Global Macro Research - Insight

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#India / #Growth / #Forecast

Will India become the next Asian tiger?

India is on the path to becoming a major driver of global growth, helped by favourable demographic trends. The challenge is formidable, but, if policymakers seize the opportunity presented by the changing nature of deglobalisation they could unleash the next Asian tiger.

Key Takeaways

- India will be the fastest growing major economy in 2023 and is set to become the fourth largest economy in the world in the 2030s, buoyed by its favourable demographics and dynamic service sector.
- While we see downside risks from demographics for most economies' long-run growth paths, India could outperform our expectations given its scope to increase labour force participation, its increasingly educated workforce, high investment needs, large share of workers still in agriculture and the potential to benefit from shifting global supply chains.
- However, to truly become the next Asian tiger economy, India needs to accelerate the share of its workforce entering productive areas of the economy, namely industry and services.
- For this to occur, more reforms will be needed to encourage private sector investment and reduce operational costs, while physical infrastructure will also need to improve to reduce the costs of doing business.
- However, we see challenges pushing through major reforms – particularly of the agricultural sector - while a tendency towards protectionism may cap the pace of manufacturing growth.
- Overall, India is primed to impress – our growth forecast is consistent with it becoming one of the major engines of global growth. But, without significant reforms, or a more meaningful acceleration in sectoral reallocation, it will likely fall short of the dynamism seen in the Asian tigers who attained advanced economy status in record time.

The country's economy is roaring ahead

India is set to be the fastest growing major economy this year, buoyed by government infrastructure spending and a strong services sector. The economy grew 7.6% year-over-year in Q3 2023, and we forecast the economy to outpace global growth and even China's economy in 2024.

India's growing and young workforce, along with its significant scope for catch-up growth – since income levels are still low – gives reason for optimism. Unlike many other major economies its workforce can continue to be a contributing driver of growth.

Dependency ratios are typically calculated as the ratio of those below 15 and above 64 versus those 15-64. However, since people are joining the workforce when they are older and retiring later, we find that looking at the ratio of workers to non-workers is a better indicator. Using this measure, India will be one of the few major EMs to have its dependency ratio improve, helping to boost its long-term potential growth.

Along with improvements in educational and skills levels among its workforce and government efforts to improve transport infrastructure, power generation capabilities and access to the internet, capital deepening and productivity growth can be expected to be key drivers of growth.

Putting it all together, we expect India to become the fourth largest economy in the world in the 2030s, reflective of these underlying strengths.

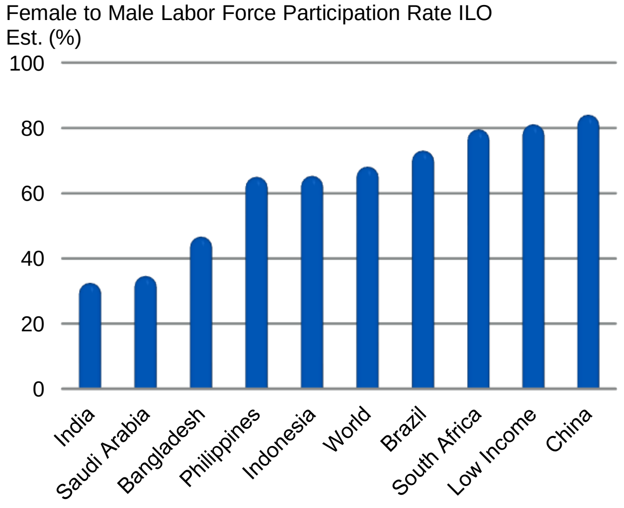
Reaping the demographic dividends

India's demographics provide significant upside potential to its growth outlook. The sizeable working age population could mean an even larger labour contribution to growth if employment levels can increase.

Indeed, India is not fully utilising its workforce as it stands. Estimates show labour force participation at 51%, below an average of 56% for lower middle income and 72% for upper middle-income countries.

India also suffers from extremely low female participation rates (see Figure 1). Were employment opportunities to improve and labour laws to change, the country's labour contribution could boost growth.

