



Submission No 8

Inquiry into Australia's relationship with India as an emerging world power

Organisation: Knights Restructuring Services

**Contact Person: Mr Bill O'Chee
Special Counsel**

**Address: 57 York Street
Brisbane QLD 4000**

57 York Street
Spring Hill
Brisbane QLD 4000
AUSTRALIA.

Senator Alan Ferguson
Chairman
Joint Standing Committee on
Foreign Affairs Defence & Trade
Parliament House
Canberra ACT 2600.

By Email Delivery

Dear Senator ~~Ferguson~~ ^{Alan},

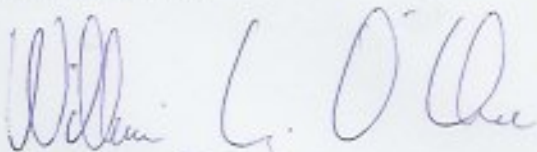
Inquiry into Australia's relationship with India

I refer to the above reference to the Joint Standing Committee on Foreign Affairs, Defence and trade, and have pleasure in enclosing herewith the submission of our company in regards thereto.

I would be grateful if you could advise when the submission has been received and published. I also advise that I would be happy to appear before the Committee to answer any questions its members might have, should that be considered desirable.

I may be contacted by email at wochee@knights-india.com.

Yours sincerely,



Bill O'Chee
Special Counsel

Brisbane, 30th May, 2006.

Encl

SUBMISSION TO THE

JOINT STANDING COMMITTEE

ON

FOREIGN AFFAIRS, DEFENCE AND TRADE

INQUIRY INTO

AUSTRALIA'S BILATERAL RELATIONSHIP WITH

INDIA

prepared by



TABLE OF CONTENTS

1	INTRODUCTION AND SUMMARY.....	1
2	BACKGROUND	4
3	BROAD ECONOMIC DEVELOPMENT ISSUES	7
4	THE CASE FOR AN INDIA STRATEGY	12
5	AUSTRALIA'S CULTURAL ADVANTAGES.....	14
6	THE IT CHIMERA.....	15
7	AUSTRALIA'S TRADE & INVESTMENT OPPORTUNITIES.....	17
8	IMPEDIMENTS TO CLOSER RELATIONS.....	24

SUBMISSION TO THE JOINT STANDING COMMITTEE INQUIRY INTO AUSTRALIA'S RELATIONSHIP WITH INDIA.

1 INTRODUCTION AND SUMMARY

- 1.1 This submission is based on our experiences over the last three years in developing investments in the non-IT service sector in India.
During this period of time we have made over twenty visits to India, and have conducted business with some of the largest Indian public sector entities, most notably those in the banking and finance sector.
- 1.2 Our area of expertise is in business restructuring, particularly in relation to non-performing loans, and in capital investment in India.
- 1.3 Australia has a deep historical connection with India that has been eclipsed since the late 1950's by an increasing economic and political engagement between Australia and the countries of the East Asian region. This recent pattern of engagement has come at the cost of a close relationship with the countries of Southern Asia, most notably India.
- 1.4 Both Australia and India share many legal, political and social structures derived from our common heritage as part of the British Empire. These inherited systems and structures go a long way towards crossing the perceived cultural differences between the two countries, and can and should form the basis of a closer bilateral relationship.
- 1.5 Australia and India have many common medium and long term interests, especially in terms of the future of the broad East and Southern Asian region. There are closely aligned security interests



to which both governments should develop. These include how best to engage with the Peoples Republic of China.

- 1.6 On an economic level, Australia and India represent complementary economies, although there are many impediments to direct Australian investment in India, especially in the resources, banking, and services sectors. India would benefit generally from a deregulation of foreign investment guidelines, and specifically from Australian investment that would flow into the country as a consequence of such deregulation.
- 1.7 Australia can also contribute substantially to the development of private infrastructure, and the financial, educational, and the agricultural sectors, among many.
- 1.8 India has been irreversibly propelled on a path of economic development which will rival that of the Peoples Republic of China, and will see it become a significant world power in the next twenty to thirty years. Australian foreign and trade policy should be suitably cognizant of this.
- 1.9 Australia has specific comparative advantages over many other countries in developing a closer economic and political relationship with India, and the Australian government would be wise to exploit these advantages now, before international interest in India becomes more widespread than it is at present.
- 1.10 Because of the existing political and business structures which exist in India, the development of better relations between the two countries will be dependent upon the Australian government demonstrating its willingness to play a leadership role in such a process.
- 1.11 We make the following recommendations for consideration by the Committee:
 - Australia should embrace the opportunities to develop exports and outward investment to India so as to better survive any economic shock that might be caused by a change in China's economic circumstances.



