Letter 33

India, a fettered but courted power.

"The world flatters the elephant and tramples on the ant" Indian proverb.

According to ***Maddison***, India accounted for 22.6% of world GDP in 1700, but only 3.8% in 1952. Today, India presents a contrasting picture, hampered in its development that of a poor country, and courted by the major Western powers that of a key player.

A poor country, there is no doubt about it as India posted an annual GDP/capita of $2,000 in 2020, according to the IMF. It is the 148th highest in the world, compared to $10,000 for China in 72nd place and $62,600 for the United States. In terms of annual GDP/per capita based on purchasing power parity, India ranks 126th in the world with $5,000, China 82nd with $16,000 and the United States with $59,000.

A key player, from a political point of view, because India ranks as the 7th largest in the world in terms of GDP, behind Great Britain and France. A key player, demographically, as according to the UN, its population of 1.44 billion will surpass China's by 2025, and already for several years, the 20-24s have outnumbered their Chinese counterparts – 116 million compared to 98 million in 2013.

From a political point of view, the BJP, a party led by Mr Modi, was in power from 1998 to 2004 and has been in power again since 2014. Modi, helped by the divisions in the opposition and the weaknesses of the Congress party, was easily re-elected in 2019 and is pursuing a populist and nationalist policy, fighting against the elites and the Muslims.

From an economic perspective, since the early 1990s, India's weight in global GDP measured in terms of purchasing power parity has increased from just over 3% to 7%, from a GDP of $300 billion in 1990 to $2,600 billion in 2020. Mr Modi would like to enhance the country's attractiveness but at the same time, he cannot govern India, a federal state, in the same way he ruled Gujarat, a small federal entity of 60 million people, between 2001 and 2014. He faces difficulties in reforming taxes, facilitating land consolidation, easing the labor market, reducing unproductive subsidies, restructuring state-owned enterprises, privatizing them and overcoming pollution problems. As ***Subrahmanyam*** noted in ***Is 'Indian Civilization' a Myth?:*** "Bangalore, an idyllic city, has become an ecological garbage can."

While average annual growth has been close to 7% over the past two decades, this flattering rate is nevertheless lower than that of China. It has even declined in recent years and is probably inflated; it is obviously closer between 3.5% to 5.5% before Covid.

From a health point of view, the mismanagement of the Covid is penalizing the country seriously and prompts us to take stock of the country's strengths and weaknesses. Let us recall the statement made in March 2020 by the Indian novelist ***Arundhati Roy, "And what of my country, my rich and poor country, India, suspended somewhere between feudalism and religious fundamentalism, caste and capitalism, ruled by far-right Hindu nationalists?"*** Modi, like many populist leaders, has managed the crisis through denial, multiplying political rallies, posing himself as a guru, stamping his portrait on vaccination certificates, and still claiming again in early March 2021 that the country had emerged from the crisis. He refused a new containment, but since then, the number of cases has increased tenfold in five weeks.

Before examining the country's economic situation, we will analyze the Indian demographics and present the country's handicaps.

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I. Population growth as an asset and a source of challenges:

In 1845, before Queen Victoria became Empress of India (1876), India had a population of only 130 million. Today, it has between ten to eleven times as many. This population explosion is recent, as the census in 1950 indicated less than 380 million inhabitants. This expansion, which is vastly different from that of China, will continue at a rate of 1.2%/year and thus, making India one of the youngest countries in the world, with an average number of children/women of 2.8. The comparison of the median age with Russia and China is illuminating. India is only 28 years old, Russia at 39, and China at 37 with rapid ageing. While China's working population is declining, India's, nearly 870 million in 2019, is growing and will reach 1 billion by 2050.

This youth is an asset that must overcome 4 challenges:

- The challenge of financing education as the country still has a 30% illiteracy rate, as compared to 5% in China, and yet spends only 2.7% of its GDP on education. The percentage of children not attending school has fallen from 50% to 10% since 1980 but, apart from the elite, the quality of teaching and teachers is poor, teacher absenteeism is high and is that of children as well. All these factors risk squandering the country's demographic advantage.

