India: Economic superpower in the making

But a long way to go

- **The Indian economy is growing at a healthy pace, mainly thanks to the reforms implemented in the past 15 years. Although the government relies on a motley leftist coalition, there is broad support for the reform strategy.**
- **The budget shows a deficit, but it is manageable. The biggest obstacles to economic growth are substandard infrastructure and rural poverty. Labour market rigidity is also hampering portions of the manufacturing sector and slowing direct investments.**
- **India's dynamism and potential are nevertheless so large that good growth should be able to continue for a long time to come. Within a few decades, India will be one of the world's three largest economies.**

A land of contrasts

During September 2005, a large group of representatives of the Nordic business community took a trip to India, organised by SEB. The delegation – which was led by Marcus Wallenberg – met an impressive array of economics, politicians, journalists and others.

This article summarises my own impressions from the trip. However, it is impossible to provide a picture of this giant country in a few pages. The contrasts are so enormous, and many observers maintain that diversity is precisely what defines India. The country's history goes back thousands of years. It is a continent eight times larger than Sweden and with 120 times more inhabitants. It is teeming and vibrant. The heat and intensity, the smells, the colours and the contrasts are what strike a visitor from well-organised, chilly little Sweden. India has fiery hot deserts, tropical rain forests and the world's highest mountain range. There is an enormously sophisticated, well-educated upper class, while a couple of hundred million people are still illiterate. There is phenomenal wealth right next to extreme poverty. There is a huge mosaic of languages and religions. And there is cutting-edge technology side by side with stone-age technology.

Thus no simple analysis is capable of grasping the whole. I unreservedly admit that my attempts here to capture a few important trends undoubtedly miss others.

Reform policy having an impact

The impression nevertheless remains of **a nation that has chosen a new path during the past 15 years**, and that this is now yielding results in the form of a new self-assurance and strength. The first 45 years of the post-colonial period (1947-1991) were dominated first by Jawaharlal Nehru's and then his daughter Indira Gandhi's attempts to build a special Indian socialism, with extensive regulation, protectionism and centrally controlled licensing (the "licence raj"). Growth was weak and purchasing power rose only slowly.

Early in the 1990s, India chose a new direction. The triggering factor was a deep economic crisis, with India hovering on the brink of national bankruptcy. At that time, Finance Minister Manmohan Singh (today prime minister) pushed through a **deregulation strategy**, with sector after sector of the economy gradually being opened to competition. Tariffs were lowered. The licensing system has been largely abolished. Marginal taxes have been cut. Large government-owned companies have begun to be privatised.

This strategy has remained in place both during the late 1990s (when the country was ruled by a coalition led by the Hindu party BJP) and today (when the Congress Party governs together with a motley alliance of leftist parties). One crucial crossroads was an economic slump in 1996-97 when it turned out that the deregulated economy handled the downturn smoothly. After that, deregulation gained new momentum and companies accelerated their efforts to boost productivity.

The result has been **an increase in GDP growth** to about 7 per cent annually, a pace that most observers believe is fully possible to achieve – and perhaps even exceed – during the coming decade as well. Meanwhile population growth has slowed somewhat and per capita income has climbed sharply. Today the middle class encompasses 250-300 million people and is growing by about 25 million a year.

India's growth is broad-based and includes both industry and the service sector. Household savings are high and capital inflows are sizeable, especially from the large diaspora of Indians abroad, who send home an estimated USD 30 billion per year.

Major challenges

Today, however, India faces several challenges. The crucial ones concern agrarian poverty and infrastructure.

- **The infrastructure – the road network, energy distribution, telecom network etc – is substandard**. No more than some 3 per cent of GDP annually goes towards capital spending for infrastructure, compared to about 7 per cent in China (from a substantially higher level as well). As a result, logistics and inventory management are difficult, while companies are often hit by disruptions in energy supply. India's outmoded infrastructure is a factor that is clearly slowing the influx of foreign direct investments. Personally, I experienced this problem at the micro level. At Delhi Airport – a structure seemingly held together by twine and chewing gum – I watched my suitcase being tagged with strange handwritten pieces of paper. After which it naturally disappeared on the journey home…

- **Rural poverty is still enormous**, with widespread undernourishment and high infant mortality. No other country in the world has as many poor inhabitants as India. The climate – drought alternating with monsoon rains – makes agriculture dependent on archaic irrigation systems and highly vulnerable to the weather. A few years ago when the monsoon season yielded unusually little rain, a large proportion of India's harvests dried up and GDP growth turned out one and a half per cent lower.

