INDIA, INC. —- A PROGRESS REPORT

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The many positive changes which have taken place in India over the past eight years have been greater than perhaps during the whole previous 40 years of independence, and more substantial than for many other economies, emerging or not. These changes have helped to precipitate the almost vertical rise of the software industry, which itself has added velocity to the general process of structural change.

Ten years ago, India was a quasi-socialist economy with the dead hand of tariffs and licences to limit imports. This has been changing, slowly at first and now much more rapidly.

India has just held an election, the final complexion of which should be clear by the end of October, but with the likelihood of a BJP-led coalition government. Expectations for the BJP government, which first came to power in 1997, were low, and the Finance Minister, Mr Sinha, exceeded even those low expectations with his first Union Budget, and its many amendments. Happily, Sinha read his reviews and has now become an adequate performer.

Now, for the first time in Indian political history, the three main political groupings – the Congress, the BJP, and the UF alliance – all share the same basic agenda for economic reform and greater liberalisation. This even includes the thorny subject of privatisation. India has long had a political sub-plot of *swadeshi*, which means "self-reliance" – that is, keep out the foreigners, and especially the capitalist Americans. The swadeshi "hawks" have kept a low profile for a while, but they may not stay that way if the BJP gets a large majority. If they can be restrained, the outlook looks very promising for the Indian economy and market.

Indian export performance has not been so impressive that an isolationist policy is generally seen any longer as a desirable one; it has certainly been a tragic waste of human opportunity. From 1980 to 1995, India's share of world exports rose from 0.5% to 0.6%, a rise of 20%. By comparison, China's exports as a percentage of world exports rose over the same period from 0.9% to 3%, a rise of 230%. As a result, many millions more Chinese can prospectively enjoy a higher standard of living and life chances than their Indian contemporaries (see Figure 1).

The corporate sector, the capital markets, and the economy have all been subject to sustained reforms, which have now reached critical mass; thus raising our expectations still further.

THE NEW LANDSCAPE

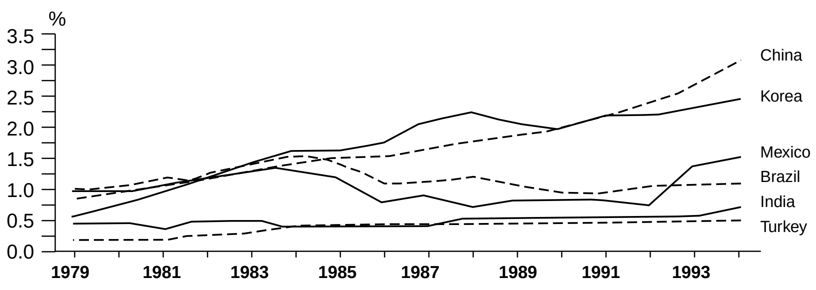
Every corporate CEO and annual report in India talks these days about "shareholder value" and "restructuring"; even a year ago, this would have been a surprise in most cases. There are several reasons for this change, but perhaps the key one was the passing of share buy-back legislation, which became effective this spring. Another is an outcome of the liquidity crunch that took place between 1995 and 1998. The decline of many of the state-related companies of the dinosaur-producing "Licence Raj" has progressed, and in some cases has become acute enough to generate the "restructuring" speak among them also.

"Return on equity", "dividend payout ratios", and "capex" are all also a part of the new language. Buy-back will also allow some foreign corporates to use their Indian subsidiary's cash to increase their stake at no capital cost, as buy-back shrinks the free float of shares.

The economic reform process has gathered pace over the past three or so years. The oil supply, telecom, and banking sectors have all been opened up, with competition starting to become especially sharp in the telecom sector, as more suppliers are licensed to provide, among other things, Internet access.

The state finances are much less healthy. While the federal budget is increasingly in touch with the real world, those of some of the individual states are less so, and deficits and debt levels are both rising sharply. A stronger central government is expected to impose and enforce budget and target discipline, or so it is hoped. (See Figure 2 for the composition of central government revenue expenditure.)

