India – Tomorrow's Story

25 October 2010

By Gerard Lyons

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At the recent Institute for International Finance (IIF) annual conference in Washington there was, "The Great Debate: India versus China". I took part in this debate, arguing the case for India. It was not, I should stress, an argument against China. Indeed, having spoken on a number of occasions at IIF events about China, I am fully aware of the attractions of its economy, and its potential. In this debate, I was up against Greg Fager (Director Asia/Pacific Department at the IIF) who argued the case for China. The two judges were: Tim Adams (Managing Director, The Lindsey Group) and David Eldon (Senior Advisor, PricewaterhouseCoopers LLP). There was also a timekeeper, an audience of about 400 people and a ballot vote! The debate took the format of four rounds, plus questions and answers sessions after each of the first three rounds. The full text of my comments or of the Q&A sessions is not available. Instead, here are the slides used in the first three rounds, plus some comments that will assist in your analysing the graphs and in understanding the arguments.

Round one: economic and financial fundamentals

At the end of the nineteenth century in the City of London, one of the big debates was which was the best emerging market to invest in. As hard as it may be to imagine now, the choice in that debate was between the US and Argentina! Today, we debate China versus India. Perhaps one may be the modern day equivalent of the US, perhaps one may be the new Argentina. Perhaps it may be that China succeeds, perhaps India. Who knows? Although, in my opinion, it makes sense to believe in both China and India.

Today, in this debate, I am putting the case for India. In saying that, I am positive about China, and having spent just over three weeks in the last couple of months in Greater China, I am fully aware of the present mood and issues there. Today, however, I am arguing the case for India, based on:

- its catch-up potential;
- and its long-term prospects.

In section A there are three slides to support the three points I would make in favour of India based on its economic and financial fundamentals:

- the growth potential is huge;
- the balance of the economy is good;
- investment has the potential to power the economy over the next decade.

India has already come a long way. Whereas China opened up in 1978, India opened up far later, in 1991, and then took a long time to get going. Following the 1991 balance of payments crisis, India opened up. But by the end of the 90s there had been little progress. At that time the Confederation of Indian Industry highlighted six areas of concern: the need for economic reform; trade and investment; manufacturing; financial services; energy; and geopolitics. All made sense. Of these I would suggest energy is still a big concern. Also, around that time, the World Economic Forum cited that India's reforms lacked coherence, communication or credibility. The message is that, in its first decade of opening up, India really didn't open up.

In contrast, over the last decade a shift has been witnessed. Thus, today, the story about India is a very different one. This dramatic change reflects the combination of ambition, aspiration and entrepreneurship.

Slide A1 highlights India's growth potential is huge. On the left-hand side of that slide one can see that trend growth has risen sharply. It also includes our projections for growth rates over each of the next few decades.

The top right, meanwhile, highlights the size of the Indian economy, looking at GDP in nominal and real terms. In 2009, the Indian economy was $1.3 trillion in size. By 2020 it will have risen to $11.2 trillion (nominal) and $4.2 trillion (real, after taking account of inflation). By 2030, the respective forecasts are $38.7 trillion and $10.6 trillion. Even if our forecasts are not spot on, the likelihood is that India will witness rapid growth.

The bottom right of slide A1 puts this potential growth in the context of China and the EU and US, showing how much each will have grown, on our forecasts, by 2020 and by 2030. By 2030, India could be 8.4 times bigger, China 4 times, and the EU and US 1.7 times. Another indication of India's growth potential.

Slide A2 highlights another positive for India, the balance of its economy. There are similarities between China and India. In China, for instance, in recent years, the authorities have highlighted five imbalances: urban-rural; regional; social; environmental and international. All are valid issues in India, plus the additional concern of health.

China's economy is seen by its policymakers as being heavily skewed towards exports and investment, this is not an issue in India. Yet, the balance of the economy is key for the sustainability of growth. Over the last five years, the average ratio of consumption to GDP is 70%, of which private consumption is 59%, investment 35%, and net trade -5% (exports 22%, imports 27%). These ratios stabilised over the last cycle, suggesting India runs on the twin engines of consumption and investment, and this helped the economy to be relatively unscathed by this crisis.

Finally, in this section, **slide A3** shows that investment has the potential to power the economy over the next decade. The left-hand side of slide A3 shows that, compared with China, the gap is closing as measured by investment as a per cent of GDP. Whilst the right-hand side shows that, in terms of average annual investment growth, India has outpaced other major economies. Supporting this is that, in India, gross-savings are 34% of GDP, a high rate.

So, to conclude section A, India's economic and financial fundamentals are highlighted by: its catch-up, as seen by its rising trend growth; its balanced economy and by its rapid investment.

Round two: macroeconomic management and institutional framework

Section B focuses on macroeconomic management and the institutional framework.

Here, I show three slides to reflect three key points:

- India's democracy, legal framework and property rights;
- its deep, financial markets;
- macroeconomic management as reflected in its exchange and interest rate.

Slide B1 shows a map of India. It is hard to quantify the benefits of democracy, legal and property rights. All are key, perhaps property rights, including the enforcement of intellectual property rights, are most important. India's legal system is, in theory, a plus, although it is widely seen as too slow.

India has twenty-eight states and seven union territories. It has three million elected representatives, of which one million are women.

The map here shows, in red, states with an average growth rate around 6% and, in blue, those around 10%. Let me highlight Bihar (towards the top, right of centre in blue). This state has moved from low to higher growth. Others can follow. Bihar was part of the Bimaru Belt, alongside Madhya Pradesh, Rajasthan and Uttar Pradesh, a range of poorly performing, highly populated states. But now, to quote an Indian Minister, "The so-called sick states have recorded a faster pace of growth in the recent past." Bihar, with its double-digit growth, may be the exception at present, but it highlights the potential. In my view, good economics is good politics, and people are now seeking policies that generate jobs for India's young population. In turn, this is forcing states to change.

In contrast, the West and South, the rural hinterland, are poor, heavily dependent upon agriculture and lacking good infrastructure, but that can change. The challenge is that India is a complex economy. The West and South contrast with the North and Centre. The West and South are industrialised, well educated and contain three states that account for more than half of the country's exports: Karnataka, Maharashtra and Gujarat.

Slide B2 highlights that India's deep financial markets offset doubts about its fiscal deficit.

The left-hand side shows the fiscal deficit. Once India's big problem it is now less of a concern. Debt to GDP is 79%, of which 54% is at the centre, 25% the states. There are two reasons why the deficit is less of a concern. One is the growth dividend. For the five years from fiscal 2003 to fiscal 2008, average economic growth was 9%, but taxes rose to 22% versus 12% growth in government spending. The second is privatisation. There are 473 public sector firms in India, with a market capitalisation of $500 billion, The government is now committed to divest at least 10 – 25% in each firm.

The top right highlights the daily turnover in a range of markets. The bottom right, rising foreign direct investment.

The message is India has the absorptive capacity. Inflows can be accommodated. For instance, the Bombay Stock Exchange (BSE) is number one for listed companies and number five for transactions handled through electronic trading systems. The breadth and depth of its markets is highlighted by index futures, index options, stock futures and stock options. India is also encouraging technology development in its equity markets. But, still, the corporate bond market is small, as in China and financial depth still low.

