# ISAS Insights

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# Why the Long-Term Case for India's Economic Acceleration is better than Many Think

*Continued improvements in governance and structural reform could unleash India's long-term potential and set it on a sustained upward growth trajectory.*

Manu Bhaskaran[1]

The Indian economy's upward trajectory moderated in the second quarter of 2016 (2Q16), as the economy grew by 7.1% year-on-year (y/y) in 2Q16, down from 7.9% growth in 1Q16. With cyclical indicators firming, growth is likely to remain above 7% in 2016. With recent developments from the top-down showing promise for improved governance, we now assess India's long-term potential based on its inherent advantages and bottom-up strengths that have yet to be fully leveraged.

Our view is that continued improvements in governance and structural reform could unleash India's long-term potential and set it on a sustained upward growth trajectory.

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**India has a number of inherent advantages**

- **First, India's demographics gives it a unique ability to scale which few others have.** India is primed to receive a "demographic dividend" in the coming years and decade, boosting its potential growth. Its working-age population is projected to increase further until 2040, and its age-dependency ratio, a measure of the burden on the young to support the aged, is also projected to fall. As household incomes rise and urbanisation continues apace, a burgeoning middle class will produce unbeatable scale economies within India's domestic market. The prospects for its consumer market are endless and its youthful population will provide an invaluable supply of labour to businesses as India continues to prosper.

- **Second, a competitive cost structure**: With low unit costs of labour, India remains an attractive location for outsourced activities. Coupled with the large number of graduates with engineering and technology related skills it churns out, India now hosts a global leading IT sector.

- **Third, bottom-up strengths in innovation:** In 2016, India ranked 66 in the Global Innovation Index, an improvement from its 2015 ranking of 88.

**Chart 1**

**Mediocre performance amongst BRICS...**

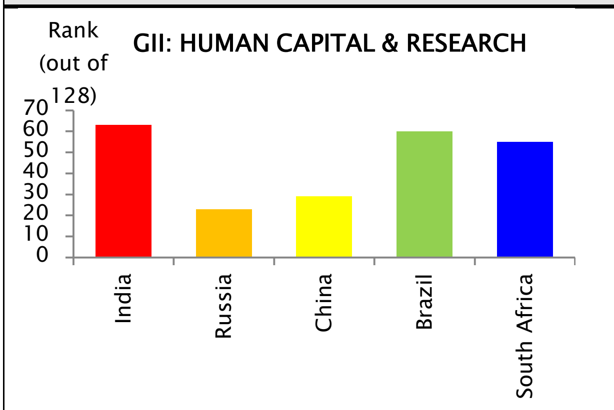
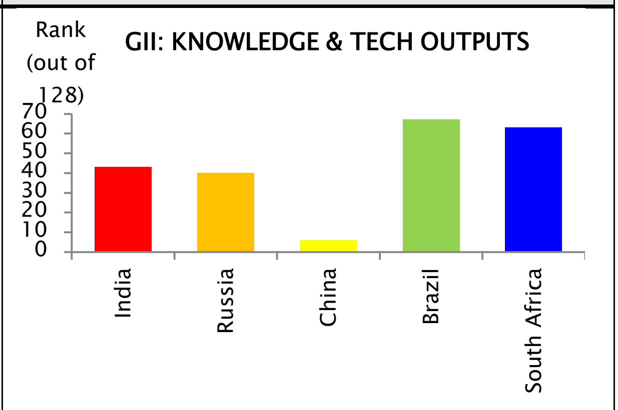



**Chart 2**

**...but signs of bottom up strength**




Source: Collated by Centennial Asia Advisors from INSEAD Global Innovation Index 2016

A breakdown of the Index's subcomponents shows that India's rankings amongst the BRICS in "Human Capital & Research" are mediocre (Chart 1). However, it performs decently in knowledge and technology output (Chart 2). This is a strong sign of India's propensity towards high-technology industry and services, which rely on knowledge and innovation as key inputs.

Anecdotally, we know this to be true as India has produced several world-class firms in IT services and business process outsourcing (BPO) - Tata, Infosys, and Cognizant are a few. India's Institutes of Technology are also world renowned.

India hosts six IT clusters - of the six, Bangalore is known colloquially as the "Silicon Valley of India", and Hyderabad now serves as home to leading technology companies e.g. Microsoft, Facebook, and IBM. These are a testament to Indian bottom-up strengths and its ability to value add in a variety of software and high-tech exports meant for global consumers and firms.

These inherent advantages have made the country attractive to foreign investment - since 2005 India has seen a steady pick up in foreign investment.

**Improving competitiveness to support growth of investment**

- **India is creditably climbing up world competitiveness rankings:** India climbed 16 places to 39 on the World Economic Forum (WEF) Global Competitiveness Index from a year ago. With India's performance underscored by progress across all subcomponents of the index, but significantly in market efficiency, business sophistication and innovation, reformation efforts are clearly easing the constraints on doing business in India.
- Continuous efforts to improve the business environment will translate into greater investment. The bottom line is that India is not just growing fast but is becoming more competitive as well.