- It is essential that the Australian government formulate an “Indian strategy” and that this be communicated to the business sector and the broader community. Business should likewise be encouraged to make provision for India in their broader planning. This might be achieved by having a high level Government task force to encourage these business links.
- The Australian government should consider entering into an investment financing agreement with the Government of India. This would entail the Australian government agreeing to carry the cost of credit insurance through EFIC as part of the national interest cover. In turn, the Australian government would receive a direct governmental guarantee from the Government of India that the underlying payment obligations would be met.
- Australia should work towards reaching framework investment agreement with India similar to those formulated for the SAARC. Matters for inclusion in such an agreement would include automatic approval for certain classes of investment, the free repatriation of capital and profits, and “one-stop shops” within the trade departments of both countries to assist in obtaining necessary permits.
- While a double taxation agreement currently exists it needs to be revisited so that issues such as the recognition of franking credits generated by companies operated in India but owned by Australian interests as available under Australian taxation law are addressed as failure to do so substantially affects the return on such investments.
- Greater emphasis should be placed on political exchanges and mutual trade and investment promotion. A political exchange programme similar to the one currently operating between Australia and the United States would serve to significantly raise the level of political understanding on both sides of the Indian Ocean.

- The Australian government should also investigate the possibility of more cultural exchanges with the Indian government.

2 BACKGROUND

- 2.1 It is not possible to properly consider the current nation of India without putting it into a historical context, for historical considerations loom large in the Indian psyche. A brief examination of the broader history of the subcontinent is also instructive to Australia enquirers, who might otherwise be ignorant of many factors governing India's development, both past and present.
- 2.2 The Indian sub-continent has been the basis of a thriving civilisation for at least four thousand years, since the time of the Indus River culture. Notwithstanding the physical barrier presented by the Himalayas and the Mountains of the Hindu Kush, the states of the subcontinent became well integrated with their neighbours to the north, as well as to the east and west at an early time. This close integration is demonstrated by the spread of Buddhism along existing trading routes to China and Japan, some two thousand years ago. Indeed, there were also well established sea trading routes between India and North-east Asia at this time.
- 2.3 India's links with the outside world have always included the Middle East, although this is frequently overlooked from an Australian perspective. An example of this is the fact that India's Christian community (numbering upwards of 70 million people) traces its origins to the missionary work of the Apostle St Thomas, who journeyed to the area around what is now Chennai shortly after the martyrdom of St James in AD 62. His journey to India merely followed the along the trade routes already well plied by spice and gem traders. The Jewish community in India was established at approximately the same time, after the Second Jewish War with

- Rome, although many came via Baghdad, which was a significant gem trading centre.
- 2.4 Of course India was known to the west during the fourth century BC, though the conquests of Alexander the Great, and India has similarly known of the west.
 - 2.5 Historically, the subcontinent has always been politically fragmented from the earliest times. This is not surprising, having regard to the degree of political unity in other parts of the world at corresponding times. The establishment of the Mughal Empire throughout Northern India, and ultimately Persia and areas to the East therefore represented a milestone in the political development of the subcontinent. The Mughal Empire was also a significant time in the artistic and economic development of the region. It subordinated the varying princely states to an overarching bureaucracy and political structure.
 - 2.6 The spice trade with Europe, coincided with the formation of state capitalism in England and other European countries, which had its expression in trading entities like the Levant Company and the East India Company. History records that Britain ultimately chose a path of military domination in the subcontinent, which led to some 150 years of resource exploitation and a massive transfer of wealth to Britain.
 - 2.7 Although the period of the Raj brought to India many economic and administrative advancements necessary to capital formation on a European scale (such as uniform laws, uniform weights and measures, a land title system and the Rule of Law) it is significant to note that British rule would not have been possible in the form it took without the prior existence of the Mughal Empire.
 - 2.8 While most Australians look positively upon the British colonialism in the formation of our nation, the colonial legacy in India was different. India remained at all times essentially a coloured continent ruled over by white masters; Australia on the other hand became a



predominantly white country in which other races, including the Aborigines, were consigned to the margins.

- 2.9 The psychological impact on contemporary Indians of this historical experience is very real and cannot be understated. The events of 1857, which are commonly known to us as the Indian Mutiny are frequently referred to in India as their War of Independence, or the War of 1857.
- 2.10 Of course Britain's exploitation of the subcontinent also extended to manpower, particularly in the armies that served Britain in its various colonial adventures. Thus, not only did Australia have close links with India arising from sea trade with Britain in the nineteenth century, troops from the Australian colonies, and later Australia itself, found themselves fighting alongside Indian troops in South Africa, in Gallipoli and the Middle east, and in Europe in the First World War. This continued during the Second World War.
- 2.11 These shared experiences of British colonialism, albeit in differing forms, lead contemporary Indians to perceive themselves as having a common bond with Australia and Australians. This, and our close sporting relationship creates a good basis for closer relations between both countries, at both a governmental and private sector level.
- 2.12 When Britain ultimately granted independence to India and Pakistan, it was on different terms to that enjoyed by Australia. India also took a different path in terms of economic development. This is most particularly seen in the widespread state socialism championed by successive Indian governments, and evident today in the high degree of state ownership of the real economy.
- 2.13 There is strong evidence to suggest that the period of state ownership and excessive regulation (the latter being known as the "permit Raj") actually impeded India's economic development. This is dealt with further below.
- 2.14 Since 1991 India has, however, embarked on a process of economic liberalisation that is increasingly yielding demonstrable benefits, and



both sides of politics regard economic liberalisation as inevitable, and broadly bipartisan.