Most observers agree that **growth must become even broader and must also benefit the poor** out in the villages. If growth does not extend "downward", the gaps will become too wide, and the backlash from the poor will be violent. Thus small farms must be mechanised and modernised. But this also presupposes rapid growth in cities, where redundant farmers will be moving. This is why a **functioning social safety net** is also needed – accompanied by functioning tax collection – as the old self-supporting village collective is replaced by an urban money-based economy.

Then, of course, there are all the other challenges that flow from rapid population growth, such as expanding the health care and education systems at a pace that will make a rising education level and better public health possible.

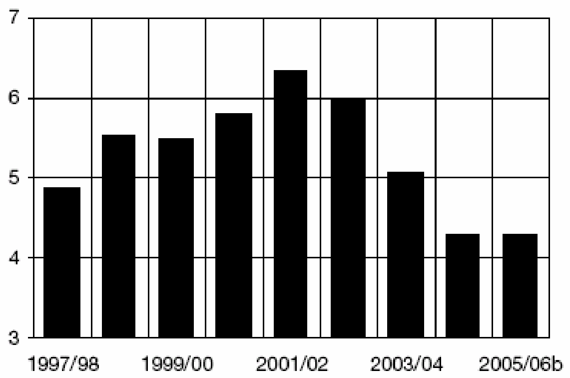
Economic policy

In the medium term, the central government budget may be a source of concern. The budget deficit is about 4½ per cent of GDP; in addition, deficits at the state level are about the same. Consolidated public sector debt totals more than 80 per cent of GDP and has climbed in recent years.

In its evaluations of India, the IMF has repeatedly recommended a tighter budget policy. However, the general perception in India is that today the deficit is not a serious obstacle. **The deficit has fallen in recent years**, underlying growth is strong and interest rates are low. What is more, the public sector is small (central government expenditures amount to only 14 per cent of GDP and the tax burden is a mere 10 per cent). The government therefore believes that it has time to gradually bring down the deficit, as long as the growth rate can be maintained.

Parliament has adopted a medium term strategy, the Fiscal Responsibility and Budget Management Act, which states that the central government budget deficit shall be lowered by 0.3 percentage points of GDP per year over the next four years. One part of this strategy is the introduction of a uniform value-added tax, thereby simplifying tax collection and probably leading to substantially higher tax revenues.

Central government budget deficit
Per cent of GDP



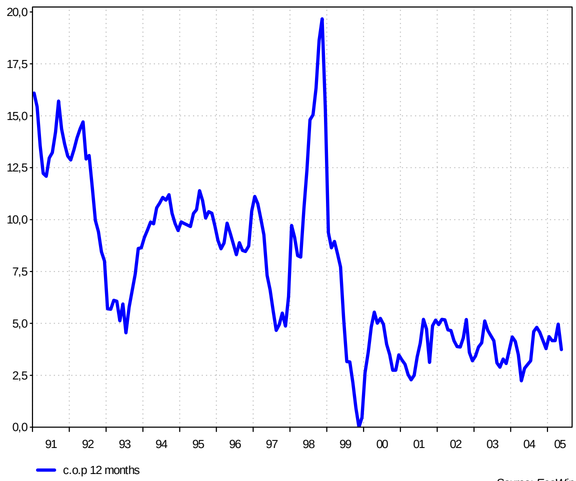
Nowadays the budget deficit is being financed mainly via domestic borrowing. A **rapidly growing foreign exchange reserve** (which today totals about USD 140 billion) has enabled India to accelerate its principal payments on old foreign debts. Today the country's net position is essentially zero. Only five years ago, foreign debt was four timed larger than foreign currency assets.

Inflation has gradually fallen from levels of above 10 per cent before the reform policy to 3-4 per cent today. Rising oil prices have not yet had an impact in the form of higher inflation. The combination of low inflation and foreign currency inflow has **strengthened India's credit rating**. The spread between Indian interest rates and those in hard currency countries has fallen sharply; today the central bank's key rate is at 5 per cent and long-term bond yields are below 7 per cent.

The trend of interest rates is currently upward, due to strong economic expansion (GDP grwoth this year is likely to exceed 7 per cent), rising asset prices and rapid credit growth (lending to the private business sector is currently rising at 25 per cent, year-on-year).