Finally, in this section, **slide B3** is a big positive for India compared with China. Whilst China's economic management has been good, India has the advantage of a flexible exchange rate (shown on the left) and of an interest rate not set by politics, but by the central bank. China is not a bubble economy but it is an economy prone to bubbles, not helped by low rates. India, meanwhile, is vulnerable to inflation, hence the importance of its macroeconomic management. Wages and productivity also come into the debate about currencies.

So, in conclusion, for section B on the macroeconomic management and the institutional framework, India has democracy, the legal framework and property rights, deep financial markets and a credible macroeconomic management.

Round three: structural issues and prospects

The third section focuses on structural issues and prospects.

Again, three slides to highlight three key points:

- the demographic dividend;
- jobs will be provided by services and manufacturing;
- entrepreneurship and creativity.

Slide C1 focuses on India's demographic dividend. This is a big positive for India, certainly relative to China and with respect to many countries. China has a gender and age problem, as its population ages rapidly. Of course, it could adopt policies to address the age issues. The top right shows India's rising population, relative to China. The bottom left focuses on the age issue, showing that in 2020 the average age in India will be 29 versus 37 in China and 48 in Japan.

The gender issue also needs to be highlighted. In 1901 India's gender ratio was 972:1,000; with 972 girls for 1,000 boys. By 1991 it was 927:1,000. The trend has been reversed since then, reaching 933 in 2001 and 932 in 2009. In Punjab, there is a problem, at 876. If one was to look at this versus China, there the ratio may be as low as 840.

The top right shows India's rising middle class. This provides another attraction: India has a big domestic market to sell into. Indeed, alongside infrastructure spending, consumer durable expenditure is currently buoyant. This should continue. The rising middle class and growing working age population suggests consumer spending on durables is already at a tipping point. Consider some figures. The proportion with fridges: China 48%, India 18%; with washing machines: China 66%, India 18%; with televisions: China 80%, India 56%.

The bottom right show the changes in working age population. Over the next decade it rises 118 million in India and 4 million in China. In the subsequent decade, from 2020, the figures are India up 95 million, China down 51 million.

India's demographic dividend is highlighted by the fact that it has 17% of the world's population and that half of these are below 25. Whereas China's dependency ratio bottoms in the next five years, for India it bottoms in 2040.

Slide C2 shows jobs will be provided by services and by India moving into manufacturing. The three parts to this slide show the falling trend of agriculture and the rising trends of services and industry in relation to GDP.

As the share of agriculture in the economy falls one would expect productivity to rise. This will occur alongside increased urbanisation. A recent report by McKinsey's on this, suggests that India's urban population will rise from 340 million in 2008 to 590 million by 2030. By then, according to that report, Mumbai and Delhi will be two of the world's largest five cities and Mumbai's economy alone will be $265 billion.

Services are already important for India, and their share will likely rise further. In my view, India is already an IT superpower and has the potential to establish itself on the world stage in manufacturing. Over the last decade IT contributed about 45% of the incremental urban employment. Exports of IT rose from $2 billion in 1998/99 to $47 billion last year. By 2020 exports could rise threefold to $175 billion.

[redacted]

Furthermore, India has all the potential to move further up the value curve, with its pool of English speakers, technical education, links to Europe and North America, free trade agreements with Asia, a head start in IT and software, and enabling legislation. Areas talked about as potential sources of growth include tax consulting, financial services, sub-editing, law, accountancy and design.

Likewise, industry has the potential to grow. India's leading sectors could be in three areas. First, infrastructure, particularly power, roads and telecoms. Second, inclusive growth, as purchasing power in rural areas grow. Third, an inflexion point in per-capita income could trigger even faster spending on consumer durables. It is often said that as per capita income rises above $3,000, vehicle demand rises exponentially, it is thought helping feed the growth in the auto sector. This could be significant. Per 1,000 people, the US has 765 cars, China 128, India 12.

The final slide in this section, **slide C3**, focuses on entrepreneurship and creativity: built to last. Top left shows the number of small and medium sized enterprises (SMEs) is 26 million, employing 60 million people. The bottom left shows the contribution of SMEs to exports is 40%, the top left shows the contribution of SMEs to output is 45% and the bottom right touches on the issue of access to finance. SMEs account for 17% of India's GDP, expected to reach 22% by 2012.

A recent United Nations study showed that the majority of research and development (R&D) investment used to go to OECD countries, and thus to developed countries, but that this is now changing. And that in terms of countries most mentioned it is China, USA and India. India's cost advantage and skilled labour force should make it attractive for R&D.

So, to conclude section C on structural issues and prospects, there is the demographic dividend, the ability to generate jobs from services and manufacturing and India's entrepreneurship and creativity.

Round four: summing up

In conclusion, India is tomorrow's story. One has to put this in the context of the world economy where there is a shift in the balance of power from the West to the East.

In this global shift, the winners are the countries that have the cash, the commodities or the creativity. India does not have the cash or the commodities, but it has the creative potential.

Although there are positives, there are challenges, not least in health and future social stability. Infrastructure and regulation are often cited as concerns. The authorities are now attempting to address the infrastructure deficit.

Although it is important to keep these challenges in mind, so too should one focus on the potential of India's domestic consumption and growing domestic market.

I have highlighted many issues: India's democracy, its demographics, deep financial markets, macroeconomic management and its creativity.

As India continues to open up it has the potential to boost trade ties across South Asia, with the Middle East and with East Africa, in much the same way that China boosted trade across East Asia.

There are many positives about China. There are many positives about India. At the beginning I talked about the US and Argentina over one hundred years ago. Who will be the new USA? Perhaps both.

