Insights
Market Outlooks

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India

Where the Fireworks Come From

Krishna Bhimavarapu
Economist

From undergoing an acute balance of payments crisis in 1991 to having over half a trillion US dollars in foreign reserves currently, the Indian economy has come a long way. Robust consumption and capital expenditures have put the economy on a solid developmental path over the next few decades. In light of the impending general elections in 2024, we dive into India's unique strengths that we believe will help its economy to maintain a high growth rate.

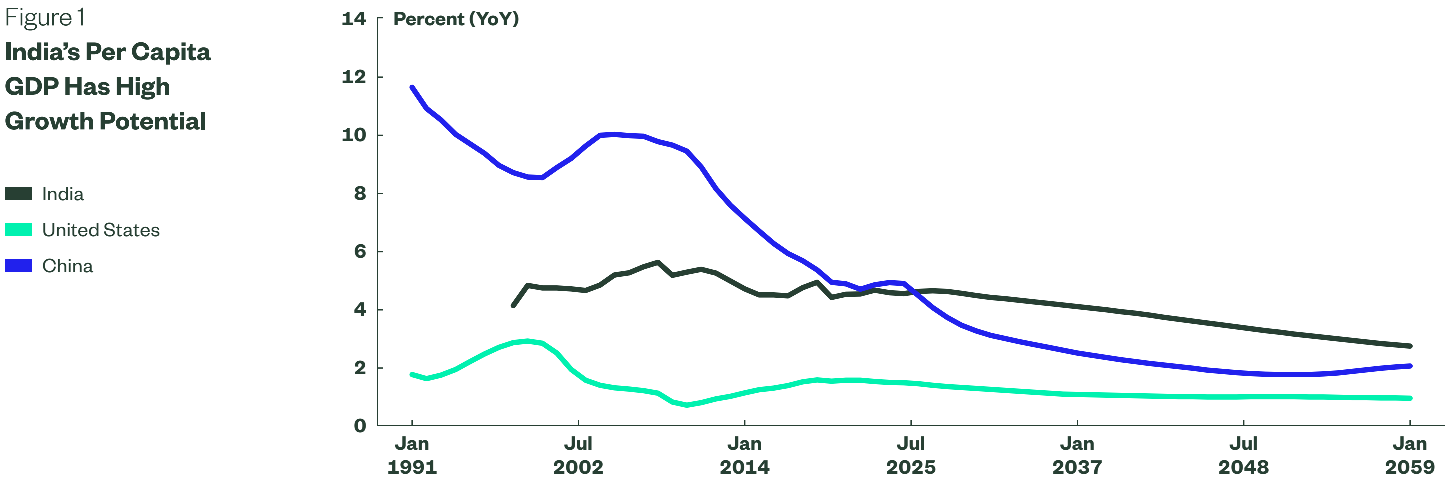
Introduction

India's economic reforms began in 1991 when it underwent an acute balance of payments crisis, with the country at one stage having only three weeks of import cover remaining. The government's immediate response was to secure $2.2 billion from the International Monetary Fund (IMF) by pledging 67 tons of gold reserves. Fast forward three decades, and the country has foreign exchange reserves of $646 billion and its per capita income rose by nearly eight times to $2,411 in 2022.

These wealth gains have been made possible by an impressive average GDP growth of 6.1% since 1991. What is even more impressive is that India is expected to continue to outperform its peers in the coming decades. The economy is expanding robustly in the near term, and the long-term growth potential looks favorable as well.

The Organization for Economic Co-operation and Development (OECD) projects India's potential per-capita GDP growth to overtake that of China in 2026 and remain above China's throughout the forecast range (until 2060) implying sound fundamental drivers (Figure 1). Note, however, that this refers only to the growth rate and not the level, and India is not expected to rise above China's economic size during that period.

