CLSA
ASIA-PACIFIC MARKETS

Solid Ground

Global outlook

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Asia
Macro strategy

Buy chaos, sell order

As an investment destination, India often suffers in comparison to China, but India's problems come from tackling its most difficult problems first. We now perceive a tipping point where structural impediments have been sufficiently dismantled to permit a new form of economic growth. Many investors ignore the order evolving out of India's apparent chaos, while also failing to accept that China's state-imposed order will one day decompose. This dynamic means that returns from Indian equities are likely to far surpass Chinese equities over the medium and long term.

Structural mispricing of money is ending in India, but not China

- India often compares unfavourably to China, but India's problems come from tackling the most difficult problems first; China has postponed these problems.
- China is not working to privatise its financial system or create a more porous capital account.
- China is not focused on domestic consumption-driven growth, nor is it moving to a more representative, less corrupt political system.
- China's economic foundations are based on government-determined prices, whereas India has moved materially towards market rates.

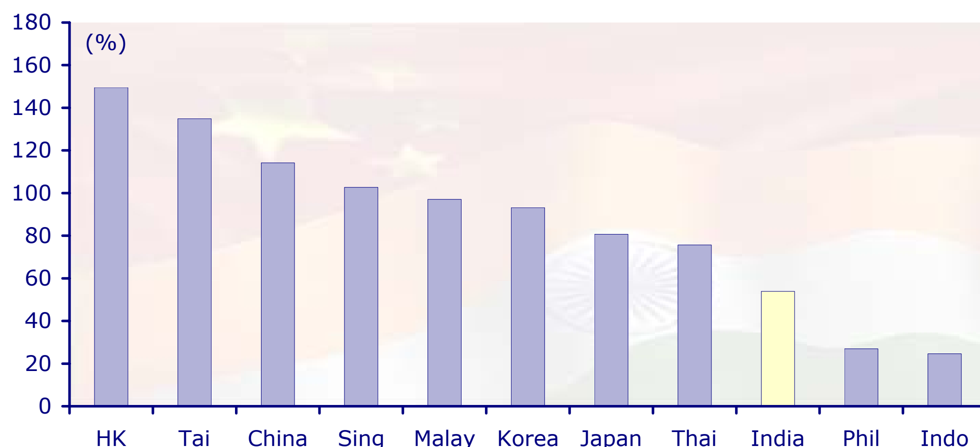
The post-mercantilist world will begin in India

- India is far advanced on China in developing a private-sector financial system.
- India is nearer to a market rate for exchange rates and interest rates than China.
- India is less reliant on exports and can move more easily to a consumption-driven economy than China can.
- India's private-sector banking system can more easily provide consumer credit, whereas Chinese credit is still needed to support state businesses, not consumers.
- If China does not abandon mercantilism, it will depress inflation and help India to grow.

India's democracy is starting to look like the USA's circa 1900

- Foreign investors regularly fled from the chaotic democracy of the late-19th Century United States.
- The order of the British Empire was an investment illusion.
- When India's democracy works, Indians can be as successful at home as abroad.

Credit as a % of GDP - India has much more room to grow than China



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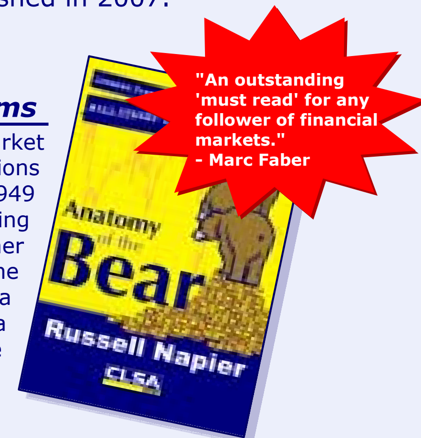
About Russell Napier

Russell Napier is a consultant with CLSA, writing on issues affecting global equity markets. He worked as an investment manager at Baillie Gifford in Edinburgh, before moving to Foreign & Colonial Emerging Markets in London. In May 1995, Russell became Asian equity strategist at CLSA in Hong Kong. He was ranked No. 1 for Asian strategy in both the *Asiamoney* and Institutional Investor polls in 1997, 1998 and 1999. Since 1999 he has worked as a consultant for CLSA. Russell has developed and runs a course called A Practical History of Financial Markets. The course is aimed at fund managers and involves teachers with some 200 years of experience communicating the key lessons in financial history in just three days (www.sifeco.org). Russell's book *Anatomy of the Bear* was named investment read of the year for 2006 in the *FT*, and was republished in 2007.

Available from select bookstores, amazon.com and clsabooks@clsa.com

Anatomy of the Bear:
Lessons from Wall Street's Four Great Bottoms

Russell Napier's acclaimed book examines financial market history as a guide to the future. Looking at the four occasions when US equities were most undervalued - 1921, 1932, 1949 and 1982 - Napier set out to answer key questions by analysing every article that appeared in *The Wall Street Journal* either side of the market bottom. Through the 70,000 articles he examined, one begins to understand the features pointing to a great buying opportunity arising. Napier offers investors a field guide to making the best financial provisions for the future



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Buy chaos, sell order

In a world of more government, India offers something very different

A weeklong visit to India confirmed this analyst's opinion that long-term returns from equities will be much higher there than in China. The visit also raised the much larger issue of how India can be a winner in a world where the North Asian pursuit of market share/full employment above profit might continue.

Low emerging-market equity returns due to mercantilist policies

There is little relationship between levels of economic growth and returns from equities, particularly in emerging markets. While there may be many reasons for this, a likely key cause is that most emerging markets pursue mercantilist policies on the road to development. The resulting artificial depression of exchange rates acts to depress returns from equities in numerous ways:

Thriving export sector is often not well represented on the stock market

- Exports are promoted at the expense of consumption. Most export-oriented companies are small or nonreliant on capital markets and thus do not represent a large part of the listed market. This may not be true in the capital-intensive commodity businesses in some emerging markets, but has been particularly true for the manufacturing export economies of Asia.
- Exchange-rate targeting produces extreme monetary conditions, which can produce boom/bust economic cycles on a scale that is inherently dangerous for equity investors. Not only does this complicate issues of timing for investment but it reduces long-term returns due to the scale of the damage to equity in deflationary downturns or when instead exchange rates are devalued.