Figure 1 India's Share of World Exports, 1980-1995



Source: Indian Economy - 19 February 1999, Merrill Lynch

QUALITY OF MARKETS

In 1993, US$5.6 billion was raised in the primary and secondary markets. Current levels of capital raising are around half that, and the quality of the issues has increased markedly. The most critical point for listed equity investors in India has been paper settlement. All trades used to settle in multiples of paper share certificates for 100 shares, along with transfer deed, etc. Anecdotal stories about paper-eating rats, and documented cases involving fraud, theft, incompetence, and custodial disinterest, along with bags of newspaper being registered as shares, abound.

Dr Mark Mobius of Templeton famously once stated that he would not invest large sums in India until this problem was solved. Today it is well on the way to being so. The "dematerialisation" of paper certificates was once optional, whereas now it has become mandatory for many companies. Rematerialisation was also once possible, while it is not so now.

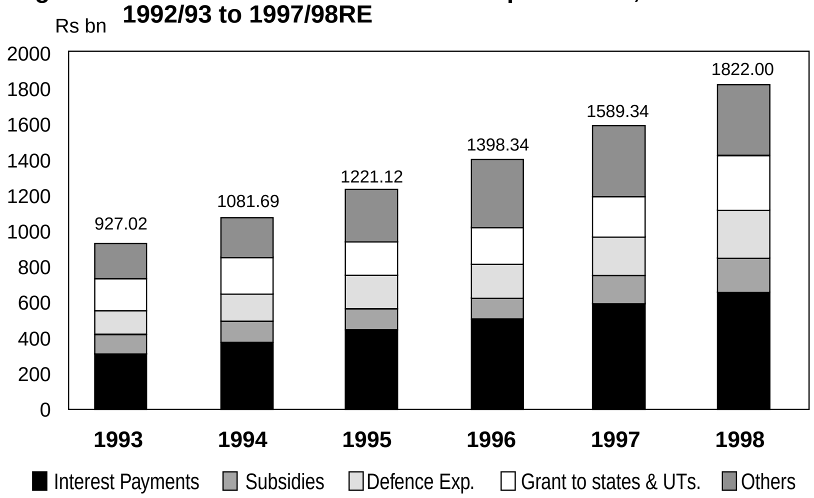
The bias has shifted away from the retail investor who wanted his or her 500 Reliance shares stored safely under the bed, to the institutions, local and foreign, who will not continue to carry the costs and the risks associated with the literally mountains of paper.

Currently, 436 prominent companies have dematerialised an average of 35% of their stock. Brokerage and custody charges are thus plunging, which adds liquidity and depth to the market.

DEBT

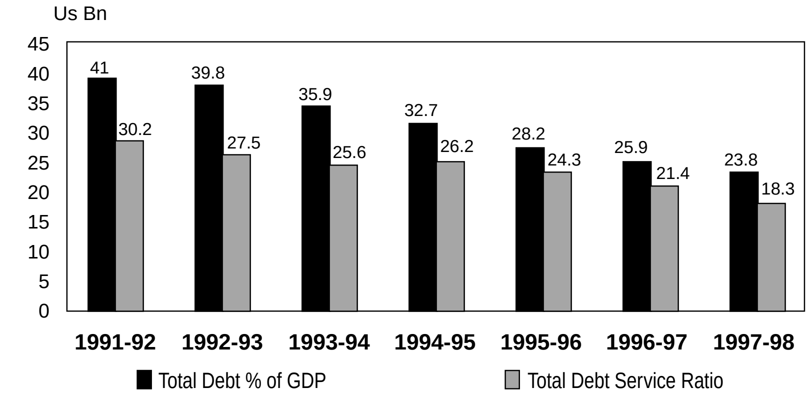
External debt and debt service ratios have all been declining, along with positive foreign exchange reserve levels (see Figures 3 and 4), while debt to GDP has been trending positively since 1993 (see Figure 5). The ratio of concessional debt, which is defined as part grant/part debt, and where the debt element is below market or norm terms, was at 48.2% of total external debt in 1997. This is compared to 16% for China, 9% for Korea, and 1.8% for Brazil.

