Weekly Geopolitical Report

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India's Albatross

India is a paradox. On one hand the country has a young population, a large consumer base, enormous entrepreneurial spirit, and is spending large amounts on building a global navy. On the other hand, the country has inequality on an unprecedented scale, ramshackle infrastructure and near-constant electricity black-outs, all highlighted by corruption reigning in the expansive and complicated government system. Although the country is committed to a democratic process, its government seems unable to implement reform and has largely failed the poverty-stricken majority. Recently, these impediments have weighed on the country's growth, and in turn, have deteriorated investor confidence, leading to funds exiting the country en masse.

This week, we will look at where India stands today economically, politically and socially. A brief description of India's geopolitics and history will aid the reader in understanding the current situation. We will further discuss the major impediments to growth and pay special attention to exploring why the difficulties have developed.

As global investors it is important to understand each investable country's specific differences, strengths and weaknesses. Although emerging markets are generally grouped together and often perceived as having the same risk factors and correlation to other markets, each country will react differently to global changes.

History

Geopolitically, the Indian subcontinent, the region that includes Pakistan, Bangladesh, Nepal and Bhutan, is a "self-contained" region, meaning it is isolated on all sides by either an ocean or difficult terrain. For all intents and purposes, India could be thought of as an island. This is the reason India has been building a world-class navy.

Historically, the Indian subcontinent has been highly fragmented, but also fluid, as there are no major internal barriers other than the country's rivers. In turn, these rivers have served as hubs for different regional centers. The differences between the territories are mostly tribal in nature, although prejudice manifests itself strongly between regions.

The British Indian territories gained independence in 1947 following approximately 150 years under British rule. India had been ruled by a relatively small group of outsiders without a major military threat. The British Empire used a "divide and conquer" method to play different power centers against each other. Interestingly, India still uses much of the legal system set in place by the British government. After independence, the region was partitioned into India and Pakistan. Ever since, the two countries have been in near-constant conflict over religion, with India being majority Hindu and Pakistan being majority Muslim. The countries have also fought over Kashmir, a region that both countries claim as their own.

Additionally, India separated from Britain at the height of Britain's socialism. Two years before India's independence, Clement Attlee, head of the Labour Party, defeated Winston Churchill in a general election. Attlee implemented the party's social democratic program, nationalizing some industries and creating a welfare state. However, Britain's politics reversed with the election of Margaret Thatcher. Thatcher's policies emphasized deregulation, flexible labor markets, privatization and diminished power of the trade unions. Unfortunately for India, the country established its independent policies with the British socialist framework and has not had a Thatcher-like political figure to change the country's course toward capitalism.

The independent India attempted to maintain a neutral position through its "non-alignment" movement. "Non-alignment" called for India to maintain independence and not attach itself to either side of the Cold War. Still, India had better relations with the Soviet Union than the U.S. However, after the end of the Cold War, rather than shifting its foreign relations, India turned inward and cautious. At that point the U.S. had a working relationship with Pakistan. India has had a long history of conflicts with Islamists, limiting India from forming relations with the U.S. However, 9/11 aligned the interests of the U.S. and India, as the U.S. entered a war against al-Qaeda. Primarily, neither the U.S. nor India wanted further development of Pakistan's nuclear weapons.

India and other emerging economies

In the emerging market context, India and China are often spoken within the same breath. However, these two countries are different, both politically and economically. Looking within the BRIC group, India is the poorest of the four countries, with less than a third of China's GDP per capita. Even after adjusting for purchasing power parity, India's GDP per capita ranks well below the other countries. Brazil and Russia benefit from their rich natural resources, which India lacks. In fact, India has only 0.8% of the world's known oil and gas reserves, but 17% of the world's population.

However, India does have a fertile agricultural sector. Currently, the sector suffers from underinvestment, lacking an efficient distribution network and using minimal automation in production. As with many areas of Indian life, the sector lacks a uniform regulatory framework, demonstrated by the recent tragedy of over 20 children dying of insecticide poisoning in school lunches.

Although India has a large domestic consumer base, it is less export-oriented, making it somewhat more immune to international economic conditions. This has served the country well during the most recent global downturn. However, it also means that India needs a well-functioning domestic market to boost growth. The relatively young population base also offers the country immense opportunities. The demand side of the economy is hindered by socioeconomic inequality and the lack of social mobility, but these are the results and not the causes of the problem. It is the supply side that suffers from over- and mis-regulation, policy paralysis, lack of reform and overall unwillingness to challenge the status quo.