- 2.15 From our extensive contacts in Indian business circles, we believe there is a general belief among Indian businessmen that further liberalisation is desirable. This belief would also appear to be accepted at a popular level, although many wish for economic liberalisation without wanting to experience labour deregulation.
- 2.16 Alongside a rising Indian GDP is an increasing belief amongst Indians themselves that their country is destined to be a major world power. While always being reluctant to accept inevitabilities, it would be foolish to bet heavily against such an eventuality.

3 BROAD ECONOMIC DEVELOPMENT ISSUES

- 3.1 Many commentators are frequently drawn to make comparisons between the economic growth of China in the last fifteen years, and the future growth of India. Both countries have recently experienced high rates of GDP growth. Both countries come off low levels of per capita GDP, and both have populations in excess of one billion people. In the case of India, GDP grew by 8.1% in 2003-04.
- 3.2 We certainly subscribe to the view that the circumstances exist which would lead one to believe that relatively high rates of GDP growth will continue in both countries. As will be seen in Table 1 below, these growth rates would propel China to become the world's largest economy by 2015, and India the World's third largest economy.

Table 1: GDP growth and global rankings of selected economies

Country	2005 GDP		Projected GDP growth	Projected 2015 GDP	
	US\$ billion	Rank		US\$ billion	Rank
United States	12,332	1	3.2%	16,950	2
China	8,092	2	8.0%	17,550	1
Japan	4,009	3	1.5%	4,650	4
India	3,603	4	6.0%	7,015	3
Germany	2,499	5	1.5%	2,897	5
Australia	639	16	3.4%	900	21

Source: ANZ Economics

- 3.3 The factors driving growth in China and India are very different however. Whereas China has built its economic growth on trade with the rest of the world, and has funded that growth with substantial FDI, India's growth has been driven by internal factors.
- 3.4 Two headline measures demonstrate these differences very easily. For the period 1994 to 2004, exports constituted 24.5% of China's GDP whereas exports accounted for only 12.4% of Indian GDP during the same period. This shows that India's integration into the world economy lags substantially behind that of China. This is also borne out by FDI expressed as a percentage of GDP for both countries over this period. Annual FDI was equal to 4.1% of Chinese GDP, whereas annual FDI in India was only 0.8% of GDP. In dollar terms that meant China received 12.5 times more FDI than India did during 2004.
- 3.5 There are many consequences of these simple differences. China has a much greater impact on world commodity prices, at the moment, than India does, for example. China is, however, also more dependent upon a continued demand for cheap Chinese products. India, by comparison, will be able to maintain high rates

- of economic growth in the face of any slowdown in worldwide GDP growth since India's growth is mainly derived from internal sources.
- 3.6 Another useful comparison is to look at the rate of savings in each country, and where those savings are directed. China's savings rate is currently 39.7% of GDP, whereas India's is 21.9% of GDP. While both are high by western standards, China's is greater than India's by a factor of almost two. Much of India's domestic savings goes into the purchase of gold, which is essentially non-productive saving in terms of wealth creation. This is a consequence of the poor faith Indians have in their banks.
- 3.7 Ironically, while both countries' banks have high rates of NPL's, China's situation is much the more parlous. There is a view held in informed circles that China's banks are facing the prospect of a devastating crunch. Under the terms of China's accession to the WTO, it must open banks to foreign competition by the end of 2006. Offered the choice between placing their money in a crippled state owned bank burdened by loans to insolvent state owned companies, or a foreign owned bank with a much cleaner balance sheet, the likely reaction of an intelligent depositor is obvious. China's banks cannot survive a run on deposits, which is why bank regulators have been trying for the last two years to limit the growth of credit creation.
- 3.8 In India, NPL's remain at high levels, but these are more easily addressed by the introduction of foreign investment into the banking sector, and bank consolidation, which is why India has set the end of this (Indian) financial year as the deadline for the introduction of Basel II into its banking sector. It is my belief that asset recovery rates on defaulted loans are potentially high in India, whereas actual recovery rates among NPL's in Chinese asset reconstruction companies have been poor.
- 3.9 The remarkable thing about Indian growth is not that it has not matched that of China, but that it has been so high at all, given the poor state of India's infrastructure. This is most evident in the



electricity sector. Only 56% of the Indian population are connected to the mains electricity grid. Even this figure may be misleading, since it is alleged that connection was deemed to be mean one or more dwellings in a village having mains connection, rather than households or persons actually connected.