- The challenge of managing the transition of the active population from agriculture to industry and services, as the low-productivity agricultural sector still employs more than 50% of the population but does not even make up 15% of GDP. In other words, a lot of restructuring needs to be undertaken.

- The challenge to reduce the unemployment rate, which is at the highest level in 45 years. To absorb young people entering the market, annual job creation would need to more than double to 10-12 million. This is unprecedented and participation rates, especially those of women, remain extremely low. A more job-inclusive growth path must be found, because while the tertiary sector accounts for more than 50% of GDP, it provides only 28% of jobs.

- Finally, the challenge of urban development as the rate of urbanization is still only 35-40%. It is a challenge because the development of the middle class, already at 680 million, will have a formidable impact on pollution. One example is automobile. The penetration rate in India is only 2% compared to 12% in China, 56% in the European Union and 79% in the United States.

II. Five structural handicaps: the development of agriculture, the weakness of the industry, infrastructure, the financial situation of companies and administrative obstacles.

1. Agricultural development :

After the United States, India has the most cultivated hectares, but the monsoons are later and less rain-bearing each year. Much of these lands are either in semi-arid areas that lack water, where it is impossible to plant high-yielding seeds, or in areas that are frequently flooded. The Green Revolution model is proving its limits because it requires subsidies, fertilizers, pesticides, and agricultural machinery. All these costs require large areas to be amortized but this is not the picture that Indian agriculture paints. At first glance, yields have increased significantly, India is producing more, and rice and sugar exports are rising, but in real terms farmers' net incomes have hardly grown in the last 20 years. With land consolidation and the inaccessibility to credit, small farmers have been expropriated and are facing difficulties finding work. Today, Modi wants to eliminate the intermediaries between agricultural producers and consumers, but the reform is not well accepted. Malnutrition still affects one in two Indians and one-third of the world's malnourished children live in India. As Joseph ***Boillot*** noted in his recent book ***"Utopias made in the world***", the land is impoverished by exploitation, groundwater is dried up, cancers are increasing with the spread of pesticides, and certain food products can no longer be exported because they are too damaged by fertilizers.

2. Industry and tourism :

In 1750, India accounted for a quarter of the world's industrial production, and on the eve of the 1914 war, it stood at 1.3%. At the same time, the colonial power, England had seen its share increase from 2% to 13%.

Today, the industry is underdeveloped and represents only 27% of GDP compared to 59% for services and 14% for agriculture. The country lacks skilled labor and, while there have been some notable successes in the automobile, steel, petrochemicals, and generic pharmaceutical industries, unlike China, it has not managed to bring about a real industrial revolution. The recent example of vaccines is topical: with the Serum Institute of India, the country houses the world's leading vaccine manufacturer but is powerless to treat its population.

Research and development spending does not exceed 1% of GDP, that is not even half the percentage of China or a quarter of South Korea. Unsurprisingly, India does not even register 1% of international patents, far from China's 5%.

The Indian industry suffers from small business. While in China, half of the companies have more than 200 employees, in India it is only 10%. A McKinsey study estimates that only 270 companies have a turnover of more than $125 million while there are nearly 7,700 in China, 3,500 in Russia and 1,300 in Brazil.

India remains not very receptive to the outside world, exporting only 20% of its GDP, achieving only 2% of world trade and just over 3% of trade in services. And although it has a current account deficit that is less than the 5% of a few years ago, it is nevertheless still close to 2% of GDP. Among the causes of this recurring deficit, it is the import of 80% of the oil consumed and of good quality coke.

Tourism, with less than 10 million visitors each year, a third of China and a quarter in terms of revenue, is still too weakly developed.

3. Infrastructure :

The state's budget for infrastructure remains desperately low at around 4% of GDP, less than half the amount spent by China. The investment rate is only 28%, whereas emerging countries generally devote more than 35% of their GDP. This is due to a lack of local savings, about 30% of GDP compared to 45% in China, and difficulties in attracting foreign investors, $57 billion in 2020, the equivalent of 2% of GDP, 6% of international flows in 2020. Foreign investment stocks as a percentage of GDP account for only 13% of GDP, which is, on average, half of other emerging countries.

