11 June 2024

Investment Institute Macroeconomics

India’s economy: A compelling growth and investment story but challenges remain

The Indian outlook under Modi’s third term and beyond

Macroeconomic Research

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Key points

- Narendra Modi takes office for a third consecutive term, albeit for the first time without a majority. But his win should mean pro-investment policy continuity
- The medium-term economic outlook is positive, with India remaining among the fastest-growing emerging markets
- High unemployment among the educated youth remains a critical issue, with India’s ‘demographic dividend’ potentially becoming a burden
- A weakened Modi government may struggle to push through difficult reforms and there is a risk of backsliding fiscal consolidation efforts
- The expanding services sector and energy transition will create investment opportunities. But longer-term, India faces severe adverse impacts of climate change, and artificial intelligence adoption could challenge job creation as productivity improves

Narendra Modi has secured another five years in office but the election’s outcome was not the overwhelming victory he had hoped for. Modi’s ruling nationalist Bharatiya Janata Party (BJP) has lost the absolute majority it enjoyed during the previous two parliamentary terms. And even though the BJP-led National Democratic Alliance (NDA) won 293 seats, above the 272 required to form a government, this is down from the 353 it held during the previous parliamentary term and shy of the 362 seats required for greater constitutional flexibility.

Financial markets reacted negatively to Modi’s failure to secure a stronger mandate and the election results herald the end of the ‘strongman’ era. However, Modi is still the first leader to win three consecutive terms in office since Jawaharlal Nehru (the first Prime Minister of independent India in 1947), and the NDA’s victory should ensure pro-investment policy continuity. The initial negative market reaction may be short-lived with India’s fundamental position expected to remain stable. But concerns are warranted as the new political environment could make it even more difficult to enact challenging but necessary reform, with a risk that policymaking drifts towards short-term populism, undermining fiscal consolidation efforts.

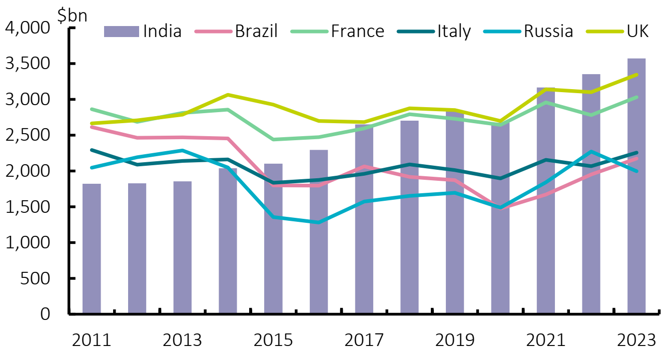
In this paper we look at the outlook for India under Modi’s next term and beyond, setting out our expectation for India to remain a growth powerhouse over the coming years. The world’s fifth largest economy is expected to grow at over 6% per annum – with energy, technology and services sectors all presenting opportunities for investment. However, we also highlight how India's growth path looks set to be very different from those of key Asian growth stories of recent decades. We look at India's specific dynamics and consider the impact of both artificial intelligence (AI) and climate change.

Growth and improved resilience under Modi

Over the past decade under Modi's leadership, India's economy outperformed most major markets, expanding at an annual average rate of 6% (and close to 7% excluding the pandemic disruption of 2020-2021). In nominal US dollar terms, in 2013 India's economy was the 10th largest in the world. By 2023, at $3.5tn, it had risen to 5th, above France and the UK (Exhibit 1).