The limits to mercantilism have been reached

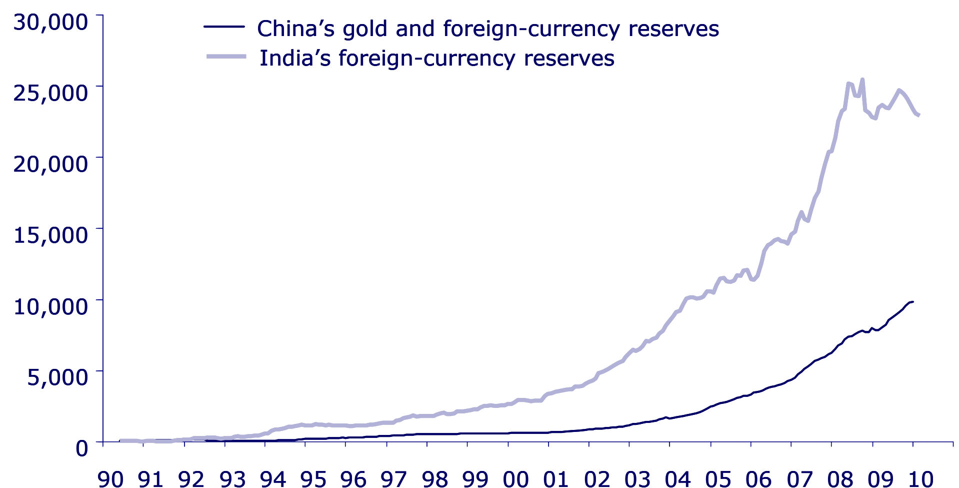
In 2010 there is a general realisation that mercantilist policies have reached their limit. The West's ability to continually gear up to buy more stuff is clearly much more limited now. In particular, it is difficult to see how very populous countries such as China and India can achieve western living standards by sticking with mercantilist policies.

Post-mercantilist market offers higher and non-correlated returns

A key question for investors must be how easy it will be for any individual country to make the transition to the post-mercantilist world. While this report deals with the many differences between China and India, the crucial conclusion is that China still faces many hurdles, whereas India is far ahead. Whichever emerging market can make this transition would both deliver the returns expected from high GDP growth, while simultaneously breaking the correlation of returns with developed markets. India is the Asian equity market most likely to deliver.

Mercantilism distorts monetary policy, particularly in China

Chinese and Indian foreign-exchange reserves, indexed to 100



Source: Datastream

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Where the real commercial banks are

Reforming a command-economy banking system the hardest step of all

The move from a command economy to a market economy is fraught with difficulties, but the greatest difficulty of all is privatising the banking system. The point of a command economy is to suspend the laws of supply and demand and at the core of that legerdemain is the distortion of the price of money. From this distortion all others spring and it is the key reason why the Chinese have not yet reformed their banking system. The seeming controlled economic reform in China can thus happen, apparently smoothly, behind the iron curtain of a command-economy banking system. However, even a gradual introduction of market forces tends to bring a realignment of prices, which destroys financial systems based on fabricated prices. It was just such a process that brought the Korean financial system to its knees in 1998 and it is difficult to think of any command-economy banking system that has been transformed into a private-sector banking system without an intervening crisis.

Bank reform would end much of China's price misalignment . . .

. . . with negative consequences for investors

Of course such a crisis could come tomorrow or could be a decade or more away. The point is that when it comes, it heralds a period when money, credit and assets will be correctly priced and that is invariably a very painful realignment for the owners of assets. It is fine to invest in a jurisdiction where such is the status quo, but clearly one must accept the risk that the reality of market pricing will dawn during your watch. This will not be a pleasant surprise for the sentries of capital guarding a portfolio of Chinese assets.

India's reforms have taken it much closer to the correct price of money

Nobody would call India a free market without government controls. However, control is less evident in the one price that drives the price of everything else: money. India has always had a private-sector banking system subject to the unpredictability of the marketplace. That private-sector banking system was clearly depressed in the postwar period, but since 1991 it has been rejuvenated. This rejuvenation brings the uncertainty of a greater role of market pricing for money and also the associated problems of credit availability and credit mispricing at certain times in the business cycle. Part of the apparent chaos in India is a normal side effect of the move to a market system and away from the "license Raj" with its command-economy characteristics.

Reform may be chaotic but it leads to reality and away from unreality

A command-economy financial system reduces chaos and promotes certainty, but at the price of massive distortion of capital allocation. Investors should pay more for the chaos of advanced reform than the order of mass distortion. India's once-depressed commercial banking skills, enhanced by the skills of returning nonresident Indians (NRIs), means that the country's financial system has made major progress towards more efficiently allocating capital. While in India order is beginning to form from the chaos, in China the inevitable eventual reform of the state-owned banking system will at some stage trigger a period of chaos.

The distortion of a state-owned banking system is further distorted by a policy of mercantilism in China. An undervalued exchange rate depresses consumption growth, but more importantly it creates excess money, with the usual ensuing distortions. India of course has pursued something of a similar policy, but its interventions have been conservative compared to those pursued by China.

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Mercantilism distorts monetary policy, particularly in China

Figure 1

Chinese and Indian foreign-exchange reserves, indexed to 100

Source: Datastream

As we discuss later it will be easier for India to adjust to the post-mercantilist world as its reliance on exports is much lower. However, and perhaps more importantly, the monetary and price distortions that are the legacy of such a policy are much larger in China than they are in India. The negative legacy of mercantilism will thus be much smaller in India than it is in China.

In China, government prices by fiat; achieves what markets can't?

Investors have to be aware that the mispricing in China is on a monumental scale. There is an individual in China who on any given day can determine the price of money, the quantity of credit/money and the exchange rate. That one person, it seems, can do accurately for China what a myriad of highly paid market professionals fail to do for the USA!

While it is possible that there are no drawbacks to the Chinese approach to pricing, there is ample historical evidence to suggest that this is not the case. Indeed, by depressing the Chinese exchange rate China has played a key role in swamping the global marketplace with state-directed savings and thus distorted the price of money (US Treasury yields), the quantity of credit/money (encouraging credit growth with lower credit costs) and exchange rates across the planet. This could be a wise or fortunate government distortion, but it is much more likely to be stupid, as they invariably are. In the past, *Solid Ground* has argued that there was a good time (1998 onwards) for investors to shelter capital in command economies and avoid the deflationary dynamics of market economies. This of course was a tactical rather than a structural call. The structural call could not be more different.