Figure 1
India's Per Capita GDP Has High Growth Potential

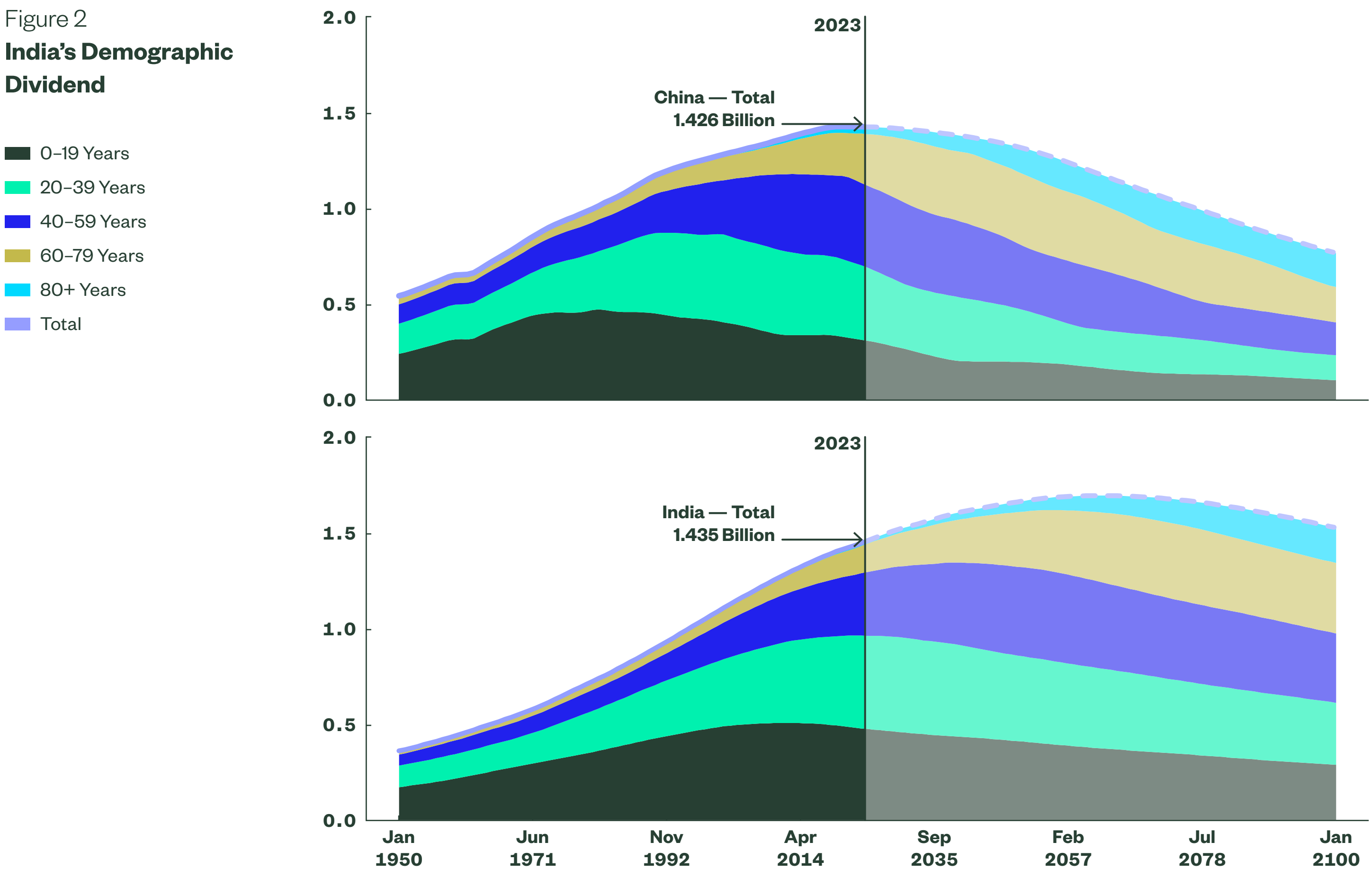


Source: Macrobond, Organization for Economic Co-operation and Development, State Street Global Advisors, as of February 25, 2024.

India's Fundamental Drivers of Growth

India's fundamental drivers of growth are sound — the country is already the most populous in the world. However, a key advantage for India lies in the high proportion of youth in its population as compared to China. As of 2021, India had almost 227 million more people under the age of 40 as compared to China. The United Nations estimates that India's population will peak at 1.7 billion people in 2063, suggesting the demographic advantage will likely remain in place for another 40 years.

