



Assessing India and China

Investors often compare India and China, debating the two in their assessments, though China has historically enjoyed better luck with foreign investments. However, as portfolio managers, we find the contrasts between the two to be advantageous. Unlike policymakers who must deal with the cards they have been dealt, we can enjoy the benefits of investing in each country. In assessing the two, we find that China promises higher but arguably more volatile growth, while its Indian counterpart seems to be on a relatively more moderate and sustainable growth path. Ideally, each camp should gather a sufficient following. But the reality is that the typical U.S. investor looking at Asia is probably growth starved, which tilts the argument in favor of China. Because the case for investing in China is probably better known, I sought to emphasize the case for India.

The stability of the Indian economy has often been underappreciated, though the recent global slowdown was an eye opener. Both China and India bottomed out at about 6% GDP growth during the second quarter of 2009. However, while China plunged to less than half of its peak of 13% from two years ago, India fell by only about a third of its peak of roughly 9% over the same period. India's ability to not only achieve respectable economic growth in a turbulent environment but to do so without injecting mammoth stimulus demonstrates its inherent resilience. The Indian government did take fiscal measures during the peak of the crisis, but the stimulus measures amounted to about US\$80 billion, or just 7% of its GDP, and were limited mostly to tax cuts. China, on the other hand, was much more aggressive, infusing its economy with about US\$600 billion of investment-led stimulus, almost 15% of its total national income.

One factor that helped India during the crisis was its high dependence on domestically oriented demand, notwithstanding its reputation as a major exporter of outsourced services. In fact, India is a net importer, whereas, China enjoys a trade surplus, which has been as high as one-tenth of its GDP. Exports contribute to national income in good times, though

excessive reliance on external trade also brings uncertainty during global slowdowns. Another savior for India's economy was its reliance on consumption, which contributes as much as two-thirds of its national income, compared to less than half in China's case. Consumption-driven economies tend to be resilient, even though they may grow moderately.

Savings and Investments

I believe that by drawing on lessons from China, India can also achieve similar growth rates for years to come, provided it is able to sustain its recent uptick in savings and investments. China's journey of growth has been accompanied by a high savings rate, which exceeded 35% of GDP for almost two decades. This has helped the country achieve an average investment rate of about 40% of GDP during this period, amid a low cost of capital. The situation was further helped by external trade surpluses and high rates of foreign direct investment, which were in the range 3% to 5% of GDP in the last decade. India, on the other hand, had much lower savings and investment rates, in the low 20% range during the 1980s, and rising to about 30% only in the last decade. Not surprisingly, the cost of capital has been high and is still in the double digits, setting a high hurdle for many businesses to clear in order to flourish. The good news for India is that in the last few years, the country's savings and investments have achieved a rate of more than 35%, putting the country on a growth track similar to that of China. India's foreign direct investments, which had averaged less than 1% of GDP for the last decade, crept up to 2% even in the middle of the global crisis, suggesting increased investor confidence in its growth potential. Given that India's capital efficiency is on par with or even better than that of China, it would not be surprising for India to replicate China's growth under a similar savings and investment environment.

Feeding India

The area that has probably been most "starved" of investment is India's agriculture sector. In my view, excessive regulation and lack of infrastructure have held back this sector's growth, and left it to the mercy of India's unpredictable monsoons. Indian agriculture contributes about one-fifth of the country's total income, even though it employs more than two-thirds of the population. The low productivity is also reflected in India's farm output, which for food grains is about one-third of China's and one-fifth that of the U.S. It is not difficult to see why this is the case. India's investment in agriculture has averaged about 3% of the income generated from the sector,



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compared to about 6% in China’s case. Consequently, over the past three decades, India’s agricultural output has increased by an average of less than 3%, compared to more than 6% for China. Given India’s political inertia, liberalizing agriculture, executing land reforms and shifting subsidies from consumption toward investments might not be easy, but the value that could be unlocked from the sector could be enormous. A healthy doubling of farm productivity in the sector over the next decade is achievable, and in my view, could add another percent or more of growth on a continuous basis. As an off-shoot, higher agricultural productivity would enable greater food security and domestic price stability, paving the way for a long-term lower interest rate regime that would benefit the entire country.

Containing India’s Fiscal Deficit

Another major hurdle toward lower funding costs has been the government’s inability to self-finance its expenses, which stems mostly from consumption subsidies and wage hikes. Years of deficit have caused the government to borrow heavily, resulting in a public debt as high as two-thirds of GDP. In fact, about a quarter of the deposits collected by banks in India are used to fund government borrowings. The argument that the private sector’s inability to invest in social infrastructure justifies the government’s inefficient usage of capital doesn’t hold water when you consider that the government has borrowed primarily to fund consumption expenditure over the years. China, on the other hand, has been almost debt-free, and deficits, if any, have resulted from increased investments in fixed assets. At the same time, China has been able to contain deficits via good tax collection. India’s government expenditure as a proportion of its GDP is actually lower than China’s,

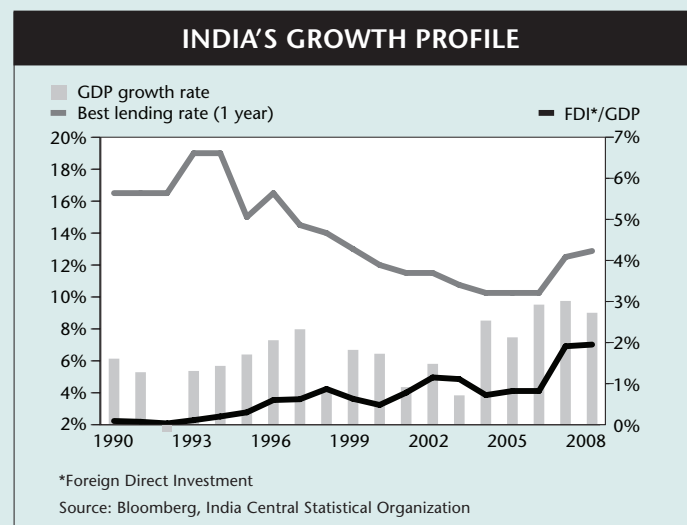
but its poor tax collection has led to huge deficits. The current government has initiated tax reforms, which over time could bridge the fiscal deficit. Meanwhile, the least India could do is to use deficit financing, if only to fund investments rather than give them away as subsidies.

