

Indian Economy: Higher, Stronger, Faster

Introduction

Industrial deregulation, a more flexible exchange rate, stronger debt and equity markets, and lower trade barriers have injected resilience to the economy, leading to higher savings and income. With a GDP of just below \$800 billion (775 billion), India has the tenth largest economy in the world and the third largest economy in Asia today.¹

The country's gross domestic product grew at 8.4 between April 2005 and March 2006—which is India's financial year. The growth buoyancy is expected to be maintained up till March 2007, and GDP growth is estimated at 8%. In fact, during the first quarter, GDP grew at nearly 9 per cent. Despite the reforms process having slowed down due to coalition politics (pension reform, labour reform, banking reforms, retail FDI are still pending) there appears to be a structural shift in economic growth, as this is the **12th consecutive quarterly increase over 7%. The growth is being driven by robust manufacturing (over 11 per cent), and service growth (in excess of 9 per cent).**

Role of savings and investment

Growth is also being propelled by a high rate of savings. Household savings have moved on to a higher growth trajectory—in 1997, savings of Indian households were pegged at 17 per cent of GDP. Savings rate is now in the 28-30 per cent – and on par with that of ASEAN countries. Given the young profile of India's labour force, it could grow by 4-5 per cent in the coming years.²

The Indian private sector has been doing its part; its savings rate rose to around twenty seven percent of GDP in 2005 from around twenty percent before the 1990s (private sector savings consist of household sector savings plus corporate sector savings). There are also growing signs that the private savings are being used intelligently; financial assets managed by Indian mutual funds rose 44 percent to the equivalent of \$66 billion as of Sept. 30, 2006, compared to a year earlier.³

India's current phase of growth has been relatively pain free. The Reserve Bank of India has increased its benchmark interest rate by 150 basis points since October 2004 to 6 percent, a four-year high, to keep record fuel costs and bank lending from stoking inflation. Inflation, on the other hand, has been pegged back at 5 per cent, compared to double digit levels in the previous decade.

Externalisation of economy

¹ IMF data

² Prime Minister's Office estimate

³ Association of Mutual Funds of India

Nothing illustrates the Indian economy's journey better than its integration with the global economy. There are several indicators of this but the most obvious ones are **tariffs, overseas acquisitions, and inward institutional investments.**

Tariffs: Prior to the 1990s, India had the highest tariff barriers against imports of any non-communist country and supplemented them with import quotas and other policies that discouraged trade. Since then, most non-tariff barriers have been removed and tariff rates cut dramatically, with peak tariff rates dropping to 12.5 percent from 155 percent. As a result, exports and imports of goods and services have reached almost one-third of GDP from about seventeen percent in 1990. Before economic reforms kicked in, India's exports accounted for less than 6 per cent of GDP. By the beginning of 2004, they accounted for nearly 14 per cent. Similarly, India's foreign trade has gone from \$ 90 billion in early 2001 to more than \$200 billion in early 2006. ⁴

Outward bound: The second indicator is the quantum of foreign acquisitions by Indian companies. According to Dealogic, the data provider, in the first 9 months of 2006 Indian companies announced a record 112 foreign acquisitions worth \$7.2bn. This compares with \$4.5bn in 2005, itself treble the 2004 figure. Factors driving the global acquisition spree include: access to historically cheap capital, with Indian interest rates falling to around half the level of a decade ago. Deregulation has also enabled cheap overseas borrowings in growing amounts. At another level, a buoyant stock market has provided a favourable climate to raise money locally. Finally, there has been considerable re-structuring of balance sheets, leading to good cost control and rising profitability.

Portfolio flows: The third indicator is portfolio flows. Foreign portfolio investors are eagerly buying into India's growth story. In the last two years, over US \$ 20 billion has been poured into India's capital markets—one of the highest inflows recorded among emerging markets across the world.⁵

[India's growth story: in perspective...](#)

Between 1980 and early 2003, the Indian economy grew around 6 percent per year, compared with an earlier average of 3.5 percent. From early 2003 to March 2006, the country has clocked average growth of close to 8 per cent. To put it a bit more in perspective, it would have taken fifty-seven years for per capita income to have doubled at the pre-1980 growth rates for income and population but takes less than 15 years at the 2003-2005 growth rates.