The banking system is stable, with low credit losses. The proportion of non-performing loans has fallen to about 5 per cent of outstanding loan volume. India's currency – the rupee – is now deregulated, but the central bank intervenes now and then, when it believes that the rupee's fluctuations are excessively large. The trend is a **gradual appreciation of the INR** against the USD.

Inflation
Year-on-year change in CPI



Source: EcoWin

The world's largest democracy
India prides itself on being a well-functioning democracy. Its elections are undoubtedly the world's largest demonstration of democratic logistics – with hundreds of millions of voters, millions of election officials and hundreds of thousands of polling stations. **Democracy enjoys deep support, and freedom of speech is secure** – Indian media are independent, articulate and always on the ball.

The party system is markedly different from that of Sweden. More than 400 parties stood in last year's election, and today more than 40 parties are represented in Parliament. But it is difficult to discern any clear right-left spectrum. Instead the parties are election organisations, often grouped around a region, a single issue or a family. Partnerships are begun and ended, and horse-trading continuously results in new alliances. The political landscape is thus constantly shifting.

Two major groupings are discernible, however. The ruling government alliance (since the 2004 election) consists of some 15 parties, with the **Congress Party** as the main actor. The opposition is grouped around the **Hindu party BJP**, which nevertheless does not appear especially influenced by religion upon close inspection.

Western media initially described the prevailing government alliance with large war headlines: the fact that leftist parties, including communists, were part of the government's parliamentary base would threaten its reform policy, they maintained. The stock market fell sharply out of pure fear. It is true that the pace of privatisations has slowed and that greater attention is being paid to the powerful industrial trade unions. Strikes are also currently underway, with trade unions at government-owned companies protesting against potential privatisations. But to an outsider, the differences in domestic policy between the two main political groupings still seem small. The communists may speak with red letters, but where they themselves have local power – in West Bengal – they pursue the same economic policy as the Congress Party, including free zones and the works.

During our visit, we met politicians from a number of different parties and it was striking how **all of them, without exception, expressed their support for the current reform strategy**. The differences lie in rhetoric, tactics and pace, not in their long-term direction. The reform strategy has yielded such clear advantages − and such an obvious sense of national self-assurance and pride – that it is no longer questioned by any leading political force.

Direct investments

In recent years, India has become an attractive destination for offshoring and outsourcing in service sectors. India's direct investments are nevertheless small compared to China's (USD 5 billion and USD 60 billion, respectively, during 2004). But if portfolio investments and capital flows from overseas residents are also included, the difference is more than halved. Taking into account that a large proportion of Chinese direct investments consist of flight capital that has been laundered abroad and then sent back, the difference narrows even further.

Yet it is undeniable that direct investments in India are disappointing. The IMF distinguishes several explanations for their small size. Shortcomings in infrastructure have already been mentioned and are the most obvious reason. Another is **strict labour market laws −** a legacy from the era of regulation that has not been abandoned. Above all, this consists of a special employment protection act, which makes it difficult to dismiss workers − thereby also reducing employers' willingness to hire. The government has taken some of the criticism of this legislation to heart and is trying to attract larger investment flows by creating free zones with lower taxes and fewer regulations. Here we can expect tough defensive battles by the trade unions.

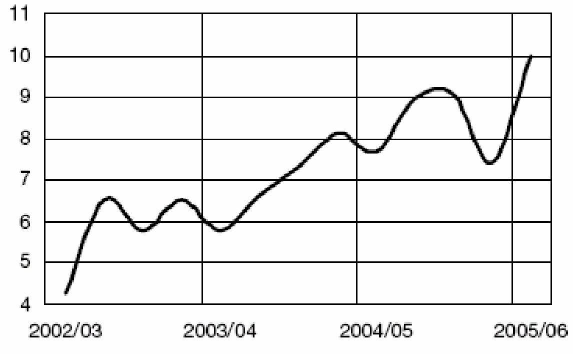
India's experience of labour market legislation is mixed, however. Firstly, the laws apply only to blue-collar workers in industry while the whole rapidly growing service sector is exempted (the reason for this remarkable practice is that the legislation dates from 1948, when industry was a focus of political attention and no one could foresee a rapidly growing private service sector). Numerous companies, both foreign and domestic, therefore get around the law by simply hiring only white-collar workers (defined a little vaguely).

