and still have an income per person only half of China's today.

Kaushik Basu, the World Bank's chief economist, once compared India's "unpardonably large" bureaucratic costs to buried treasure. "Cutting down these costs is like unearthing a free, valuable resource that was lying idle," he wrote. "Ironically, this can be India's gold rush." To grow quickly India does not have to do anything exceedingly well. It simply has to do enough things less badly than before.

[13] International Monetary Fund's World Economic Outlook Database, April 2015 Edition http://www.imf.org/external/pubs/ft/weo/2015/01/weodata/weorept.aspx?pr.x=27&pr.y=4&sy=2014&ey=2014&scsm=1&ssd=1&sort=country&ds=.&br=1&c=924%2C534&s=NGDPDPC&grp=0&a=

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