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Economics Group

Special Commentary

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Is an Economic Renaissance in India at Hand?

Executive Summary

Real GDP growth in India, which was stronger than most analysts had expected in Q3-2014, has been trending higher in recent quarters. The election in May of Narendra Modi as India's prime minister has raised hopes among some observers that an economic renaissance in India is at hand. In order to achieve stronger economic growth on a sustainable basis, the government will need to raise the country's labor force growth rate and/or its labor productivity rate. What is the prognosis for long-run Indian economic growth now that a new government is in place in New Delhi?

The Modi government has advanced some reforms in the few months that it has been in power, but many reforms will either need the cooperation of the political opposition or will need to be enacted at the state level. We look for Indian GDP growth to strengthen into the 6 percent range over the course of the next two years. A return to the heady growth rates of 2003-2007 does not look achievable, in our view, in the foreseeable future. Those strong growth rates would require some significant long-term economic reforms that likely would not start to bear fruit until the long term.

Economic Fundamentals in India Are Improving at the Margin

Real GDP in India grew 5.3 percent on a year-ago basis in Q3-2014.

Recently released data show that real GDP in India grew 5.3 percent on a year-ago basis in Q3-2014 (Figure 1). Although the outturn represents a slowdown relative to the 5.7 percent rate that was registered in the second quarter, it was stronger than the 5.0 percent growth rate that the consensus forecast had anticipated. A breakdown of the real GDP data into its underlying demand-side components is not readily available yet, but the sector components show that growth in real GDP continues to be driven largely by the service sector (Figure 2). Growth in agricultural output slowed for the second consecutive quarter. Rainfall during this year's monsoon was 10 percent below "normal" levels, which likely contributed to the deceleration in agricultural output.

Growth in manufacturing output nearly slowed to a halt in Q3, rising just 0.1 percent on a year-over-year basis. More recently, however, the manufacturing PMI for November experienced its second consecutive gain, reaching 53.3, the highest level in over a year. Given this recent upturn in the manufacturing PMI, some acceleration in manufacturing output in Q4 seems likely. Construction growth was firm, rising 4.6 percent on a year-ago basis in the third quarter. Due to Prime Minister Modi's efforts to streamline the approval process for infrastructure projects, which we discuss in further detail, we could see stronger growth in construction spending in coming quarters. The bottom line is that real GDP growth in India has trended up from the sub-5 percent rates that were registered throughout most of the past two years, and we expect it to strengthen into the 6 percent range in the second half of 2015 and throughout 2016.[1]

[1] **For details, see our "*Monthly Economic Outlook*", which is posted at www.wellsfargo.com/economics.**

Figure 1

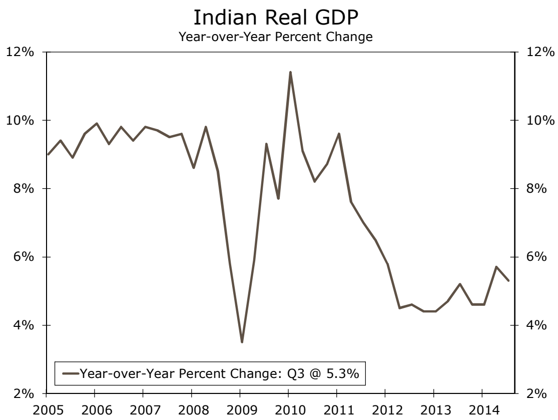
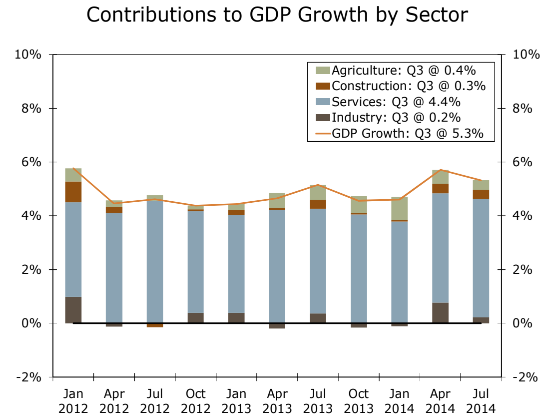


Figure 2



Source: IHS Global Insight and Wells Fargo Securities, LLC

The CPI inflation rate has receded from nearly 9 percent at the start of the year, to only 5.5 percent in October.