From a global context, India's growth performance of the last decade and a half ranks among the top six in the world growth league--along with China, Korea, Thailand, Singapore and Vietnam. In purchasing power parity terms, the growth puts India among the top four in the world.

[Future scenarios](#)

On the basis of current metrics, different growth scenarios are being forecast for India. In a 2004 research paper, Morgan Stanley projected that at 7 per cent rate of growth, India's nominal GDP

⁴ Indian Budget papers

⁵ Securities Exchange Board of India

could cross US\$1 trillion by the end of the decade Goldman Sachs has projected that India's share of world GDP will move up from around 2 per cent to nearly 16 per cent by 2050. However, this projection assumes a GDP growth rate of 6 per cent. India has actually grown at an average of over eight per cent in the last four years; the government's own strategy document for the 2007-2012 period, has set a target of 9 per cent growth, with a stretch target of 10 per cent growth. Once this happens, the 2050 projection would have to be brought forward by quite a few years.

Based on current economic and demographic trends, the western and southern parts of India, as well as large pockets in the north, are likely to be largely middle class (by local definition) and urban by 2020. The current pockets of modernity—mainly wealthy cities, their hinterlands, and some prosperous rural areas—will continue to grow but will be complemented by new growth centers, largely transforming about half of India's states into middle income economies (especially if measured using purchasing power parity). The modern half of the country, with about 500 million people, will be increasingly connected with the world, with decent education, good English language skills, and globally competitive private firms.

Symptoms of robust economy: stock markets, tax buoyancy and social change

Rocking stock markets: The market capitalization of the BSE crossed the country's GDP for the first time ever when markets closed in the second week of October 2006. In 2005, India's GDP at current prices was 714 billion dollars; while market capitalization was 732 billion dollars. India now joins an exclusive club of developed markets, including the US and UK, along with a few emerging economies such as South Africa, Malaysia and Singapore. Indian firms have increasingly benefit from India's maturing equity markets. India's National Stock Exchange and the Bombay Stock Exchange are ranked third and fifth in the world by the number of transactions.⁶ They are increasingly approaching world-class standards thanks to improved design, computerization, modernization of the market infrastructure, an improving regulatory and legal infrastructure, and the availability of ample, trained personnel.

Good economies of scale (thanks to lots of companies and many market players), plus better infrastructure make it easier for firms, especially ones that are mid-size by global standards, to gain access to liquid stock markets in India than in most developing countries.

Buoyant taxes: A decade ago, Dr Manmohan Singh, while he was finance minister, took two pathbreaking steps. First, he kickstarted the dialogue on VAT with India's states, and second, he introduced the concept of service tax. His successor, Mr P Chidambaram, took a third crucial step: he brought down tax rates.

Today, each of these reform measures have had a significant impact. India's service sector accounts for 54 per cent of the country's gross domestic product, but only five per cent of the taxed economy. Initially the tax was imposed on telephones, non-life insurance and stockbrokers. Today, there are more than 100 services included in the ambit of service tax. In 2005-06, the Government earned a revenue of Rs 23,000 crore and fixed a target of Rs 34,500 crore for 2006-07 – a jump of

⁶ The Economic Times and other media reports

50 per cent. ⁷Finally, almost all of India's states have opted for a uniform value added tax, making it easier for state governments to collect taxes; at the same time, also making it easier for companies to plan their investment decisions seamlessly across the country.

Scripting social change: The improvement in both literacy and poverty was at a faster rate than in previous decades. The absolute number of illiterate people fell by thirty-one million in the last decade, along with the number of people working in agriculture, heralding two major demographic shifts.

