ZURICH

Topical Thoughts
March 2024

India's golden opportunity

India shines as one of the fastest-growing economies in the world. Having surpassed China as the most populous nation, India boasts a young demographic profile and a rapidly expanding middle class. These advantages, coupled with the global trend of diversifying supply chains away from China, have attracted global firms to the country, presenting India with a golden opportunity to thrive in the coming decade. However, India's success in leveraging this opportunity will hinge on its ability to tackle a number of structural challenges that currently impede its full growth potential.

India's past decades

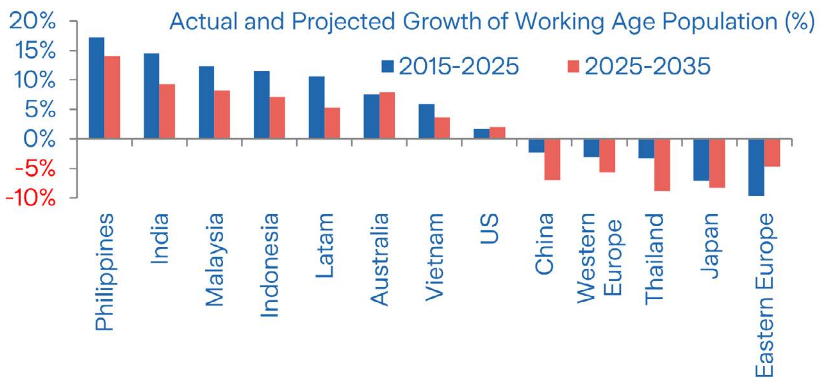
Before transitioning to an open economy in the 1990s, India followed a socialist economic model, emphasising protectionism and state control. After a severe economic downturn in the late 1980s, the economic liberalisation in the 1990s marked a pivotal change, leading to a significant increase in growth from low single digits to double digits at its peak in the 2000s. In recent years, growth has stabilised at around 6-7%.

Despite a significant transformation of the economy over the last few decades, elements of the past remain. The public sector continues to play an important role in the economy, bureaucratic hurdles endure, and trade barriers persist, leaving India less integrated into global trade compared to many of its Asian counterparts. However, as India's growth is more domestically focused than its peers, it benefits from internal drivers more so than other countries that rely largely on global trends.

Demographic dividend: a huge advantage

With a population of around 1.4 billion, India is now the world's most populous country, according to the United Nations' latest estimate. The median age of the population is approximately 28, with close to 70% of people in the working-age range of 15-64. This provides India with an exceptionally favourable demographic profile for economic growth.

Demographic tailwinds offer a major boost to India's economy



Source: United Nations

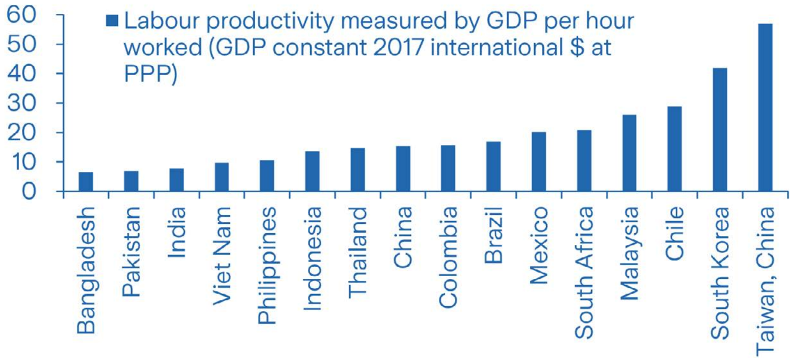
From an income perspective, India's middle-income bracket includes more than 400 million people, representing about 30% of its total population. According to forecasts by the People Research on India's Consumer Economy, the number of middle-income households is expected to double over the next 20 years. This segment forms the key customer base for consumer goods and services, representing a vast market for firms in the coming decade.