India: tomorrow's story

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6 October 2010

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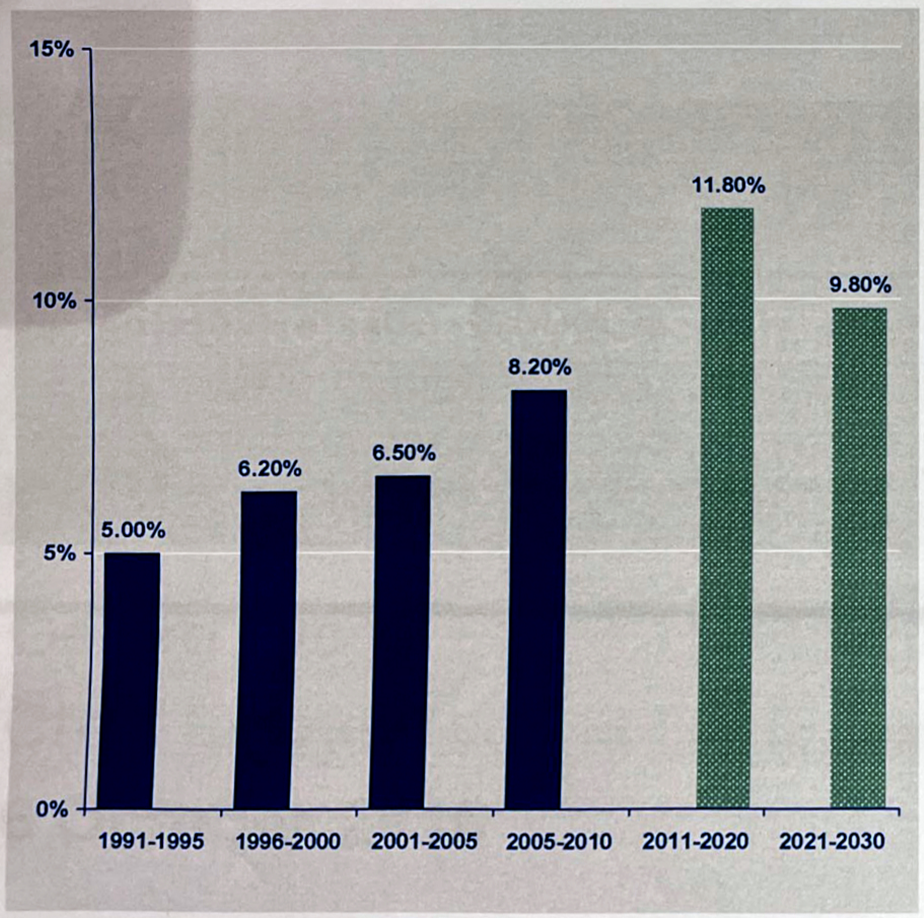
Economic and financial fundamentals

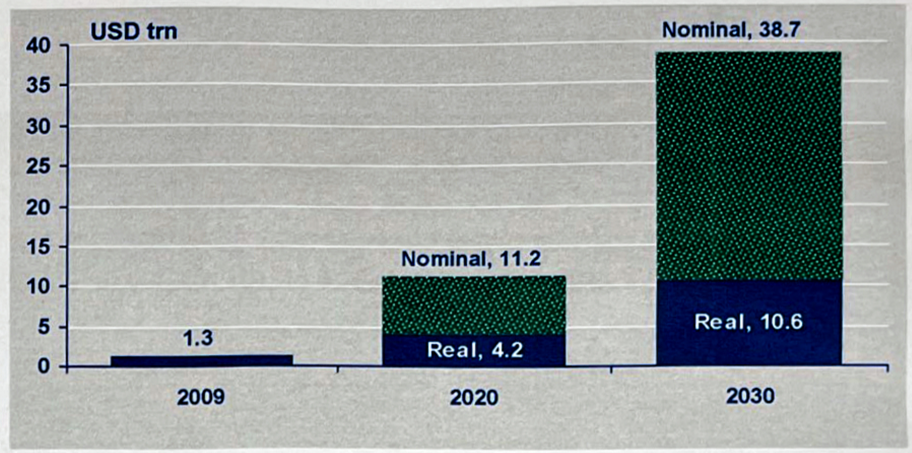
A1. Growth potential is huge
A2. Balance of the economy
A3. Investment has the potential to power the economy over the next decade

