

ECONOMIC VIEWPOINT



India: On the Cusp of Rapid Growth and Several Challenges

A Trading Partner That Could Turn into a Major World Player

India is in line to become the world's fastest-growing economy in the coming years. It is also expected to dethrone China as the most populous country within six years. The country's role in the global and Canadian economy should not be underestimated. This issue of *Economic Viewpoint* presents an overview of the Indian economy's outlook, structure and challenges. The country would appear to offer short- and medium-term investment opportunities, but certain factors need to be monitored in order to ensure sustainable growth over the long term.

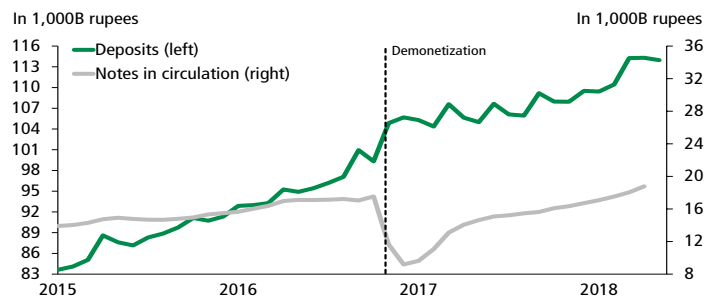
Sudden but Long-Awaited Reforms

The election of the Narendra Modi government in May 2014 changed India's political and economic course. The government has implemented two major reforms as part of its modernization efforts. These are largely aimed at reducing corruption and the weight of the informal sector¹—which accounts for more than 80% of jobs—and increasing government revenue. Although their implementation has been widely criticized, their effects over the long term should be beneficial.

First, demonetization, which replaced 86% of banknotes in circulation, has been a drag on consumption and investment, while liquidity has been temporarily restrained (graph 1). Smaller companies were the most affected by it, as they operate mainly in cash and didn't have the technology to process electronic payments. Around 1.5 million people lost their jobs in the first four months of 2017 following the start of the demonetization, resulting in an estimated 2% drop in GDP growth. However, many people were forced to open bank accounts (between US\$43B and US\$66B in new deposits), thus reducing the proportion of people excluded from the banking system. The percentage of the Indian population over age 15 with a bank account rose from 53% in 2014 to 80% in 2017, partly due to demonetization. Wider access to financial services would make it

GRAPH 1

The jump in commercial bank deposits in India is consistent with the removal of 86% of notes from circulation



Sources: Reserve Bank of India and Desjardins, Economic Studies

easier to target tax evasion, reduce transaction costs and inject more liquidity into the financial market. By increasing the tax base, the government would be better able to balance its budget and reduce gross public debt, which stood at 70.2% of GDP in 2017 (graph 2 on page 2).

Second, a new goods and services tax was implemented in July 2017 to unify the country's tax system and reduce barriers between regions. Its implementation has slowed the economy; businesses have had to adapt, and its six taxation levels have led to some confusion. However, those businesses that were already paying their taxes were better prepared, and thus benefitted more than businesses that had not been paying their

¹ The International Labour Organization defines the informal sector as the part of the labour market that is not registered with government authorities and that is involved in independent, small-scale activities.

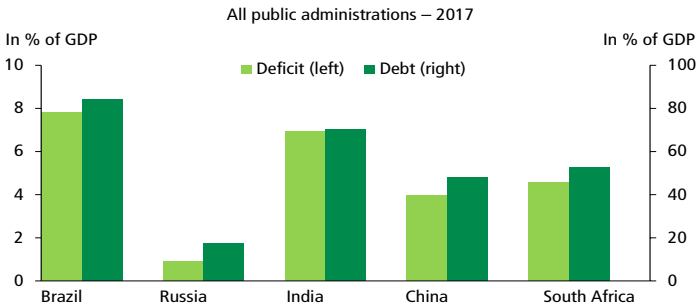
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GRAPH 2
India's debt and deficit are high compared to BRICS countries



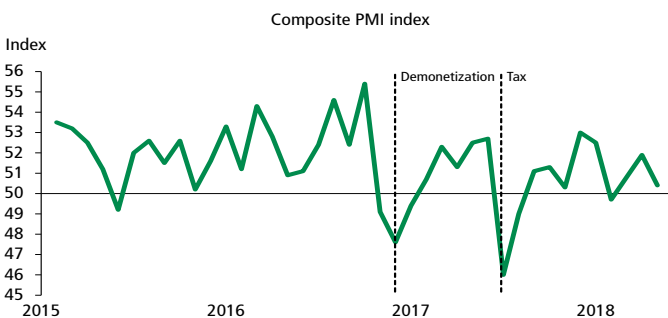
BRICS: Brazil, Russia, India, China, South Africa
Sources: International Monetary Fund and Desjardins, Economic Studies

taxes. By reducing the informal sector and regional barriers, this reform could improve competitiveness, productivity and the business climate. India's Ease of Doing Business index ranking went from 130 in 2017 to 100 in 2018 (with 1 being a perfect score)—above the South Asian average, but still trailing China by 22 points.²