According to government figures, the poverty rate (using very Spartan measures) fell to twenty-six percent in 2000 from forty-four percent two decades earlier. Given much controversy on the appropriate definition of poverty, the falling trend is more meaningful than the actual level.

The growth of industry in the west and the south, combined with the spread of high-yield seeds into the eastern states of Assam and Orissa, as well as into parts of Uttar Pradesh, Madhya Pradesh and Bihar, should sustain the decline in poverty in coming years. Income inequality, as measured by the Gini co-efficient, was lower in India (32.5 as of 2000) than in China (44.7 in 2001) and Brazil (59.3 in 2001).⁸

GDP: A sectoral analysis

Agricultural sector: The gradual liberalization of agricultural trade is being pushed by India's growing organized retail firms that seek secure supply chains to get access to large amounts of foodstuffs directly from producers, cutting out the middlemen as much as possible. More and more states are permitting "contract farming," allowing the farmer to sell products directly to a firm and bypassing traditional rural markets and middlemen.

Private investment in agro-industry is picking up, even as public investment in irrigation, water management, and in new seeds stagnates. Although only about forty percent of India's sown area is irrigated, the process of transferring wealth generated from the Green Revolution in farming into the Grey Revolution of rural industrialization is likely to accelerate, at least in some states.

Exciting possibilities also exist in India's farm and food processing sector which have been identified as a priority area by the government. The value addition in the farm sector today is only six per cent, despite the fact that India among the world's largest producers of milk, vegetables and fruits. To address this problem, the government has unveiled a number of legislative and policy changes to make India's farm sector attractive to foreign investors. For example, With the APMC Act being modified across more and more states, farmers will finally begin to see more buy-in for moving up the farm value chain; there could be a shift from cereals to horticulture, and the government might be forced to revise current policies relating to procurement.

⁷ Budget papers and media reports

⁸ Economic Growth and India's Future, by Joydeep Mukherjee, Occasional Paper No 26, March 2006, University of Pennsylvania

GDP Dynamics: Over the Years

Sector	1980	1990	2005
Agriculture	39.7	31	20
Industry	23.7	28	26
Services	36.6	41	54 ⁹

Manufacturing: The industry sector, which accounts for approximately 26% of GDP, India's clocked its highest growth since 1996 in July this year—growing at 12.4 per cent. This strong performance was driven by manufacturing, which accounts for about four fifths of industrial output. Some segments of the manufacturing sector have been traditionally strong; for example, Indian Engineering and Construction industry have recorded a CAGR of 8.4% over the last two decades.¹⁰

But in the last few years, Textiles, basic metals and alloys, pharmaceuticals and transport equipment have emerged as the fastest-growing product categories. Specific factors have driven growth in each of these sectors. For example, the phasing out of the MFA agreement in textiles has provided a huge fillip to the textile sector, and the national textile policy aims to take up the textile and apparel exports from USD 11 billion in 2004 to USD 50 billion in 2010.

Similarly, during 1999-2005, drugs with annual sales of \$30 billion went off patents. The Indian pharma industry, with its reverse engineering skills and relatively low cost structure, is ideally placed to tap the global generics market.

The Indian industrial sector is also benefiting from Prime Minister Manmohan Singh's decision to increase infrastructure spending by a quarter to 992 billion rupees, or \$21 billion, from April 2006. Increased infrastructure spending is spurring demand for steel, cement and electricity in India.

User industries are also clocking handsome growth. By the middle of 2006, growth in consumer goods production more than tripled to 19.9 percent, compared to a year earlier.

Growth in the automobile and consumer goods sector is an outcome of rising incomes. Salaries in India may rise by 7.3 percentage points above inflation in 2006, the biggest increase forecast among 70 countries that includes U.S., U.K. and Japan, according to Mercer Investment Consulting Inc.