Demographic advantages, however, are not low hanging fruits

While India's robust population growth and youthful workforce offer significant economic advantages, the country faces challenges in fully capitalising on these benefits. Key obstacles include low labour participation rates and inadequate education levels among the workforce.

India has a labour participation rate of around 52%, primarily driven by an exceptionally low rate of female participation of around 30%. Although India is well-known for its highly skilled tech workforce, this segment does not represent the broader working population. India's Human Capital Index, a metric devised by the World Bank, remains low, ranking 116/174 countries. Around 71% of adults lack upper secondary education. This educational deficit contributes to lower productivity and skill levels in India compared to China and other major emerging economies in Asia.

India's labour productivity lags most of its emerging market peers



Source: International Labour Organisation

Despite rapid economic growth, the unemployment rate is high, hovering between 7% and 8% over the past decade. With over 60% of people living in rural areas and slow urbanisation, the informal sector that operates outside of the formal labour market and mainly includes low-skill and low-paid jobs, continues to play an important part in the economy. Wage growth in this sector has been sluggish and productivity is low.

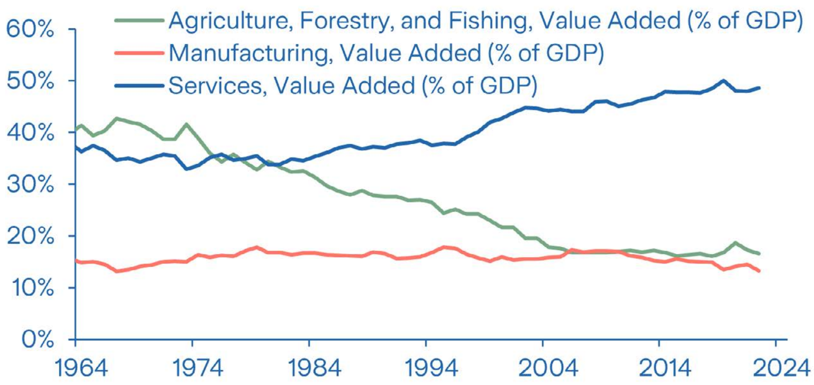
From the consumer perspective, Indian consumers are relatively poor, with an average of more than four members per household often relying on a sole breadwinner. Despite being one of the world's fastest-growing economies, India grapples with a stubbornly high poverty rate. Around 12% of the population lives on less than USD2.15 a day, which is higher than that of many of its emerging market peers. Therefore, discretionary spending is limited and consumers are price sensitive. Given the country's diverse cultures, languages, religions, and income strata, India's consumer market is complex and fragmented. As a result, firms need to establish extensive distribution networks and deeply understand cultural nuances to effectively reach diverse consumer segments.

Overall, to fully capitalise on its demographic dividend, India needs to boost labour participation, especially among women, and shift workers from low-skilled sectors like agriculture to more productive areas such as manufacturing and services. Crucially, driving long-term growth hinges on enhancing labour productivity through substantial investments in education and training for the overall labour force, rather than relying heavily on a small pool of highly skilled workers in the service sector to drive growth.

India’s economic model is unique

India’s economic model is notably distinct from that of its emerging market peers, which are mostly export-oriented and focused on commodities or semiconductor exports. In contrast, India’s economy is service-driven and domestically oriented, with the service sector contributing around 50% to GDP, while the agriculture and manufacturing sectors each account for below 20% of GDP. This pattern differs from many developing economies, where manufacturing typically precedes the emergence of services.