An economy targeting full employment drives deflation

A command economy is no place for those seeking to invest private-sector capital to secure good long-term returns, preferably without severe volatility along the way. China has managed to inflate its own assets while simultaneously pumping out deflation in the global goods market. That deflationary dynamic has triggered a government reaction in the West. Increasingly, western economies will have something of the command economy about them. The 2008-09 episode shows that democratically elected governments will, in extremis, implement command-economy remedies if faced with extreme deflationary outcomes. A move towards government determined pricing is not new:

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> On October 25th the great experiment began. That morning and on each subsequent weekday morning, Roosevelt, Morgenthau, Jesse Jones, head of the RFC, and sometimes Warren, met in the President's bedroom and, while the President ate breakfast, decided on the price at which gold, would be bought that day . . . . The little group in Roosevelt's bedroom would simply decide, more or less arbitrarily, a gold price a few cents above the previous day's free-market price and upon concluding their deliberations would announce to the world the sum the RFC was now prepared to pay for all the newly mined gold in the United States - that is to say, presumably all the gold available for sale in the country now that private hoarding was illegal.
>
> *Once In Golconda* (1969), John Brookes

Command-economy characteristics spreading, driven by risk of deflation

When markets fail to deliver what people and politicians want, then the politicians can and do change markets. For more on this dynamic, see *Solid Ground: No free market in a world of fools* (2003 reprinted 2008) and *Solid Ground: Supply, demand and government* (2009). We are seeing this dynamic at work already and there is much more to come. Increasingly everybody realises that the rules have changed, but the important point is that predicting the direction of political change is particularly difficult. As John Brookes goes on to observe about Roosevelt's interference with the market:

> What can be said in retrospective summary about Roosevelt's tinkering with the dollar during his first year of office? Certainly his understanding of the whole matter was ludicrously superficial and his attitude toward it scandalously offhand; certainly he disregarded the advice of all the learned and accredited money doctors of the land, and accepted that of a virtual quack. Yet somehow or other, the farmers neither starved nor made a revolution, and out of the episode, incredibly, came a stable dollar that would endure for a generation and more. Essentially, the wise but frightened Wall Streeters offered no program; the Warren program, unsound as it was, did no permanent harm and at least offered action and motion, bringing hope.
>
> *Once In Golconda* (1969), John Brookes

In India markets can still deliver the 'action and motion' society needs

In the eyes of the public, markets have failed and they seek the 'action and motion, bringing hope', which can lead to all sorts of curious and 'superficial' government remedies. Roosevelt chose a remedy out of left field and across the developed world politicians could be looking well into left field for the 'action and motion' people crave. China continues to buck the market and western governments will be increasingly tempted to follow suit in an attempt to avoid economic, social and political pain. This is very unlikely to be the case in India.

While government rolls back in India, it is rolling forward in the West

In India the markets are delivering and the electorate and even the politicians are realising this. Investors in India can expect to see an increasing role for the marketplace and increasingly to live in a world were supply and demand become important factors in determining price. This gradual liberalisation will be in great contrast to other parts of the world. In the rest of the world, the prices that result from supply and demand, particularly any deflation, will be considered unacceptable by society and politicians.

Market delivers in China, but will it do so when the shock of reform comes?

As any market practitioner knows, assessing future prices based on an estimation of future supply and demand is far from easy. However, it has its own rules, which add certainty, and is in marked contrast to the impact of the often capricious 'action and motion' which will be become an increasing political

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certainty in most places in the world. In India the 'action and motion' required of politicians is being delivered by the marketplace, whereas in China we will not truly know whether such delivery is taking place until the economy operates with at least a partially privatised banking system. The path that leads through banking reform could yet produce economic dislocation on a scale that would seriously question China's commitment to liberalisation. That is simply a risk constantly postponed in China, while it is one which has gone some way to being addressed in India. If you want to invest in a jurisdiction where it is very likely that the market will be allowed to deliver returns, then India is likely to be a better investment than the G7 or China over the coming decades.

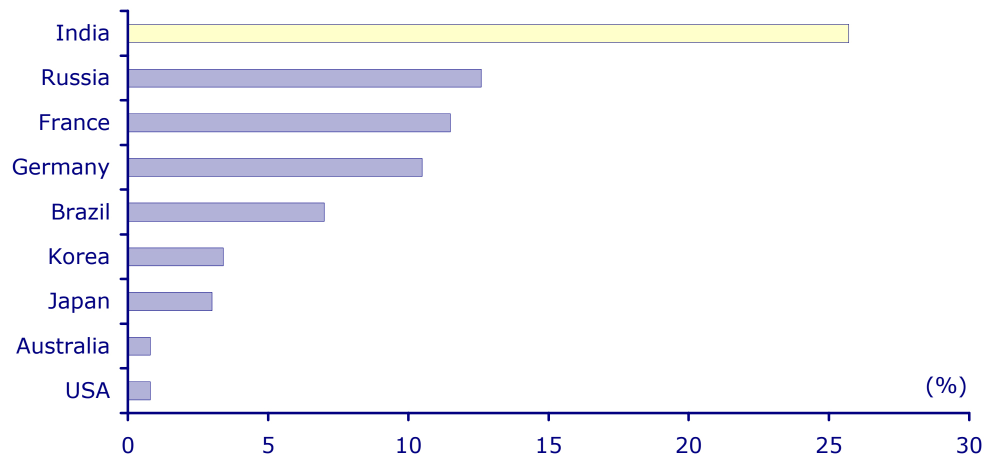
Western government action means smaller capital flows, but India is less reliant

This analyst has argued before, and does so later in this report, that the shock coming to western government debt markets will result in capital controls. In such an environment it is important to be invested in a jurisdiction with a lower reliance on foreign savings. India's love/hate relationship with foreign investment is well known and this has tended to make it less reliant on foreign savings than many fast-growing emerging economies. The country has a high savings rate, which provides a much larger buffer than in emerging countries such as Brazil and Russia, where savings rates are much lower.

Among the highest savings rates globally

Figure 2

Net savings as % of personal disposable income, 2006



Source: Euromonitor

More savings are mobilised and they are used more efficiently

More importantly, the increasing depth of the Indian financial sector has resulted in an increasingly more efficient use of India's own savings. The private sector provides savings products such as mutual funds and life insurance policies that can harness the savings of Indians for more productive purposes. Other developments in businesses such as factoring and bad-asset recovery enhance the productive use of savings.

Of course many of these changes are also benefiting China. However, it is the private sector that is driving the enhanced efficiency of savings gathering and allocation in India, whereas China continues to rely very largely on the state-owned financial system to deliver.