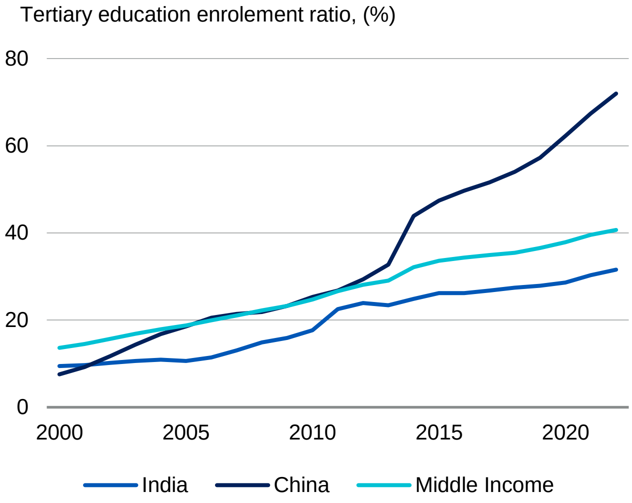
Figure 1: Recognising female power



Source: Haver, abrdn, November 2023

Another upside from India's workforce could come from the quality of labour, with the increasing share of students entering tertiary education helping to boost worker productivity (see Figure 2). India's tertiary enrolment share is already around double that of China at the same stage of development and the government has pledged to boost education and skills.

Figure 2: A smarter growth path

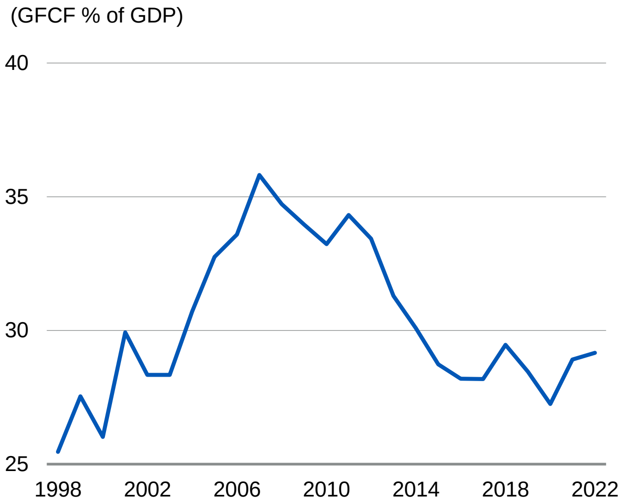


Source: Haver, abrdn, November 2023

Infrastructure needs are high

India's relatively poor infrastructure – and its development potential – could turn into another source of upside as the country's growing population needs housing, transport and utilities. We have already accounted for an investment-to-GDP ratio of around 30% in the long term as part of our central case, yet there is scope for gross fixed capital formation (GFCF) to return to prior highs (see Figure 3).

Figure 3: Investment has fallen from its highs, but it is still strong and should remain robust



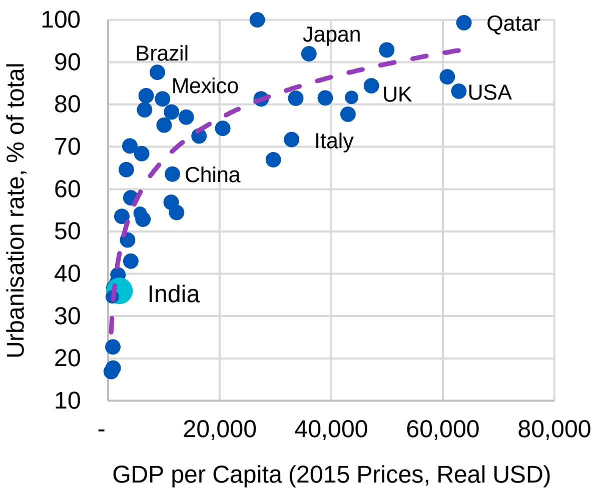
Source: Haver, abrdn, November 2023

If the country can accelerate its infrastructure investment – for example in cross-country transportation links – it could boost GDP via investment, and reduce the cost of doing business, thereby giving growth a further lift via productivity. This could create a virtuous cycle as businesses expand capacity to meet growing demand.

Relatedly, there is lots of scope to drive growth via urbanisation.

Relative to India's level of development, its urbanisation rate is as expected (around 36%, see Figure 4), but this is very low in an absolute sense, implying considerable scope to accelerate growth via capital deepening (i.e. buildings) and via sectoral reallocation (i.e. taking more productive city jobs and leaving behind low paying agricultural work).

