ASIA MONTHLY

April 2019

Topics Rising expectations toward startup companies in India ···················1
Topics China's economic stimulus measures are fully in progress ·············3

株式会社日本総合研究所

http://www.jri.co.jp/english/periodical/asia/

This report is the revised English version of the April 2019 issue of the original Japanese version (published 29th Mar.).

Topics Rising expectations toward startups in India

Startups are gaining momentum in India. Investments towards Indian startups are flowing from all around the world, with expectations that India will become a startup superpower in the future following the example of China.

■ Increase in the launch of startups

India has been known as a global hub for offshore development (outsourcing the development of systems and software to overseas enterprises, etc.) and overseas BPO (business process outsourcing, the off-shoring of IT and back-office operations) centers. However, major global enterprises have, in recent years, been establishing research and development centers for IT in India. Through these developments, India has accumulated knowledge, technology, and human resources, leading to the boom in the launching of startups, and the world has started to recognize India as a startup nation. According to NASSCOM, the trade association of the Indian IT BPM industry, more than 1,000 technology-related startups have been established every year since 2016. Some of them have grown significantly, becoming "unicorns," i.e. privately-held companies with estimated valuations worth US$1.0 billion or more. There are at present 13 unicorns in India (CB Insights, as of January 2019).

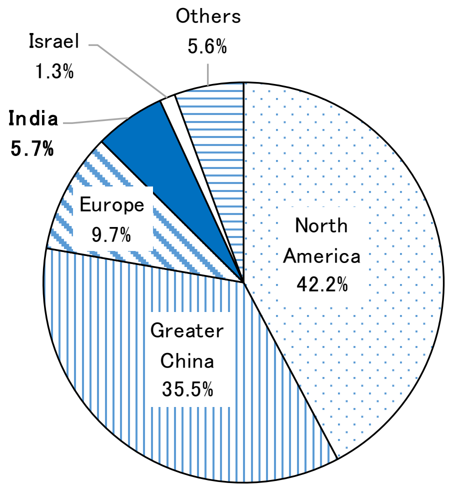
Most Indian startups adopt so-called "time machine" business models: adopting businesses or business models that have succeeded in developed countries. However, successful startups have, instead of just copying the businesses or business models, have modified them to adapt to the situation in India. For example, in the case of E-commerce, startups have established their own logistics system to cope with the poor distribution network, while offering cash-on-delivery services to respond to the low credit card penetration rate. Meanwhile, startups which are fully utilizing cutting-edge technologies such as artificial intelligence (AI), IoT, and data analysis, or those which strive to solve various social problems that India faces, have been increasing gradually in recent years.

■ Inflow of investment and support by government policies

Indian startups have recently been receiving worldwide attention. As people witnessed China growing into the second largest startup superpower after the United States over the past 10 years, they expect India, which has a similarly large population and enjoying high economic growth, to follow a similar course as China and become the next startup superpower. Reflecting on such a situation, investment in Indian startups has risen. India attracted 5.7% of global venture capital investment in 2017, becoming one of the major investment destinations in the world. Furthermore, investors have become more diverse. In the past, a large portion of investment came from the United States, but today investment is also coming from various countries such as Japan, China, and South Korea.

Along with a rise in investment by institutional investors, investment by enterprises have increased. There are two reasons for this: firstly, they aim to secure advanced technologies and top-notch human resources owned by Indian startups. Acquisitions by most of the U.S. major IT companies fall into this category. Secondly, they aim to tap the Indian market. India is forecast to become the most populated country in 2024, surpassing China. Furthermore, India is expected to continue receiving a "population bonus," the benefit of economic growth brought about by the rise in the working-age population, due to its young population. Focusing on such a great future as a market, they have the intention of securing a foothold.

<Venture Capital Investment Amount by Country/Region (2017)>



Source: Preqin, *Venture Capital Activity in 2017: exclusive extract from the 2018 Preqin Global Private Equity & Venture Capital Report*, 2018

Regarding government policies,

the Modi administration has launched "Startup India," an initiative to promote budding entrepreneurs in India. The administration aims to achieve sustainable economic growth and to generate employment opportunities by nurturing startups in India. The Action Plan of Startup India announced in 2016 consists of three pillars: (1) simplification of various procedures, (2) the grant of funding support and incentives, and (3) the promotion of industrial-academic alliance and incubation. In response to the central government's efforts, local governments have launched their own promotion measures one after another, competing to entice startups across the country.

■ Issues to be addressed to bring benefits to the entire economy

It is only in the past few years that the launch of startups has become full-fledged in India. Therefore, the country is still in the initial stage of development. Many startups have been forced to fight an uphill battle because of entrepreneurs lacking experience, a lack of peripheral environment development, and an insufficient support system. However, the business environment is expected to improve gradually in the future due to encouraging factors, such as the rise in the inflow of investment money and the government's incentive measures.

