INDIA

Last year was a rocky time for emerging markets, but India's future looks bright, says Arvind Chari

Last year was undoubtedly a turbulent time for emerging markets because political instability, inflation and the fledgling recovery in the West all caused significant headwinds. Unsurprisingly, this has led some commentators to be sceptical about the prospects for these markets, including India. But the Indian economy is showing signs that it will weather the challenges of the next few years. This may not be an easy task given the way the Indian rupee plunged in response to the US Federal Reserve's decision to taper asset purchasing. Nevertheless, India does have the political will to make the necessary reforms to deliver on its potential.

While the Fed's decision has caused some fallout in emerging markets, commentators expect that this will tail off over time. Meanwhile, India's economy is driven by domestic demand, which means that it is better placed than most to deal with the world post-quantitative easing. Without the so-called 'taper tantrum', investors in India might have focused more on the positives in 2013. But given the overall improvements in the economy and the political outlook, we feel the India story will be harder to ignore in 2014.

One of the most significant changes in recent months has been the appointment of Dr Raghuram Rajan as governor of the Reserve Bank of India (RBI) in September 2013. He is clearly part of a dying breed of central banker: that is, one who actually knows how the world works. He will make mistakes, but the most important thing is that he will be trying to move India in the right direction, as shown by his decision to continue with a hike in interest rates at the end of January. Bond and currency markets have reacted very well to this move, which shows the bank is now ahead of the curve in fighting inflation. In October, Rajan remarked that India's debt market needed to attract stable investors over 'bond tourists', a reference to the short-term foreign flows that have been evident in India's bond markets. His stance is an indication that policies could be shifted to attract more long-term, stable money into India's government bond markets, away from a focus on the foreign-bank 'proprietary' investments that dominate flows currently.

India's current account deficit (CAD) was set to halve in the year ending March 2014. It was due to fall to 2.5% from 4.8% of GDP in 2013. The fall in gold imports, alongside currency depreciation, was a major contributing factor to this reduction. India's exports have become more competitively priced over the past few months, which has led to higher exports in textiles, chemicals and leather goods, while the drop in the value of the

Country file

Population size: 1.2 billion
Area: 3,287,263km^2
Type of government: Federal republic
Official language: Hindi
Capital city: New Delhi
Largest city: New Delhi
GDP (2012): $1.825 trillion
Central government debt as a proportion of GDP: 67%
Currency: Indian rupee
Conversion rate against the euro: 0.012

SOURCE: INDEX MUNDI

Beach view, Mumbai, India

PHOTO: SAPSIWAI/SHUTTERSTOCK

TOP TIPS FOR DOING BUSINESS IN INDIA

1. **Hire a local manager or partner who has a very good understanding of local rules and regulations.**
2. **Have a longer-term investment horizon because the Indian rupee will remain volatile for a while.**
3. **Don't view volatility as a risk; view the integrity of the government and management as a risk.**
4. **Be patient and have realistic expectations – things take time to work out in India.**
5. **Travel to India and feel the 'micro' India story rather than just read about the 'macro' India story.**

rupee has also led to a fall in non-oil/gold imports. We expect the CAD to increase to around 3% of GDP for this financial year as gold import restrictions are removed, a shift that should still be easily fundable. Additionally, the RBI's FX reserves have increased by $34bn through the bank and non-resident Indian deposit swaps, which was a much higher figure than anticipated. This gives the RBI the additional firepower to intervene in the markets if it is necessary to counteract currency volatility. In fact, the rupee has been remarkably stable since October and has steadily outperformed its other 'fragile' emerging-market peers.

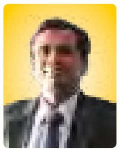
There has also been an improvement in how other countries perceive India. Net foreign direct investment is stable, despite some negative sentiment driven by the outflows from the bond markets and banks in July and August 2013. Vodafone, described by Rajan as 'the poster child for companies with difficulties in India', is investing more in spectrum and also buying out minority operators. In addition, significant Japanese investment into India's infrastructure is a further boost to the country. Japanese prime minister Shinzō Abe was the guest of honour at India's Republic Day and this relationship will be one to watch over the coming years.

Overall, the world has a much better impression of India than it did a few years ago, when the country was facing significant obstacles. In 2010, increasing inflation, expanding fiscal deficits and an escalating CAD – all coupled with slowing growth rates – put India in a very difficult position. But in 2012, the government realised that the current situation could not continue and, since then, there has been a much greater focus on reform.

A mixture of poor growth and bad policies dramatically hampered India's progress earlier this century, frustrating many investors. But the country is now beginning to drive a wedge between itself and the other, more troubled emerging-market economies. We feel that these differences will mean that India significantly outperforms those economies over the coming years. And while we might still be facing some turbulent times, for India, at least, the dark clouds are beginning to break.

Politically, the Bharatiya Janata Party appears to have gained good momentum in preparation for this month's general election. The possibility of a government with a growth and infrastructure development agenda – in conjunction with the new RBI governor's mandate of inflation and currency stability – seems a very exciting prospect for the next five years. But predicting India's election outcome with any certainty is fraught with risk because there is a high likelihood of a future coalition government. Since 1980, six of India's nine governments have been coalition governments and our research shows that GDP growth has averaged 6.3% per annum. As a result, if investor expectations are realistically set at 6% to 6.5% GDP growth for the long term, it will not largely matter which government is in power. In addition, the drive towards fiscal consolidation and inflation control will continue, irrespective of the government at the centre.

As with any emerging-market economy, the next few years will present challenges alongside opportunities, and investors will have to be comfortable with this state of affairs. But India is committed to making the reforms it needs to improve its future. The country has much better potential for growth than any developed country and it is also in a far better position than many of its emerging-market peers. Now is the time to take advantage of all that India has to offer to investors.



Arvind Chari is fund manager at ACPI Investment Managers. www.acpi.com