Exhibit 1: India's growth spurt

Nominal GDP



Source: International Monetary Fund and AXA IM Research, June 2024

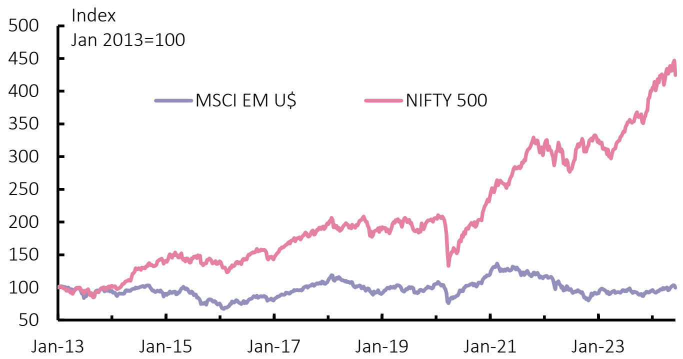
India still only accounts for a small share of global merchandise trade, but it has become more integrated in the global economy thanks to its services exports. India's so-called global capability centres (GCCs) are providing international firms with greater levels of services, in the form of telecommunications, computer and information services, professional and management consulting services among numerous others.

India's capital markets have also surged, reflecting the expanding domestic market. The market capitalisation of the National Stock Exchange has risen four-fold over the past decade, and the NIFTY 500 index has outperformed the MSCI Emerging Markets Index (Exhibit 2). India is also soon to be included in emerging market bond indices; the JPMorgan Government Bond Index-Emerging Markets (GBI-EM) benchmarks will include Indian government bonds from this month.

Under Modi, there has also been a sharp upturn in government capital spending to improve infrastructure, with a vast expansion in the country's road and railway network, as well as airports and power generation. Targeted welfare support schemes have also helped to reduce poverty, with 248 million people exiting "multi-dimensional" poverty since 2013, according to NITI Aayog, a government think tank[1].

Exhibit 2: India's booming capital markets

India - Equity market performance



Source: LSEG Datastream and AXA IM Research, June 2024

India's economy has also become more resilient. Before Modi took office for his first term in May 2014, India had been included in the original ignominious grouping of "the Fragile Five" by Morgan Stanley (along with South Africa, Turkey, Brazil and Indonesia). India is still running twin deficits: the current account deficit stood at 1.2% of GDP in 2023, and the general government budget deficit has averaged around 8% of GDP over the past 10 years. Nevertheless, the downside risks have been contained, and on the eve of the election results, S&P changed its outlook for India's BBB- rating from stable to positive. Gross public debt is high at 83% of GDP in 2023, and the International Monetary Fund (IMF) projects that public debt will ease back to 77.5% of GDP by 2029, but this requires continued fiscal consolidation (and fast nominal GDP growth). Moreover, India's persistent current account deficit is manageable in the context of foreign exchange reserves holdings which provide coverage of around eight months of imports of goods and services, and although the rupee has dropped 28% against the US dollar over the past decade, it has been stable on a real trade-weighted basis. The current account deficit is thus a corollary of the capital account surplus, suggesting ongoing investment from overseas in India's growth outlook.

Youth unemployment rises

Despite the growth and relative stability, there is much that has not gone well under Modi's government, notably widening income inequality, rising youth unemployment, and stubbornly high food price inflation. These factors contributed to the reduced support for Modi in the election (along with broader social tensions, including a rejection of his polarising Hindu nationalism rhetoric and growing authoritarian tendencies).

[1] NITI Aayog, National Multidimensional Poverty Index 2023, July 2023

Of major concern is that India has yet to reap the benefits from its favourable demographic profile. India now has the world's largest population of 1.4 billion, surpassing China in 2022, and its population is young, with a median age of 28 years (below China's 39 years). The failure to generate formal employment opportunities for its expanding young labour force means India is at risk of wasting this much-vaunted demographic dividend.

The International Labour Organization (ILO), in its *India Employment Report 2024*[2], highlights several worrying trends. For example, the high unemployment level among the educated youth reveals a growing mismatch in the aspirations of India's younger generations and the jobs available. In addition, there is a large proportion of India's youth not in education, employment or training – and this is particularly acute for young women while employment is dominated by poor-quality jobs in the informal sector. Moreover, according to the ILO, although more younger people are employed in industry and services, India's youth is generally engaged in lower quality employment and more likely to be engaged in unpaid family work or casual wage work. India's youth accounted for almost 83% of the unemployed workforce in 2022, and the share of young people with secondary or higher education among the total of unemployed Indians jumped from 35% in 2000 to 66% in 2022.

