# Aviator Update – January 2020
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## India

It's a new year which for Aviator means more of the same – searching for opportunities to make money. Over the past month, the search has taken me to India. Not literally, I'm afraid – personal circumstances currently render a fact-finding mission to India difficult. But in this information age that doesn't really matter.

I must admit it's been some time since I looked at India. It's one of those places that's often cited as full of great opportunities. It is, but for whom, when and how to take advantage of them are the challenges.

There's so much to talk about that this can only serve as a broad overview of India… Something we can refer back to and build on at a later date.

**Vital Stats:**

| | India | Australia | Difference |
|---|---|---|---|
| Land Mass | 3.287km² | 7.692 km² | Australia More than double |
| Population | 1,320,000,000 | 25,000,000 | India 50 times bigger |
| GDP | US$2,670 (bn) | US$1,432 (bn) | India almost double |
| GDP per capita | US$2,020 | US$54,000 | Australia 25 times higher |
| Official Interest Rates | 5.15% | 0.75% | Australia much cheaper |

Let's start with a brief, crude, history lesson...

For centuries, India has been a fairly advanced and prosperous collection of states headed by various regional rulers and rich in natural resources. In the late 1500's European colonial powers began their quest for new sources of wealth and prosperity. Italian explorer Christopher Columbus, supported by the nascent Spanish Empire, set off to find a westerly path to the Far East, but in 1492 ended up discovering the Americas instead.

Soon after, various European nations found their way south around the Cape of Good Hope and up to India – the first to arrive being the Portuguese in 1498. The Dutch and British weren't too far behind although as a trading outpost the Portuguese had the place largely to themselves for the good part of a century.

The Dutch and British took an interest in the latter part of the 16th century. The British East India Company was formed in 1600 and the Dutch East India Company formed in 1602. These entities were joint stock companies with numerous “shareholders” pooling their money to raise the capital needed to finance voyages to the Far East.

Digressing for a moment, the Dutch East India company holds a special place in business and finance history. Although not the first joint shareholder company, the Dutch East India company is considered the first “modern”, global corporation. Its creation coincided with the creation of the Amsterdam Stock Exchange for the exchanging of its shares and it became the first formally listed public company.

Trade was the key focus of the British East India Company throughout the 17th century. Fortunes were made bringing boatloads of basic wares like cotton, silk, spices, tea and opium back to Europe. With ample supplies, and plenty of money to be made relationships were relatively amicable amongst all the trading nations and the Indians themselves.

The British East India Company’s focus turned to empire-building during the 1900’s. They had become an incredibly large, profitable business – accounting for half of the world’s total trade. With this, they were an important business partner to Indian merchants and held strong political influence. Through the support of locals, some military force and a crumbling of historical rulers, the British East India Company came to rule India on behalf of Britain. Its wealth enabled it to amass a private army of around 260,000 – twice the size of the British army.

After the Indian Rebellion of 1857 was quashed, rule of India was formally transferred to the British Crown, ushering in the British Raj era.

Life wasn’t great in India during the British Raj. Multiple famines, bubonic plague outbreaks, cholera pandemics etc. There was heavy investment such as railways, irrigation and manufacturing capacity, however economic activity wasn’t spectacular. Further, it was perceived that the British largely ruled India for their own benefit with limited regard to locals – an example being food exports that continued unabated even when famine was killing millions.

Plenty happened during the 1900’s – not least of it being two world wars. Understandably, there was a constant opposition movement simmering away, pushing for Indian self-government. The strains of WWII were the last straw – India no longer had much economic significance to the British and with growing political unrest, the British announced in early 1947 that British rule would be ended.

On 15 August 1947, sovereignty was granted to India and former British India partitioned along religious lines - fragmenting into India and Pakistan, then further into Bangladesh and Burma (Myanmar). Whilst most of the nation had a peaceful transition to self-rule, violence

ensued along the newly-created border area with some estimates putting the death count as high as 1.5 million.

The British left behind their democratic values which India adopted in its constitution putting in place a secular and democratic republic. To its credit, India has managed to maintain its democratic freedoms – a rare feat among newer nations and emerging economies. By population, it is the largest democracy in the world.