Nevertheless, we believe it is important to upgrade the overall business infrastructure so that activating the launch of startups will result in bringing benefits not only to particular enterprises and fields but also to across every corner of the Indian economy in the form of improved productivity and increase in employment. For example, quite a few Indian startup companies have their head offices in Singapore or the United States where business infrastructure is well established, although they mainly conduct business in India. As results of the economic reform under the Modi administration, India leapt from 130th place in 2016 to 77th place in 2018 in the World Bank's "Ease of Doing Business ranking." However, India's ranking is still low at the absolute level. There is as yet room for improvement, especially in the field of real estate registration, contract fulfillment, and tax payment. India needs to strive to improve its business infrastructure on a long-term basis.

(Kaori Iwasaki)

<Startup India Action Plan>

(1) Simplification and Handholding

- Compliance regime based of self-certification
- Legal support and fast-tracking patent examination at lower costs
- Relaxed norms of public procurement for startups
- Faster exit for startups

(2) Funding Support and Incentives

- Providing funding support through a fund of funds with a corpus of INR 10,000 crore (INR 100 billion)
- Credit guarantee fund for startups
- Tax exemption on capital gains
- Tax exemption to startups for 3 years

(3) Industry-Academia Partnership and Incubation

- Organizing startup fests for showcasing innovation and providing a collaboration platform
- Harnessing private sector expertise for incubator setups
- Buiilding innovation centres at national institutes
- Setting up of 7 new research parks modeled on the research park setup at IIT Madras

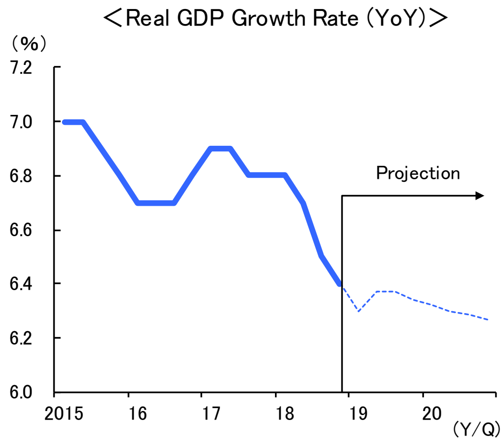
Source: Startup India, *Action Plan*, January 16, 2016

Topics China's economic stimulus measures are fully in progress

After entering 2019, the Chinese government implemented economic recovery programs, such as an increase in lending, tax reduction, and frontloaded issuance of local government bonds, one after another. Thus, these measures are expected to help China avoid entering into a serious recession, but may prevent the country from solving its structural problems in a timely manner.

■ The administration changes its stance to place prime importance on economic growth

The slowdown in the Chinese economy has become remarkably obvious these days. In the October to December quarter of 2018, China's real GDP growth decreased to 6.4% from the same period of the previous year, declining for three consecutive quarters. Furthermore, we have seen bad economic omens, including a downturn in imports, similar to ones we witnessed during the financial crisis in 2008 (the collapse of Lehman Brothers) and the China shock in 2015.



Source: The Japan Research Institute, Ltd. based on data from the National Bureau of Statistics

The largest factor to decelerate economic growth is a slowdown in fixed asset investment. In particular, capital expenditure by manufacturing industry is weak. The declining capacity utilization indicates that the sense of overcapacity at enterprises is becoming stronger. Imports of capital goods, which reflect the trend of capital expenditure, also decreased sharply. Such a slump in capital investment is attributable to the fact that the Chinese government strengthened the deleverage policy to restrain the expansion of credit and debt obligations.

However, the Xi Jinping administration reviewed its excessive deleverage policy and shifted the focus of its economic management to stable economic growth, since it felt a strong sense of crisis over a sharper-than-expected decline in capital expenditure. According to the reports on government activities announced on March 5, 2019, the first day of the National People's Congress (NPC), the Xi administration also clearly showed its stance that it will not allow a sharp downturn in economic growth by implementing a fiscal stimulus and an easy-money policy.

The Chinese government's economic measures can be classified into the following three categories: (1) measure to expand capital expenditure, (2) measure to promote infrastructure investment, and (3) measure to stimulate private consumption.

Firstly, monetary easing is a policy package that the central government immediately introduced as a measure to expand capital expenditure. The People's Bank of China (PBOC) cut the deposit reserve ratio by 0.5 percentage point on January 15, 2019 and January 25, 2019, respectively. The PBOC has lowered the ratio over the past year faster than it did during the China shock. The move allowed financial institutions to reduce cash that they must hold as reserves (with no interest paid on reserves) at the PBOC, which in turn enabled them to increase lending to enterprises for capital expenditure and to individuals for the purchase of houses. Furthermore, the Chinese government requested financial institutions to expand lending to enterprises and to lower lending interest rates.