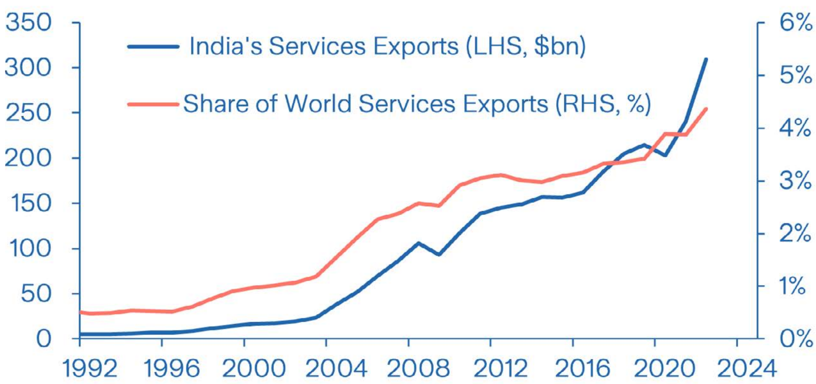
India’s service sector leads the way while manufacturing remains lacklustre



Source: World Bank

Within the service sector, India’s tech services have emerged as the country’s distinct strength. Domestically, the economy is experiencing a surge in digital transformation with a boom of tech startups and significant public investment in digital infrastructure, such as the unified digital payment system. Internationally, India’s tech service exports evolved beyond software services in the 2000s. The country now offers a broad array of IT and consulting services. This sets India apart from other tech exporters, such as Taiwan or Korea, which focus on semiconductor manufacturing, thereby giving India a unique competitive edge. As the most productive, least labour intensive, and highest margin sector, services should continue to be an important growth engine for India in the years ahead.

India’s services exports have grown rapidly



Source: World Bank

Another sector that plays a significant role in the economy, particularly from an employment perspective is agriculture. While contributing less than 20% of GDP, agriculture employs around 40% of the workforce. India's agriculture typically operates on a small scale, tends to be labour intensive and unproductive. For a country with 1.4 billion people to feed, agriculture will undoubtedly remain a crucial sector. However, this sector needs to transition towards a more efficient, larger-scale, and less labour-intensive model through the use of technology. Doing so will help free up labour for more productive and higher value-added sectors in the economy.

Having said that, the considerable skill and education gap between workers in the service and agriculture sectors presents a challenge. Even as labourers from agriculture become available, transitioning these workers will be difficult. This is where manufacturing becomes crucial, as it helps to bridge the skill gap between the agriculture and the services sector. India is at a pivotal moment in expanding its lacklustre manufacturing sector as global firms seek to diversify their supply chains away from China. Recognising this, the government has shifted its focus towards strengthening India's manufacturing capabilities in recent years.

Launched in 2014, the 'Make in India' initiative has led the government to invest significantly in subsidies to boost domestic production and simplify regulations for foreign investment. Aimed at attracting FDI and positioning India as a global manufacturing hub, especially in the high-tech and semiconductor fields, this strategy targets mid to high-end sectors as key growth drivers for the next decade. Nevertheless, as will be discussed, India confronts major obstacles in its quest to swiftly evolve into a manufacturing powerhouse.

India's rise as a production centre will not happen overnight

India's aspiration to become a global production centre faces formidable challenges, rooted in the country's current manufacturing landscape. India's manufacturing sector is currently small, falling short of China's scale and efficiency. Despite significant investments in infrastructure, India's logistics, including roads, railways, and industrial complexes, are not as well-developed as in China. Apple's recent experience in India's factories, where the defect rate reached up to 50%, significantly higher than in China, highlights that Indian workers still need time to accumulate experience in manufacturing processes to achieve the same efficiency as in China.

Protectionist trade policies, including high tariffs and reluctance to fully engage in global trade agreements, also hinder India's integration into global value chains. Of note, average tariffs in India have steadily increased from 13% to around 18% in the last 10 years, notably higher than its major Asian counterparts. Additionally, bureaucratic hurdles and inconsistent regulatory practices across states pose challenges for businesses operating in India. That said, India has made strides in improving its business environment, with ongoing reforms aimed at enhancing ease of doing business.

Energy consumption is another challenge for the country in accelerating its industrialisation process. In the coming decade, electricity demand is likely to rise markedly. While India has increased its investment in renewable energy to support its rapid growth, it is likely that the country will still need to rely mostly on fossil fuels. The growing number of countries imposing carbon taxes on imported products, starting with Europe, could pose a challenge for India's goods exports. Therefore, India will need to strike a balance between its industrialisation goals and its commitment to sustainability.