- 3.10 Even then, India's generating capacity lags far behind the level of consumption. we have not yet encountered an Indian business (other than those having captive power stations) which does not rely directly or indirectly on a back up diesel generator, so prevalent is load shedding in the major metropolitan centres. For example, in Mumbai at the end of 2004 generating capacity fell short of demand by around 3,700 MW, or 26% of peak demand. This translates to load shedding of four hours per evening. In neighbouring Pune, which is the centre of the automotive manufacturing industry, load shedding was averaging eight hours per day.
- 3.11 Despite continuing efforts to bring investment to the power sector, growth in generating capacity has consistently fallen short of growth in demand. In the period from 1994 to 2005, manufacturing output grew at a compound annual growth rate of 8.0% while generating capacity grew at a CAGR of only 6.1%.
- 3.12 So serious is this problem that the Planning Commission, in its Mid-Term Review of the Tenth Five Year Plan, acknowledged that generating shortfalls were a constraint on GDP growth. They further warned that during the current Five Year Plan growth in generating capacity would fall short of its target by between 23.9% and 34.4%.
- 3.13 Another significant constraint on economic growth is the ongoing fiscal deficit. Central and state debt now stands at 85% of GDP. The unwillingness of the Centre and the states to bring spending into line with receipts has led to India being assigned a credit rating of only BB+ by Standard & Poors. This means that it is perceived as being less credit worthy than Egypt. As a consequence of this, many potential investors have been deterred or prevented from investing in India. This is particularly so of many US domiciled funds which



are precluded from investing in other than BBB or better rated investments.

- 3.14 An improvement in the Standard & Poors rating of India's sovereign risk to investment grade will lead to an influx of funds into government bonds, and would also lead to an upgrading of the credit ratings of many public sector entities, such as ONGC, NTPC, GAIL, and SAIL. The resultant lower cost of funding would result in a significant growth in investment activity.
- 3.15 The issue for India gazers is to accurately predict the likely rate of economic growth, and the sectors that will contribute most significantly to that growth. We believe that to is safe to draw the following conclusions about future Indian growth:
- Indian GDP growth will continue at or about its current level of 6-8% per annum for the foreseeable future.
 - Indian GDP growth will be largely unaffected by changes in global GDP growth due to its low level of integration with the world economy. This will change over time as the Indian economy becomes more broadly correlated with its trading partners.
 - In the short to medium term, GDP growth will be driven by improvements in the agricultural and manufacturing sectors, although this pattern will change with a rising middle class.
 - Continued growth in the Indian economy will result in increasing demand for resources, many of which Australia is well placed to supply.
 - The most significant limitations on GDP growth will be internal, and governed by the capacity to provide sufficient infrastructure to sustain economic activity.
 - GDP growth could exceed its current level if the appropriate policies are followed by the Central government. These include broad financial sector deregulation, easing restrictions on foreign investment, and greater fiscal responsibility.

3.16 Finally, while there are those who doubt that India and China can be major economic powers, we merely note that if both countries continue on their current rates of growth, their share of the global economy in 2025 will be the same as it was in 1825.

4 THE CASE FOR AN INDIA STRATEGY

- 4.1 Given the policy of successive Australian governments to seek to cement Australia's place within the East Asian region, it could be argued that placing greater emphasis on our relations with India constitutes a significant shift in our foreign relations policy. The contrary argument is that improving relations with India is a complementary strategy to Australia's existing focus on East Asia.
- 4.2 As has been demonstrated above, India can be expected to display high rates of economic growth over the next decade or longer. Much of this growth will demand consumption of resources such as iron, coal, gas, aluminium, magnesium, and other mineral resources which Australia is capable of supplying. Moreover, our close geographical proximity means that Australian exporters enjoy a advantage over many of their rivals due to lower transport costs. The same is true of the potential trade in agricultural commodities, and many services.
- 4.3 In our view there are clear tangible benefits to this. With much of Australia's trade in commodities being directed towards China, Australia runs dangerous concentration risks. Any sharp downturn in Chinese demand would represent a major economic blow to Australia.
- 4.4 To mitigate this risk, Australia should embrace the opportunities, outlined below, to develop exports and outward investment to India. This would enable Australia to better survive any economic shock that might be caused by a change in China's economic circumstances.