Exhibit 3: Primary sector's high share of employment

Source: ILO, MOSPI and AXA IM Research, June 2024

A key challenge over the past few decades has been to move workers out of low productivity agriculture into manufacturing and services. There has been a structural shift to some extent in employment and economic output over the past two decades, but the agricultural sector still accounts for a much larger share of employment than it does of output. In 2022, the primary sector accounted for 45% of employment, down only marginally from a decade previous (although it has fallen from around 60% over two decades ago), but it accounted for just 16% of gross value-add (GVA) (Exhibit 3).

Widening inequality

Despite the hubris over India's fast-growing economy, per capita GDP is still low. In nominal US dollar terms in 2023, India's GDP per capita stood at $2,500. This was up from around $1,500 a decade ago, but still far below other large emerging markets, such as China ($12,500), Brazil ($10,600) and South Africa ($6,100), according to IMF data.

There has also been a widening gap in income distribution. According to the World Inequality Lab, a global research centre funded by public and non-profit institutions that is focused on the study of inequality and public policies, inequality in India declined post-independence until the early 1980s, but then it began rising and has skyrocketed since the early 2000s. In its March 2024 report, *Income and Wealth Inequality in India, 1922-2023: The Rise of the Billionaire Raj*[3], the authors estimate that in 2022 the top 1% of income earners had a 22.5% share of total income, while the bottom 50% had a 15% share. The gap has widened over the past 30 years: in 1992, the top 1% had 10%, while the bottom 50% had 22%.

Becoming a manufacturing and services hub

The Modi government has initiated policies to generate employment opportunities and expand the manufacturing sector to absorb the growing workforce. Upon coming to office in 2014, one of Modi's key policies was "Make in India", which focused on attracting foreign investment in manufacturing to drive employment and transform India into a global manufacturing hub. This included investment plans to strengthen logistics and improve supply chains. Much has been achieved in terms of infrastructure development, and some reforms to the business environment have simplified processes. There has also been success in allowing 100% foreign direct investment (FDI) through the 'automatic route' (without the need for specific government approval) for a greater number of sectors.

However, India's manufacturing sector has yet to secure a large share of global trade. In 2022, India's goods exports accounted for 1.9% of the global total, up only marginally from 1.8% in 2014. Although Vietnam has a much smaller economy, during this same period its share of global exports rose from 0.8% to 1.5%, while China's increased from 12% to 13.7%. The manufacturing sector has also stayed fairly flat in terms of its share of India's overall output (at 17.2% in 2023 compared to an average of 17.9% in 2014-2022), falling short of the initial "Make in India" target of 25% by 2022.

[2] ILO, Employment in India Report, 2024, March 2024

[3] World Inequality Lab, Income and Wealth Inequality in India, 1922-2023: The Rise of the Billionaire Raj, March 2024

The Modi government's most recent major policy initiative is the Production-Linked Incentive (PLI) scheme, offering up to ₹1.97tn (around $24bn) to manufacturers to boost capacity and exports in 14 key sectors (including mobile phones, electronic components, active pharmaceutical ingredients, and automobiles). Under the scheme, financial incentives are provided for eligible firms based on their incremental sales from products manufactured in India. There has been marked progress in the production and export of mobile phones, notably Apple iPhones, supported by the PLI scheme. According to the India Cellular and Electronics Association, India's domestic production of mobile phones rose to $44bn in 2022/2023, up from just $3bn in 2014/2015, with exports rising to $11.1bn. The pharmaceutical sector has also been a standout performer; based on the industrial production index, the sector has doubled in size since 2014.

India has had greater success on the global stage on the services side, with the expansion of GCCs providing a range of services to international companies. India's exports of telecom, computer, information and other business services accounted for an 8.1% share of the global total in 2022, up from 6.5% in 2014, according to World Trade Organization data. This was ahead of China (6.8%), close to the UK (8.4%) and below the US (11.5%). This success reflects not only positive structural factors, notably its cheap and large pool of English-speaking labour, but also recent improvements in advancing India's information technology infrastructure and the evolving domestic ecosystem. India also offers lower real estate costs compared to other major cities across Asia.