Unleashing the potential of the private sector

So far, the government has been in the driver's seat in shaping India's growth strategy and industrial policy. Public infrastructure investment, particularly from the central government, has been the leading growth driver. In contrast, private sector investment has been lacklustre for years, although there are tentative signs of improvement recently. India's significant fiscal deficits and high public debt are obstacles, as the need to finance budget deficits through public borrowings leads to crowding out private investment, given that the government and the private sector are competing for the same limited capital.

However, with economic growth showing exceptional strength, a shift is anticipated as the strong growth environment could motivate private companies to invest. More crucially, should India succeed in drawing in FDIs in the coming years, private capital expenditures are expected to gain momentum. India's financial system has grown healthier after several years of restructuring following the shadow banking crisis in 2018, and the flow of credit through the economy has improved, providing a more conducive environment for investment.

Financial stability has improved

In 2018 India's economy was rattled by widespread defaults by non-bank financial corporations (NBFCs), which partly contributing to a significant slowdown in growth from over 6.5% to around 3.9% in 2019. Since then, authorities have intervened and strengthened regulations within the banking sector, including NBFCs, resulting in a notable improvement in both banks' and NBFCs' balance sheets. This improvement has been marked by enhanced asset quality and a reduction of non-performing assets.

Furthermore, there has been a significant enhancement in the operational efficiency of the central bank, with the Reserve Bank of India (RBI) adopting a flexible inflation target regime since 2015, aimed at maintaining inflation within a 4% +/- 2% range. The central bank also started providing forward guidance to steer market expectations regarding its monetary policy trajectory. As a result, inflation has become more stable.

Despite some adverse weather conditions causing upward pressure on food prices since last year, both headline and core CPI fell back to the top end of the RBI's target range in 2023. The central bank is expected to deliver mild rate cuts in the second half of this year once the US Federal Reserve starts cutting its policy rate. All in all, India's macroeconomic environment appears healthy, with strong growth and inflation staying within range.

On the path of fiscal consolidation

One of India's Achilles' heels is its persistently high fiscal deficits, with one of the highest public debts among emerging markets. Currently, elevated interest rates have led the government to allocate half of its tax revenues towards debt repayment. The Covid-19 pandemic exacerbated fiscal challenges, with central government budget deficits soaring from below 5% to above 9% of GDP. Combined state and central government debt surged from around 75% to nearly 90% of GDP. India's budget deficits are linked to poor tax revenues, which result from the dominance of informal sectors in the economy, coupled with high subsidy bills and cash transfers.

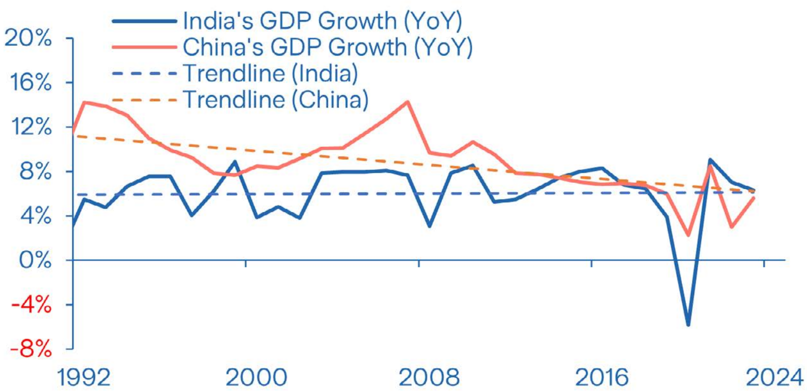
Contrary to expectations of pre-election spending increases, the FY2024 budget emphasises fiscal consolidation, aiming to decrease the fiscal deficit from 6.4% to 5.8% for FY2024 and further to 5.1% for FY2025. Strong economic growth is expected to boost tax revenues, with a focus on reducing subsidies while maintaining robust fiscal spending on infrastructure. Post Covid-19, there has been a growing emphasis on improving the quality of fiscal spending, reflected in an increased ratio of capital expenditure to total spending at both state and central government levels.