- 4.5 On a more positive note, China's dramatic growth over the last fifteen years has been such that it has actually changed the prices of the things it consumes, and produces. As a significant net importer of commodities, and a significant net exporter of manufactured goods, China has pushed up the prices of commodities, and reduced the manufactured goods. This has resulted in a major improvement in Australia's terms of trade since 1994.
- 4.6 It is in Australia's best interests that this improvement in our terms of trade continues. The best way for us to bring this about is to pursue a strategy which stimulates the demand for commodities, and which will at the same time continue to reduce the price of manufactured goods.
- 4.7 India has second largest population in the world, and is likely to maintain high rates of GDP growth for the foreseeable future. It follows, therefore, that India represents the best opportunity for Australia to prolong and improve upon this trend in our terms of trade.
- 4.8 From a political perspective, it is in Australia's interest that the broader Asian region should not be dominated by any one power, even one with whom we might be broadly aligned. To that end, the rise of India as a regional power is potentially very advantageous to Australia, provided that we can forge a close relationship between our two countries.
- 4.9 In this regard, India is a natural political partner. It is the world's largest parliamentary democracy, adheres to the rule of law, and is embarked upon a process of economic deregulation which will deliver an increasingly free market economy.
- 4.10 Notwithstanding all of the above, it would be foolish to believe that closer relations between Australia and India are inevitable, or even obvious. To bring the potential benefits to both countries to fruition will require clear direction and leadership from those foremost in business and politics. It is essential, therefore, that the Australian government formulate an "Indian strategy" and that this be



communicated to the business sector and the broader community. Business should likewise be encouraged to make provision for India in their broader planning. This might be achieved by having a high level Government task force to encourage these business links.

5 AUSTRALIA'S CULTURAL ADVANTAGES

- 5.1 The British colonial experience shared by India and Australia gives rise to a number of cultural similarities which mean that Australia is well poised to forge closer relations with India. Importantly, many of these opportunities are not enjoyed by other countries with whom we compete in economic terms, leading to our having significant comparative advantages.
- 5.2 The first and foremost similarity we have with India is in our political systems. Like Australia, India is a federal nation, with three levels of government that correspond closely to that seen here. This makes it easy for Australians to understand the governmental system, and to adopt appropriate planning strategies in their dealings in India.
- 5.3 Like Australia, India also inherited a British legal system. Many major components of Indian legislation, like their companies law for example, were either enacted prior to independence, or are essentially modifications of earlier British laws. Since all economic activity is governed by the legal environment in which it is conducted, Australians enjoy potential advantages in conducting business in India. These similarities are not shared with many of our trading rivals. For example, companies based in Europe are governed by a civil law system, and hence they can find difficulties in understanding the environment in which they might potentially make investments, or enter into trading agreements. The same applies to investment out of the United States of America.
- 5.4 Another similarity we share is linguistic. While India has a number of vernacular languages, English is the first language of business.



Although this does not give Australia any particular advantage, it does make it easier for Australians to do business in India than other Asian countries, such as China or Japan, for example. The lack of a necessity to employ translators also reduces the costs of conducting business, especially in the establishment stages.

- 5.5 Finally, there are intangible advantages to doing business with India. These include the Indian perception of Australia having had a similar colonial experience, and a shared love of cricket. These factors are impossible to quantify, but in my experience are important in building relationships in India.

6 THE IT CHIMERA

- 6.1 There is no doubt that the IT sector has been a great Indian success story. This is particularly so in a country which remains largely agrarian. In 2003-04 the agricultural sector accounted for 67% of total employment, although accounting for only 22% of GDP. The total services sector employs 21% of the workforce, and accounts for 52% of GDP, but the IT sector is only a small portion of this.
- 6.2 The McKinsey Global Institute estimates that the IT sector employs only 1 million people, and accounts for only 4% of GDP. Seen in this context, it is obvious that it is incapable of making a meaningful contribution to the welfare of the 600 million people who live in rural areas. This is all the more evident when one recalls the low rate of connection to mains power. Without electricity it is simply not possible to operate a computer, use the internet, or participate in the IT sector. For those people who lack electricity, the IT sector is simply an irrelevancy.
- 6.3 Supporters of the importance of the IT sector argue that it is a generator of wealth which will ultimately drive the Indian economy forwards, and that the wealth generated will be diffused throughout the Indian economy. These views are not supported by facts. At 4%



of GDP, the IT sector is not capable of driving general economic growth. Perhaps more importantly, the wealth created through this sector is narrowly confined, and is not widely distributed.

- 6.4 It should be understood that the cost of computer hardware in India is roughly the same in dollar terms in India as it is in Australia. This is attributable to two facts. India is not a major manufacturer of computer hardware, and therefore has to import most computers from overseas. Moreover, high tariffs and state sales taxes mean that in some cases computers are actually more expensive in India than they are in Australia.
- 6.5 The cost of computer hardware is important in considering who gains the requisite skills to obtain employment in this sector of the economy. In India, a family is considered middle class when its total household income exceeds Rs 3 lakhs, or approximately A\$9,000 per annum. Assuming that the cost of a computer is around A\$1,000, this means that purchasing a home computer represents an investment of over 11% of a middle class family's entire income for a year.
- 6.6 Given that employment in the IT sector is given almost entirely to those who have prior computer skills, it follows from the above that most of the one million IT sector workers are from middle class families, and upper middle class families at that. It is not a sector which is open to facilitating the upward social mobility of India's urban working classes, nor India's agricultural classes.
- 6.7 From an Australian point of view, it should also be understood that computer services skills are a broadly international market in which Australia has no broad comparative advantage, even though particular Australian companies may have some narrow advantages that will allow them to achieve success either in the Indian market, or in collaboration with an Indian partner.
- 6.8 The IT sector will continue to be important to India, but in a narrowly focused way. It will not, however, be a major driver of the Indian economy while the economy remains largely agricultural, and there



exist major disparities between those living in the cities and those living in rural areas.