A new growth model for a different world

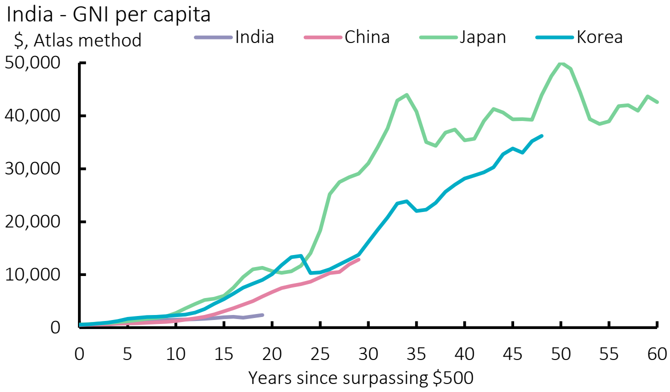
Modi will continue to push ahead with efforts to turn India into a global manufacturing and exporting hub. As discussed above, there have been some notable successes in recent years. However, India has failed to match the startling performances of China and other East Asian emerging markets in their export-oriented industrialisation processes.

At different periods over the past few decades, Japan, South Korea and China succeeded in quickly shifting the labour force out of agriculture and into low-skilled manufacturing at scale, driving up export revenue, which in turn supported an expansion in investment. This created a virtuous growth cycle, with rising skills levels and productivity generating higher wages and tax revenues. India has yet to have such success. Since surpassing gross national income (GNI) per capita of $500 nearly two decades ago, India's average income per head was just $2,390 in 2022, based on the World Bank's Atlas Method, and its growth trajectory has been flat (Exhibit 4).

India's struggles to follow China's growth path may reflect its greater focus on lower productivity services growth until the last decade, but it is also indicative of how the world has changed. As discussed by economists Dani Rodrik and Joseph Stiglitz in their January 2024 paper, *A New Growth Strategy for Developing Nations*[4], the efficacy of the East Asian growth strategy has been undermined by technological changes that have made manufacturing more skill and capital-intensive based, and less of the labour-absorbing process that it had been over previous decades.

Modi's schemes to drive the manufacturing sector have incorporated import-substitution industrialisation policies of East Asian economies and latterly the export-oriented ones. Pursuing such policies during the era of heightened globalisation contributed to the successes of China, drawing FDI and enabling integration into expanding global supply chains. India's chances of succeeding in repeating these feats seem low, particularly given the deglobalisation process now underway.

Exhibit 4: India's lagging per capita income growth path



Source: World Bank and AXA IM Research, June 2024

Conversely, technological change is likely to enhance the growth potential from services. There is optimism that India is well-positioned to benefit from the productivity and efficiency enhancing impact of AI adoption. India is already well-connected digitally, with 800 million broadband users. In a 2023 study, consultancy EY estimated a substantial boost to Indian GDP from AI adoption; over seven years to 2030, it could contribute an additional 0.9% to 1.1% in annual growth[5]. Much of this would come via efficiencies in key services, such as business and financial services, retail trade, and healthcare. However, while this may boost India's services output, a key objective for India's long-term development is job creation for its educated youth, and AI could create challenges in this respect, potentially diminishing the advantage that India's demographic dividend should confer. Moreover, global companies may look to AI adoption to reduce costs associated

[4] Rodrik, D. and Stiglitz, J.E., A New Growth Strategy for Developing Nations, January 2024

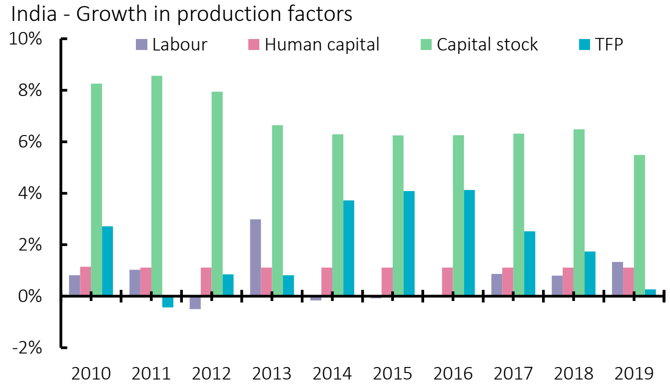
[5] EY, Is Generative AI beginning to deliver on its promise in India?, May 2024

with the outsourcing of support services, and this could contain the long-term expansion in India's GCC environment.