In India, faith in growth will increase faith in money

For good reasons, Indians have had little faith in currency as a store of value. As a result, a large proportion of their wealth is tied up in gold, jewellery and other collectibles. Gold is a sound store of value in a world without opportunity, but in a society of growth and opportunity it is a wasting asset. In an era when faith in

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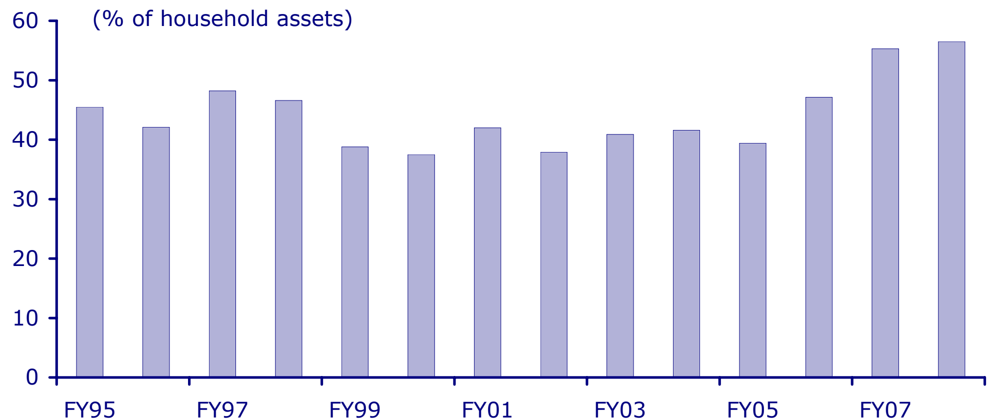
currency is likely to be declining across the world as governments eventually monetise their deficits, faith in money is likely to rise in India. Portfolio investors get their ultimate returns in paper currency. There are advantages to be had where the population is likely to be shifting assets into such a currency rather the running from it. In the West, bad money (paper) may be driving out good (gold), but in the Indian environment the flow could continue to be in the other direction. Moving Asian savings from the inertness of gold into the creativity of a modern financial system will be good for growth and returns.

At a peak

Figure 3

Bank deposits in household assets

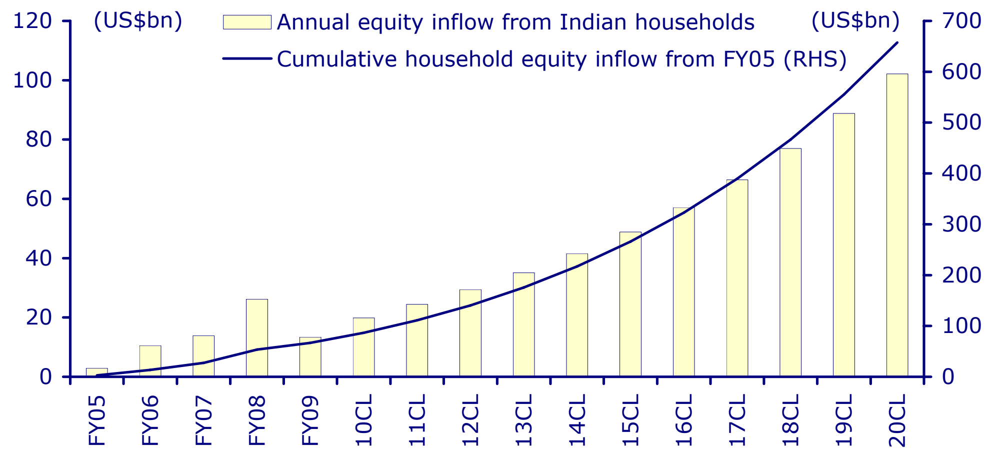


Source: Reserve Bank of India, CLSA Asia-Pacific Markets

Households could pump in US$600bn by FY20

Figure 4

Equity inflow from Indian households



Note: Priced on 27 October 2009. Source: CLSA Asia-Pacific Markets

Mobilising Asia's savings through the private sector is a key strength

As foreign savings become less available, a key strength of any emerging market will be its ability to gather and more efficiently use its own savings. India's growing private-sector financial system is likely to be much better at this than China, and in an era of greater scarcity of capital from the developed world this will be a key strength.

Key difference is India's more sophisticated banking system

If there is one reason above all others why India is more likely than China to produce better long-term returns for equity investors, it is because of these key structural differences in the countries' banking systems.

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When mercantilism dies

India will lead the post-mercantilist world

Has there ever been a bigger consensus than that the future for economic growth lies in the emerging markets? That is a consensus which sees the huge potential of a shift towards domestic consumption-driven growth in these populous economies. This chapter considers how India is better placed to make such a shift compared to China.

Of course there is also a possibility that mercantilism does not die in all the emerging markets. The next chapter looks at how India can also benefit in that scenario.

The death of mercantilism is a structural shift and fraught with risks

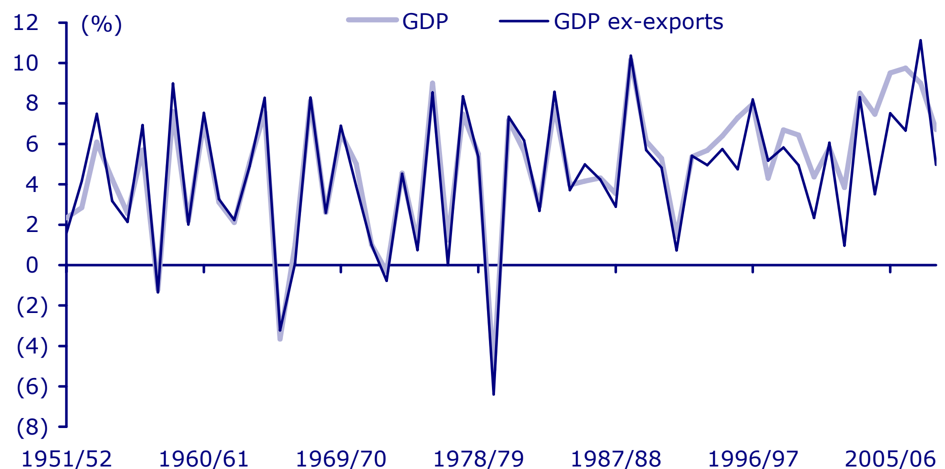
If the G20 is correct then the "rebalancing of global growth" will herald the end of mercantilism. The West will save more and the East will spend more. Economic growth would thus be higher in the East and perhaps, depending crucially on valuations, the returns from equities in the East will be higher. Of course we must recognise that not all emerging markets can make the transition from mercantilism to consumerism with the same ease. This is a structural shift and not just another business cycle. Such structural shifts tend to come with great social, political and financial friction. Investors should seek to invest in jurisdictions were those frictions will be minimal, as they massively complicate forecasting the impact of the shifts on the price of financial markets. When it comes to forecasting outcomes in complex non-linear systems, the fewer variable inputs the better.

In the transition from mercantilism to consumerism, India has far fewer variable inputs to consider. China, being much more reliant upon exports than India, is much less likely to transit smoothly. As Figure 5 shows, India is capable of growing strongly even in a world of zero export growth.