There are indications that some other economic fundamentals in India have improved recently as well. For example, the CPI inflation rate has receded from nearly 9 percent at the start of the year to only 5.5 percent in October, the lowest rate in nearly seven years (Figure 3). Moreover, wholesale price inflation, which usually leads CPI inflation, tumbled to only 1.8 percent in October. If further declines in the CPI inflation rate are indeed in the cards, then the Reserve Bank of India (RBI), which hiked its main policy rate by 75 bps between September 2013 and January 2014, may begin to ease policy next year. A reduction in interest rates could help to boost real GDP growth prospects in India in 2015. The trade deficit, which has narrowed in recent months, is another economic fundamental that has improved at the margin (Figure 4). Concerns about the widening current account deficit contributed to the rout of the Indian rupee in 2013.[2] A smaller current account deficit should make the currency less susceptible to extreme selling pressure as it encountered in mid-2013.

Figure 3

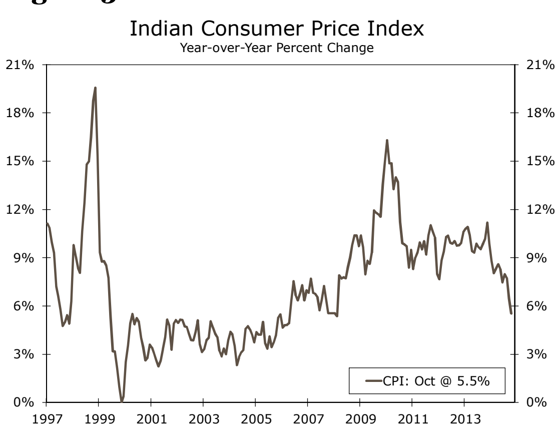
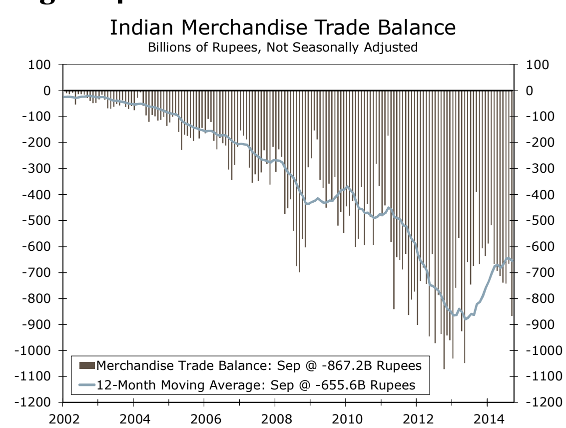


Figure 4



Source: IHS Global Insight and Wells Fargo Securities, LLC

The Importance of Labor Force and Labor Productivity Growth Rates

As noted above, a modest reduction in interest rates, should it occur, could help to boost Indian real GDP growth somewhat next year. In addition, the depreciation of the rupee should help to support export growth. That said, most analysts expect Indian economic growth in the foreseeable future to fall well short of the 8-9 percent per annum growth rates that characterized the 2003-2007 period. For example, the International Monetary Fund (IMF) forecasts that Indian

[2] **The rupee tumbled more than 20 percent vis-à-vis the U.S. dollar between May 2013 and August 2013.**

real GDP will grow 6-7 percent per annum between 2015 and 2019. Obviously, the living standard in India would rise less rapidly than it did during its supercharged years of the past decade if real GDP grows slower in the future. Although 6-7 percent per annum real GDP growth is certainly admirable, could the Indian economy do even better?

A country's long-run economic growth rate is essentially the sum of its labor force growth rate and its labor productivity rate. A country with zero labor force growth can still have positive GDP growth if each worker becomes more productive (i.e., can produce more output per hour worked). Conversely, a country with zero productivity growth can still realize positive GDP growth if more workers are employed every year. Obviously, countries with positive labor force growth and positive labor productivity growth will realize positive rates of economic growth.

The UN projects that the working age population in India will grow 30 percent between 2010 and 2030.