**Economic History:**

We can begin our review of economic history from the time of independence.

Referring back to the key statistics earlier, India remains a poor, developing nation. Per capita GDP is around US$2,000 – a tiny fraction of developed nations. Average incomes are similar. At the time of its independence, India was even poorer.

The first democratic leaders of India felt that India's development required careful strategic planning. Believing that a market economy would not be good for strategic planning and development, a decidedly "socialist" India emerged with the state having a dominant role in the economy. A growth program encapsulating five-year plans was undertaken. Modelled on the USSR, the strategy was that of centralised economic and social growth. The first 5-year plan, launched in 1951, focused on boosting farm output by investment in irrigation and agriculture in order to combat a reliance on imported foodstuffs. The plan succeeded with economic activity surpassing expectations.

The second 5-year plan focused on industrialisation. There was significant investment in heavy industry and capital goods capacity, although the plan's reliance on deficit financing later proved to be problematic. The plan remained highly socialist with the state seen as the only one capable of operating any industry categorised as having basic or strategic importance. The private sector was left mostly with consumer and services business under the watchful eye of the government via strict licensing requirements.

The second 5-year plan exposed some of the issues with central planning. Whilst the first 5-year plan was successful in its goals within the agricultural sector, the sector was all but abandoned in the second plan as resources were re-allocated to the industrial sector. Food shortages ensued, inflation spiked and a trade deficit resulted from importing foodstuffs, which depleted valuable foreign exchange reserves.

A new prime minister emerged in 1964. Convinced that India needed to move away from its central planning model, he renewed the focus on agriculture and also allowed private enterprise to assume a larger role in the economy.

Progress was slow and the ‘60’s was a tough time for India. Food shortages were a constant feature and the constant need for imports, a reliance on foreign aid and the strains of two local wars challenged the still young nation.

In 1969, the government made an interesting move which we will see is still having an influence today. They nationalised 14 private banks – not because they were financially strained but to allow the government control over credit creation and accelerate lending to the agricultural sector.

The move had the desired effect. But it had another predictable outcome. Lending decisions became more politically-motivated and lending standards went out the window. Poor lending practices now haunt the banking sector with the Indian banking sector drowning in a sea of bad debts. Indeed, this is one of India’s biggest economic challenges which we will get to in more detail shortly.

The economic challenges of the late ‘60’s prompted leaders to take other dubious actions. Still immersed in a decidedly socialist mindset, foreign investment and exports were not a priority. But a persistent trade deficit was wreaking havoc. The government devalued the rupee by 57% against the USD. Intended to boost exports, for a country reliant on imports it had the obvious impact of accelerating inflation. It impacted other nearby nations – at the time the UAE, Qatar and Oman all used the Indian-issued Gulf rupee. The devaluation saw them abandon the currency.

The ‘70’s saw a continuation of the anti-foreign investment stance. The government enforced a law that a local business could not be more than 40% foreign owned. IBM and Coca Cola abruptly shut down their Indian operations.

India hobbled along through the ‘70’s and ‘80’s still reliant on foreign aid. Economic reforms were introduced through the ‘80’s in order to secure loans from the International Monetary Fund and in an attempt to boost competitiveness. Fortunes were made but prosperity was not widespread. Government decisions were heavily influenced by those successful industrialists keen to protect their interests and very wary about foreign investment fuelling competition. This remains a feature of doing business in India.

The ‘90’s began with India’s worst ever economic crisis. Essentially a balance of payments crisis, it resulted from an evaporation of foreign exchange reserves. This can be largely attributed to the Gulf War which had the effect of greatly reducing the remittances coming into India from expats working in the Gulf region. Currency devaluations were pursued in order to try and spur exports and the crisis was a wake-up-call to finally break from the socialist model and move towards a market economy.

Through the ‘90’s and into the 2000’s the government’s role in the economy reduced. Bureaucracy was reduced, although not nearly enough, and many state-owned companies were sold off.

An interesting thing actually happened after the crisis of the early '90's. The crisis resulted in various bold reforms by the government aimed at ease of doing business. The growth generally experienced in a low-income country tends to be centred on the manufacturing with a spill-over effect into the services sector. The most noticeable (although certainly not unique) example of this phenomenon in recent times has been China.