Lack of accountability and corruption

The country's fundamental problems stem from the lack of reform and accountability in the government. The lack of reform reflects the profound ambivalence of India's aging rulers toward bettering the country as a whole. The government has failed to be held responsible for the needy majority and has instead served the best connected minorities, the privileged. The large inequalities create a system whereby social mobility is difficult, if not impossible. Importantly, the country lacks historical examples of upward hierarchical progression, possibly due to prejudice based on background and tribal affiliation. Additionally, the ruling elite, often defined by caste, gender, educational background and income, are not interested in social equality. Some observers have argued that the deeply ingrained prejudice within the regions is the root cause of the unprecedented disparity. As the country was formed out of tribes, the tribal mentality has been an obstruction to building a unified country. Historically, tribes would take advantage of each other as a matter of practice—cheating the other tribes to better your own was how tribes functioned. Teamwork extending outside one's immediate group was never an important cultural element. During British rule, the common enemy unified the different regions, but the regional leaders were managed by the British and did not directly work together. This same tribal mentality has sabotaged progress and reform in the independent India. As a result, each regional government strives toward its own goals with very little regard to a unified strategic vision.

Additionally, the country has corruption on an epic scale due to the cultural acceptance of bribes, very little transparency or accountability and the convoluted political structure. The Indian government is a complex machine with many divisions, commissions, administrators and specialists. And that is just on the federal level. The same complexities abound on the regional levels. This means that not only does each regional government have its own agenda and very little interest in cooperating with the central government, but also, in order to take a project through to completion, it involves numerous approvals and accompanying bribes.

India also ranks low in the World Bank's "ease of doing business" list. Although the country has made strides since the end of the Permit Raj era, it still takes an entrepreneur about 30 days to start a business in India. More than time, it also takes about half of the annual GDP per capita to start a business, adding to the underlying inequality. Financing difficulties for small and medium businesses have also caused problems, causing bottle-necks and allowing only the well-connected to be able to borrow. Investment decisions have also become extremely inefficient, with funds given out to favored companies, often ones connected to a specific person with connections to the government. Currently, one-third of India's corporate debt sits in firms with interest costs in excess of operating earnings.

It's no surprise that the country's incredible entrepreneurial spirit and large domestic market, both possible strengths for growth, are hindered by the complex political environment and perpetual corruption.

Generational leadership change

Adding to the problems is the age of the current government representatives. At the age of 80, India's prime minister, Manmohan Singh, is one of the oldest world leaders, and his cabinet is mostly filled with representatives approaching pension age. Although some new representatives have been included recently, the old guard has complained that the younger people have brought "personal agendas." However, looking at the track record of the aging parliament leaves much to be desired. The parliament has passed fewer laws and sat for less time than any other full parliament in India's history. The low turnover in the parliament has also maintained the country's socialist tendencies of over-regulation as the aging politicians are deeply rooted in their historic economic context.

The government body also remains rather large and inefficient, with multiple convoluted branches. Since so much power is devolved to the regional governments, the central government in New Delhi has limited say in how many parts of the country are run. The much needed generational shift will be hard for India. Examples of other emerging countries that have successfully switched the leadership suite, such as China, do not apply as those countries have followed fairly strict rules in doing so. Yet, India holds enormous growth potential if the political situation would be improved.

Infrastructure in red tape

Additionally, the Indian business community has repeatedly ranked the lack of infrastructure as one of the biggest hindrances to doing business. The massive bureaucracy is creating problems as much-needed infrastructure projects have been tangled in red tape. For example, current land regulations make it very difficult to buy land, holding back growth.

Infrastructure expansion does not need Parliamentary approval, so coalition politics play a small role in this. Worsening the problem is the politicians' stance that infrastructure investment funds should come from foreign investors, and that India itself cannot afford these large projects. Consequently, the country suffers both economically and socially. Only about one-third of the population has access to sanitation, while well over one-third of households do not have electricity. Separately, foreign direct investments would likely follow if infrastructure were in place.

State monopolies in energy production and distribution (especially coal) have created major bottlenecks, causing near-constant black-out conditions. Liberalization of the energy markets, including fuel subsidies, would create a much more transparent market, with competition ensuring a more reliable energy supply.

Additionally, although the risk of government expropriation is low, the Indian government has set a precedence of changes to the tax code, resulting in retroactive taxation of foreign companies doing business in the country. This action undermines the country's political stability.

Vicious cycle

As a result of decelerating economic growth and loss of investor confidence in the government's ability to turn the country around, foreign funds have been leaving the country. The large outflow of capital, in addition to rising inflation, has put pressure on the rupee, making it the worst performing major emerging market currency. The weaker rupee, in turn, hurt exports as Indian products become relatively more expensive, and hurt imports, as domestic buyers are relatively worse off in the international markets. This has caused the current account deficit to widen and investor confidence to slump further. Additionally, public debt markets have spiraled into a large deficit, further hurting trust in the government. The lack of solid infrastructure, political vision and conviction, along with high levels of bureaucracy and corruption, have all contributed to the country's slowing growth.

India seems to be stuck on the socialist political approach that it inherited from Britain after its independence. While Britain went through deregulation to become capitalist, India has not yet fully embarked on reform to free its markets from over- and mis-regulation. The complex government structure, in addition to the lack of transparency and accountability has allowed for corruption to flourish. The aging political elite have mostly failed the needy majority, and do not seem to be willing or able to improve the country's living standards. Consequently, the lack of cooperation has led to a political paralysis that does not allow the country to thrive.

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