**However, top-down government failures have held India back from achieving higher growth rates.**

In particular, governance has been poor and its impact on economic growth potential is clearest in India's failure to deliver public goods such as basic infrastructure and a well-functioning business environment that that are crucial in allowing manufacturing – especially export-oriented manufacturing – to flourish. Perpetual under-investment has led to a serious infrastructure shortfall in India which drives up business costs and in turn impedes foreign investment.

Export-oriented manufacturing needs an efficient provision of public goods such as good roads and high level of vocational skills development: this has been heavily constrained. Overall manufacturing has stagnated in recent years at approximately 17%, below regional peers such as China (34%), Indonesia (21%), Malaysia (22%) and Thailand (27%); export-oriented manufacturing has not taken off. India is thus unable to take advantage of this crucial growth driver that can absorb its ready supply of labour, thereby allowing the country's workers to join the formal economy.

**Notably, with signs of progress from top-down emerging quickly, the outlook is more positive.**

India's pro-development pro-business Prime Minister, Narendra Modi, is delivering slowly but surely, setting in place the pieces needed to dismantle barriers to investment and business activity in India and to improve India's economic structure.

**Renewed push to reinvigorate business environment**

- **A more open economy:** Reforms have eased foreign ownership restrictions in sectors including aviation, retail, defence and pharmaceuticals, reducing bureaucratic restrictions to improve process rather than substance. Restrictions were also eased in the defence sector.

- **Clean up of bad loans to accelerate:** The passing of the Bankruptcy Bill should revitalise India's banking sector. The Bill which streamlines the process of debt recovery facilitates recovery of banks' balance sheets at a faster clip. This will help revive sluggish credit growth in the economy. Additionally, newer efforts at corporate bond reform mean that serious efforts are being made from the top-down to drive diversified credit growth.

- **A unified market at long last:** The Goods and Services Tax (GST) Bill which was passed in August will greatly simplify India's tax system and integrate India's fragmented product markets. This will likely lead to a surge of investment by both domestic and foreign firms and is forecasted to accelerate economic growth by at least one percentage point.

- **Road construction in India has accelerated to an all-time high pace:** The government's new highway construction model which sees the government committing up to 40% of the project cost has revived private sector participation and accelerated road construction across India to 20km/day, and a more astounding 139km/day for rural roads. Greater connectivity will vastly reduce logistics costs and allow access to new untapped markets across the country.

**A more stable governance regime is also taking shape**

- Modi's efforts to stamp out high level corruption and improve the ease of doing business mean that India has begun on the long road towards fixing its notoriously difficult business environment. Modi's success in overhauling the coal and banking sectors through privatisation and divestment will vastly improve economic efficiency, reduce costs, and raise hopes for similar reforms in other industrial sectors.

- **Fiscal discipline has improved:** Divestments of shares in state-owned companies and better targeted subsidy schemes for food and fuel are helping Modi's government to achieve fiscal deficit targets. With more tax reforms and expenditure management measures on the horizon, further improvements to the fiscal position should help contain excess demand pressures. Measures are moving in the right direction to increase public spending to enhance much needed infrastructure in India.

- **A structural fall in inflation will eventually lower currency risks and the cost of capital:** In June the government amended the RBI Act to entrust the job of monetary policy-making in India to a Monetary Policy Committee (MPC) which has motioned to abandon the multiple indicator approach and adopt inflation targeting as the primary objective of monetary policy. Despite Rajan's term as RBI Governor having come to an end, the pieces are in place to ensure RBI's inflation reducing strategy continues.

**Financial inclusion boosts productive spending and investment**

- The Jan Dhan Yojana Scheme has taken off positively. 210 million bank accounts have been opened, receiving more than INR370bn in deposits. The scheme is helping to plug leakages in subsidy transfers, leading to less wasteful public spending. Improving financial inclusion in an economy where informal money lending is prevalent will go a long way in increasing the economy's total stock of savings, thus providing the necessary ingredients for higher capital formation in India.

- Jan Dhan Yojana is only one component of the larger JAM trinity scheme to enhance financial inclusion in India. JAM (short for Jan Dhan-Aadhaar-Mobile) links the bank accounts opened under the Jan Dhan Yojana scheme to the unique identification numbers assigned by the Aadhaar scheme and to mobile phone numbers to ensure that subsidy transfers reach the right recipients. The comprehensive scheme systematically streamlines the transfer process to minimise leakages.
- The Gold Monetisation Scheme will encourage individuals to hold more liquid assets and reduce gold holdings, boosting the overall money supply. More substantial amounts of savings are likely to be available for channelling into productive investments as a result.

These are but a few of the more recent prominent reforms that have catalysed economic activity in India. If structural reforms continue to be applied and India's governance deficit is tackled, this could unlock India's long-term potential and trigger higher growth rates.

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