Figure 2
India's Demographic Dividend

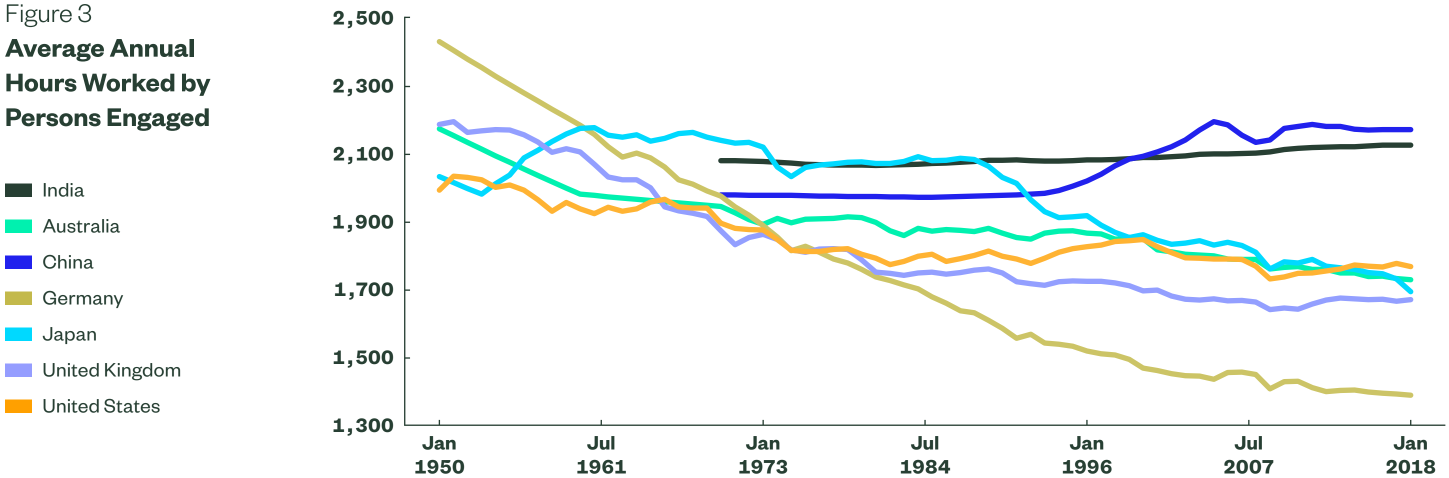


Source: Macrobond, United Nations Department of Economic and Social Affairs, State Street Global Advisors, as of April 10, 2024.

However, productivity wise, India has a long way to go. According to data from the Conference Board, India's labor productivity — measured as output produced per hour — was $9.37 in 2023, half of China's and much lower than the United States' $87.15. Yet productivity growth was more positive than that of advanced economies at 3.2% year-over-year (YoY) in 2023 (albeit below China's 4.8%).

Fundamentally, productivity growth is driven by three factors: capital deepening (better capital/technology), quality of labor, and total factor productivity (TFP). In India's case, capital deepening has been the key driver of growth, as economic growth is getting increasingly capital intensive due to declining cost of capital when compared with cost of labor. However, the average annual hours worked by individuals engaged have remained above 2,100 since 2009 — slightly below China, but significantly above advanced economies, where this measure has been declining (Figure 3).

Figure 3
Average Annual Hours Worked by Persons Engaged

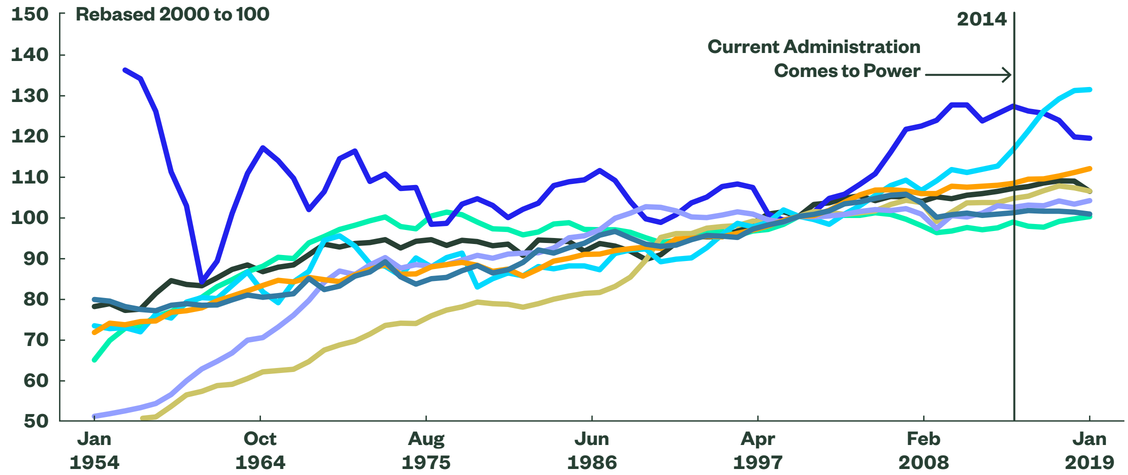


Source: Macrobond, Penn World Table, State Street Global Advisors, as of April 10, 2024.