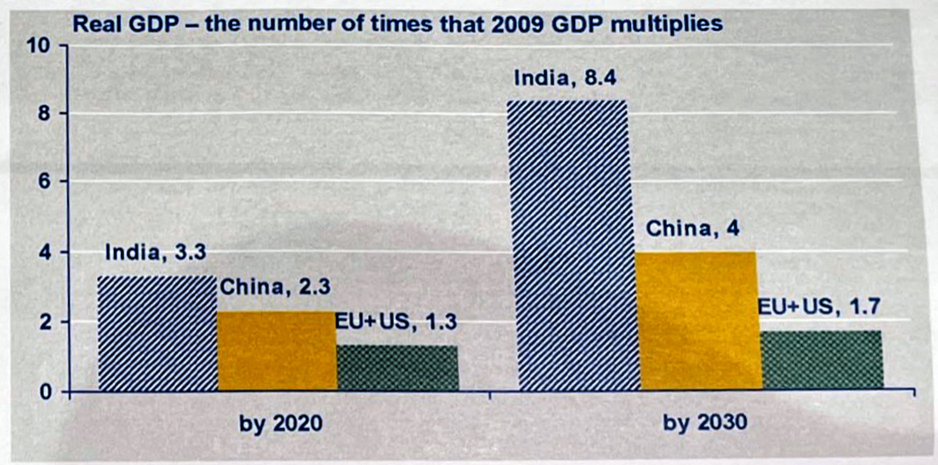
A1. Growth potential is huge

Trend growth



Real and nominal GDP forecasts

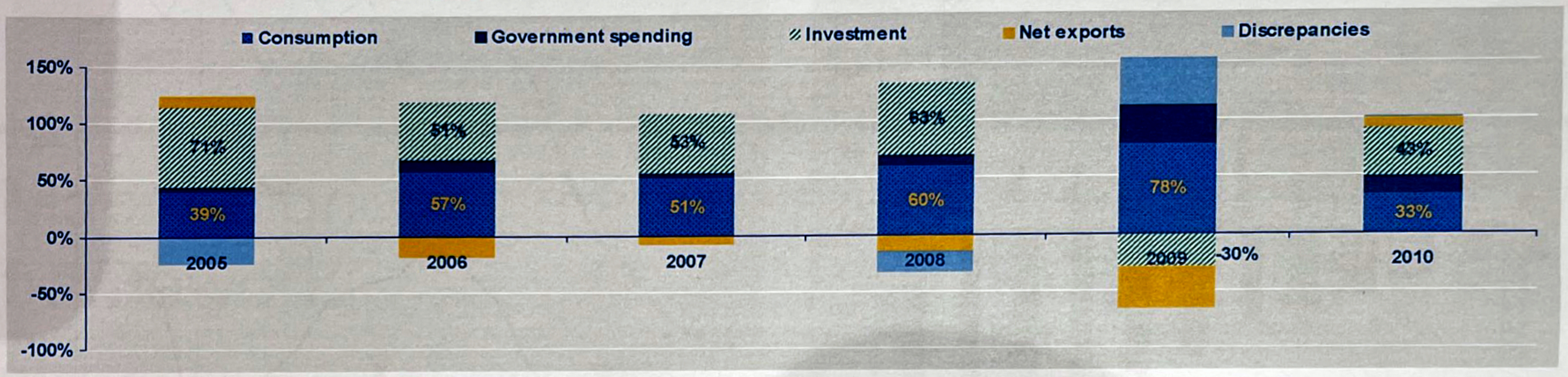




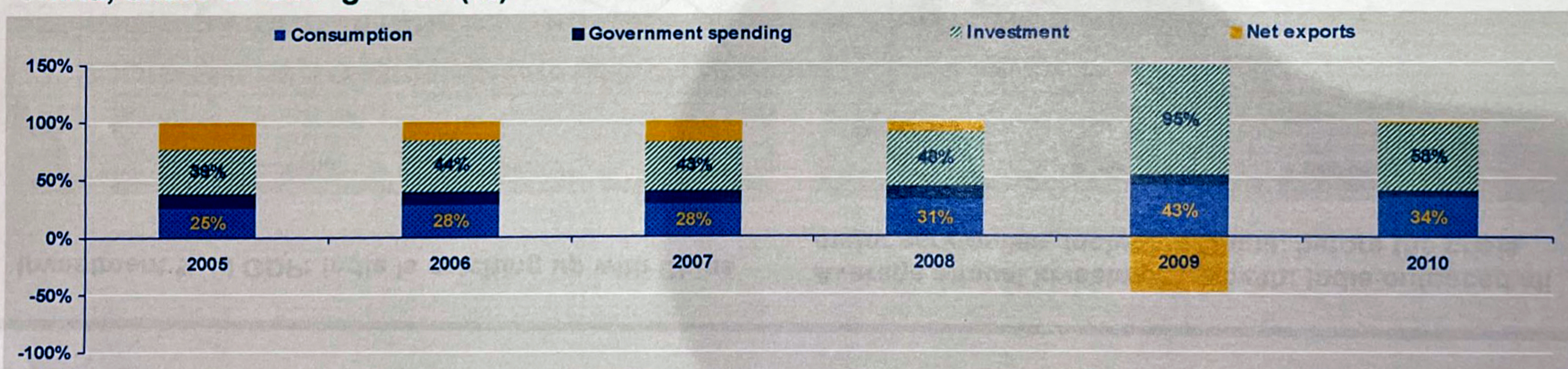
Sources: IMF, Standard Chartered Research

A2. Balance of the economy

India, share of GDP growth (%)



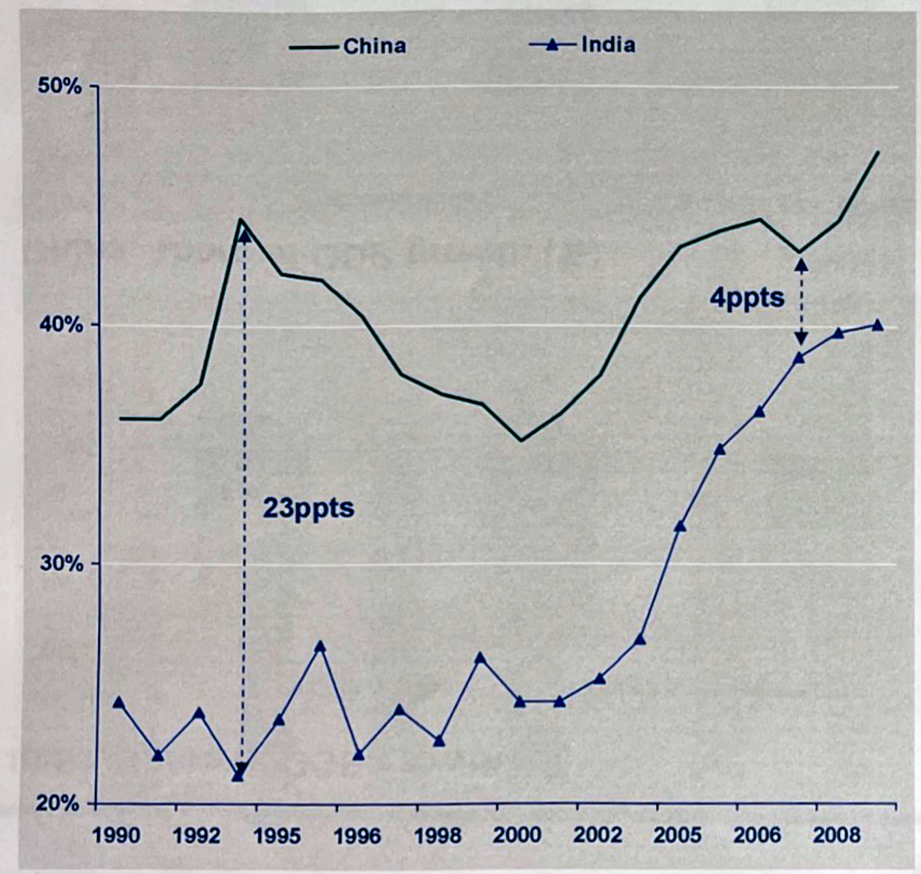
China, share of GDP growth (%)



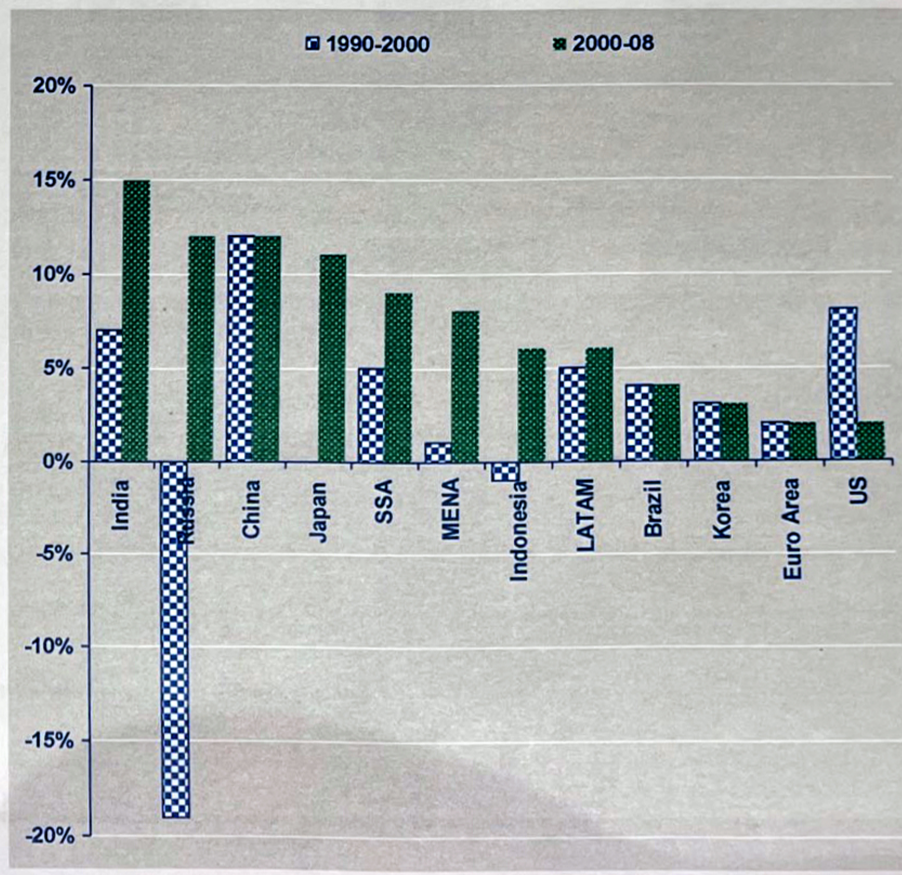
Sources: CEIC, Standard Chartered Research

A3. Investment has the potential to power the economy over the next decade

Investment % of GDP: India is catching up with China



Average annual investment growth: India outpaced all major economies, including China, before the crisis