The tax cut for enterprises and reduction of social security costs presented at the NPC are considered as measures to expand capital expenditure. Specifically, these measures are comprised of the following three pillars: (1) the lowering of the value-added tax rate (manufacturing industries: from 16.0% to 13.0%; and transportation industries: from 10.0% to 9.0%), (2) various tax reductions for small-to-medium-size businesses, and (3) the reduction of the burden of social security contribution on enterprises, including pension premiums, and the hike of the public contribution percentage. The central government explained that these measures would alleviate the burden of tax and social security costs for enterprises by around two trillion yuan. According to the Standing Committee of State Council of the People's Republic of China on January 9, 2019, the tax relief measures, such as reduction of income tax for small-to-medium-size businesses, value-added tax, natural resources tax, and urban land-use tax, are temporary and will end by 2021.

Secondly, a frontloaded issuance of local government bonds was announced as a measure to promote infrastructure investment at the Standing Committee of State Council of the People's Republic of China on January 9, 2019. Every year, the issuance limit of municipal bonds is approved at the NPC held in March. After that, local governments issue local government bonds to raise funds for improving infrastructure and purchasing land. However, as the approval for issuing municipal bonds was pushed forward to January 2019 this time, local governments, including the City of Beijing and the Guangdong province, issued bonds successively, starting with the Xinjiang Uygur Autonomous Region. At the NPC, the issuance limit of special municipal bonds, one of municipal bonds, was raised to 2.15 trillion yuan in 2019, up by 0.8 trillion yuan from 2018.

Thirdly, the subsidy program for purchasing automobiles and electrical appliances was introduced as a measure to stimulate private consumption. For example, the Beijing government already announced that it would grant a subsidy, equivalent to 8.0% to 20.0% of the sales price, for 15 kinds of electrical appliances, such as television sets and refrigerators. This measure is valid only for three years from February 1, 2019, and persons who are recorded in the city's register or live in the city are eligible for the subsidy program. The NPC added a job training program for stabilizing employment (for approximately 15 million persons in total) and emphasized the implementation of personal income tax cut and preferential measures for child rearing and nursing care again.

■ Putting a brake on economic slowdown

Then, how should we evaluate the effectiveness of these measures? First of all, it is rather difficult for us to believe that the measures to expand capital expenditure will immediately lead to the expansion of capital spending, since Chinese enterprises hold excess capacity and have excessive liabilities. In China, capital investment in information technology and the automation of manufacturing process grew sharply from 2016 to 2018. Capital spending expanded rapidly over the past few years, so that we think it will need considerable time to see the sense of overcapacity come down. In addition, the corporate outstanding debt-to-GDP ratio in China has already exceeded that of Japan observed during the period of the economic bubble. Enterprises tend to become cautious about further expansion of liabilities, due to the heavy burden of interest payments. As the interest elasticity of enterprises' capital demand declines greatly, capital spending is unlikely to rise, even if the government takes an easy money policy.

Meanwhile, we expect that the measures to promote infrastructure investment will produce positive effects steadily. Zhejiang Province, which issued municipal bonds worth 46.3 billion yuan in January 2019, has expressed that it will use the raised capital for improving roads, constructing schools, and treating waste water. Henan Province, which issued the largest amount of municipal bonds next to Zhejiang province, plans to invest capital in the improvement of railways, redevelopment of an area where many poorly built houses are crowded together, and construction of hospitals. The amount of local government bonds issued in January alone has already reached 418 billion yuan, which is equivalent to 30.0% of the total amount of bonds issued in the period of January to June 2018.

Furthermore, we believe that the measures to stimulate private consumption are likely to largely help to halt economic slowdown, since the subsidies for purchasing automobiles and electrical appliances is projected to reach an appropriate size.

The capital raised through municipal bonds that local governments plan to significantly expand the issuance of can be used not only for investing in infrastructure but also for stimulating consumer spending. In this connection, television sets and refrigerators are found in almost all the households in China. However, the penetration rate of automobiles still remains at a low level in China, one unit for every seven persons, far below Japan's level of one unit for every two persons. Considering this fact, we think that the subsidy program to purchase automobiles will be more effective.

As we discussed above, the Chinese government's economic stimulus measures are having a considerable effect on a pickup in infrastructure investment and the sales of automobiles, enabling to prevent the slowdown from turning into outright recession. Although the economy continued slowing down in the January to March quarter of 2019, the economic slowdown is estimated to temporarily end in the April to June quarter of 2019.

However, it can be said that these simulative measures have been realized by shelving fiscal improvement of local governments. Furthermore, the measures may make problems, such as excess capacity and excessive liabilities, more serious. Of course, the Xi Jinping administration fully understands this matter. Nevertheless, the Xi administration has no other choice but to shore up the economy by implementing both monetary and fiscal policy in order to stably manage government administration. It can be considered that the economic stimulus measures reflect the Xi Jinping administration's strong sense of crisis that if it stands idly by and does nothing, the situation will become serious.

(Shinichi Seki)