- 6.9 Whilst not dismissing the IT sector to Australia, it would appear more realistic to recognise it as an area whose promise is not as great as a number of other sectors.

7 AUSTRALIA'S TRADE & INVESTMENT OPPORTUNITIES

General Principles

- 7.1 There are significant trade and investment opportunities for Australian companies in India. These follow from the broad economic growth that India will experience, but also have specific foci that are correlated with areas of economic activity in which Australia has demonstrable advantage.
- 7.2 Although it is impossible to predict every sector in which Australian companies will be successful, it is possible to identify certain sectors where our expertise or competitiveness makes success in trade and investment more likely. We have endeavoured to identify a number of promising sectors in the following paragraphs.

Infrastructure

- 7.3 As noted above, infrastructure investment in India is some way short of what is necessary to sustain a modern industrially developed country. These infrastructure shortages are across the board, and include electricity generation, road transport infrastructure, ports, airports and water supplies. Rather than dealing with each and every one of these, we will restrict our remarks to the electricity sector, where we have undertaken a large body of work, and use this as an example of the opportunities which exist in infrastructure provision generally.



- 7.4 The failure of investment in electricity generating capacity to keep pace with consumption has already been briefly discussed at paragraphs 3.9 to 3.12 above. It is useful, however, to deal with the problem here in greater detail, as it is a singular exemplar for the broad infrastructure sector.
- 7.5 The electricity generating shortfall which has been observed is not a problem which had not been predicted. Electricity generation has been a high priority for a number of Five Year Plans, yet as Table 2 below shows, generating capacity in this Five Year period will again fall short of what was planned.

Table 2: Generating capacity targets vs. actual additions in MW

	Tenth Plan Target	2002-03	2003-04	2004-05 Expected	2005-07 Likely	Tenth Plan Likely Actual
<i>Centre</i>	22832	1210	3035	3630	9222	17097 (74.9%)
<i>State</i>	11157	1114	819	1443	7727	11103 (99.5%)
<i>Private</i> [^]	7121	548	232	173	2137	3090 (43.4%)
<i>Total</i>	41110	2872	4086	5246*	19086	31290 (76.1%)

* Actual as at the end of Jan'05 was 3644 MW.

[^] Excludes windmill capacity with private sector

Source: Planning Commission of India

- 7.6 From the table, it is evident that both private sector investment and central government investment fall short of India's needs. The reasons for this are instructive.
- 7.7 Many generating projects have been mooted recently, however they have been slow to come to fruition. One of the problems has been the creditworthiness of the Indian central government. This came in part from the uncertainty arising from failure of the Dhabol power project. Since the resolution of the claims of US investors in 2005, there has not been any noticeable improvement in project financing.
- 7.8 The principal issue remains broad creditworthiness. In so far as government projects are concerned, financing costs are escalated

because of India's poor credit rating. The difficulties associated with obtaining financing guarantees for EPC contracts extends the lead time of projects to a substantive degree, and in turn leads to higher EPC costs.

- 7.9 Once a government project has been commissioned, there are also creditworthiness issues that flow from the operation of the plants. These revolve mainly around the credit risk assumed by suppliers of feedstock. Most Indian power generation is thermal, and most of that is coal fired, although gas fired stations contribute sizeably to generation as well.
- 7.10 Although India has large deposits of steaming coal, it is unclear whether these deposits will be sufficient in the near term to meet the requirements of power generation. It is certainly the case that Indian companies are looking to Australia to source their requirements of both steaming and coking coal.
- 7.11 Even if India can meet its coal needs domestically (which we doubt) it will need mining expertise to extract these deposits. In either case, it will be dependent upon foreign companies to either sell coal and gas, or else assist in the extraction of domestic deposits. Again, the credit rating of the government owned power stations is an issue, since suppliers have to assume a counterparty risk when they supply coal, gas, or services.
- 7.12 It will take some time for all ratings agencies to accord the Government of India an investment grade rating. Even after this has happened, issues will revolve around the creditworthiness of the various power companies and state power boards.
- 7.13 There is no doubt that Australia has very valuable expertise in the construction of thermal and hydroelectric power stations, as well as the transmission of that power across large distances. This expertise is the result of domestic experience in meeting Australia's own power challenges, and the provision of power to large industrial consumers such as iron ore and aluminium smelters and refiners, for example.