India's growth has not been driven by exports

Figure 5

Indian GDP growth with and without exports



Source: CEIC

Over the past 10 years this crude measure of nonexport growth (it does not adjust growth upwards for imports that arrive for re-export) shows a country that has produced almost 6% real GDP growth.

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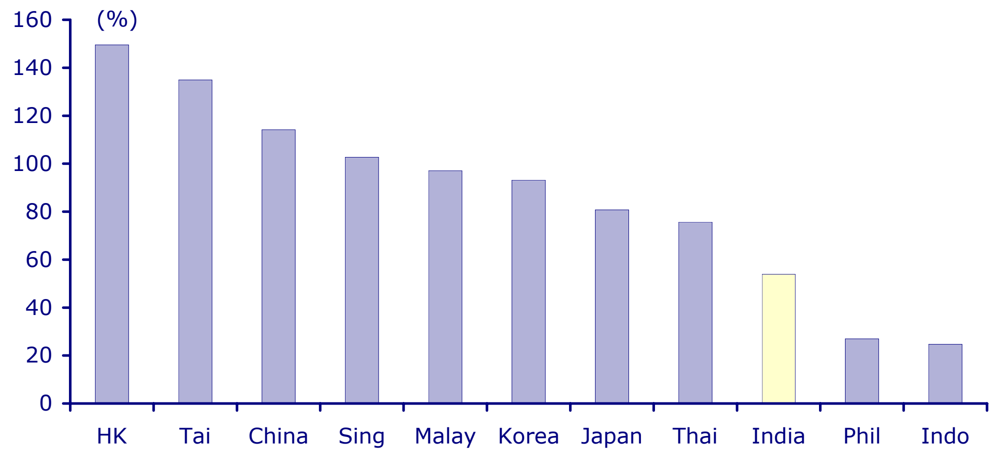
Consumerism needs consumer credit

A key to a rapid mobilisation towards consumerism is the development of consumer debt. China had made progress in this area, but once again it has been developed within the state-owned banking system. While China has low levels of credit in the private sector, it has much larger levels of debt to GDP generally than India. India thus has much greater flexibility to grow future credit towards than consumption than China, where credit is already a much larger percentage of GDP and is highly concentrated in the government/corporate sector.

Significant room for credit penetration

Figure 6

Credit as a % of GDP



Source: Euromonitor

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Living with North Asia

Free-market capitalism in conflict with social-market capitalism

For almost three decades a key conflict has driven financial returns. A form of capitalism that targets financial returns has been in conflict with a form that targets market share/full employment. Some might quarrel with the term "capitalism" for the latter system, but crucially it has at its core the allocation of capital, albeit in a form that is anathema to free-market capitalism. It would be easy to define it simply as mercantilism, but mercantilism is the symptom and not the cause. This form of capitalism lives in North Asia (China, Japan and Korea) and derives from different societal goals than those that spawned free-market capitalism. It is the product of a society where full employment, social stability and some equality of outcome are socially important.

North Asian business system sent deflationary forces through the global system

The "creative destruction" that free-market capitalism endorses is anathema to North Asian culture. It is this form of capitalism that leads to steady over-production by ignoring returns on capital in pursuit of other goals. This has set the scene for the past three decades, as the North Asian business system has sent deflationary forces through the global system. Financial market practitioners have been on the frontline, as western monetary authorities and now fiscal authorities have sought to offset these deflationary forces by enabling more debt creation in the free-market system. This debt was aimed at supporting consumption demand and offsetting deflation. This swing between the fire of inflation and the ice of deflation has been the key driver of financial markets and will remain so. While some things may be clearer post the Great Recession, one thing is less clear - which system will prevail?

Like a parasite on a host, the free-market capitalist system can and does the adjusting. The social-capital approach produces huge competitive pressure on the free-market capitalist system, which seeks to compete in similar areas. In many parts of the world this means that many industries have all but disappeared from the free-market system. However, the host also creates great opportunities for the free-market system, which consumes the goods produced at uneconomic rates. The result of this war has been the creation of a free-market system based largely on finance and consumption and a social-market capitalism that thrives on production.

Leveraged-consumption model is being forced to implement government intervention

In this form the two systems are unsustainable and it had been the common assumption - extrapolating western beliefs - that the free-market system would destroy the social-market system. Many times in the past two decades western analysts have proclaimed that Japanese companies would begin to target profit and not market share and employment. Many times in the past two decades western analysts have proclaimed that China had only a flirtation with social-market capitalism, which would be replaced by free-market capitalism. It is time to realise that this view of the world is western-centric and dangerous. One system is leveraged to consume and one is leveraged to produce, and yet it is the leveraged-consumption model that is being forced to implement more government intervention rather than the other way round. In 2008-09 it was the excess leverage for consumption that led to the collapse of the West and not, as many had expected, the excess leverage to fund unproductive investment that led to bankruptcy in North Asia. The social-market capitalist system, sustained by a social-market-capitalism banking system, is winning. It is winning either because its society can take the pain of running such a system (Japan) or because in a world of state-determined interest rates, exchange rates and bank lending (China) you can win for decades until you will suddenly and irrevocably lose.

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Surging public debt limits ability to fight off North Asian powers of deflation

So we assume that all the emerging markets will move forwards with freer markets and a switch from mercantilism to consumerism. While this may be true in many jurisdictions it is clearly not true in North Asia. There are clear problems for the free-market capitalist system unless North Asia also shifts to this new model of growth. Monetary policy has historically delivered an answer to the deflation that pours out of North Asia but this remedy becomes exhausted when higher levels of debt cannot be supported. This has led in the Great Recession to the addition of an incredibly supportive fiscal policy to prevent deflation and support the system. However, surging public debt to GDP levels now places limits on the power of fiscal policy to fight off the North Asian powers of deflation. With the authorities firepower increasingly committed, an eventual deflationary outcome would seem highly likely unless social-market capitalism is abandoned. While this is possible, investors must not rule out a more likely outcome, which is that western governments begin to manipulate markets (capital controls, tobin tax, compulsory sovereign debt purchase, etc) so that they are free to provide even the monetary and fiscal responses that markets will no longer otherwise tolerate. In that scenario social-market capitalism will have defeated free-market capitalism. Given the perilous scale of western government debt, this is now the most likely scenario.

