



## India Elections: Reality Check

India—the world’s largest democracy—just completed its marathon practice to elect its next head of government. The results of the national elections—held every five years and spanning a lengthy five-week electoral process—have indicated a landslide win for Narendra Modi and the Bharatiya Janata Party (BJP). It marks the party’s most definitive win in 30 years.

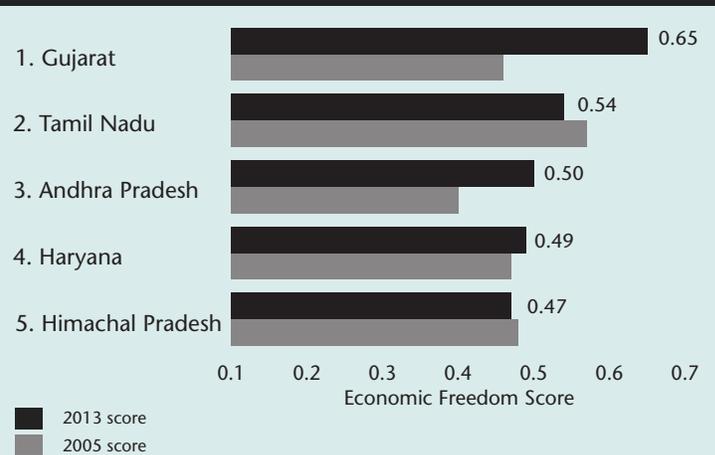
The country’s Congress-led government has been in power for two terms, and many have speculated that a victorious pro-reform party would help India spark more investment-led growth. That may, in turn, bolster many of India’s infrastructure-related projects as well as job creation.

While the markets are responding with expected euphoria over this win, we remind investors to take a tempered view as we look forward to the real challenges ahead for Modi and his party. The country continues to battle long-standing inflation, low job growth and stalled investments. Under Modi’s stewardship, the state of Gujarat responded to these issues by accelerating agriculture growth and improving its economic freedom—which involves the freedom to choose how to produce, sell and use one’s own resources.

The state’s economic freedom rose from levels

considered reasonably good to the highest in India according to a study that has grown out of the Fraser Institute’s global Economic Freedom of the World project; this project has shown an enduring empirical relationship between economic freedom and prosperity, growth and improvements in human well-being. Hopefully, if Gujarat’s success can be replicated across the entire nation, some pressing national issues could also be resolved. Let’s evaluate how much of that is realistically possible.

### TOP 5 INDIAN STATES BY ECONOMIC FREEDOM



An enduring empirical relationship has been shown to exist between “economic freedom” and prosperity, growth and improvements in human well-being. According to one study, the median score for economic freedom in India generally improved in 2013 to 0.43. However, it is still a far cry behind the score of its top-ranking state, Gujarat—indicating that most states have a long way to go. Lacking consistent data for many Indian states, the study scores the states by a few main parameters: the size and efficiency of state governments; legal structure and security of property rights; and the regulation of labor and business.

Source: “Economic Freedom of the States of India 2013,” by Debroy, Bhandari and Anklesaria Aiyar; co-published by the Cato Institute, Friedrich Naumann Foundation, Indicus Analytics and Academic Foundation



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There are two parallel but different points of view about what can be achieved with the BJP's rise to power. Optimists are hoping that inflation will be contained and investment reforms will forge ahead full swing in light of their win. Inflation in India has been primarily fueled by rising food prices, which cannot realistically be contained without investing in agriculture and infrastructure, two segments which require considerable reforms. Stronger federal leadership would help, but must have the consensus of state governments, which is easier said than done, though not impossible. Even with such positive developments falling into place, real progress may still take considerable time. To be fair, Gujarat demonstrated double-digit agriculture growth from 2001 to 2010 despite its limited natural resources, compared with low single-digit growth for the entire nation. But, the other viewpoint is that given the fact that agricultural policies and, thus agrarian reforms, are within the exclusive control of the states (in legislation and execution), Gujarat's success may not percolate everywhere. Gujarat's industrial progress is also commendable, but the state has long been known for its spirit of entrepreneurship, and perhaps Modi was able to let this thrive simply by ensuring a free environment. Whether this model can work across India's many diverse regions is something yet to be tested.