- 7.14 Australian companies could gain a very tangible advantage in penetrating the Indian infrastructure market if they could defray the risk incurred on these projects. A realistic way in which this could be achieved would be if the Australian government entered into an investment financing agreement with the Government of India. This would entail the Australian government agreeing to carry the cost of credit insurance through EFIC as part of the national interest cover. In turn, the Australian government would receive a direct governmental guarantee from the Government of India that the underlying payment obligations would be met. This would be similar to the financing arrangements entered into for exports to Indonesia and Korea in the aftermath of the Asian Financial Crisis.
- 7.15 These financial arrangements would be applicable not only to the power sector, but also to engineering contracts in other areas of infrastructure spending, such as water and roads.
- 7.16 Of course, Australian companies also have a great degree of experience in the provision and operation of infrastructure projects, both at home and overseas. This has been made possible by innovative financing structures developed by Australian banks, and funded in large part by investment funds here in Australia.
- 7.17 We believe that there is great scope to exploit this expertise in India in just the same way as our engineering and mining expertise could be brought to bear. A higher government focus on our relationship with India would, we believe, encourage investment funds to look to India as a potential destination for their investments.
- 7.18 Apart from the major infrastructure projects, such as the construction of power plants, or dams, there is a plethora of business available to Australian companies in maintaining or upgrading existing infrastructure. These opportunities range from contracts suitable to Australian SME's in smaller towns and villages, to major contracts in the metropolitan centres.

Agriculture



- 7.19 As noted above, agriculture is by far the largest source of employment in the Indian economy, and contributes in a significant way to Indian GDP. It is, however, burdened by inefficiency. This is notably demonstrated by the fact that although it has the world's largest area under cultivation (161 million ha), it has had to resort to importing food in recent years in order to meet domestic demand.
- 7.20 Not only are yields low compared to Australian agriculture, post harvest losses are very high. Post harvest losses amount to 10% of all grains and 25% of all fruit and vegetables. There are a number of reasons for this, but the foremost is that only 25% of total production utilises any form of scientific storage.
- 7.21 It is too early to predict whether India will, in the long run, become a major competitor to Australia in key agricultural markets. While this is a possibility, it is equally possible that rising disposable income will lead to a greater consumption of agricultural produce than India can supply itself.
- 7.22 In any event, there are opportunities for Australia to provide extension services to the agricultural sector, and to participate in the processing, storage and distribution of agricultural commodities within India.
- 7.23 Although many areas of farming remain tightly controlled, India has, in principle, now made FDI possible in floriculture, horticulture, seed development, pisciculture, tea plantations, the cultivation of mushrooms and vegetables under controlled environments, animal husbandry, food processing, agricultural services.

Financial Services

- 7.24 At present there is little involvement between the financial services sectors of Australia and India. Of the 286 Indian trading banks, only one, State Bank of India, has a banking licence in Australia. No Australian bank has a full banking operation in India.
- 7.25 To some degree, the existing restrictions on the level of foreign investment in Indian banks can account for this lack of



correspondence, although it is to be noted that there seems little integration in each country from NBFIs in the other.

- 7.26 The low level of correspondence in financial services should be a matter of concern to the Australian government, since it makes trade and investment financing difficult. Nearly 90% of all international trade with India is conducted on confirmed letter of credit or similar terms. A greater presence by Australian banks in India would make it easier to facilitate exports to India, as well as provide performance guarantees on engineering contracts.
- 7.27 We note that British and American banks are increasingly focusing on the possibilities for them in India, and at the end of 2005 we advised a British bank in the largest secondary market transaction yet undertaken in the Indian debt market. While British banks have a long tradition in the Indian market, American banks do not. American bankers have reported that they have been moved to enter the Indian market in search of higher yields, and because of the increasing interest in India on the part of American corporates.
- 7.28 One of the reasons British banks have been the main foreign participants in India's banking sector has been because the prevailing legal system is essentially British, so that in the areas such as the registration of real title interests, and the creation and enforcement of security interests, British banks have always had an advantage in understanding the inherent risk profile of the transactions undertaken.
- 7.29 There is no reason, however, that British banks should be so singularly advantaged. Since Australia also has a British legal system, Australian banks could derive an equal advantage within the Indian financial services market.

Educational Services

- 7.30 While most countries in the developing world face the prospect of a declining workforce, this is not the case in India. Not only does India's population continue to grow, the median age of the Indian



population is approximately 22, and is not expected to reach 35 until shortly after 2040.