Sectors creating manufacturing momentum

Sector	Story
Pharmaceutical	Total pharmaceuticals production is estimated to be about \$ 8 billion and India today is among

⁹ Economic Survey of India papers

¹⁰ Destination India, Story of Success, KPMG Presentation, January 2006

	top five global producers of APIs. Sales are likely to exceed US\$15.2bn by 2010, with annual growth at around 9%.
Automobiles	The Indian automobile sector currently generates revenues of \$34 billion a year. According to an estimate prepared by the government, annual revenue from the country's automobile sector could grow to \$145 billion by the year 2016. This will increase the contribution of the auto sector to India's GDP to 10 per cent from 3-4 per cent currently. the rapid emergence of India as a regional and global hub for small cars and components is expected to sustain this growth trend.
Biotech	India is one of the five emerging biotech leaders in Asia Pacific, according to an Ernst & Young Report. \$5 billion in revenues and more than one million jobs in next 5 years. Key drivers: increased partnering activity, transition to a product-driven model, growth in the biogenerics market
Apparels	Government has set an export target US \$ 50 billion by 2010, following the dismantling of the MFA. Manufacturing of readymade garments de-reserved, which means that large apparel manufacturers no longer need to outsource part of their production to smaller units. 100 per cent FDI is allowed in garment ventures.

Producer-led and consumer driven growth has taken shape in India largely on account of credit growth. Commercial bank loans to companies and individuals are growing at 31 percent on year, among the fastest since the central bank started collating data in 1971.

More specifically, industrial production is getting a boost from demand for houses. Rising incomes and tax breaks on mortgage loans are enabling Indians to borrow more to buy houses in recent years, spurring construction. Homebuyers are allowed to deduct interest payments of as much as 150,000 rupees a year from their annual taxable income. With the government also deregulating interest rates, the effective interest rate on a home loan has come down to around 8 per cent

percent from 11.73 percent between 2000 and 2006, boosting mortgage loan growth.¹¹ What's more, the upside potential is huge: at the moment, India's loan-to- GDP ratio is around 3 percent, compared to 36 per cent in the case of a country like Singapore.

Services: This sector accounts for 54% of economic output and grew by an unprecedented 9.8%. IMF forecast estimates that by 2010 this will be around 58 per cent, on par with a mid-level developed country. The service sector has been driven by IT exports which have grown at a compound annual growth rate of 26% over the last 4 years. This was mainly the result of significant increases in the demand for domestic services. The export-oriented information technology (IT) and business process outsourcing (BPO) sectors also continue to perform very well due to growing international demand for skilled, low-cost, English-speaking Indian workers, although these sectors constitute only a small portion of total services output. Indian competitiveness in IT and BPO has been aided by substantial investment in telecommunications infrastructure and the phased liberalization of the communications sector.

India exports IT products and IT enabled services to 133 countries and 220 of the Fortune 500 companies outsource their software from India. The IT industry like to maintain high growth and is expected to generate revenues of \$ 62 billion by 2008 and \$ 148 billion by 2012

In India the IT sector employs around 650,000 people currently, which is likely to increase to 2 million by 2010¹². There is strong government backing for this sector; infrastructure support is provided through setting up of technology parks, and communication facilities are being continuously strengthened through increased bandwidth availability and spectrum allocation.

SOURCES OF COMPETITIVE ADVANTAGE

Entrepreneurship: Unlike China, India isn't about foreign capital. Domestic entrepreneurship is the engine that is driving India's growth. Economic reform has largely transformed India's private sector, and the growth is being driven by many companies that were set up in the nineties.

About half of the top 100 Indian companies in 1991 by size are no longer on the list today, showing the dynamism of the economy. New sectors, such as information technology, and modernized old sectors such as the auto parts industry, generate growing exports and contribute to record levels of foreign exchange reserves in a country that traditionally faced foreign exchange shortages.

More than any other country in Asia with the possible exception of Korea and Japan, The Indian engineering eco-system has helped homegrown Indian companies make a mark on the global stage. (see chart) We now have among the world's largest manufacturers of plastic raw materials, motorcycles, colour picture tubes, forgings, commercial vehicles, optical storage devices, among others.