Transport and electricity infrastructure are deficient, and this is a hindrance to development: firstly, the rail companies are investing insufficiently because they keep fares too low and, by trying to compensate for increasing freight, they divert traffic to the road and saturate the network.

Secondly, the country produces less electricity than France though its territory is 6x larger and its population almost 20x bigger! Many electricity companies are not profitable because they still offer electricity for free, or almost free, to farmers. A quarter of the population do not have access to electricity. It would be necessary to invest in nuclear power, but this development cannot be done without external capital.

4. The financial situation of companies :

The financial situation of companies and banks are two other handicaps. The former bears high level of debt, allocates more than a third of their operating income to financial costs and sometimes has to give priority to deleveraging over investment.

The latter bears bad debts, valued between 10% and 15% of total loans and a much higher percentage for loans to local companies.

The government wanted to recapitalize public banks, because 70% of bank loans depend on them, and merge 10 public banks to keep only four, but this takes time.

5. The persistence of administrative obstacles :

In the various rankings of business environment, India always stands out with low scores, especially a 185th ranking for the level of corruption related to construction activity even though according to the World Bank ranking, the country went from 130th place in 2016 to 63rd in 2020 for the greater or lesser ease of doing business!

Many infrastructure projects are blocked by difficult expropriations and labor regulations impede layoffs. Both reforms were part of Mr Modi's program but have not been finalized. Other obstacles to development are social rigidities, with 16% still "untouchable", frequent attacks against religious minorities, and a lamentable health system. Public health expenditure accounts for only 1% of GDP, as most of the spending is private, and the black market for oxygen exacerbates inequality.

III. Ambitious reforms but a less favorable economic climate :

- **Reforms :**

Mr Modi's government has unquestionably carried out reforms that benefitted the economy in reducing bottlenecks. The reduction of petrol prices subsidies has enabled the state to free up capacity for investment in infrastructure. The opening of up to 49% of the capital of insurance companies, railway infrastructure and cable networks to foreign interests is expected to attract investors. The desire to increase the number of taxpayers subject to income tax, which was previously 1%, and to broaden the tax base, which represents just 15% of GDP, a percentage lower than the average of emerging countries and among the lowest in the world, should generate revenue.

There was also the withdrawal of almost 80% of banknotes, but in a country where nearly 60% of households do not have a bank account and where the underground economy is estimated at more than 20% of GDP, growth was penalized.

There was also the introduction of VAT in July 2017, a key tax reform but implementation was nevertheless a little complicated with four rates between 5 and 28%, a dozen exemptions and an abundance of forms to fill out.

Finally, at the end of 2019, Modi lowered the corporate tax rate from 30% to 22% in the hope of boosting investment.

- **Economic difficulties :**

But beyond the reforms mentioned, Mr Modi has done little to correct the relative weakness of exports, 18% of GDP, to reduce the structurally high trade deficit, and to make up for the weaknesses in savings to reduce the shortfall in infrastructure investment. Consumption remains the key factor of growth, which is high as a percentage of GDP i.e., 64%, a level close to the 70% observed in the United States, higher than the 57% of Japan, 54% of the European Union and 38% in China. But with the crisis, it has fallen by more than 10%. The unemployment rate of around 30% could be cited as the cause, but in a country where the informal economy affects 90% of the population, this percentage is of little significance.

The stimulation of public investment in port, road and rail infrastructure, and Modi's willingness to subsidize the industry to the tune of $27 billion to strengthen the country's independence have not prevented a stagnation of private investment. The low-capacity utilization rate of 63% does not encourage companies to invest.

Depending on the duration of the pandemic, GDP growth is expected to be negative again this year. But it will be difficult for the Central Bank to lower rates below 4% because the inflation rate is at 5%, and it will be tricky for the State to resort to the budget deficit since it has already reached 9.5% last year. Before the crisis, public debt exceeded 70% of GDP and as of last summer, Moody's had downgraded the country's rating to Baa3.

Public finances offer little room for maneuver with a high budget deficit and public debt. More than $25 billion in privatization revenues have been projected, but the outcome is doubtful.