- 7.31 There are many implications that flow from these demographics. One is the fact India will be the increasing source of global labour for the first half of this century. Another implication is that India will have an increasing demand for educational services. Education remains a significant issue for India's development. For example, as at 2002, India's adult literacy rate was only 61.3%, and the literacy rate among women was as low as 46.4%. With basic skills receiving such poor attention, the provision of vocational skills training can only be assumed to be as poor or worse.
- 7.32 For Australia, India's age profile and need for educational services represent a significant potential market. In recent years Australia has worked hard to improve the provision of vocational education through both the private and public sectors. The lessons learned by Australia's vocational training providers during this time will place them in good stead in providing similar services to the Indian market.
- 7.33 It is reason to posit that Australian companies will be able to gain market entry opportunities on the back of possible Australian investment in infrastructure, and EPC contracts won by Australian companies. For example, an Australian engineering company which wins a contract to construct a gas pipeline would need to source a certain portion of its workforce locally; and the best way in which to ensure that the labour force is capable of meeting the specific skill requirements of the contract would be to use an Australian vocational training company to provide local skill based training.
- 7.34 Opportunities also exist for Australian universities to tap into the demand for undergraduate and postgraduate level education. Indians look favourably on overseas university education, or education provided by overseas institutions through distance education or residential courses. Many Indian students attend UK

and American universities to obtain postgraduate degrees, particularly MBA courses.

- 7.35 Although the cost of obtaining such degrees is high, Indian banks know that graduates can look forward to good prospects, and aggressively market educational loans. For example, Bank of India currently offers loans of up to Rs 7.5 lakhs (approximately A\$22,000) for university study within India, and up to Rs 15 lakhs (approximately A\$44,000) for study overseas.
- 7.36 Australian universities have shown themselves adept at tapping into the market for degree courses, and there is no reason to believe that, with proper planning they should not be at least equally successful in India.

8 IMPEDIMENTS TO CLOSER RELATIONS

- 8.1 The impediments to closer relations between India and Australia fall broadly into three categories: regulatory; policy; and, attitudinal.
- 8.2 The regulatory impediments to closer relations are predominantly economic, taxation, and investment regulations within India.
- 8.3 Many regulations in India seem to lack any basis that would appear rational to an Australian observer. This notwithstanding, such regulation is accepted without much questioning by most of the Indian population, and defended vigorously by the bureaucracy which administers it.
- 8.4 Most economic studies of the existing economic regulatory environment have found strongly in favour of deregulation, drawing the conclusion that the excessive bureaucracy stifles greater productivity. From our experience, these conclusions are correct.
- 8.5 Much management time is devoted to procuring endless permits from grossly inefficient government offices. An example of this can be seen in the fact that it has taken our Chennai office several months to obtain a title deed which had been erroneously lodged



with a Debt Recovery Tribunal. Much of that time was taken up by the Tribunal staff insisting that they did not know where the documents were, and then later refusing to release the deed to the bank that had deposited it in the first place.

- 8.6 It is interesting to observe that the industries which have exhibited the greatest growth have been those which were not subject to regulation. The IT sector is a classic case in point. It was able to grow and flourish because there was no prior regulation governing who could establish a computer services company, what permits were needed, how many people could be employed, where the business was to be conducted or so on.
- 8.7 Australian companies wishing to do business in India are as disadvantaged by these regulations as most other foreign investors, although one could make the case that excessive regulation deters many Australian companies from entering India in the first place.
- 8.8 India has been willing to enter into bilateral agreements on foreign investment and business regulation which have had the effect of lessening the impact of the regulatory framework. The best example of this is multilateral arrangement being negotiated as part of South Asian Association for Regional Cooperation that will reduce or eliminate many impediments to business and investment among India, Bangladesh and Sri Lanka.
- 8.9 It is our belief that Australia should work towards reaching a similar framework agreement with India as part of a broad reworking of the bilateral relationship. Matters for inclusion in such an agreement would include automatic approval for certain classes of investment, the free repatriation of capital and profits, and "one-stop shops" within the trade departments of both countries to assist in obtaining necessary permits.
- 8.10 Another matter requiring attention is the existing double taxation agreement between Australia and India. While a double taxation agreement currently exists it needs to be revisited so that issues such as the recognition of franking credits generated by companies



operated in India but owned by Australian interests as available under Australian taxation law are addressed as failure to do so substantially affects the return on such investments.

- 8.11 Solving this problem should be a priority for the Australian government in order to facilitate better trade and investment between India and Australia.
- 8.12 The attitudinal impediments to better relations between the countries lie principally in mutual ignorance. These impediments can be overcome by concerted efforts by both governments to raise the profile of the relationship, and to explain the benefits of closer relations. For countries that have so much to gain from working with each other, there seem to be a paucity of Ministerial visits and other political exchanges. Greater emphasis should be placed on political exchanges and mutual trade and investment promotion. A political exchange programme similar to the one currently operating between Australia and the United States would serve to significantly raise the level of political understanding on both sides of the Indian Ocean.
- 8.13 The Australian government should also investigate the possibility of more cultural exchanges with the Indian government.