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INDIA'S STAR HAS RISEN AND WILL CONTINUE TO BURN BRIGHTLY

A couple of weeks ago, we took a look at China, the world's fastest growing major economy. This week we focus on India's economy, number two in the global growth race. More specifically, we will:

- Describe the recent progress India has made in significantly raising its growth profile and the reasons for that higher pace of growth
- Examine the higher-than-desired inflation that has arisen there and what the central bank is doing to bring it down
- Explain why the higher growth trajectory of late will likely be sustained, not transitory
- Look at the strong possibility of the already strong growth there getting even stronger in the not-too-distant future
- What all of this could mean to global financial asset prices over time

India has been growing strongly over the last three years, averaging about 8% per annum during that period. The stronger growth profile of late represents a significant pickup from the roughly 6% longer-term average. This stronger growth recently is starting to compare favorably to China's longer-term average of 9–10% per annum.



There are good reasons for this change in India's trajectory. Infrastructure spending by governments, public-private partnerships, and businesses there has picked up recently. India's roads, airports, seaports, and utility facilities are inadequate, and, in many cases, extremely old and in disrepair. This is especially true of electric power production, whose inadequacy and unreliability (including staged summer blackouts in major population centers like Mumbai) has barred India from attaining higher sustained growth rates. Basically, the infrastructure there is today where China's was 10–15 years ago. Fortunately, India's policy makers have finally started to address these infrastructure problems through increased government spending, public-private partnerships, the privatization of formerly government-run firms, and industrial deregulation.

Financial services deregulation is another positive force and has led to a housing and consumer credit boom there. Previously, banks were reluctant to grant mortgages for buying a home and offer consumer credit, largely due to interest rate regulations there. Also, Indian households, due to cultural reasons, shunned debt, wishing to be debt free. But with the deregulation of interest rates and households (especially younger households) now less debt-averse, India has witnessed a surge in housing demand and production (resulting in home prices in some areas rising sharply), as well as greater consumer spending due to increased use of consumer credit.

Still another reason for India's improved growth performance has been the staggering growth of its knowledge-based industries. India's IT industries continue to grow rapidly, constantly gobbling up global market share. Many IT firms there have seen their revenues increase by 40+% annually over the past several years. The rapid expansion of those firms has contributed significantly to business construction activity, employment, and exports. The biotech sector, another important knowledge-intensive industry in India, has made similar, albeit smaller, contributions.

Nonetheless, there has been some downside to India's stronger growth profile of late. Inflation has risen lately into the 6–6.5% range, significantly above the Reserve Bank of India's (RBI) maximum 5.5% target. However, much of the recent rise in inflation is due to higher global energy prices and to rising costs resulting from India's still inadequate

and unreliable infrastructure. As a result, the RBI has been raising interest rates to slow the economy some and the government has continued to foster infrastructure spending. Hopefully, this two-pronged approach will bring inflation back within bounds in the next year or two.

But, will India's higher growth trajectory of late be sustained into the future? There are good reasons to answer "yes" to that query. First, India's demographic profile will help sustain high growth. The population there is large, young, growing solidly, and still mostly rural. A large population means that there is a large supply of potential workers and consumers. The large, growing pool of young workers translates into sustained sizable increases in the labor force and in the economy's potential for producing goods and services. Typically, as countries with large rural populations develop, the migration of people into cities becomes a significant source of economic growth. We have seen this phenomenon in 19th century England, late 19th–early 20th century U.S., 20th century Japan, and currently in China.

A second reason for sustainable higher growth in India revolves around infrastructure and, more generally, business capital investments. Better infrastructure means lower costs, helping to make India more attractive for foreign direct investment and more price-competitive on world markets. Also, improved infrastructure should improve agricultural productivity, freeing up workers to migrate to manufacturing and service jobs in cities, thereby reinforcing urbanization as a growth driver. And lastly, infrastructure improvements should help to bring down inflation and interest rates, both of which are pro-growth.

Third, India's knowledge-based industries should continue to grow rapidly. India's universities are generally very good, many being world-class. This is especially true of the Indian Institutes of Technology and Indian graduate schools of business. Those schools are excellent and are very hard to get into. So, India's IT and other knowledge-based industries (including biotech) have a large pool of very well-trained and talented graduates to draw upon for employment and as a source of innovative ideas. In addition, Indian firms in those industries invest heavily in training their employees to maintain and improve their skills. So, it is likely that these knowledge-based industries will continue to grow vigorously to be an increasingly important growth engine for India's economy.

And the final reason for thinking that high growth will be sustained is that economic reform will likely continue apace, albeit at a slow rate inherent to India's large democracy. The cumulative effect of past reforms has now reached critical mass and is helping to boost the potential growth rate through the improved resource utilization that comes from the better price signals engendered by reform. Future reforms will improve that price signaling process further.

What does all this mean to global financial markets? First, at some point in the not-to-distant future India will run sizeable trade surpluses and see much more foreign direct investment (FDI) flow in. This probably means that India will see large gains in its foreign exchange reserves, much of which will be recycled back into the financial markets of developed markets, a scenario that is very similar to what we are now seeing in China. The recycling of those funds could result in upward pressure on financial asset prices, bonds as well as equities.

To summarize, India experienced a period of stronger economic growth recently. This improved growth profile arose from a number of sources, including larger contributions from infrastructure spending, business investment, housing, consumer spending, the output of knowledge-based industries, and economic reform. However, inflation has risen to higher-than-desired levels, prompting interest rate rises by the central bank. But, there are good reasons to believe that the current higher growth trend will be sustained into the future, reinforced by a favorable demographic profile and further reforms. Higher growth will partially result from improvements in foreign trade and significantly increased FDI. That would probably mean that foreign exchange reserves would increase, perhaps sharply, over time. The reinvestment (recycling) of those reserves into developed country markets might exert upward pressure on financial asset prices in those markets.

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