Secondly, there are plenty of good examples of how, in particular, foreign companies that have established operations in India have still generated very good profitability, even in industry. It should be pointed out that the **profitability of the Indian business sector is higher than that of China**. Our delegation included various representatives of companies with very profitable operations in India. The most successful seemed to be those that concentrated on high-tech, engineer-oriented manufacturing activities.

Industry – stronger than you think

That is the niche that many observers regard as the foremost one for India. Competing only on the basis of low costs is difficult, given China's role as an established low-cost producer. Relying only on information technology (see below) is not enough. But in fact, India has a large, well-educated cadre of engineers, with advanced mathematical and technological expertise. This would indicate that the **country's competitive advantages lie in the technologically advanced engineering industry −** or as one of the Indian business executives we met put it: "the ability to take advantage of high technology in an environment of low wage costs."

Industrial production
Year-on-year percentage growth



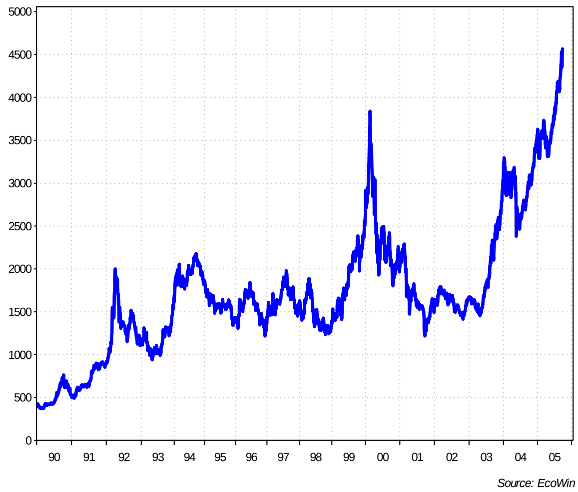
Contrary to what many people believe, Indian industry has grown vigorously in recent years. During the past year, the increase in manufacturing output exceeded 10 per cent, with the rapid expansion of the automotive industry as the clearest example. Having been mainly a sub-contractor, the Indian automotive industry – due among other things to large direct investments – has become a sizeable exporter of assembled cars.

The expansion of manufacturing industry has also resulted in **good profitability, as well as a sharp upturn in the stock market**. The profits of the 100 companies included in the Bombay (Mumbai) Stock Exchange's national index rose by 30 per cent during 2004, and the market capitalisation of the Exchange has more than tripled in the past four years. Due to good profits, valuations are still rather low: on June 30 the average price-earnings ratio stood at 14.

An IT superpower

Despite industrial successes, India's information technology sector has attracted the greatest attention. Directly after my return to Europe, I attended at meeting in Brussels of the European Commission's economic advisors' group. The topic was

Bombay (Mumbai) Stock Exchange
100 Index



outsourcing and competitiveness: how can Europe manage against Chinese industry and the Indian service sector? And the following week when I visited Washington for the IMF annual meeting, Thomas Friedman's new bestseller *The World is Flat* was prominently displayed at all bookstores, chock full of features about booming Indian service companies.

The strong growth of IT is based on India's traditional engineering expertise – 36 per cent of all those earning natural science doctorates in the United States are Indians – along with its rapidly growing young population of English speakers. There has been strong expansion in telecoms and software, but also in call centres and other **back office functions**. However, we should be aware that the upswing started at a low level and that this sector is still small in absolute numbers.
Its growth is rapid, however. **Internationally competitive IT clusters** have emerged in Mumbai and Bangalore. Some of the leading companies are working extremely hard to develop business process outsourcing (BPO), i.e. accounting, e-mail processing, IT support etc. The labour cost

for such functions in India are about 15 per cent of those in the US, and exports in this sector have tripled in the past four years. Here India is rapidly moving upward in terms of value-added. Development costs are low, and several high-quality universities are pumping out hundreds of thousands of new graduate engineers each year. Today there are increasingly frequent references to "knowledge process out-sourcing" (KPO) instead of BPO. Indian companies hope they can take over more and more advanced functions from companies in the West, such as Internet-based instruction. One of IBM's executives in India told us that his daughter wanted to move to the US, "because then I can outsource doing my homework to India"…

Here **the potential seems large**. The IT clusters have achieved critical mass, and several major international companies are moving their cutting-edge development departments to India. One example is IBM, which has nearly 30,000 employees in India. The number is climbing rapidly. Various calculations show that R&D costs are 40-50 per cent of those in the West − and that the quality is normally *higher*.