Rapid Growth Is Expected and Necessary

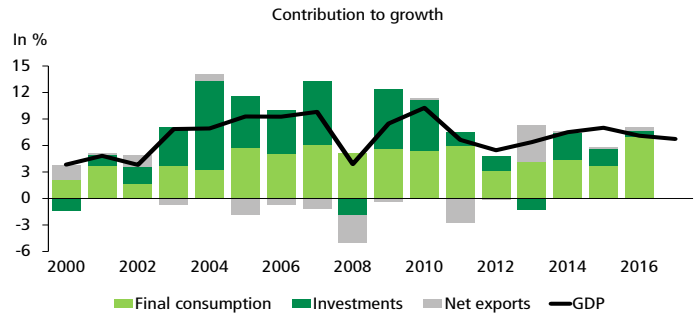
Confidence indexes fell after each reform, but quickly recovered. In the past two years, the composite PMI index fell significantly below the neutral threshold of 50 only after the announcement of demonetization and the new tax. Its latest value was 50.4 in May (graph 3), however the services PMI seems weaker than that of the manufacturing sector. Industrial production was up about 6.2% in Q1 2018, and private consumption continues to be strong, comprising almost 60% of GDP (graph 4). Despite the disruption brought about by the reforms, according to the International Monetary Fund (IMF) real GDP growth was 6.7% for 2017, one of the world's strongest. The IMF expects a 7.4% gain in 2018, which would surpass China's gain of 6.6%.

GRAPH 3
The Purchasing Managers' Index recovered quickly from the shock of reforms in India



Sources: Markit Economics and Desjardins, Economic Studies

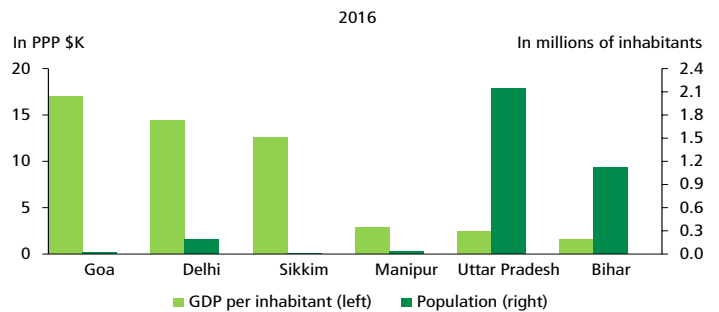
GRAPH 4
Consumption is the principal driver of growth in the Indian economy



Sources: World Bank, International Monetary Fund and Desjardins, Economic Studies

It should be noted, however, that this growth is taking place in a context of poverty, where the GDP per capita adjusted for the purchasing power parity (PPP) conversion rate is only slightly higher than \$7,100, while those of China and the United States are around \$16,600 and \$59,400, respectively. Moreover, this poverty varies greatly among India's regions. The poorest state, Bihar, has a GDP per capita that is nine times lower than that of Delhi (graph 5). Given its economic development and the reforms it has implemented, India should continue to converge towards more developed countries and maintain its rapid pace of growth in the coming years.

GRAPH 5
Regional disparities in India are important



PPP: Purchasing power parity
Sources: Ministry of Statistics and Program Implementation and Desjardins, Economic Studies

Need for Investment in Physical and Human Capital

Private investment had a number of difficulties as nonperforming loans represented 10.0% of gross loans in the fourth quarter of 2017, compared to 5.9% two years earlier. Following the 2008–2009 global recession, the banks invested heavily in infrastructure projects that were held up by bureaucracy. This has limited the amount of credit available for new loans and curbed investment. Things could get better, as the government has announced that it will pump US\$32B into public banks by

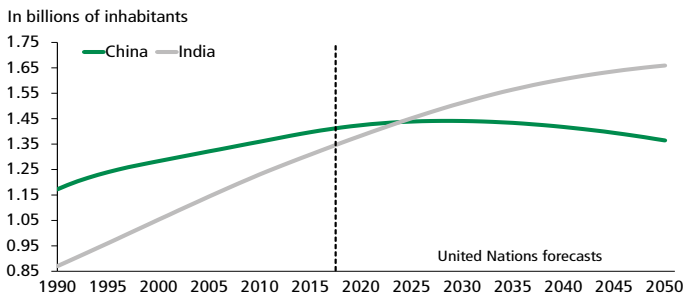
² *Doing Business 2018: Reforming to Create Jobs*, World Bank, 15th Edition, October 31st, 2017, 312 p.

the beginning of 2019. Some instalments have already been distributed since the beginning of the year.