India could develop relations with North Asia similar the West's

So what has all of this got to do with India? Investors need to look to invest in jurisdictions that can still benefit from the North Asian system's cheap production. If the West is increasingly overleveraged and unable to do so, then there may be other jurisdictions that have only begun to benefit. India is such a jurisdiction. It is a country that is prone to inflation due to a lack of commodities, infrastructure bottlenecks and the sheer size of its potential consumption. A North Asia that does not abandon social-market capitalism would produce the deflationary tendencies that would help to offset India's inflationary tendencies. In some ways India could develop a relationship with North Asia very similar to that which the west has developed over the past few decades. While this of course is inherently dangerous in the long run, it did result in wonderful financial returns in US assets (1982-00) as a similar relationship developed. North Asian capitalism produced an environment that allowed the USA to pursue high economic growth while producing low levels of inflation. It may now have the same impact on India. While the West's adaption to North Asia may have taken it to the limits of leverage, there could be huge profit as a very underleveraged and underconsuming India follows the same path.

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Bad hair, good investment

Do age and guile really beat youth, innocence and a bad haircut?

It was PJ O'Rourke who declared himself in favour of age and guile at the expense of youth, innocence and a bad haircut. Had he invested accordingly, he would probably now be clutching shares of Japan's leading brewer Kirin at a price almost 50% below its 1986 level. When it comes to economics, youth and inexperience, key drivers of consumption, are often more rewarding than the age and guile that brings conservatism and savings. Japan may not be a template for how poor financial returns have to be in an aging society, but it provides a warning of how poor they can be. The following histograms reveal two very different demographic outcomes for China and India.

Demographics not as supportive for consumption in China

Figure 7

China 2000

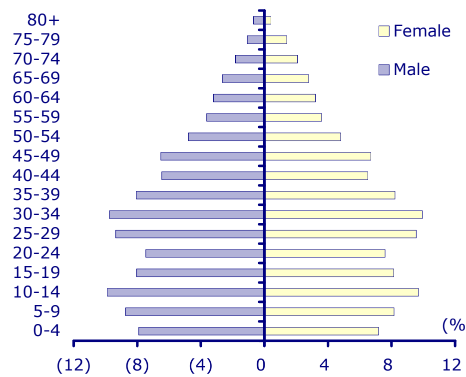
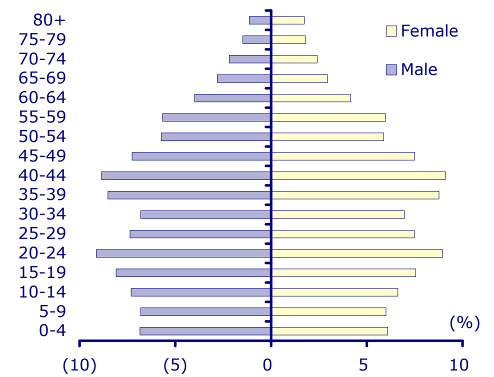


Figure 8

China 2010



India's demographics support a switch to consumerism

Figure 9

India 2000

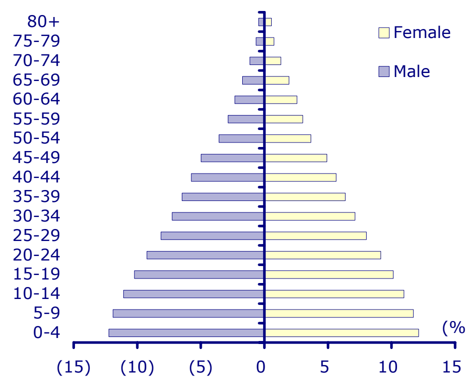
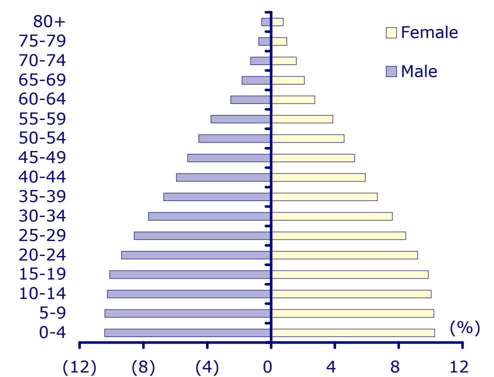


Figure 10

India 2010



Source: CLSA Asia-Pacific Markets

Demographics may be the nearest things we have to a fixed variable

The problem with forecasting price is that we are forecasting the product of a social activity. This is difficult because of the lack of fixed variables in a social system. Indeed, demographics may be the nearest things we have to a fixed variable when we look to the future, and long may it remain so. Now everybody knows that things happen painfully slowly in demographics, but they have the advantage of also happening with painful certainty. China will need to mobilise more savings to support its aging population, whereas India can focus on mobilising its savings to facilitate consumption. This too will change, but not for a very long time.

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Youth is not held back by fear of debt

Youth is probably the key ingredient for a population moving towards a consumer society. The older generation in India and China remember the deprivations of a different age and the risks or apparent stupidity of borrowing to consume. However, the youth of both countries increasingly comes with less of such baggage. In an era of growth, debt is good or not bad, and higher living standards make debt less dangerous. Indian and Chinese households save more because they need to protect themselves from negative outcomes. Such negative outcomes are just less likely for those possessing youth, innocence and a bad haircut. India has a lot more youth than China; this will be a key strength in making the transition from mercantilism and will promote higher returns for investors.

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World-beating bureaucracy

Maximising capital's share of wealth may not be in the long-term interest of investors

We are all bureaucrats now! The long swing in power from capital to labour and government, which began around 1932, reached its apex around 1979. The swing back was powerful, but the key danger for any capitalist was to extrapolate that swing and to believe that capital share of GDP could rise to ever higher levels. Such a swing was economically impossible, as it undermined consumption and was very probably socially and politically unacceptable. Indeed, maximising capital's share of wealth may not be in the long-term interest of investors anyway. A key result may be that it produces greater investment while undermining consumption, as the rich save the marginal dollar that the poor would have spent. The result is overproduction and lower returns. This is one reason given for the great depressions that ended capitalism in many jurisdictions and materially impaired it even in the USA for a generation. The words of one the 1920s' greatest capitalists and speculators about the decade stand as testament to the benefits of stability above short-term profit:

> In those days I felt and said I would be willing to part with half of what I had if I could be sure of keeping, under law and order, the other half.
>
> Joseph Kennedy

New structural norm will see governments more involved in market place

Joe Kennedy adapted to the "new normal" after the bust by joining the government (as head of the SEC and Ambassador to the UK) and grooming four sons for the political future. The new normal is often said to be slower rates of economic growth, but as Joe Kennedy realised in 1933 this is not as important as the new normal of more government and less markets. The new structural norm will see governments much more involved in the marketplace and particularly in the market for capital. The new BIS capital-adequacy rules are the first small step by governments on a long and winding road. These rules force more private capital into government debt markets. The Volcker/Obama package on bank reform is a more major step, forcing one form of private capital (commercial banks) out of certain types of investments. Whether one agrees with the process or not, the important thing is that these changes are taking us to a place where the efficiency of a country's bureaucracy will become increasingly important.