India's big neighbour to the north

Comparisons with China are naturally unavoidable. The two countries have almost equally large populations (1.3 and 1.1 billion inhabitants, respectively). Their modern history began around the same time (1949 and 1947, respectively). In both cases the starting point was widespread poverty and an agrarian economy. However, China's reform policy began more than a decade before India's (1978 and 1991, respectively), and China has doubled its GDP per capital compared to India. China's industrial output and exports have grown substantially faster, along with direct investments and infrastructure spending. As a result, average life expectancy has climbed more, and literacy has risen faster in China. The proportion of the population living in extreme poverty (an income of USD 1 per day or less) is 25 per cent in India against 10 per cent in China.

But India is highly advanced in services and BPO. Its service exports are substantially larger than China's. The reform policy has borne fruit and GDP growth has approached that of China in recent years. Foreign companies are not exposed to pirate copying. Protection of ownership rights is stronger and legal rights are greater than in China − even though due to bureaucracy, the wheels of justice grind slowly. India has completely accepted to WTO's regulations. In a longer perspective, these factors − and possibly also India's democratic institutions in a broader sense − are likely to stimulate growth. Due to faster population growth, India has long-term potential to catch up with China economically. The structure of their business sectors is also likely to become more similar, since India is investing in high-tech industrial production while China's industry is increasing its service content and becoming more R&D-intensive.

In foreign policy, a rapprochement is underway with India's old adversaries China and Pakistan. Under Nehru and Indira Gandhi, India was close to the Soviet Union, but since the fall of the Berlin Wall, India has clearly shifted to the American sphere of influence. Today the US regards India as an important ally in the battle against terrorism. Meanwhile India reserves the right to secure its access to energy, among other things by cooperating with Iran. Herein lie the seeds of future conflicts.

An enormous potential

Given rapid growth and a burgeoning population, today the Indian economy has become the world's fourth largest, measured in purchasing power. If the standard of comparison is instead GDP in current dollars, however, the country ends up considerably further down the list (in twelfth place, twice as large as Sweden). The trend is clearly upward. Among the world's major economies, only China is growing faster. Potential growth can be estimated at about 7 per cent. All long-term projections of growth consequently say that **in a few decades, India will be the world's third largest economy, even in current prices**, after China and the US.

Those of us who participated in the Nordic delegation were struck by the **pride and self-assurance** with which India speaks today. India sees itself as the next economic superpower − something that was illustrated symbolically when India turned down foreign assistance after the Asian tsunami and instead offered its own help to hard-hit neighbouring countries.

India's new optimism is most clearly noticeable in its approach to population growth. A few decades ago, such growth was viewed as a major threat. Nightmare scenarios of mass starvation were painted by prophets of doom, and not only in the West. During the 1970s Sanjay Gandhi (brother of Rajiv), with the consent of his mother the prime minister, carried out a brutal forced sterilisation campaign in rural areas. Today, however, population growth is viewed as a major asset. Half the Indian population is under age 26 − this alone is a population twice as large as that of the entire United States. **One fourth of the world's children and young people live in India**, which in itself guarantees that the global importance of the country will grow.

Nevertheless, India has often disappointed optimists. One anecdote illustrates the old Indian bureaucracy and the India where things move slowly and listlessly: An Englishman who was going to take a train trip found out that he could choose between an ordinary train and a fast train. He chose the more expensive fast train, only to discover that it travelled just as slowly as the cheaper alternative. He complained to the Indian conductor: "This is no fast train." The conductor replied: "Yes, of course it's a fast train. It's just going slowly."

For decades, India was a fast train that moved slowly − an economy with enormous potential that never managed to take advantage of its possibilities. Today's reform policy has caused the train to accelerate. The prospects are good that in the future, it will become a genuine fast train.

Klas Eklund

Economic Research:

Klas Eklund, Chief Economist	+46 8 763 80 88	klas.eklund@seb.se
Håkan Frisén, Head of Economic Research	80 67	hakan.frisen@seb.se
Ann Enshagen Lavebrink, Research Assistant	80 77	ann.lavebrink@seb.se
Olle Holmgren, Economist	80 79	olle.holmgren@seb.se
Mikael Johansson, Economist	80 93	mikael.johansson@seb.se
Tomas Lindström, Economist	82 97	tomas.z.lindstrom@seb.se