Against the backdrop of its fast-growing labour force, India's growth dynamic is also concerning. Over the past decade or so, India's growth factors have been more like those of developed economies than emerging markets, with capital being the key driver and labour having a limited impact (Exhibit 5).

Rodrik and Stiglitz argue that emerging markets will need to focus development policies on the green transition and labour-absorbing services. On the services side, India is relatively well-placed in this regard given the growth momentum in the GCC sector. However, despite the fast growth in India's services sector, it has yet to absorb large swathes of labour; while accounting for 53% of GVA in 2022, it employed only 30% of the labour force. There are also limited employment opportunities in the services sectors for India's vast low-skilled and low-educated workforce.

Exhibit 5: Capital's key role in driving growth in India



Source: Penn World Table and AXA IM Research, June 2024

India should also see strong growth in the energy transition and security front, given the huge energy requirement the country will have over coming decades, and its success so far in driving investment in renewables. India is currently heavily reliant on fossil fuels for energy generation (according to the International Energy Association, coal accounted for 72% of electricity generation in 2021), but in recent years renewable energy has accounted for a large share of newly installed generating capacity. As of April 2024, India's total capacity stood at 443 gigawatts (GW), of which thermal accounted for 55%, renewables (including hydropower) for 43%, and nuclear for the remaining 2%. The target is to increase the share of renewable capacity to 50% by 2030. A greater challenge is the need to double overall capacity to 900GW by 2030 (according to government estimates). India's electricity consumption per head is still low; in 2021 it stood at just 0.96 megawatt hours (MWh), far below China's consumption at 5.48MWh and Vietnam's 2.44MWh.

The energy transition drive will require large upfront investment, and for India this will need a combination of domestic and external financing. India's inclusion in global bond market indices is likely to contribute to an expansion in external sources of finance, and India's major corporations are also on board in terms of investments to support the transition. For example, Adani Group is developing the $5bn 30 GW Khavda Renewable Energy Park in Gujarat, as part of its subsidiary Adani Green Energy's plans to deliver new capacity of 45GW by 2030, and Reliance Industries is delivering the $10bn Dhirubhai Ambani Green Energy Giga Complex.

Reform to drive up potential growth

While the expansion in services and investment in renewable energy (and transport infrastructure) will continue to support overall growth momentum, there is still doubt that India will generate the high number of productive jobs needed to keep pace with the expanding labour force. An IMF analysis of "missing jobs" shows the shortfall in employment opportunities is currently 87 million (equivalent to the population of Turkey) and by 2031 India will need to generate opportunities for 148 million people (the size of Mexico) plus another 96 million (the size of Vietnam) over the following two decades.

Much still needs to be done to improve the overall business environment to lift investment and create jobs. The IMF has estimated that India's potential growth in the medium term stands at around 6% under a baseline scenario of limited change in the key growth dynamics[6]. This scenario assumes:

- Capital stock growth is supported by public investment in infrastructure as well as resilient credit growth
- Employment growth returns to pre-pandemic levels, with a declining rate of employment to population that reflects a continued fall in the female labour force participation rate and high youth unemployment
- Human capital growth avoids long-lasting impacts of the pandemic
- Total factor productivity recovers from the impact of the pandemic (reversing the shift that took place with workers moving from high productivity services and manufacturing sectors to agriculture) and is improved by progress with digitalisation

An upside scenario for the medium term puts potential growth at around 7%. This requires continued infrastructure investment and further steps to attract FDI. Inward FDI has picked up from the minimal levels of the 1990s and 2000s, but since 2014 FDI inflows have levelled off, averaging around 1.8% of GDP (China's FDI inflows averaged 3.7% of GDP in the 1990s and 2.9% in the 2000s). India's FDI inflows have mainly been