Standard Chartered

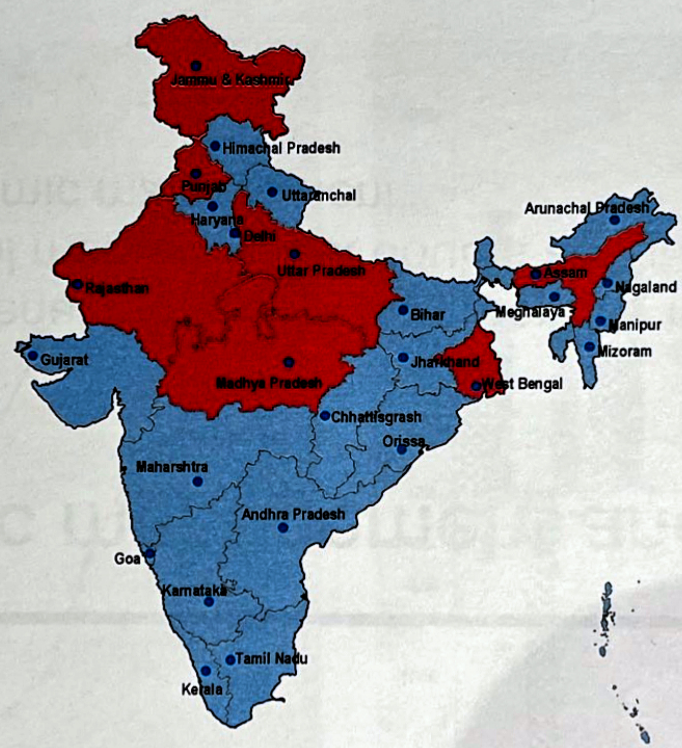
Sources: The World Bank, Standard Chartered Research

Macroeconomic management and institutional framework

B1: India's democracy, legal framework and property rights
B2. India's deep financial markets offset doubts about its fiscal deficit
B3. India's macro-economic management

B1: India's democracy, legal framework and property rights

2005-2009: higher growth rate, higher inequality

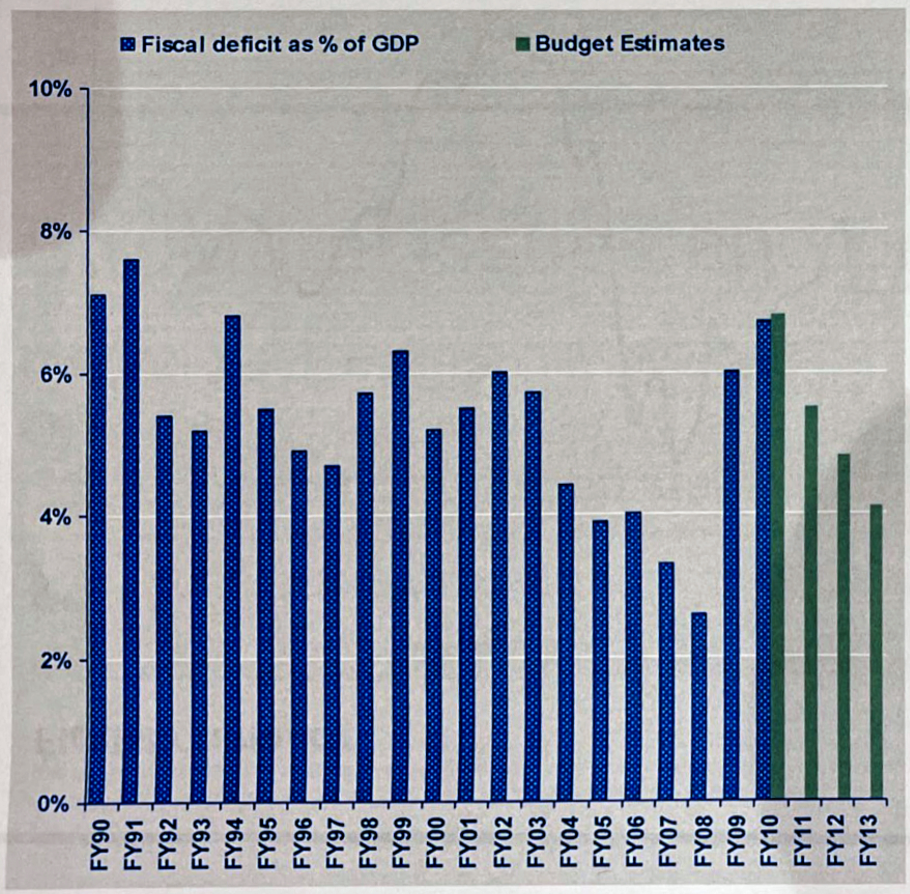


Red –average growth rate 6%

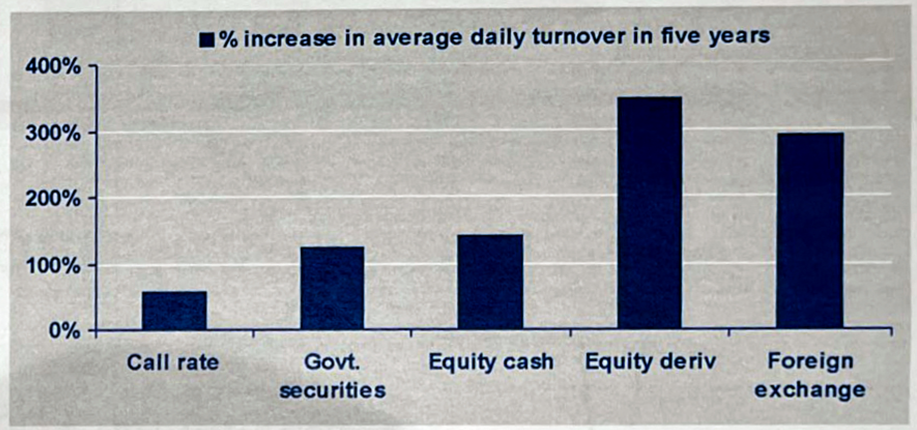
Blue – average growth rate 10%

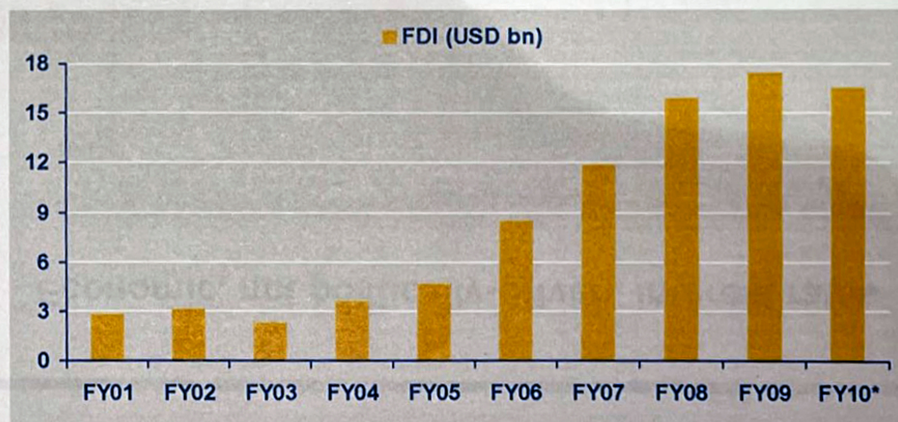
B2. India's deep financial markets offset doubts about its fiscal deficit