Figure 4: Urbanisation a potential investment boom



Source: Haver, World Bank, abrdn, November 2023

Recent government budgets have in fact been focused on improving infrastructure and reducing logistical costs. Capital expenditure as a share of central government spending has risen from around 13% before the pandemic, to around 18% in 2023.

Improving logistics is an important step to reducing the costs of doing business in India, which remains high. The government hopes to reduce logistical costs from around 13% of GDP to 8% to 2030, but it remains to be seen whether policies can realistically achieve this. India's relatively high government debt-to-GDP ratio (81%) does also raise the risk of fiscal constraints in the future.

Reshoring winner

Domestic savings and government debt need not be a constraint if India becomes a destination for more foreign direct investment (FDI) flows.

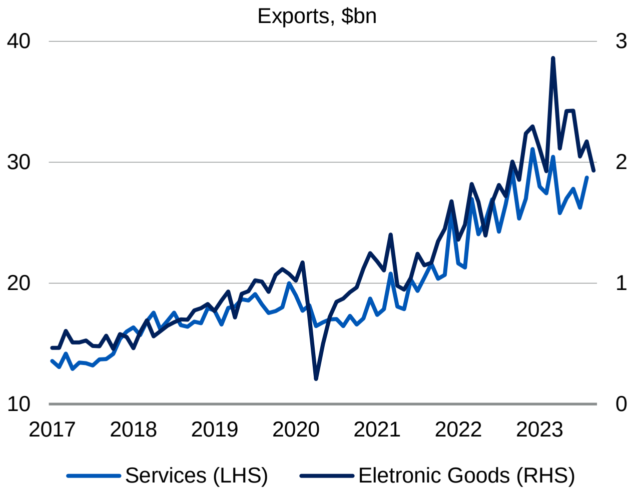
Globalisation may be slowing but Western policies aimed at reinforcing national security and reducing supply-chain risks are creating opportunities for economies like India which can benefit from its geopolitical alignment with the West.

India's government is taking steps to reap these benefits. Initiatives for manufacturers – such as the Production Linked Incentive scheme – and improvements to logistical infrastructure aim to increase FDI from its relatively low levels (1.3% of GDP).

While Modi's 'Made In India' slogan has some protectionist aspects to it, it is also premised on the idea that the country can export more. And pivoting towards a larger manufacturing sector or expanding service exports could provide further upside to India's growth outlook.

Exports of electrical goods have surged after the pandemic, providing some evidence of India's ability to tap into global demand (Figure 5).

Figure 5: Exports surging post-pandemic



Source: Haver, abrdn, May 2023

India's booming services sector could also be an avenue for stronger exports and a leapfrog towards an economy with a larger share of services. The rise in financial, IT and other business services exports through the pandemic suggests India has an advantage in this area.

Recent academic research argues services are becoming increasingly exportable and that with improved digitalisation – potentially amplified by the roll out of AI – these could become a much faster source of global trade growth than manufactured goods. As such, India's strength in this field could position it well to take advantage of both changes in global geopolitics and trade.

Growing pains

However, for the country to raise its potential growth path beyond our central case, it may need to do more to address the structure of its economy.

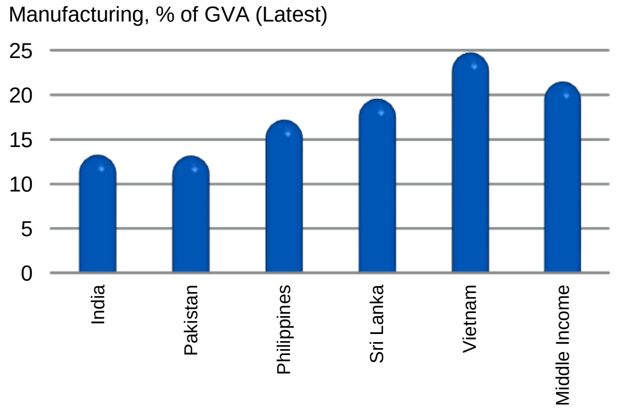
India is heavily reliant on its services sector, accounting for around 54% of GDP and credit to the sector has been fast outpacing lending to industry (25% vs 7% year-over-year in 2023).

India's high reliance on services isn't particularly unique among lower middle-income economies and neither is the low share of manufacturing (see Figure 6). However, upper middle-income economies tend to have a larger manufacturing sector.