So, given the current rally, just how should investors think about India over the long term? We argue that it is better to focus on companies that can best chart their own destinies, and avoid the ones that are dependent on macro calls playing out. Fortunately, the Indian

economy has bred plenty of companies that are not too macro-dependent. In fact, some of these companies have become stronger and better users of resources in the tough business environment.

For instance, some of India's more successful automobile firms have done well by focusing on productivity and product quality. A consumer-focused two-wheeler company, for example, has been challenged in raising prices for almost a decade but it has responded well with productivity improvements and value engineering, as ways to preserve profitability. In another case, an auto component maker, which has a business-to-business client base, has been able to grow market share and drive pricing power throughout the business cycle by focusing on product quality and operational improvements. Both of these companies have weathered the recent auto slowdown fairly well.

Similarly, some private sector banks, which recently faced an uncertain credit environment, have also bucked the trend with a single-minded focus on high lending standards. At Matthews Asia, we attempt to find businesses that do reasonably well in bad times and flourish in good times by taking a long-term call on the economy.

For all its issues, the Indian economy has been a secular and resilient growth story. When left with no options, reforms do take place. And the country has been emerging more strongly with each step, as it did in the early 1990s. Recent action by the central bank and federal government has improved macro conditions by bringing down the current account deficit, leading to a stronger rupee and higher foreign

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exchange reserves over just a few months. The weak rupee in 2013 led to a surge in exports and some moderation in imports as a natural balancing factor. Indian politics might also appear fragile and is perceived to be indecisive, but the priorities of the electorate (governance and growth; rather than religion and caste affiliations) have been slowly shifting. Already, development and governance have been the central themes of the current elections, and for political parties to fulfill even a fraction of their promises, investment reforms are a must.

Some of these initiatives have already been underway, regardless of a BJP win. On the infrastructure front, for example, India is slowly inching toward constructing its first Dedicated Freight Corridor (DFC), which costs US\$13 billion in its current phase. The DFC would link high freight destinations with dedicated rail tracks, ensuring speed and efficiency. Logistics costs in India are approximately 14% of GDP, higher than in most developed economies for which the range is about 7% to 9%. Any improvements on that front could contain inflation and boost productive growth. The DFC project itself would arguably prop up the local cement and steel industries and create jobs. Once established, it would nurture manufacturing hubs, allowing India to better take advantage of its cheap and young workforce, the effects of which cannot easily be quantified at this point. Some other reforms may be more politically challenging and might require more than just favorable election results. One serious impediment to business

success, for example, has been a complex web of policies, particularly in taxation. The various political parties have all sought to simplify tax laws. A consensus around this issue would not only increase efficiency, but improve India's image as a better investment destination, helping it attract more long-term capital.

India is perhaps one of the few economies in the world that continues to have high interest rates. In fact, many of the country's economic challenges have been self-inflicted. If India can achieve clarity of thought and action, we just might witness the next economic upswing, with global investors viewing the country as a destination of possibility where capital can be well-utilized toward growth. Meanwhile, we believe there are already plenty of good companies that are thriving in the absence of broader improvement, and they may do even better if the tide turns more favorable.

We would reiterate that despite hard-to-predict events, solid businesses, such as those with strong brands, wide reach and good management teams have tended to do well over the long term—irrespective of politics. On the other hand, weak business models, including some infrastructure companies, have seen their stocks outperform for a short while, only to give back gains with overall negative returns over longer periods.

**Sunil Asnani**  
**Portfolio Manager**  
**Matthews Asia**



**Matthews Asia**

Four Embarcadero Center, Suite 550 | San Francisco, CA 94111

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### Questions about the Funds:

800.789.ASIA (2742)

### Client Services:

888.289.7988  
[clientservices@matthewsasia.com](mailto:clientservices@matthewsasia.com)

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