Deficit reduction depends on revenue growth and privatisation



Deep and growing capital markets can absorb inflows

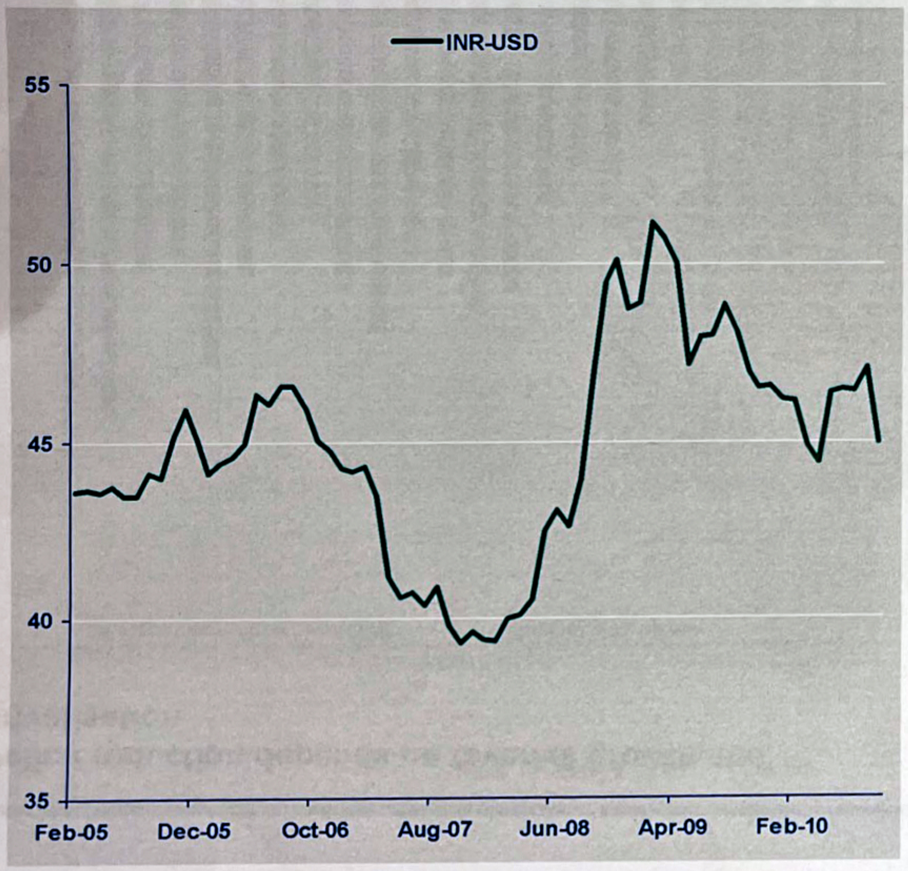




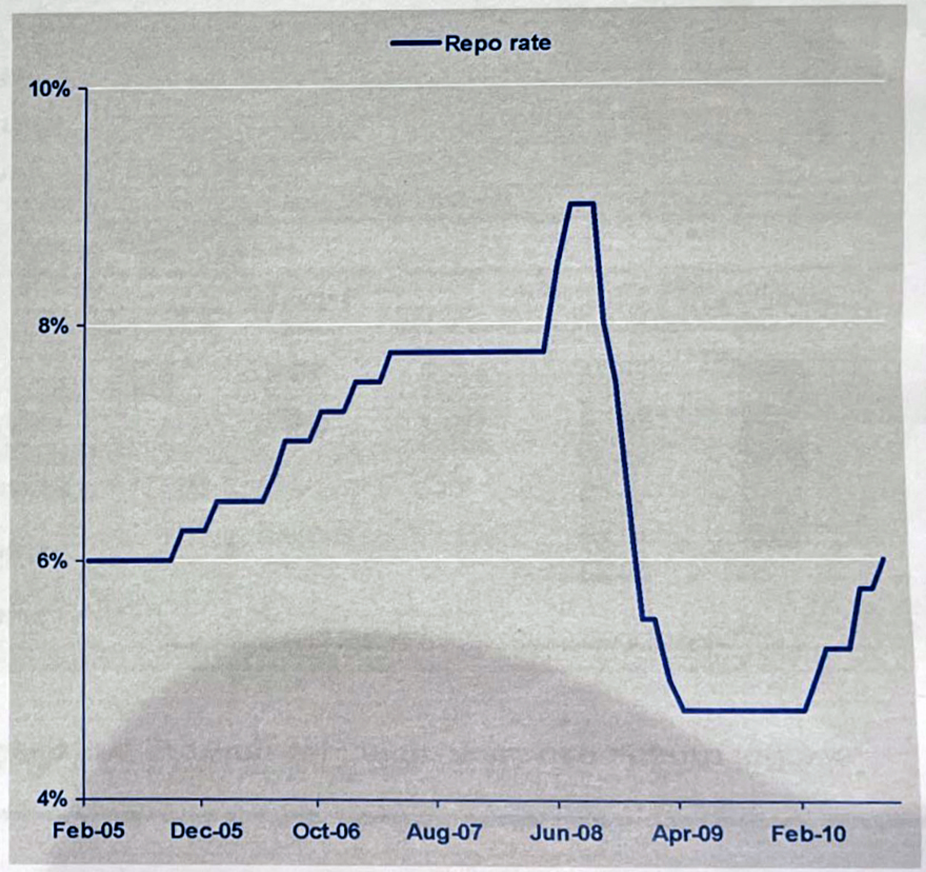
Sources: Union Budget Speech for FY11, RBI, SEBI, Standard Chartered Research

B3. India's macro-economic management

Flexible currency



Economic, not politically-driven, interest rates



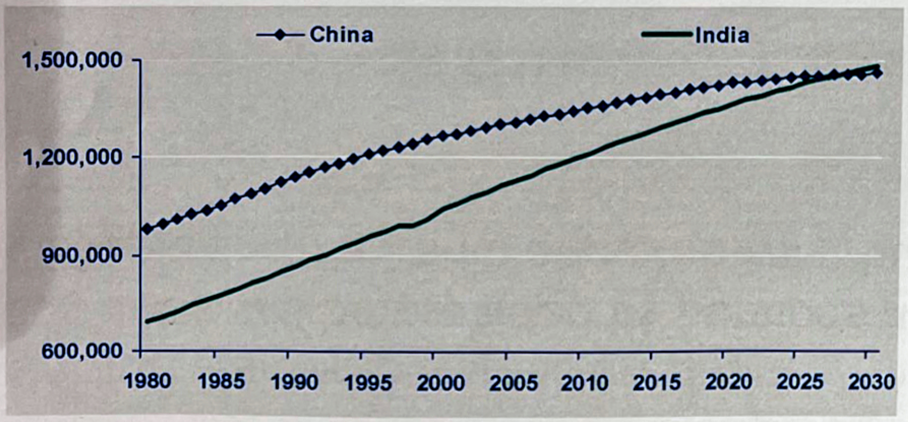
Sources: Bloomberg, Standard Chartered Research