The Asian tigers, such as South Korea and Taiwan, developed through a transition from agriculture to manufacturing and export-led growth.

Low-skilled manufacturing offered higher incomes for agricultural workers and from there these economies transitioned up the value chain, eventually expanding services sectors as well.

Figure 6: Low manufacturing base a challenge

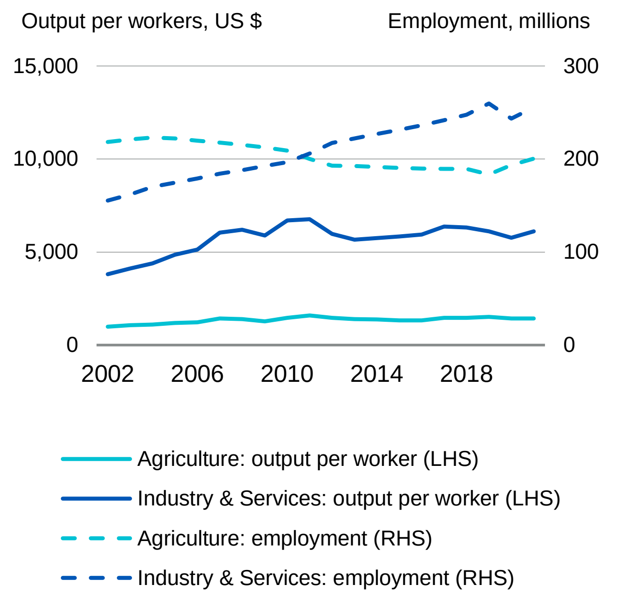


Source: Haver, abrdn, November 2023

India still has a high share of workers in low productivity agricultural employment (43%). In contrast, workers in industry and service sectors have much higher productivity (see Figure 7) – so a faster transition of workers towards these sectors could boost India's potential growth, perhaps by around 0.5 to 1ppt.

This is a double-edged sword. Under our central case, India's working population will grow by an additional 146mn workers by 2050. Therefore, it is crucial that the expanding workforce flows into higher productivity sectors, rather than dragging on India's productivity. This could threaten India's ability to boost income levels and escape the 'middle income trap'.

Figure 7: Shifting workers out of agriculture is a route to stronger growth



Source: Haver, abrdn, November 2023

Reform, reform, reform

Reforms will be key to unlocking India's potential, and they have the potential to amplify each other. Following through on reducing logistical costs and improving public infrastructure will be a boost to India's attraction as a manufacturing hub outside of China, for example.

However, failure to tackle issues also has the potential to stymie growth. As discussed in the context of sectoral reallocation above, the ability to address reforms around land ownership, labour laws, legal system inefficiencies and trade openness remains important to tackle some of the barriers to India's growth.

Pushing through reforms appears to be a major challenge. Despite Modi's high approval rating (76% in latest polling), his government has struggled at times to implement the most politically sensitive reforms.

In 2016, the sudden implementation of 'demonetisation' proved disruptive to the economy. And in 2021, the government eventually backtracked on agriculture reforms after sustained protests. The backtrack may bode poorly for other sensitive issues around land reform and opening up to international trade.

Indeed, in September, plans to curb the imports of laptops, tablets and PCs were deferred only after businesses voiced deep concerns – this protectionist mindset certainly does not fit well with encouraging manufacturing to relocate from China.

Modi is likely to win a third term in government in 2024, but it is unclear how willing he will be to take on the tough reforms and political battles needed to address the issues facing India's economy.

Further capital expenditure is likely but without trade deals and reforms to improve India's business environment, private investment may ultimately fall short. More troubling could be if Modi's 'Made in India' plan leads to an increase in inefficient import-substitution policies and tariffs, ultimately hurting Indian consumers, trade relations and India's chances of benefiting from reshoring.

Upsides outweigh the downsides

Overall, India has high potential, and demographic tailwinds could see it become the next 'Asian tiger'. Even in our central case, we see India's economy outperforming global growth to increase its share of the global economy and consumer market.

Opportunities presented by geopolitical pressures imply that risks to its outlook are skewed to the upside – contingent on policy makers pushing through tough reforms. This could see its size converge even closer to that of the US and China and challenge the Eurozone's place as the third-largest economy by 2050.

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