The more practised and efficient that Big Brother is, the better for all

To paraphrase George Orwell, previously the incantation was "markets good, bureaucracy bad". This perception will change somewhat in the "new normal". If Big Brother has to be watching you as the allocator of capital, then the more practised and efficient Big Brother is, the better for all. For a generation India has laboured under a crushing bureaucracy that was an impediment to growth and change. This remains the case, although some positive progress is being made. However, this will be seen as less of a unique impediment, as Big Brother will be increasingly looking round every global corner in financial markets with application forms in hand. In India there is less of a practised bureaucracy, while in the West we are getting a more naïve bureaucracy. It is much better to be dealing with the former than the latter.

While there is much to criticise in Indian bureaucracy, there is also much to praise. In particular, the financial regulators at the Securities and Exchange Board of India (SEBI) and the Reserve Bank of India (RBI) are forward-looking and are methodically steering the financial system towards something more fitting to the 21st Century. As communications experts vaunt the ability to leapfrog out-of-date technology, so the SEBI and RBI have the ability to leapfrog the intellectual *cul de sac* of the dangerous risk-taking activities born

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of the efficient-markets hypothesis. No regulator will ever be perfect and faults will occur, but the relative stability of the Indian financial system during the recent extreme trial is a key indicator that SEBI and the RBI have, at this stage, put firm foundations in place for India's financial superstructure.

We are all in bed with bureaucrats now

While other regulators have much bad to undo and much to relearn, the Indian financial bureaucracy is ahead of the game. As the western world rebuilds or recasts its financial regulation with the usual unforeseen consequences, it will be "steady as she goes" for the Indian financial system. We are all in bed with the bureaucrats now, so what matters is whether you are investing in a jurisdiction with good or bad bureaucrats. In the new structural normal, a bad bureaucrat can screw up returns on equity with the same unintended precision as bad management. In this light, India's plodding but improving bureaucracy has much to recommend it over the newly resurgent bureaucracy of the West, desperate to show its power relative to capital and likely to be rolling up its sleeves and getting ready for a brawl.

In India, the state is retreating

India's state is on the retreat. The public debt-to-GDP ratio is already falling. While of course much will depend on the pace of economic growth, a structural rise in the tax take is also working in India's favour. By pushing ahead with the direct Tax Code and the GST, India is making structural strides to fix its fiscal problems at a time when other countries' structural fiscal problems are getting worse.

The "new normal" is more government. In India this might not be the case - and anyway, that government is likely to be one of Mr Rumsfeld's 'known knowns' rather than the numerous 'unknown unknowns' inherent in the rising role of government intervention elsewhere in the world.

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Path of true democracy is never smooth

Political upheaval did not disrupt economic growth of the British Empire

In 1819, about 70,000 people gathered in a field in Manchester demanding greater political representation among other things. The crowd was charged by a cavalry regiment; 15 people died and up to 700 were injured. This was Manchester in 1819 and not Tiananmen Square in 1989, but the similarities are obvious. Universal suffrage finally arrived in the United Kingdom in 1928. There were many other tumultuous events that mapped the progress towards democracy from 1819 to 1928 in the UK. This political upheaval, however, never erupted into the magnitude of event that would disrupt the rise and rise of the British economy over this period. To some extent a political eruption was alleviated by the pressure valve of immigration to the USA and service in far-flung parts of the British Empire.

Pre-democratic emerging-market investors must be aware of risk of political systems disintegrating

In the 21st Century, when people's freedom of movement is heavily constrained, there is much less opportunity to diffuse political tension on the road to democracy. Anyone investing in emerging markets still in the pre-democratic state has to be aware of the risks to investment posed by a major dislocation as the old political system disintegrates. Any investor who believes that this is a largely theoretical risk ignores the lessons from Russia, where foreigners' property rights were crushed in the political system that replaced the Soviet regime. There may have been good companies in Russia and good management, but the potential to lose a fortune in such investments is still large if a new political regime cannot or will not protect property rights. A major political dislocation is perhaps the greatest destroyer of wealth. Visitors to the modern city of Gdansk might reflect on the myriad political shifts that destroyed the massive wealth accumulated in that city under its former appellation of Danzig - a key city in the Hanseatic League. Whatever the positive supply/demand dynamics for business in that city returns were entirely determined by political change.

India's economic development is leading to improvement in its democracy

Perhaps democracies can only function particularly efficiently when the general wealth of voters means that they are not prepared to sell their votes. Perhaps this statement is unfair to poor people who watch western voters receive, in benefits and corporate tax breaks, sums that would be considered scandalous if delivered in cash in an emerging market. However, from a western perspective, which is where most emerging-market investment still comes from, the willingness of voters to sell their votes results in a fractured and corrupt form of democracy that hinders economic growth. The easiest way for politicians to buy votes is to seek to reallocate wealth rather than the slower process of creating it. This is a structural impediment to growth as unfair redistribution distorts capital allocation and also as corruption hampers fixed-capital formation and in particular slows the process of infrastructure development. Indian democracy has suffered from exactly these problems, but things are changing. There is also no doubt that India's economic development is leading to an improvement in the functioning of its democracy. Figure 11 shows the path of power capacity addition, suggesting that the political process is increasingly capable of delivering.

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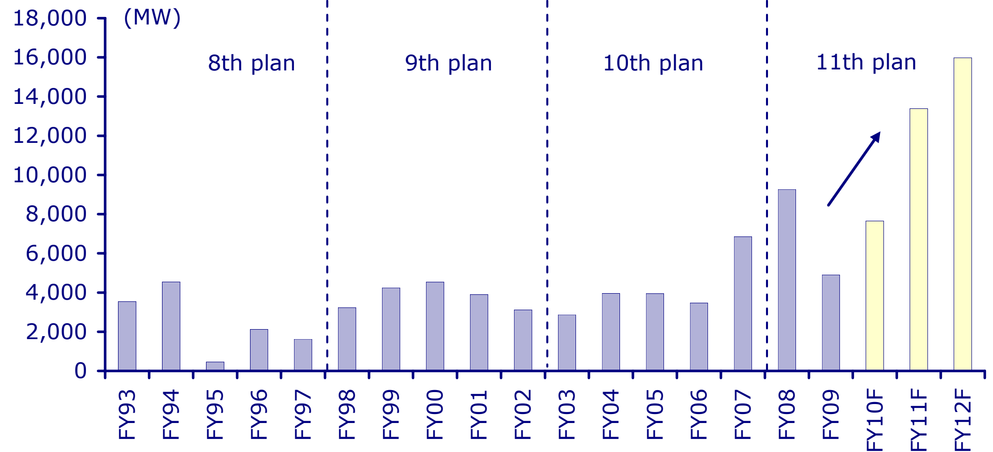
State delivering on things where it had previously failed