List of Indian firms among top ten producers in world¹³

¹¹ Reserve Bank of India statistics

¹² NASSCOM estimates

¹³ Company reports

Company	Product/Industry
Bharat Forge	Forgings
Videocon	Picture tubes
Tata Motors	Commercial vehicles
Ranbaxy	Pharmaceuticals
Reliance Industries	Petrochemicals
Tata Tea	Tea
Moser Baer	Optical storage devices
Hero Honda	Motorcycles
Hero Cycles	Cycles
Welspun Industries	Towels
Ajanta Clocks	Clocks

In the last two years, gross block of the following sectors have grown in double digits: Pharmaceuticals, FMCG, IT, Banks, Textiles. Cash profits of the top 500 listed companies (by sales) have grown in excess of 24 per cent during each year for the last three years. India Inc.'s capital expenditure touched a new high with manufacturing and services companies spending US\$ 24 billion in 2005-06. This is 29 per cent higher than the US\$ 18.4 billion spent on expansion in 2004-05.¹⁴

Skills: In skill based manufacturing, India's competitive advantage is being globally accepted. India produces 400,000 engineers a year, a close second to China's 490,000 and nearly 25 times Thailand's 25000. This skilled workforce has helped bring down process and redesign costs. In the pharmaceutical sector, for example, the cost of producing bulk drugs has been brought down by 60 per cent, and a KPMG study estimates that India's drug producing costs are 1/20th that of US companies.

Inextricably linked to the emergence of Indian skills is the improvement in education. The economic return on education has increased substantially since 1991, spurring growing private spending on education by rich and poor alike. Per capita spending on education has grown at 6.4 percent on average in real terms in 1983-99, presaging a much better-educated labor force in future.

The *de facto* privatization of higher education in India, stemming largely from the inability of the public system to keep pace (though there has been some improvement of late through the National Universal Education program), will gather in pace, helping raise the supply of skilled labor in the coming decade.

For example, the private sector accounted for eighty-six percent of seats in engineering colleges in 2003 compared with only fifteen percent in 1960. The private sector's share of medical college seats rose to forty-one percent of the total in 2003 from 6.8 percent in the same period, and over ninety percent of India's around 1,000 business schools are in the private sector. The number of university and college graduates in India rose to 48.7 million in 2004 (equal to only 4.5 percent of the population) from 20.5 million in 1991.

¹⁴ Businessworld and IBEF Reports

Demographic advantage: In the medium to long term, demographics could emerge as a source of competitive advantage for India. With half the population under the age of twenty-five, India already has the youngest labor force in the world. India is not expected to pass China in total population until 2030. But India will have more young workers aged 20 to 24 by 2013; the International Labor Organization predicts that by 2020, India will have 116 million workers in this age bracket to China's 94 million.

Resources: India also has an advantage in resource based manufacturing. India is the third largest producer of cotton; this gives India, along with China and Pakistan a huge advantage in the post MFA world. India has 5 per cent of the world's iron ore deposits and produces 3 per cent of the world's steel—this makes Indian firms to emerge as one of the lowest costs steel producers in the world. India has 4 per cent of the world's bauxite deposits and this gives Indian firms a place among the world's top aluminium producers.

Consumerism: By the next decade, countries like India will have far more spenders and savers compared to many European countries. 2005 NCAER study on India's consuming classes. Currently, around 20 million Indian families (around 100 million consumers) have an annual income of over Rs 200,000, making them ripe candidates for consumer durable purchases. The NCAER data also shows that there is currently twice the number of motorcycle owners in the Rs 200,000-500,000 income segment, compared to the Rs 90,000-200,000 income segment.