Let's start with the implications of India's labor force growth for the economy's growth rate. Figure 5 shows United Nations' (UN) projections of the working age population (i.e., persons aged 15 to 64 years) over the next few decades. The UN projects that the working age population in India will grow at an annual average growth rate of about 1.3 percent per annum between 2010 and 2030, which will translate into an overall increase of nearly 30 percent between those two dates. The American working age population should rise by roughly 5 percent over that period, while the UN expects that the Chinese working age population will decline by approximately 1 percent. Everything else equal, the Indian economy should grow faster than the respective economies of China and the United States over the next few decades due to its more rapid growth in working age population. Of course, whether or not all these individuals in India can actually find gainful employment is an entirely different question.

Figure 5

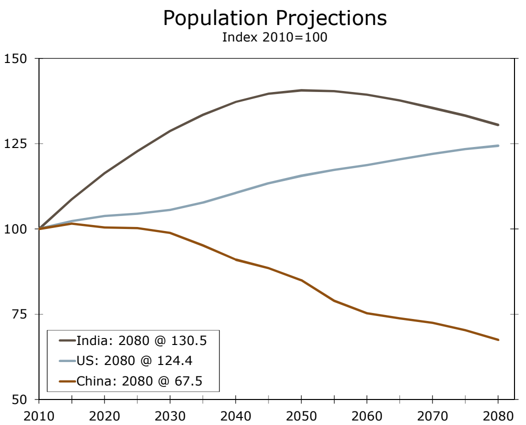
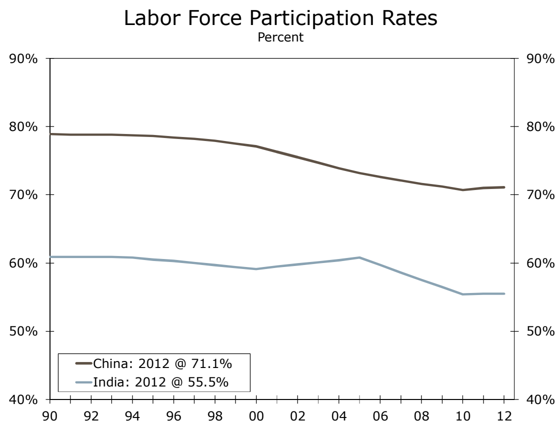


Figure 6



Source: United Nations, CEIC and Wells Fargo Securities, LLC

The participation rate among Indian females is less than 30 percent.

In that regard, Figure 6 shows that labor force participation in India has followed a downward trend since the middle of the past decade and currently stands at less than 60 percent. Although the participation rate among males is 81 percent, which is above the comparable 78 percent rate in China, the participation rate among Indian females is abysmally low at less than 30 percent.[3] If labor force participation in India, especially among females, remains low, then the economy would not be able to achieve its true growth potential in coming years.

Let's now turn to labor productivity growth. Unfortunately, data on labor productivity in India are not readily available, but economic theory shows that there is a positive relationship between capital accumulation and labor productivity growth. That is, giving workers more capital generally increases the amount of output they can produce, and Figure 7 shows that the acceleration in Indian GDP about a decade ago was associated with the sharp rise in the country's investment rate to 38 percent in 2007 from 25 percent of GDP in 2002. Equally important,

[3] The labor force participation rate among females in the United States is 57 percent. The comparable rate in China is 64 percent.

India's national savings rate (i.e., the aggregate savings of its household, business and government sectors) rose essentially in lockstep with the increase in the country's investment rate. Had the national savings rate not increased along with the investment rate, the country would quickly have started to incur unsustainable current account deficits.[4]

Likewise, the slowdown in Indian real GDP growth in recent years has gone hand-in-hand with declines in its national savings and national investment rates, and deceleration in investment spending implies slower labor productivity growth, everything else equal. Figure 8 shows that the decline in investment spending in the Indian business sector was especially noteworthy, falling to 9 percent of GDP in 2013 from 17 percent in 2008. In sum, India must lift its labor force growth rate and/or strengthen productivity growth in order to achieve stronger GDP growth rates again on a sustainable basis.