Investments will be needed to modernize the Indian economy. The service sector comprised 56% of GDP in 2017, making it India's main industry. However, it employed only one third of workers. Agriculture accounted for most jobs, but represented only 15% of GDP. This reflects the large disparity that exists where few people work in the most prosperous sectors. Accelerating urban migration and education rates indicate that the situation could well improve.

With a population of more than 1.34 billion in 2017, India is the world's second most populous country after China, and is expected to overtake it to reach the top spot by 2024, according to the United Nations (UN) (graph 6). As Indians become wealthier, this market offers huge growth potential and is becoming attractive to companies in terms of both consumption and labour supply. However, the best-performing sectors, particularly finance and technology, require highly qualified workers, and the low rate of higher education is limiting this potential. According to the latest data from 2016, India's secondary and post-secondary education participation rates were just 75% and 27% respectively, placing its educational performance last among BRICS (Brazil, Russia, India, China and South Africa).

GRAPH 6
India's population is expected to overtake that of China in the next six years



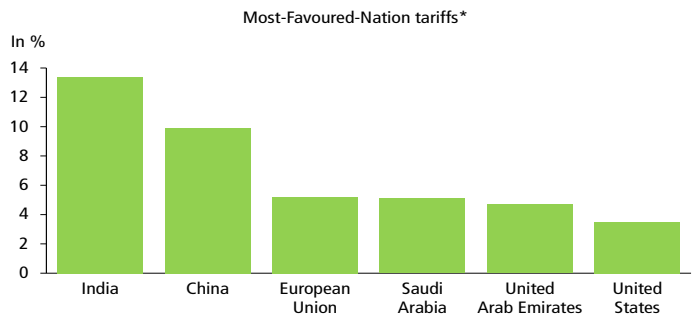
Sources: United Nations and Desjardins, Economic Studies

Toward Greater Global Integration or Insularity?

India's trade deficit has shrunk in comparison to its GDP in the last few years while its net service exports have increasingly compensated for its net imports of goods, more than two thirds of which are comprised of commodities and intermediate goods. This trend goes hand in hand with the global economic boom and its expected acceleration should sustain foreign demand in the medium term. However, the country is heavily dependent on commodities, particularly for production and energy, which makes it more vulnerable to sudden price increases.

Trade accounted for a total of 41% of GDP in 2017, while the country remains relatively closed. Its World Trade Organization (WTO) tariffs were 13.4% on average (graph 7) and there are still no free trade agreements with its principal trading partners (China, the United Arab Emirates, the United States, Saudi Arabia and the European Union). Negotiations were started with Canada (2010) and the European Union (2007) to establish bilateral agreements, but not much progress has been made. Although trade with India represents just 0.75% of Canada's trade, the reduction of Indian customs duties would be a boon to the oil, agri-food and mining sectors and to the competitiveness of Canadian businesses in general, which would increase their market share. However, the recent tariff increases ordered by the Indian government indicate a possible retreat into protectionism.

GRAPH 7
Indian customs duties are slightly higher than those of its major trading partners



* Last available data for each country.
Sources: World Trade Organization and Desjardins, Economic Studies

India has recently responded to the U.S. tariffs on steel and aluminum, and will levy additional tariffs of up to 50% on 30 U.S. products starting in August. This will add to an already strained trade relationship with the United States, which filed a complaint against India with the WTO in March. Right now, India can take advantage of its status as a developing country and subsidize its local export industries to the benefit of foreign imports. That means it has an unequal relationship with its main trading partners, but this privilege could disappear as it gets richer. Despite strong domestic demand, India still needs to maintain good international trade relationships if it wants to reach a higher level of economic development; if the other countries start to pile on the pressure, it will probably have to lift its trade barriers. However, recent U.S. protectionism could provoke India into maintaining the status quo.