As India is gearing up for its general elections, scheduled for April and May 2024, there is a possibility that the current surge in capital expenditure is related to election-related outlays. Nonetheless, in light of India's long-term economic goals, it is likely that the robustness of infrastructure spending will persist beyond the elections. Recent polls indicating favour towards the incumbent party and Prime Minister Modi suggest a high probability of their victory in the upcoming elections. Therefore, policy continuity is likely.

India will be the next India, not the next China

India is often compared to China due to its population size. However, drawing parallels between the two is akin to comparing an orange with an apple, a comparison that can significantly distort understanding the vast opportunities India offers. The differences between the two are pronounced, especially in their respective stages of development, political systems, and economic models.

Growth converging between India and China



Source: World Bank

First, India's GDP and per capita income are only a fraction of China's, and it would take India several decades to catch up with China. Being at an earlier stage, however, means that India could attain a much faster growth rate, and firms entering India can benefit considerably from the rapidly growing economy and the ever-expanding consumer market. Regarding investment, India could provide higher returns on investment, while China, in a more mature phase, is facing diminishing returns, all while grappling with a severe property downturn following years of easy credit.

Second, India has a distinct political landscape. While China's one-party system enables swift policy implementation, India's democratic framework allows discussion and fosters creative solutions. The flip side is that India's federal system and different practices across states often result in implementation delays when it comes to infrastructure investment and policy reforms. From the perspective of foreign investors, who are concerned about the challenges of understanding Chinese laws, India's legal framework, based on common law inherited from the British, is more recognised and understood.

Third, while China's growth was driven by rapid industrialisation and an investment boom in infrastructure and property, India's economy relies more on domestic consumption and services. India is currently looking to expand its manufacturing sector. However, in light of the prevailing trends of onshoring and nearshoring, as well as concerns about the environmental and social impact of manufacturing goods, India's manufacturing sector will need to adopt a different strategy. This involves balancing price competitiveness with adherence to ESG (Environmental, Social, and Governance) standards and limiting carbon footprints. This approach is distinct from China's early 2000s strategy, which heavily emphasised price competition.

At the crossroads

India is at a pivotal juncture, buoyed by its favourable demographic profile, a growing middle class, improved economic conditions, and proactive government measures to boost growth. The shifting global geopolitical landscape, which is driving firms to broaden their manufacturing base beyond traditional manufacturing hubs, offers India a golden opportunity. Additionally, the technology transformation on a global scale is poised to further strengthen India's robust tech services sector.

However, structural issues persist, including low labour productivity, an underdeveloped manufacturing sector, bureaucratic hurdles, and high public debt. Despite being a bright spot in a world of slower growth and aging populations, India has the potential to accelerate its growth beyond the current trend of 6-7% and ensure more equitable and inclusive economic development across the population and sectors of the economy.

To achieve this, India needs to accelerate the transition of the low-skilled workers to more productive sectors, including manufacturing and services while boosting labour participation and labour productivity. Moreover, India's industrial policy relies heavily on subsidies to boost domestic manufacturing, alongside persistent protectionist policy. While these policies may help in the short term, domestic companies can only truly evolve through fair competition with global brands in the long-term.

Consistency and greater openness in trade policy are essential for India to attract further FDI, while continued infrastructure investment and policy reform to cut red tape are needed to turn India into a business friendly destination. Nurturing the private sector is crucial for fostering a more dynamic and market-oriented economy, reducing dependency on government interventions and the public sector.

The upshot is that India is at a crossroads and its breakthrough will depend on how well it can play its cards.

Disclaimer and cautionary statement

Zurich Insurance Group Ltd
Investment Management
Mythenquai 2
8002 Zurich

P0723241 (03/24) TCL

ZURICH®