- **A stock market that does not reflect the economy :**

Compared to the major economies, the financial sector is over-represented with more than a quarter of the total and five of the top ten capitalizations. On the other hand, consumer credit is still underdeveloped, with just over 10% of GDP compared to almost 60% in China, 35% in South Africa and 30% in Brazil. Mortgages, too, represent only 10% of GDP against 18% in China, 44% in Singapore, and 52% in the United States. The country's well-known development centres are paradoxically represented modestly, whether it is the IT sector ("information technology"), 18% of capitalization or the pharmaceutical sector which weighs only 5% of the index. The industry (cars, cement) of 10%, is weak and this reflects an economy that is still agricultural and positioned on the tertiary sector. Such a situation should evolve in the coming years with the proliferation of IPOs. At present, the market capitalizes more than 22x the results, a valuation higher than the 15.5x average of the last 15 years.

Conclusion :

Indian or Chinese market : demographically equivalent yet opposed in the perennial border dispute of Kashmir, India and China differ profoundly. *From an economic point of view*, both countries were non-existent in the world economy at the turn of the 1950s, but today China's GDP is approximately 5x that of India's. China is now India's largest economic partner, but trade is unbalanced, with a bilateral trade deficit of more than $50 billion – India exports cotton and iron ore, and imports manufactured goods. *From a monetary perspective*, China's $3,100 billion foreign exchange reserves alone exceed India's GDP, while India's foreign exchange reserves amount to only $580 billion. *Politically*, relations with Pakistan remain hampered by Chinese support of nearly $60 billion to Pakistan for a Silk Road corridor, but India's GDP is nearly ten times that of Pakistan. *From a commerical perspective*, India and China are competing in Africa. Unlike China, which sends state-owned enterprises to carry out projects in infrastructure, agriculture and the extraction of raw materials, India's presence is primarily that of private companies. The Indian establishment, with large diasporas formerly settled in South Africa or Kenya, is evident in automobile, computer, diamonds, pharmaceuticals, and investments mainly in three countries: Egypt, South Africa and Mozambique. *From a stock market perspective*, surprisingly, the Indian market has outperformed China over the last twelve months, 62% against 51% but the capitalization of the Indian market of $2,700 billion is much lower than that of the Chinese market of $11,100 billion, and its market is now less attractive.

Politically, the populism in power reflects the frustration of a segment of the population because the economic take-off has not allowed sufficient development of the middle class. Modi, 72, was re-elected in 2019 and has control of both houses. But his party, the BJP, has just lost the elections in West Bengal and is under heavy attack for its negligence in managing the Covid crisis. This does not prejudge his political future, but on the international stage, Western embarrassment is conspicuous. Many countries, like the United States, Europe, and Japan, have played the Indian card as a strong political and economic alternative to China and as a means of bypassing the Silk Road, but have silently deplored the nationalist drift and hubris of Modi. Everyone remembers Modi's statement via videoconference at the Davos Forum on 28th January, when he declared that India had defeated the pandemic and was going to save lives around the world by producing vaccines!

Economically, Modi's record is crippled by the lack of liberalization of the labor market, the inability to develop the manufacturing industry, the difficulty in attracting foreign investment essential to infrastructure development, the lack of spending on health and education, and the throes of urbanization, with only 33% of the population as opposed to 57% in China, which will be the challenge in the coming years.

The economic problems are the result of the government's mismanagement of the Covid crisis. As of 31 March 2021, one-year GDP had officially declined by 7.7%, but is more likely by 10-15%, and this year, far from the IMF estimates published before the Covid resurgence, a similar decline is to be feared. In other words, over two years, the Indian crisis is comparable to that of some countries in 1929 and, in a country where more than 90% of the population do not earn wages, the poverty rate is rising to 50%. The country has spent 30% of its GDP since the beginning of the crisis, but only 2% of the population are vaccinated, and only 150 million, or 11%, have received a dose. The official death toll is 3,500/day, but it may be five to ten times higher. By comparison, 64% of Britons, 44% of Americans, and more than a quarter of Europeans have received a dose. The severity of this crisis illustrates the limits of India's power and pharmaceutical specialization, even though the country exported 66 million doses of vaccines.

Geneva, 10th May 2021

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