India instead experienced significant growth in the services sector with its epicentre being the burgeoning information technology sector in which the country excelled. The absorption of technology fuelling economic growth is a feature most typically associated with middle-income nations in their leap forward towards a high-income nation. India has basically done things in reverse.

Plaguing India through these changes and into today is massive income inequality. Following the market-friendly reforms of the '90's, data shows that consumption by the top 20% of the population increased dramatically… yet consumption by the bottom 80% in fact declined.

**India Today**

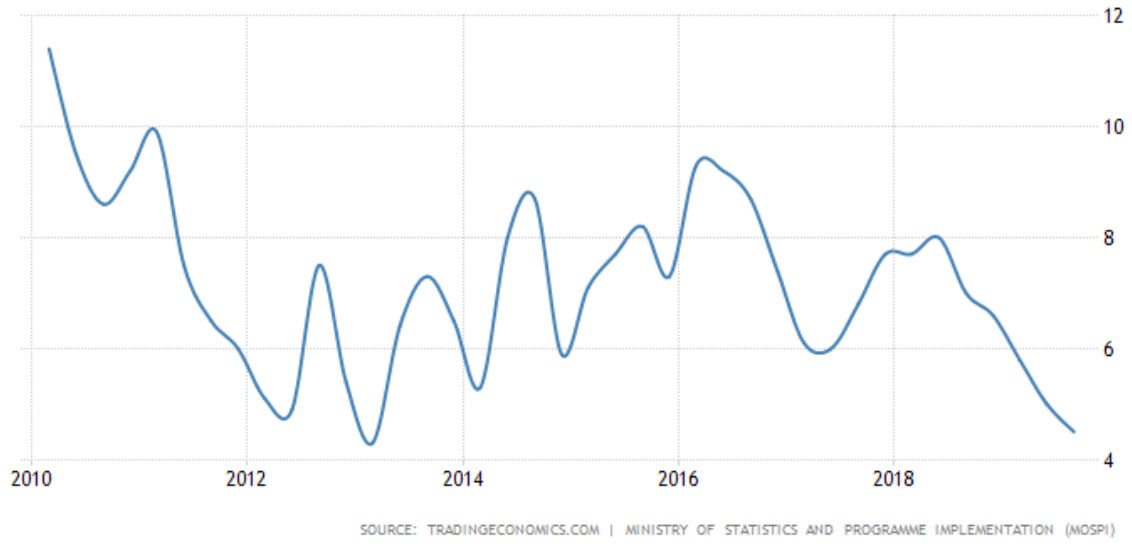
Modern India is a land of contrasts. Probably its biggest achievement since independence has been sustaining a democratic system of government separate from the legal system and not plunging into autocracy – a fate endured by most new and developing nations. They cling to a vision of an inclusive nation where the economy benefits everyone rather than only its elite rulers.

Economically and socially, there's a lot left to achieve.

Around 70% of the population are rural. Literacy rates are one area highlighting India's contrasts. Indians have a strong global presence in all sorts of professional areas such as science, medicine and engineering. Yet adult literacy rates across the country are somewhere around 75% with female literacy rates particularly abominable in some areas.

Whilst poverty has been steadily declining, it's still a major issue with more than half the nation living on just a few dollars per day. In contrast, its home to some of the wealthiest people in the world with the 4th largest number of billionaires.

The economy is not working for everyone. But it has been "working" – here's GDP growth over the past decade:




Been quite a volatile ride in recent years but growth has been solid. The recent trajectory is… well… terrible.

Simplistically, the origins of current trajectory can be traced back to the global financial crisis and from there further back to that 1969 decision by the government to nationalise banks for the purpose of aiding credit flow.

A significant portion of the banking sector remains government-owned/controlled. Although often listed on the stock exchanges, the government retains a controlling interest in many major banks.

During 50 years of government stewardship, these banks have amassed massive portfolios of loans funding projects that whilst appearing positive from a nation-building perspective, didn't make a lot of economic sense.

A weakening in global trade during and after the global financial crisis saw a weakening in exports. This strain on the economy prompted the government – via banks – to lend liberally to companies such as infrastructure development firms.