Structural issues and prospects

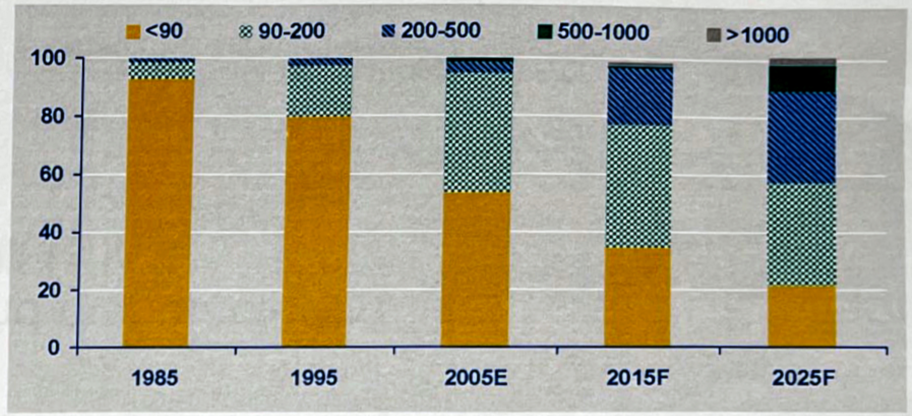
C1. India's demographic dividend
C2. Jobs will be provided by services and manufacturing
C3. Entrepreneurship and creativity: built to last

C1. India's demographic dividend

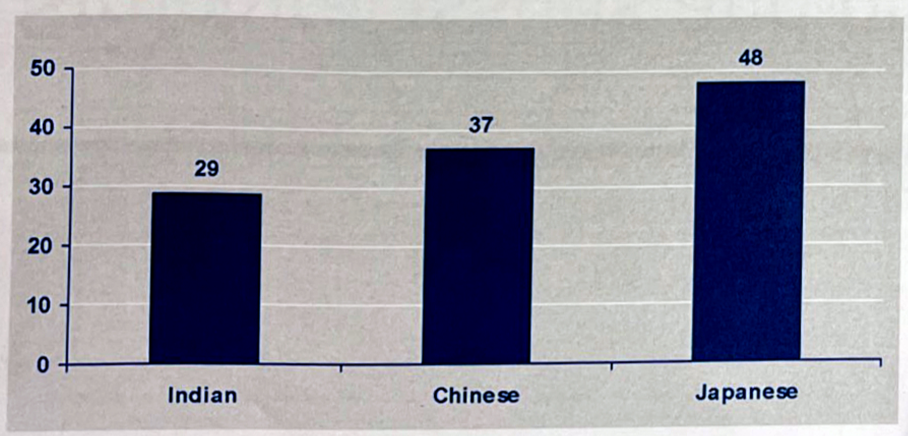
Population growth



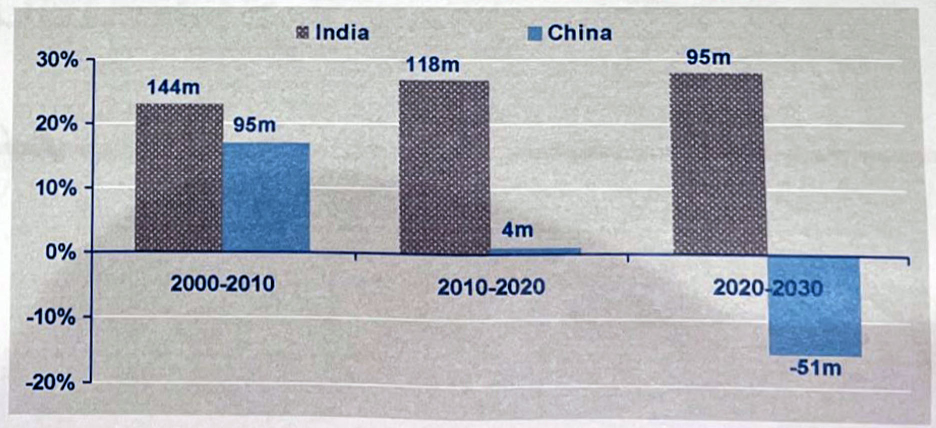
Rising middle class (% of population, '000 INR)



Average age in 2020



Contribution to global working age population



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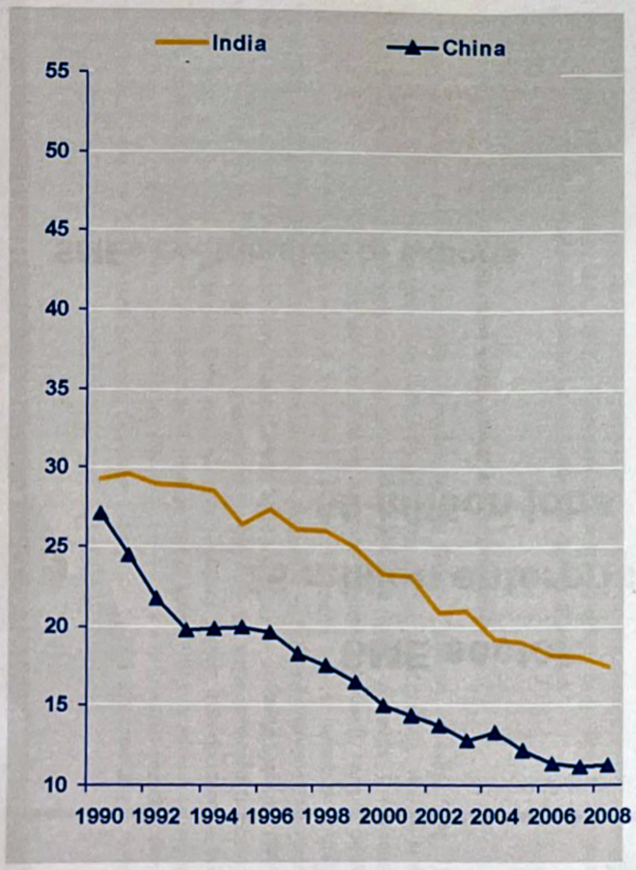
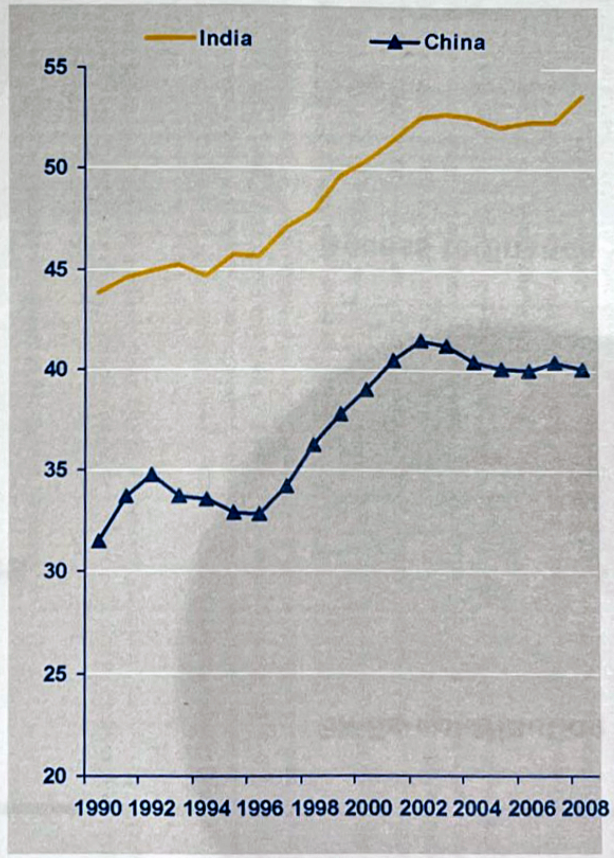
Sources: UN, McKinsey, Standard Chartered Research