Those earning between Rs 200,000-500,000 a year are projected to nearly treble by 2009-10. In the years to come, we will see a spatial spread of consumerism. Prosperity is growing and expanding across India, prompted by the rise in disposable incomes, increasing number of dual income nuclear families and changing attitude towards consumption.¹⁵ According to the 2001 census, over 67 cities in India have a population of over 0.5 million each. As India moves forward, these cities will propel and sustain growth. There are already visible manifestations of this: construction activity – through both retail and housing—is flourishing in these cities; there is a surge in IPO collections, and some of these cities are registering huge growth in mobile phone subscriptions.

India's future: A huge appetite for investments

In the years to come, India will become an even more attractive business destination. New growth opportunities are opening up. For example, India has the potential to emerge as a hub for medical tourism, education, high end transaction outsourcing; already India is a hub for new product development, with more than half the Fortune 500 companies setting up research centres in India.

Of course, we still face constraints. While Indian industry and the services sector have grown at a robust pace, infrastructure creation has been slow. Fears have been expressed that if infrastructure doesn't keep pace, the growth momentum could get lost.

But of late, these constraints are turning out to be great investment opportunities. India's Planning Commission has estimated a massive 320 billion dollars of investment requirement for

¹⁵ NCAER: The Great Indian Middle Class

development of infrastructure by 2012. According to India's finance minister, India's infrastructure sector alone could absorb FDI to the extent of 150 billion dollars over the next few years.¹⁶

- **Electricity:** India plans to add 100,000 MWs of power in the next ten years
- **Telecom:** Opening up the telecom sector has led to massive investments and expansion in supply coupled with improvement in quality. The target of 15% teledensity set for the year 2010 is expected to be realised this year itself.
- **Highways:** India anticipates investments of Rs. 220,000 crore by 2012 in the modernisation and upgrading of highways in the country. Model road concession agreements have made it much easier for foreign construction players to participate in the world's largest highway program.
- **Energy:** Industry research shows that additional refining capacity of around 110 mn tonnes will be required in India by 2010. Crude, product and gas pipeline as well as tank farms are likely to attract large investments. There is a huge potential for LNG terminals. As per the new energy exploration policy, investments in the range of \$100-150 billion expected in next 10-15 years.
- **Minerals:** The economies of India's traditionally backward states, Chhatisgarh, Jharkhand and Orissa stand a good chance of being transformed by the next decade, thanks to a slew of new policies that encourage tapping of mineral wealth. According to McKinsey, these states have the potential to grow from US \$ 30 billion in 2003 to US \$ 75 billion by 2015 if they tap their mineral wealth. Attractive incentives are available for both domestic and foreign firms to exploit this wealth.
- **The Indian Railways** is preparing an ambitious investment program of over Rs. 300,000 crore of which almost 40% is expected to come from the private sector through PPPs.
- **In civil aviation**, a financing plan for airport infrastructure has been developed, which envisages a total investment of Rs. 40,000 crore in the sector by 2012. The Indian aviation sector grew 20 per cent last year and is poised to grow at 25 per cent in the next few years. Delhi and Mumbai airports have been handed over to private companies, and modernization of Kolkata and Chennai is expected to start soon. The government is also planning to revamp 25-30 non-metro airports in the coming months. Work has already begun on the Srinagar, Amritsar, Ahmedabad and Udaipur airports. Two new international airports at Bangalore and Hyderabad are being developed through the public private partnership route.
- **In the ports sector** the government is planning to develop 76 new berths by 2012 of which 53 are to be undertaken through PPPs. An investment program of Rs. 50,000 crore by 2012 is envisaged, in which PPPs are expected to play a dominant role.

¹⁶ Estimates made by Finance Ministry and Prime Minister's Office

- In December 2005, the Prime Minister, Dr Manmohan Singh launched the \$ 22 billion National Urban Renewal Mission aimed at improving **urban infrastructure and urban basic services in over 60 cities with a million-plus population**. The funds will be spent over a seven year period. The Centre will foot half the bill while the state governments will fund the remaining expenses. The Union budget has already earmarked \$ 1.1 billion for the project.