[6] IMF, Unleashing India's Growth Potential, April 2023

centred on services and the computer software and hardware sector and in a few southern states. The failure to attract higher levels of FDI in part reflects the broad challenges that persist when doing business in India (despite recent liberalisation efforts and corporate tax cuts), as well as a failure to proceed with agriculture and land reforms. More progress also needs to be made in trade reform, although a few trade deals have been reached recently, including with Australia.

Improving human capital requires greater coordination between the central government and the states to strengthen vocational training and invest in wider improvements to the education system. The base is currently low; the literacy rate in India is 75%, and according to the Organisation for Economic Co-operation and Development (OECD), 66% of 25 to 34-year-olds have not attained an upper secondary qualification, compared to the OECD average of 14%. An improvement in education offers significant opportunity for growth and has elsewhere been consistent with addressing inequality issues.

There is also a pressing need to implement major labour reforms to drive investment, as India's generally restrictive employment environment, including a requirement for state-level approval for large firms in their hiring and firing decisions, is a deterrent to investment. Some steps have been taken recently to simplify the legal environment, with 29 labour laws being consolidated into four codes: the Wage Code, the Social Security Code, the Occupational Safety, Health and Working Conditions Code, and the Industrial Relations Code. These have been approved by parliament, but have yet to take effect, in part as implementation requires state government action.

India's regulatory environment is also restrictive, with an excessive bureaucracy. The Observer Research Foundation, an India-based, non-partisan research institute, refers to India's problem of "regulatory cholesterol" in its 2022 report *Jailed for Doing Business*[7], stifling the flow of ideas, money and entrepreneurship. India also has a low rank in Transparency International's Corruptions Perception Index; its score of 39 out of 100 (with zero being "highly corrupt") puts it 93rd out of 180 countries, below China (76th) and Vietnam (83rd).

Modi 3.0 and beyond

Barring major shocks to the global economy, India's economic expansion should continue to outpace most other major emerging markets in the next five years. A continuation of current pro-business and investment-promoting policies, combined with its growing consumer market, should keep annual growth above 6%.

Over a five-year horizon, India therefore continues to present investors with a compelling growth story, and this pace of growth could be faster if Modi manages to accelerate reform, which could unlock potential growth closer to the double-digit rates recorded by China and other East Asian economies during their acceleration phases.

However, challenges look set to grow over the longer term. If employment opportunities do not keep pace with the rising number of young and educated jobseekers, as well as those displaced from the low productivity agricultural sector, India may see its demographic dividend become a burden. The world is now a different place to that in which China managed to transform its economy, rapidly absorbing its expanding labour force to become the dominant manufacturer.

India is also among the most vulnerable markets to the adverse impact of climate change, notably the potential reduction in productivity from extreme heat, the damage to physical assets from extreme climate-related events, and the required diversion of resources to disaster risk management and mitigation projects. India's Council on Energy, Environment and Water states three out of four districts in India are extreme event hotspots, and more than 80% of India's population lives in districts that are highly vulnerable to extreme hydro-meteorological disaster[8].

Modi has achieved a rare political feat in winning a third-consecutive term, but the decline in support compared to the previous election in part reflects his government's failure to ensure the spoils of the growing economy are shared widely. At the end of this coming five-year term, India will likely have the third largest economy in the world, overtaking Japan and Germany, but the state of India's economy after Modi 3.0 is still to be determined. With the BJP losing a majority, and facing a rejuvenated opposition, Modi will need to adopt a more conciliatory and consensus-building approach to policymaking to push through difficult but necessary reforms. There is a risk instead that he doubles down on policies focused on short-term populist gains and right-wing Hindu nationalism and progress with reform founders.

[7] Observer Research Foundation, Jailed for Doing Business, February 2022

[8] Council on Energy, Environment and Water, Mapping India's Climate Vulnerability, October 2021

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