Figure 7

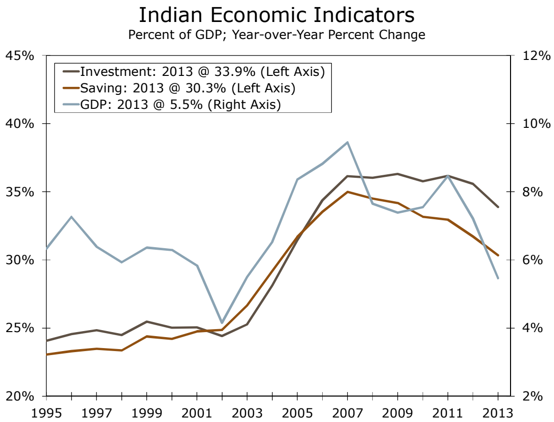
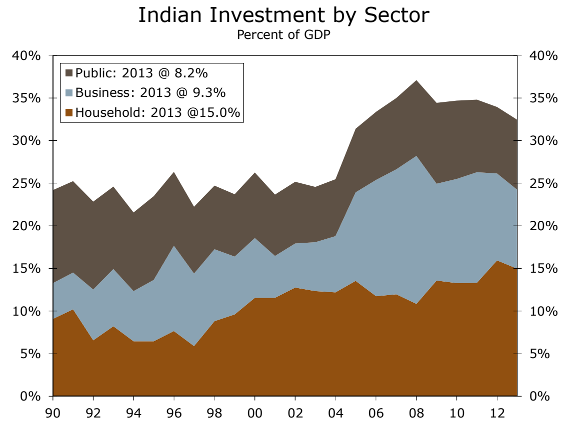


Figure 8



Source: International Monetary Fund, CEIC and Wells Fargo Securities, LLC

Will Modi Be Able to Engineer Stronger Economic Growth?

Narendra Modi became the prime minister of India in May 2014.

Narendra Modi became the prime minister of India in May 2014 as his Bharatiya Janata Party (BJP) was swept into power in a landslide election. Modi was the governor of the state of Gujarat, which has outgrown the overall national economy over the past decade or so. Moreover, while the overall national economy was sputtering along at less than 5 percent growth over the past two years, real GDP in Gujarat was growing around 8 percent per annum. During the campaign, Modi promised to do for the Indian economy what he had done for Gujarat, and the BJP received a mandate from Indian voters to reform the economy.

Monetary and fiscal stimulus could deliver a short-term boost to the Indian economy. To bring about strong economic growth on a sustainable basis, however, the government would need to raise the country's labor force growth rate and/or its labor productivity growth rate. What is the prognosis for long-run Indian economic growth now that a new government is in place in New Delhi?

As noted above, female labor force participation is very low in India. The Organisation for Economic Cooperation and Development (OECD) cites cultural influences as well as the "inadequate" amount of affordable child care as major reasons that help to depress female labor force participation in India.[5] The OECD also notes that some "labour laws restrict women's working hours and access to certain occupations." Thus far, it does not appear that the Modi government has advanced any major programs to significantly address the issue of low female labor force participation in India.

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4 For a discussion of the determinants of a country's current account see "*Is India Still a BRIC?*" (July 19, 2013). This report is available upon request.
5 See "*OECD Economic Surveys: India*", Organisation for Economic Cooperation and Development, Paris, November 2014.

More broadly, onerous labor laws, especially for large firms, discourage employment. The OECD finds that India has the most restrictive employment protection legislation among a set of 40 advanced and developing countries that it analyzes. According to the OECD, companies react to the labor market restrictions by "substituting capital for labor, staying small, or relying on 'informal' or contract labor."

The Modi government wants to liberalize the Indian labor market, and the Indian parliament recently passed legislation that will relax some restrictions governing apprenticeship. However, many labor laws are the domain of the state governments, so the Modi government needs the cooperation of those states to relax some of those laws. For example, the Industrial Disputes Act mandates that companies must obtain government permission to close down units that employ more than 100 workers. The BJP-controlled state of Rajasthan recently amended this Act by raising the limit to 300 workers. However, the BJP and its allies control only 10 of 29 state governments, so the New Delhi-based Modi government would need the cooperation of opposition parties, which may not be politically feasible, to make some of its hoped-for labor market reforms India-wide.

The Modi government wants to liberalize the Indian labor market.