A lot of the loans have proven in hindsight to be unwise. Projects have been failing. Bad debts became – and remain – a major problem.

A focus on bad debts means a lack of focus on new lending. The banking sector's ability to extend credit has been strained for many years as it tries to work its way through its mess.

As a consequence, non-bank financing rose to fill the void and become a massive industry. This credit boom saw significant money flow into real estate. Prices rose and supply of new projects rose with it, resulting in what some are willing to describe as a "bubble".

Non-bank credit has now also dried up. The catalyst was the September 2017 collapse of "Infrastructure Leasing and Financial Services" – one of the country's largest infrastructure and development financiers. Described by many as India's "Lehman Moment", it resulted in credit markets seizing up as "counterparty risk" became real.

As credit has dried up, projects get abandoned. Workers get laid off and don't spend. Consumer spending reduces.

This brings us to where we are now. Growth has slowed dramatically. A lack of credit supply results in more projects abandoned… more potential layoffs… more strain on consumer-oriented and credit sensitive areas such as autos and property…

The Indian central bank is doing what central banks do – they cut interest rates 5 times in 2019, bring rates down to 5.15% from 6.5%. Yet unsurprisingly this is yet to have any impact on lending activity.

**India Into the Future**

Where to from here? According to many economic observers, what's critical for India right now is to get credit flowing again.

Sigh… Yes, credit is very important to the health of an economy. But come on… Is more debt really the solution to kick starting an economy stalled under a mountain of bad debt?

I want to take a bigger-picture, longer term view here…

Whilst much has been done by the government to make doing business in India easier and cheaper, much more still needs to be done. The World Bank gathers significant amounts of data on business conditions for its "Doing Business" survey. Of the 190 countries it researches, India consistently falls into the lower half. Here's where it sits among other Asian nations on various metrics:

| Country | No. of days to start business | No. of days to enforce a contract | No. of years to resolve insolvency | Border compliance for exports (hours) | Border compliance for imports (hours) |
|---|---|---|---|---|---|
| India | 30 | 1,445 | 4.3 | 106.1 | 264.5 |
| China | 23 | 496 | 1.7 | 25.9 | 92.3 |
| Vietnam | 22 | 400 | 5 | 55 | 56 |
| Bangladesh | 20 | 1,442 | 4 | 99.7 | 183 |
| Malaysia | 18 | 425 | 1 | 45 | 69 |
| Pakistan | 18 | 1,071 | 2.6 | 75 | 129.3 |
| Thailand | 5 | 420 | 1.5 | 51 | 50 |
| South Korea | 4 | 290 | 1.5 | 13 | 6 |
| Singapore | 3 | 164 | 0.8 | 10 | 33 |

If you were an international business, why would you want to enter a market like this? I mean, you do because you have over 1.3 billion potential customers. But India has a terrible reputation as being hard to do business in.

Its evolution over the last 70 years has seen rules stacked upon rules. They're mostly well-intentioned but it has resulted in extreme bureaucracy.

Corruption has long been an endemic feature of the Indian economy. When researching this piece, I was saddened to learn that it seems little headway has been made to arrest it.

In many instances, corruption is a by-product of India's bureaucracy – if for example you are trying to get a business or project commenced, sometimes the most efficient way is to pay an additional "fee" to a government official capable of expediting things.

These are the things India needs to fix. Not just add more debt. Make doing business easier and there is a huge opportunity to capture a larger share of the global low-value tradeable goods market from nations like China where their success has begun to price them out.

So what investment opportunities does India offer? Lots. But at this juncture its tough. A struggling economy and still "relatively" high interest rates – the potential for currency devaluation is real. A struggling economy and a stock market not far from all-time highs – not a great combination.

This is getting quite long and whilst there's still so much worthy of discussion, I think this is where we should leave our overview of India.

Just one final point. Many see "development" as the inevitable future for virtually all nations. But sadly, it's not guaranteed. An economy the size of India's - made up of so many people – is very complex. I wish them all the best on the road to higher incomes and improved living standards. But commitment and leadership aren't enough. A lot of luck will also be required. There will be hiccups along the way and lots of opportunity as well.