Accessing Growth

While both countries are on a growth path, investors may wonder which offers better investment opportunities to access the growth in its economy. Both countries have liberalized their economies for quite some time, and the entrepreneurial private sector likely seems big enough (and could actually be the best way) to ride these waves of growth. The private sector contributes more than three-quarters of India’s GDP, and about two-thirds of China’s GDP. But a look at the MSCI indices of the two countries would suggest that privately owned companies constitute about 75% of market capitalization in India, compared to only about 18% in China. I would surmise that the majority of private sector companies in China are either not listed or not available for investment to foreigners. Not surprisingly, the listed companies (that constituted respective MSCI country indices) in both the countries grew their earnings by almost the same rate over the last decade, even though China outpaced India in economic growth.

It would be fair to say that despite their relative strengths and vulnerabilities, both India and China can learn a lot from each other. Each country offers a spectrum of unique investment opportunities for long-term investors.

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This month Asia Insight focuses on Assessing India and China, and features a conversation with the following Matthews Asia Funds Investment Team members:

- **Robert Horrocks, PhD**, Chief Investment Officer
- **Sharat Shroff, CFA**, Matthews Asia Pacific, Matthews Pacific Tiger and Matthews India Funds
- **Lydia So**, Portfolio Manager, Matthews Asia Small Companies and Matthews Asian Technology Funds
- **Winnie Phua**, Research Analyst, Matthews Asia Pacific and Matthews China Funds

Assessing India and China Roundtable

Q: What do you see as the most compelling factors for investing in India, and how does this compare to China?

Sharat Shroff: I would say one of the more underappreciated facts about the Indian economy, is that it has been driven by the private sector. In our research, we found that, surprisingly, the government accounts for less than 20% of India's GDP. This means that the private sector is the sharpest driver of growth in the Indian economy.

We have high quality companies in which to invest, and hence participate in this growth. That may not always be the case in other markets, especially at this stage of development. I think that's something that's not well appreciated by the market. If you look at the market capitalization composition in India, a large bulk of it is driven by entrepreneurial private sector companies.

Q: Are there any surprising distinctions you have found in your assessment of the two countries?

Lydia So: Consumption power in China is higher and the critical mass is also bigger than that of India. So you can probably find a broader consumption plate in China. On the other hand, India's history of entrepreneurship is much deeper and longer. You can easily find proven Indian brands with a 60-year history. So even though you have the "critical mass," of a larger middle class in China, you also have brands that are less proven and have only been around maybe five or six years.

Robert Horrocks: When it comes to India and China, they are mirror images of each other in so many ways. You have a sophisticated market structure in India, and a less sophisticated one in China; better physical infrastructure in China, and less of that in India; and stable politics in China versus a fragmented political structure in India, where they are living with terrorism. From a portfolio manager's point of view, this means we can use both China and India in a portfolio and try to get the optimal mix. It's not an either/or decision and the differences between the two makes holding both more attractive.

Sharat Shroff: It's hard to paint India in a single brush stroke. Once you state something, you're bound to find contradiction to that statement. For example, people say that India's manufacturing sector is not developed, and you should look instead to China. But telecommunications firm Nokia's largest plant globally is in India, which I think people would be surprised to know. India is also strong in pharmaceutical manufacturing.

Even though India's capital markets have the longest history in Asia—even two years earlier than Tokyo—trading volumes and liquidity in these markets leave a lot to be desired, which is why India has one of the most volatile markets in the region.

Q: There is a lot of recent discussion about real estate in China? How does this compare to India?

Winnie Phua: If you look at the urbanization rate in both countries, I think India is at about half that of China's speed right now. Urbanization is a key factor in economic network growth and income growth, which in turn encourages infrastructure build out. With a faster pace of urbanization, and hence the more rapid infrastructure progression you see in China, one sector that has developed more quickly there is real estate. China has rolled out its land reform since the mid-1990s, allowing land sales and individuals the right to own properties. In comparison, this development is slower in India where there is less clarity in land titles. Further, the real estate industry is a very capital intensive industry so with easier access to capital markets, China has a broader selection of real estate developers.

Q: In what areas do you see China and India drawing lessons from each other?

Sharat Shroff: Nearly two decades ago, China embarked on the special economic zone concept, giving tax-related incentives for business to set up operations within land earmarked for business development. That's been an inspiration for the Indian government and they've been trying to kick-start that process. On the flip side, if you look at China, they've really gone after developing information technology (IT) service businesses within their country. To that extent they've encouraged Indian companies to set up operations in China and hire from their universities, and they've given tax benefits. There's a real desire for them to boost their presence in the services segment.

Lydia So: From my experience in speaking with management teams in China and India, I get the general sense that Indian entrepreneurs tend to be more cautious about employment and returns of capital given that capital is more scarce. They seem very oriented toward profit and returns. In the case of China, where capital is more abundant, some Chinese entrepreneurs tend to go for market share growth and might place profitability as a secondary consideration. Growth and profitability are both important factors contributing to the success of a company, I suppose both China and India can draw some lessons from each other as to how to balance those two things in the longer run.



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