Figure 2 India's Central Government's Expenditures, 1992/93 to 1997/98RE



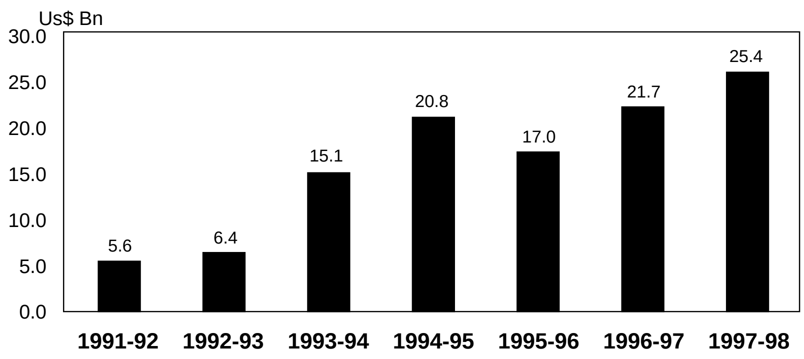
Source: Indian Economy - 19 February 1999, Merrill Lynch

Figure 3 India's External Debt Ratios, 1991/92 to 1997/98



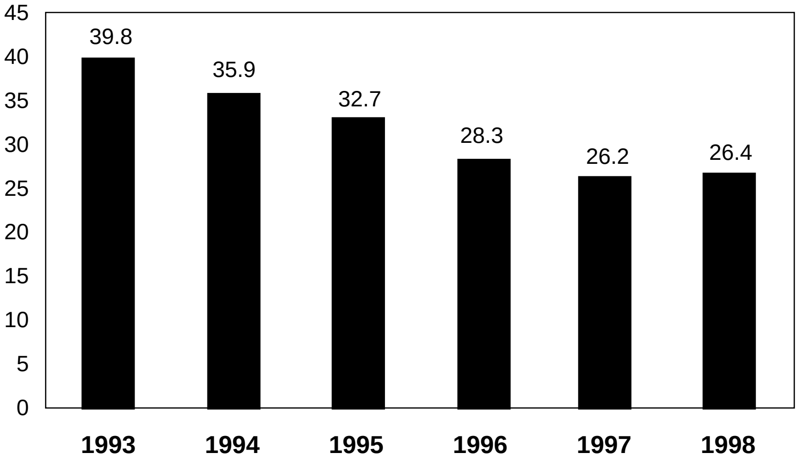
Source: Indian Economy - 19 February 1999, Merrill Lynch

Figure 4 India's Foreign Exchange Reserves, 1991/92 to 1997/98



Source: Indian Economy - 19 February 1999, Merrill Lynch

Figure 5 India's Debt-to-GDP Ratio, 1993-1998



Source: Indian Economy - 19 February 1999, Merrill Lynch

Ironically, compared to the Asian "tiger" economies, the slower expansion of corporate and federal India has resulted in comparatively lower levels of indebtedness and over-capacity, while the Indian economy also does not have the direct revenue burn-rate that the Chinese state-owned enterprises impose on governmental revenues. Similarly, social welfare provision and pensions are a negligible element in government spending, both currently and as a future liability; while for the Chinese taxpayer, these items projected at current levels will grow faster than servicing capacity.

AT THE CROSSROADS

On Saturday, August 18, 1999, Crossroads, the first shopping mall in India, in central Mumbai, was holding its second preview evening for assorted friends, clients, and glitterati. Outside the crowd reached 40,000, and was pressing against the exterior glass wall so that it was bending inwards. Rather than have a pre-opening night tragedy, the doors were opened and the closing time was extended from 11 pm to 1 am.

At least three further malls will open in India, mainly in Mumbai, by the end of 1999. The Indian consumer has now firmly arrived and, although price-conscious, will spend and has a powerful, pent-up appetite to buy their piece of the Western consumer dream that they see on satellite TV.

All recent consumption and industrial production levels are positive, with the agricultural sector having sustained Indian GDP growth these last two years. Although the Indian economy has changed significantly over the past eight years, we have only begun to see the first benefits and opportunities that these structural changes will generate. Slowly, and crab-like in a sideways motion, the Indian political-economy has reconstructed itself and may finally be about to let its very talented and competitive people off their leash. To re-use a famous phrase: we believe that this is only the end of the beginning.