Figure 11

Step-up in proposed power capacity addition



Source: Planning Commission

Indian voters see more benefit in growing the pie than fighting over the spoils

India was born as an independent country and the world's largest democracy simultaneously. Judged from the perspective of a western investor it is a democracy that has not worked; it has not produced enough politicians who have sought to improve the welfare of their electorate by facilitating economic growth. In periods of low economic growth, politicians fought over shares of power and wealth for themselves and their associated interest group - whether defined by region, caste or religion. However, in an era of higher economic growth, individual Indian voters increasingly see the greater benefits that come from expansion rather than fighting over the existing spoils. This is no revolution but a continued evolution, nevertheless it augurs a time when order will begin to emerge from the chaos of Indian democracy. This order is perhaps the most important change in India, yet is probably ranked as the most nebulous by many investors.

It is the most important because it threatens to force Indian politicians to unleash the evident industry, intelligence and entrepreneurship of the Indian people. If you think that is too vague to buy into then remember the difference between the UK in the 1970s and in the 1980s. Very different economic results were possible from the same inputs when incentives were changed, as the fight over the spoils was put aside in the pursuit of growth. This change in India will be much bigger than that: it will be the first time in the country's history that the political shackles - whether imposed by Britain or Delhi - will be removed from the people. Something has stopped the Indian people from achieving in India what they have achieved in Nairobi, Bradford, Durban, Fiji and Los Angeles. That thing was primarily a poorly functioning democracy that has taken a long time to develop, partly hindered by the colonial legacy and the politics of the Cold War. However, now we have reached a tipping point for Indian democracy where things start to work and the power of the Indian individual is finally allowed to come to the fore.

Late-19th Century US market was a rollercoaster

The USA became a chaotic democracy long before it became a great source of profit for portfolio investors. Jay Gould and Jim Fisk were just two "entrepreneurs" in New York who bribed judges and politicians to steal from minority shareholders. Foreign investors lost a fortune in state bonds (Mississippi remains in default on certain issues), and in many parts of the country the rule of law did not protect life and limb, never mind the property

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of minority shareholders. The US stock market was a rollercoaster for foreign investors and the crises of 1894 and 1907 convinced most foreign investors that it was not as safe as the sound government-backed securities issued in various parts of the British Empire. Investors feared a democracy could produce a populist like William Jennings Bryan and instead favoured the order of the Empire. The first schedule of investments for the Foreign & Colonial Investment Trust of 1868 shows US securities (government bonds) at just 2.5% of assets, one-quarter the size of the trust's investment in Egyptian securities. Presumably investors favoured the certainty of foreign-influenced Egyptian assets in a country where the Suez Canal was about to open over the securities of a country that had just torn itself apart in the chaos of a bloody civil war. From the chaos of that failed democracy, order gradually developed, whereas in Egypt the imposed order of a foreign power dissolved. The US democracy took time to mature and when it did, property rights became more certain and returns to investors improved.

When order gradually returned to the chaotic USA, returns improved

There was indeed order in the despotism of the Empire, but that order crumbled and investors did not fare well in that process. It was the contrarian who opted for the democratic chaos of the USA who was rewarded with some of the best returns that the 20th Century had to offer. The risk, of course, is that investors in India today are buying into this structural transformation too early. However, the country's ability to weather the Great Recession and the November 2008 terror attacks provide material confidence that India has progressed far along the road from democratic chaos to productive democracy. The increased ability to delivery on infrastructure projects is another key bellwether, which suggests that a tipping point is being reached.

Liberty of information increases liberty of investment

It goes without saying that India is much closer to becoming a functioning democracy than China. One key indicator of such progress is the freedom of information and press in India compared with China. In a modern economy, the liberty of information increases the liberty of investment. With a free and active press, corruption and distortion is more visible and wealth creation more widely reported. While the state continues to provide the information it believes the market requires in China, India's free press provides all the information and thus the market can choose what it requires. If a free press can truly produce lower corruption and more accurate information, then it can play an important role in producing higher returns for investors. Such a system remains a dream for China and a feisty reality for India. As India's democracy reaches the tipping point by delivering better living standards to the electorate, the importance of a free press in promoting better returns will become apparent.

Strange that many prefer China, which puts public rights before private

Perhaps the strangest thing about the great "India or China" debate is how many investors favour China because it puts public rights before private rights. China can deliver infrastructure projects in record time because it can sweep aside private-ownership rights. While there are various reasons why things move much more slowly in India, the key impediment to rapid development is respect for private-property rights. While no legal system provides perfect protection for the property rights of private citizens, the Indian legal system does allow private-property owners to delay public demands. Although this is clearly a negative in delivering infrastructure projects, why should it be seen as a negative by private-sector investors?

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Core of equities investing is a belief in the sanctity of private property

At the core of an investment in equities is a belief in the sanctity of private-property ownership; without that sanctity, balance sheets and earnings are castles built on sand. The history of India is the recognition of such rights, with all the attendant legal niceties and delays. The history of China is that public rights trump private rights. Things are improving in China and individuals have even brought some successful lawsuits against the government. However, no dictatorship can ever let private rights trump public necessity. Such a dynamic is at the core of democracy and is a key reason why private-sector investors should derive higher returns in India than in China.

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Conclusion

China might jump the structural hurdles, but the risks are high

China might jump the major hurdles outlined in this report in one bound. It might manage to develop a private-sector financial system, democracy, consumerism and strong private-sector property rights without a major crisis. History, however, suggests that the odds are against a smooth transition. Failure to achieve this should permit investors who believe in the inevitable long-term rise of China to buy its assets at very reasonable prices one day. The likely structural crisis that China will suffer on its long-term road to success can throw everything into doubt and produce very low valuations for Chinese assets.

India will clearly have crises of its own. However, from this stage on almost all these could best be described as "normal": part and parcel of any country's business cycle. In India in particular, cyclical inflation problems seem likely and even the RBI will not be able to stop the "irrational exuberance" that seems to infect all purveyors of credit at some stage.

The greatest structural threat to India comes from Pakistan

The greatest structural threat to India would be if Pakistan were to join the sorry list of failed states. Even something short of this could create major social problems in a country with enduring religious differences. Investors need to be wary of developments in the north, while embracing the fact that India, not China, is more likely to provide the type of returns enjoyed by investors in the USA in the last century.

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Notes

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