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INDIA'S STILL ON TRACK TO ECLIPSE CHINA AS WORLD GROWTH LEADER

Last month, we focused on China, the world's current economic growth leader. This week, we will take a close look at India, which, as the second fastest growing major economy, is quickly approaching China in the global growth race. Specifically, we will:

- Look at improvements India has made to its economy recently, improvements that have already raised growth there and have increased its potential for higher growth in coming years;
- Drill down into the higher inflation seen there in recent months and see whether the central bank is likely to do anything near term to contain it;
- Investigate why even higher growth can be expected and sustained in coming years, meaning growth there should eclipse China's within a decade; and
- Look at the implications of an ever stronger India in coming years to global financial asset prices.

Recently, India has enjoyed a stronger growth profile. Last year, real gross domestic product (GDP) grew 8.7%, significantly higher than the 8% average of the preceding three years and the long-term average of about 6%. As a result, India is fast approaching the stunning growth China has enjoyed in recent decades, growth that has averaged near 10% over that period. Nonetheless, India's growth last year still fell short of the hefty 11.4% rate turned in by China in 2007.



There are many good reasons for India's stronger growth performance of late.

First, sorely needed infrastructure spending has picked up markedly. There is good reason for this. The country's infrastructure development is probably 15 years behind China's. For decades, infrastructure, much of it installed during the British colonial period, was neglected. And now, with growth robust, the inadequacy of the roads, rails, airports, and utilities there has become very apparent and has stymied India in reaching even higher growth rates. This is especially true of electric power generation, transmission, and distribution. No modern, industrializing economy can flourish when electric power is in short supply. Today, blackouts and brownouts are still commonplace, cutting into the economy's productive capacity. So, India's number one infrastructure priority is to rapidly increase electric power supplies. Fortunately, based on recent evidence, India should see a large increase in electric power capacity in the not-too-distant future. However, despite a focus on electric power, the country is also moving quickly to improve its transportation infrastructure. New road systems are being built and older ones are being expanded and refurbished. Airports, still dreadful by international standards, have been privatized in major cities (Delhi and Mumbai) and expanded and modernized in many other places. Also, brand new airports are being built in fast growing places such as Hyderabad. Seaports and rails are being expanded and improved. All of these actions are helping to alleviate India's immense infrastructure deficiencies and raise the country's long-term growth profile. Moreover, the ramp up in infrastructure spending will itself add to economic growth in both the short and longer terms, a phenomenon that has helped China sustain robust growth for decades.

Deregulation has also added to India's growth potential. Less regulation has increased competition and enhanced the demand for goods and services. A prime example of this has been the telecom sector, especially in wireless. In the past, when telecom was a government monopoly, Indian households received poor telephone service and had to wait for years to get a fixed telephone line. However, after telecom deregulation allowed the entry of private firms (especially in wireless), telecom has been transformed into a vibrant industry with millions of new subscribers now being added annually. Increased competition has driven

prices down so that services are now more affordable and accessible. Moreover, service quality has improved rapidly and is in many major cities world-class. In addition, the vibrancy of the telecom industry there has facilitated new industries, such as call centers and IT servicing. Furthermore, financial services have been partially deregulated in recent years, resulting in a boom in consumer credit and mortgage financing which has lifted consumer spending and facilitated the current housing boom.

Another area that has added to India's growth has been the rapid growth of its knowledge-based industries. Capitalizing on a strong higher-education system and telecom deregulation, IT service industries have boomed. As a result, India's IT companies (mostly service companies) have grown rapidly, with many enjoying 30%–40% revenue growth rates for years on end. Biotech industries have also enjoyed strong growth, with some companies now pursuing the development of new drugs (again, capitalizing on the number of well-trained scientists), not just generics as in the past. Indeed, the IT and biotech industries have contributed significantly to India's exports lately, helping to raise the country's growth profile.

But, with growth strong recently, inflation has picked up some. Early last year, wholesale price inflation was running at a 6%–7% year-on-year rate, considerably higher than the 5.5% maximum with which the Reserve Bank of India (RBI) was comfortable. As a result, it raised interest rates to prevent inflation from getting out of control. However, as inflation receded during the year, the RBI started to cut rates. This year, we have again seen inflation pick up, but not to the levels of early 2007. As a result, the RBI has not tightened, arguing in part, that no rate hike is warranted since much of the recent run up in world food prices is beyond their control. Hopefully, this approach will not result in inflation getting out of control.

Will India's now higher growth trajectory be sustained in coming decades? Most likely the answer to that question is a resounding yes!

First, India's demographic profile can sustain high growth. India has a large and young population that is growing at a rate of about 1%–1.5% annually. Furthermore, this population is largely rural. A large, growing and young population means that there will be a large supply of

workers entering the labor force each year, helping to sustain rapid growth. In addition, a largely rural population means there is a high potential for urbanization being an important growth engine. This is especially true as agricultural infrastructure (for example, irrigation systems) is expanded and improved, and as biotech use increases (for example, better seeds), both raising agricultural productivity and capacity and thereby acting as catalysts for increased urbanization.

Second, improved infrastructure remains a positive for strong growth. Higher infrastructure spending will enhance aggregate demand and help to keep growth strong, as it has in China for decades. Furthermore, better infrastructure will enhance productivity and lower costs. Productivity in agriculture and in manufacturing industries (especially export-related) will be improved as India's roads, airports, railways, seaports, irrigation systems and utilities become better. Improvements in agricultural and industrial productivity will likely foster urbanization and foreign direct investment, both of which should augment India's growth. And finally, better productivity should help keep inflation under control and interest rates low, which are pro-growth.

Third, India's knowledge-based industries should continue to grow strongly. India's IT and biotech industries will continue to employ well-trained graduates from India's universities, many of which are world class (especially in those fields). Indeed, the continued rapid growth of these knowledge industries will add to India's growth profile for years to come, by directly increasing exports and, indirectly, by making India's industries outside of those sectors more productive and competitive in world markets.

Fourth, and finally, ongoing reforms will continue to improve India's prospects for sustained high growth. Deregulation generally fosters greater competition, higher productivity, and lower costs, all of which will improve demand, both domestically and internationally, and potential output. These reforms will likely continue since almost everyone in government now sees the immense benefits that have already flowed from the reforms already put in place. Nonetheless, the pace of reform is likely to be gradual given the complexities inherent in India's large democracy (unlike China where reform can take place by command, rather than democratic consent).

Will India eclipse China soon in the global growth race? Probably. India already is closing in on China's growth rate and is only in the early innings of acceleration. China, on the other hand, has been accelerating for a long time, has built out a lot of infrastructure (India is just beginning), and faces adverse demographics (a rapidly aging, slowly growing population) compared to India's in the not-too-distant future. In sum, it's almost a "slam dunk" that India will surpass China as the world's growth leader within a decade.

What does all this mean to global financial assets over the longer term? First, India should be running sizable trade surpluses in the not-too-distant future. This, plus increased inflows of foreign direct investment, means that India should be seeing its foreign exchange reserves increase markedly. As we see with China today, those reserves will likely be recycled back into a developed country's financial markets, helping to keep upward pressure on financial asset prices in those markets.

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