A Well Managed Monetary Policy

Until March 2015, the Reserve Bank of India (RBI) did not have a clear monetary policy objective. Years of high and volatile inflation prompted the RBI to adopt an inflation target of 4% with a band of ±2%. Annual inflation has since remained within the target range. The key rate has followed the drop in the inflation rate, which has fallen from 7.25% in June 2015 to

6.25% recently. This rate decrease, coupled with weak inflation, has pulled bond yields down. However, there has been an uptrend due to the monetary tightening announced at the RBI's last meeting and to geopolitical tensions. Rising international uncertainty has penalized the rupee, which has decreased in value since the beginning of 2018.

The Stock Market Performs

Following several years of stability, the MSCI India Index shot up during 2017, gaining 30% for the year. While stock markets have increased in value around the world, the weakness of the key rate and inflation coupled with the bustling economy in India and elsewhere have certainly contributed to India's booming market. However, the performance of the Indian stock market in 2017 is still lower than that of the continent as a whole. While the Indian stock market has been rising since April 2018, it still has not caught up with February's market correction. The price-earnings ratio continues to climb and has topped 24, which is much higher than those of China and Japan.

The reforms have led to a certain amount of instability on the stock market, which generally seems to have benefitted from it. Both the S&P 100 of the Bombay Stock Exchange and the MSCI fell after the demonetization announcement and subsequently surged back up on the January 2017 conversion deadline. The substantial influx of new bank deposits has contributed to the growth in assets as a portion has been reinvested in mutual funds. However, the announced reinstatement of the capital gains tax could penalize the stock market as many Indians had diverted their savings from real estate and gold to the stock markets.

An Encouraging Future, but Several Challenges Await

Now that the shock of the reforms has dissipated, economic growth appears to have recouped some of the losses sustained in 2017. India is expected to be the fastest-growing country in the next few years. The IMF is predicting an average 7.9% growth in real GDP by 2023 (graph 8). Meanwhile, GDP per capita adjusted for the PPP conversion rate should increase by

\$4,600 to reach around \$11,700. The reforms of recent years have demonstrated the Indian government's willingness to modernize the economy and are a step in the right direction, although there are few risks that could potentially impede these long-term projections.

Major infrastructure gaps, which significantly limit economic growth and potential, persist throughout the country. The century-old railroad system is unable to keep up with demand, while the poor condition of roads and the lack of highways and intercity connections also hamper productivity. The government has promised to invest US\$107B to build more than 83,000 km of roads in the next five years, which appears unrealistic in light of past performance and problems with land acquisition. Some World Bank data can shed light on the significance of these gaps. Many households lack functional toilets, with only 44% of the population having access to basic sanitary facilities in 2015. The percentage of the population with access to electricity went down from 88% to 85% in 2016, contrary to Brazil, China and Russia, which maintained a 100% access rate. Only about a third of Indians use the Internet.

There are also environmental risks to consider. India has shown itself to be poorly prepared to deal with the effects of climate change. Rainy seasons appear to be swinging from one extreme to another. Although they have tended to be drier, rainfall has recently been heavier and has caused major flooding, resulting in human and economic costs. In addition, more intense and frequent heat waves and smog are disrupting day-to-day activities while affecting residents' health and limiting their mobility.

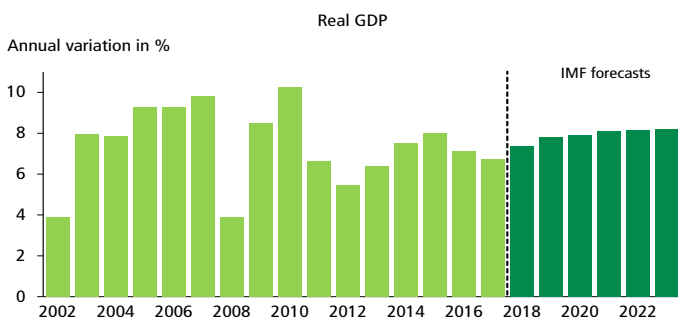
Other issues also pose a potential risk to long-term economic growth. India still has social problems such as discrimination against women, social inequality, tensions among the different cultures that coexist there, extreme poverty, violence against minorities and the lack of social mobility which is partly due to the caste system. Conflicts with Pakistan and China have still not been resolved. All these problems create instability within the Indian economy and could hold its development back.

Conclusion: Promising for the Medium Term

The healthy global economic outlook and the optimistic economic situation in India would suggest continued strong growth over the next five years, surpassing the other major economies. However, several challenges could hinder sustained long-term growth. Issues related to infrastructure, adapting to climate change, social tensions and educating the growing population are still major concerns.

Carine Bergevin-Chammah, Economist

GRAPH 8
Economic growth should accelerate in the next five years



IMF: International Monetary Fund
Sources: IMF and Desjardins, Economic Studies