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India and China: Policy choices

Summary

On Saturday 28 February the Modi administration presented its first full budget after its election win, while the PBOC surprised the markets with another cut in interest rates. These policy events are, of course, unrelated but allow for some quick and investment relevant, conclusions to be drawn as to the trajectory of the economies and of the financial markets of these two major Asian economies. India's budget held no surprises and included the usual platitudes which will need very quick implementation to have any medium term impact, while China did surprise with its urgency of more monetary ease.

Investment Conclusions

The Indian equity markets had a muted reaction to the budget and the future performance of the Mumbai stock market will depend on the outlook for another rate cut rather than just on the budget measures.

China's cut in rates just before the National People's Congress combined a theatrical timing with further easing to ensure that the economy bottoms out by early 2H.15, as we expect it to do.

Indian equities have enough impetus, and limited, by now, feel- good factors to stay attractive, while Chinese equities ,after the cut, are becoming more so

Film catchphrases , Greece and India

For those of you who remember the film "Jerry Maguire" you may remember the film's catchphrase "Show me the money!" In both the cases of India and China we can now use the "Greek" variation of the catchphrase; "Show me the money AND give it to me!" In other words, action talks louder than intentions, even when the intentions are clearly set out and appear to be believed in and believable. The EU wants to see Greece's "money" on the table and delivered on time. In the case of **India** the budget had basically nothing new to say bar more promises and, in fact, backtracked on some important issues. Poverty alleviation figured prominently with the rural employment scheme given more funds and main subsidies for various goods untouched except for a fall in their percentage as part of the budget. The administration sticks to the notion that the poor are poor because, in the memorable words of Woody Allen, "they don't have money".Poor are poor because they have no opportunities to earn and because their productivity is low. Providing them with free food keeps them alive but does nothing to treat the root cause of their poverty. This lesson has not been learned in India, even by looking sideways to China which has dealt with its rural poverty with the imperfect measure of urban development and with the jobs opportunities which come with it.

Infrastrcture investment will increase from 14% to 16% of the budget. But then it is widely known that the problem here is not absence of funding, as there are scores of projects already approved and funded but stuck in bureaucratic non-implementation. The law on the use of land, essential for industrialisation, is unlikely to be revised. This budget was not so much another lost opportunity, but just another very slow step forward

Chart 1: India 2007-2015 (*)

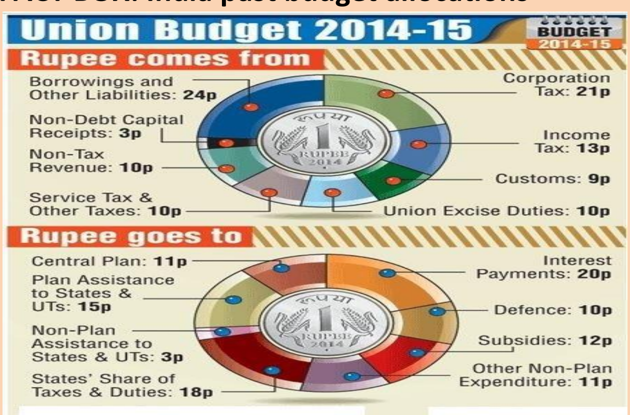
Source: Bloomberg ,(*) WPI (red),Ind .Output (green),PMI (blue),Exports (yellow)

Back to numbers: India and China

India's rebased GDP and CPI indices do not allow for long term divinations.(we use here the WPI).The exceptional 7.4% GDP growth in 2014 is forecast to rise in 2015 to 8.1-8.4%. As Chart 1 shows, industrial output and exports do not show acceleration, but sentiment in terms of PMI is improving and inflation falling..The fiscal deficit is expected to drop to 3.9% of GDP from a current 4.1%. All this may help the RBI to cut rates again.But as the Fact Box shows,an unacceptably high 20% of the budgetary funds goes to interest payments!

Some of **China's** macro trends are pointing south.Fixed Asset Investment (not shown) has fallen and the official PMI is just less than the 50.0 "break-even" point.Inflation however is falling, as is the broad money growth reflecting past tighter monetary policies (Chart 2). The

FACT BOX: India past budget allocations



Source KBK

PBOC now accelerated its expansionist efforts starting with a cut in reserve requirements in February and by two cuts in interest rates, the most recent involving a 25bps cut in one year deposit rate from 2.75% to 2.50% and a cut in one year lending rate from 5.60% to 5.35%.More importantly, however, banks have been allowed to vary the deposit rates they pay from 1.2 times to 1.3 times the official level. As the PBOC has been controlling deposit rates, this widening of the ceiling is an encouraging step towards further deregulation of interest rates. It may also contribute to futher shrinking the so-called "shadow banking" sector, by allowing the banks to pay more competitive rates on their deposits.

Chart 2:China,CPI(red),PMI (green),M2(blue)

Source : Bloomberg

Summing up

India's budget held no surprises but contained instead the familiar raft of intentions such as more spending on infrastructure, more on poverty alleviation and decreasing the fiscal deficit as percent of GDP. As usual, whether the budget will benefit equities is a matter of expectations, as its implementation will involve a number of years and not of months.What could have stirred markets more would have been bold initiatives to liberalise the land market, cut subsidies and use the money instead to encourage rural industrialisation, policies much more effective at reducing poverty.

China's further monetary relaxation fits well in its efforts to ensure a smooth bottoming out of the economy.It also shows how far the decoupling of Asian interest rates, and Chinese rates in particular, has moved from USD rates, given also the quasi-peg of the CNY to the USD, aided, however, by capital controls.The relaxation of the credit policy is equity supportive but the boost to Chinese equities will come from further signs of the reacceleration of GDP growth and its impact on earnings.The SHCOPM has been a poor performer so far this year, despite its much stronger performance in the last quarter of 2014.

Andrew Freris (writing completed on 2/2/2015)