C2. Jobs will be provided by services and manufacturing

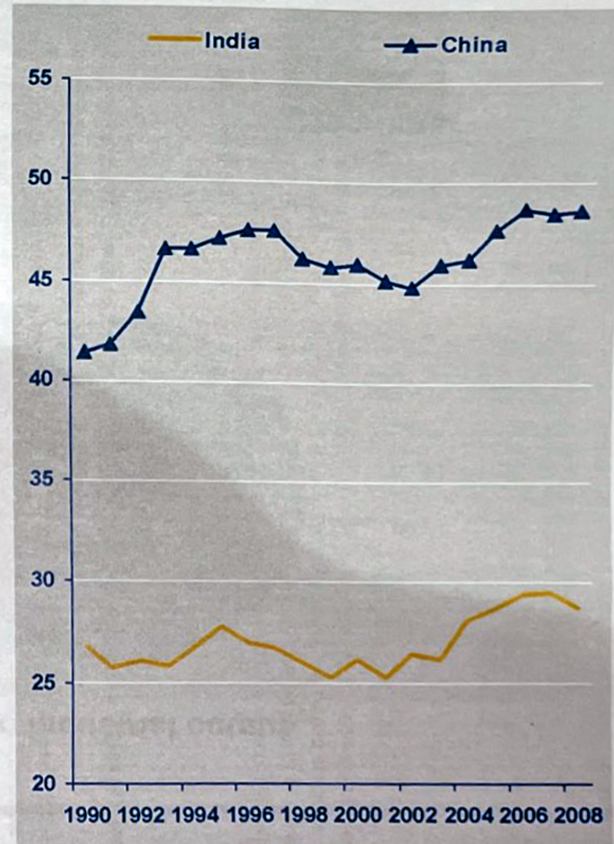
Agriculture as % of GDP



Services as % of GDP



Industry as % of GDP



Sources: World Bank, Standard Chartered Research

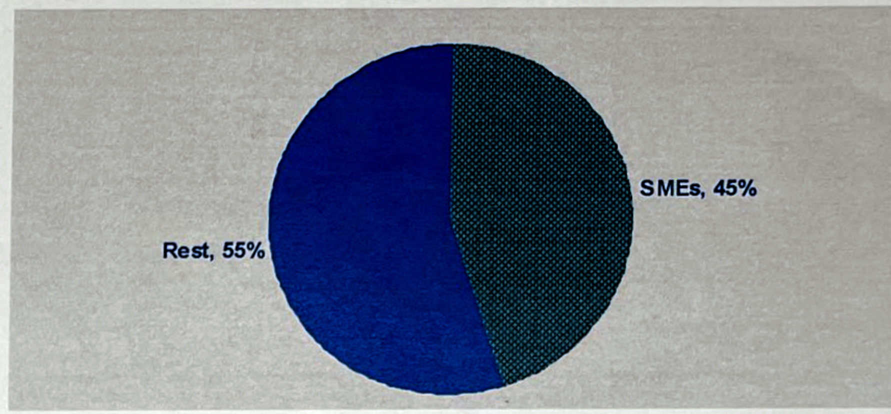
C3. Entrepreneurship and creativity: built to last

SME sector:

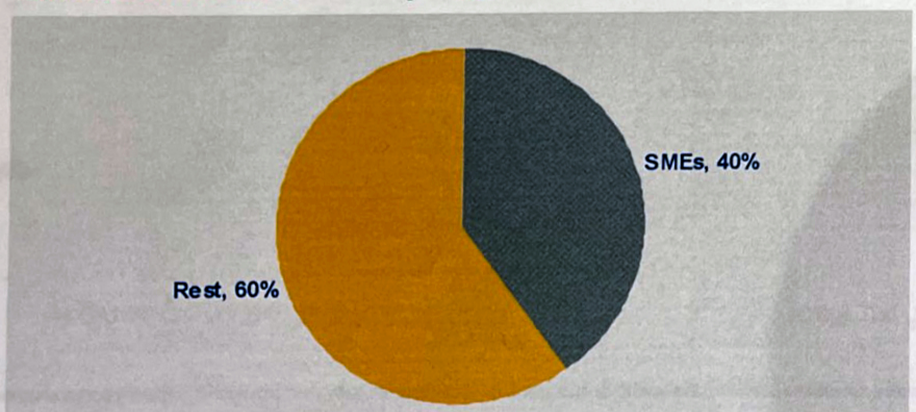
26 million enterprises

60 million jobs

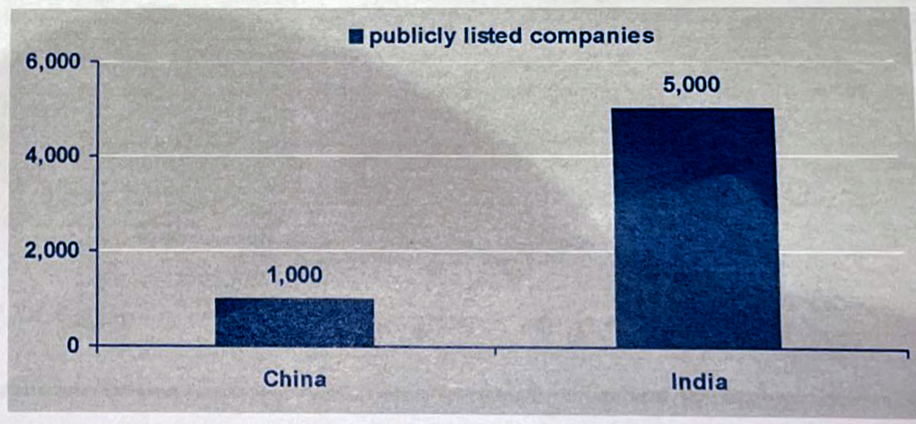
SMEs contribution to industrial output



SMEs contribution to exports



Access to finance



Sources: Union Budget Speech for FY11, Shanghai Stock Exchange, RBI, Standard Chartered Research

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Data available as of 17:30 GMT 25 October 2010. This document is released at 17:30 GMT 25 October 2010.

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