Not only is India plagued by employment restrictions, but its infrastructure is notoriously poor. Respondents in the *Global Competitiveness Report* cite "inadequate supply of infrastructure" as being the single most "problematic factor for doing business" in India, and that same report ranks India 87th out of 144 countries in the quality of its overall infrastructure. The quality of its electrical supply is especially substandard as it ranked No. 110.[6] As noted above, acceleration in investment spending can lead to stronger labor productivity growth, and the Modi government has endeavored to raise investment spending directly by clearing a number of infrastructure projects that had been stalled under the previous government. With infrastructure in India being notoriously bad, the clearance of even a few projects should make a difference in terms of labor productivity.

Government policies to encourage more foreign direct investment (FDI) in India, which amounted to less than $30 billion in 2013, could also help to boost the overall investment rate.[7] The Modi government has taken some modest steps to increase FDI in the country. Foreigners can now own up to 49 percent equity in companies in the Indian defense sector, whereas the limit previously had been capped at 26 percent. Foreign ownership of Indian railroads, which had been prohibited before Modi took office, is now permitted.

FDI in India amounted to less than $30 billion in 2013.

As Figure 6 makes clear, national investment and national savings rates tend to be highly correlated, at least in India. The government could bring about investment acceleration indirectly if it can implement policies to raise the national savings rate. In that regard, the Modi government wants to implement a goods and services tax (GST). By taxing consumption, a GST tends to encourage savings by the household sector.[8] The Indian parliament is expected to deliberate the GST in coming months, but many observers do not expect it to be implemented until 2016, at the earliest.

Conclusion

Real GDP growth in India has trended up from less than 5 percent through most of 2012 and 2013 to more than 5 percent at present, and we look for further modest acceleration in coming quarters. In our view, however, a return to the 8-9 percent growth rates that characterized the middle years of the past decade is simply not in the cards in the foreseeable future. To bring about

[6] See "*The Global Competitiveness Report 2012-2013*", The World Economic Forum, Geneva, 2012.
[7] Chinese FDI has vastly exceeded Indian FDI for years. China attracted nearly $120 billion worth of FDI inflows in 2013.
[8] Raising the savings rate is not the only reason that the Modi government wants to implement a GST on a national basis. India is characterized by a patchwork of local taxes that raise the complexity of running businesses on a nationwide basis. If these local taxes can be eliminated and replaced by a uniform GST, the complexity of doing business on a nationwide basis should be reduced. In addition, the national government could use some of the revenues raised via a GST to finance some infrastructure projects. Obviously, the national government would need the cooperation of the state governments to bring about a wholesale overhaul of the Indian tax system.

those heady growth rates on a sustainable basis, India will need to raise its labor force participation rate and/or strengthen its labor productivity growth rate. The most straightforward way to achieve the latter is via increases in national investment, which would, in turn, need to be fueled by increased savings, otherwise the country would incur large current account deficits that would be unsustainable over time.

Bringing about increases in labor force participation and labor productivity growth is a long-run process that often involves some painful decisions. For example, some of India's restrictive labor market practices, which currently benefit workers, may need to be dismantled. A GST may help to increase household savings, but it would raise the price of many goods and services. The Modi government has enacted some reforms, but progress has generally been slow rather than meteoric.

India is a democracy, and many of Modi's policy proposals will run into political opposition. The BJP has an absolute majority in the 543-seat Lok Sabha, the lower house of the Indian Parliament, which should allow it to legislate with ease. However, the BJP controls only 42 seats in the Rajya Sabha, and therefore must rely on the support of many regional parties to pass legislation in that 250-seat upper house of parliament. Moreover, some reforms will need to be enacted in individual states, and the BJP does not yet have the same level of political support at the state level that it enjoys in the lower house of the Indian parliament.

We are hopeful that the reform process in India will continue and that the country will be able to once again enjoy the strong economic growth rates that characterized much of the last decade. Although we look for Indian GDP growth to strengthen into the 6 percent range over the course of the next two years, a return to the heady growth rates of 2003-2007 does not look achievable, in our view, in the foreseeable future. Those strong growth rates would require some significant long-term economic reforms that likely would not start to bear fruit until the long term.

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