This trend echoes with a recent research paper on India's productivity carried out in collaboration with the Reserve Bank of India. The research found that India's productivity benefitted mainly from factor accumulation (an increase in the quantity of labor) rather than from an increase in the quality of productivity.[1] This means India's productivity growth still needs to converge with its average rate of 6.4% recorded during the 2000–2020 period. Currently, low female participation, low R&D advancement, lack of adequate infrastructure, and a large informal sector are the main obstacles before robust productive growth.[2] However, factor accumulations explain only a limited part of economic growth, according to a study by the Asian Development Bank (ADB).[3]

The unexplained part of economic growth is attributed to the holy grail of economic success — total factor productivity (TFP). TFP growth contributes significantly to the upward transition of an economy to higher income levels. Interestingly, India's TFP has improved markedly since 2000, and by a faster clip than that of major economies. Indeed, the high economic growth of India and China can be explained by their steady TFP growth.[4] In addition, the RBI paper found that TFP contributed significantly to higher productivity in industries that either produced (40%) or used (28%) information and communication technology (ICT). Hence, India will do well to incentivize industries to adopt ICT, in which the country has a comparative advantage.

Figure 4
Total Factor Productivity at Constant National Prices

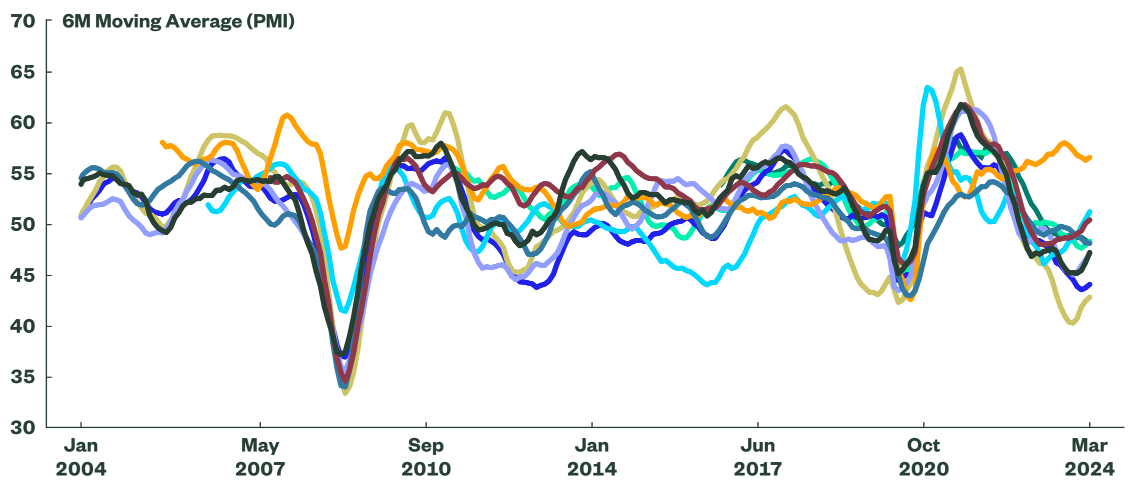


Source: Macrobond, Penn World Table, State Street Global Advisors, as of April 10, 2024.

India's Tangible Drivers of Growth

At a tangible level, private consumption, exports, and prudent government capital expenditure fuel India's growth. Consumption accounts for over 60% of GDP and is slated to improve more, as the OECD expects 68.4% of India's population to level up to the "middle class" (people earning more than $11 per day) by 2030.[5] Exports are steadily rising on the back of manufactured goods, which accounted for 60% of the $762 billion worth of India's exports in 2022–23. The resiliency of the manufacturing sector can be noted from the level of the purchasing managers' index (PMI), which has remained robust even after its post-COVID bounce, while the PMI in other economies has steeply declined since then.

Figure 5
India's Manufacturing Sector is Expanding



Source: Macrobond, S&P Global, State Street Global Advisors, as of March 12, 2024.

The most vital driver of recent GDP growth is the expansion in government capital expenditure. The government plans to spend nearly 25% of its budget on capital expenditure in fiscal year (FY) 2025 (April 2024 to March 2025), all the while narrowing its fiscal deficit to 5.1% of GDP this fiscal year before reaching 4.5% in FY 2026. This is definitely not an easy task. Fiscal deficit has been trending down but is still above its pre-pandemic level.

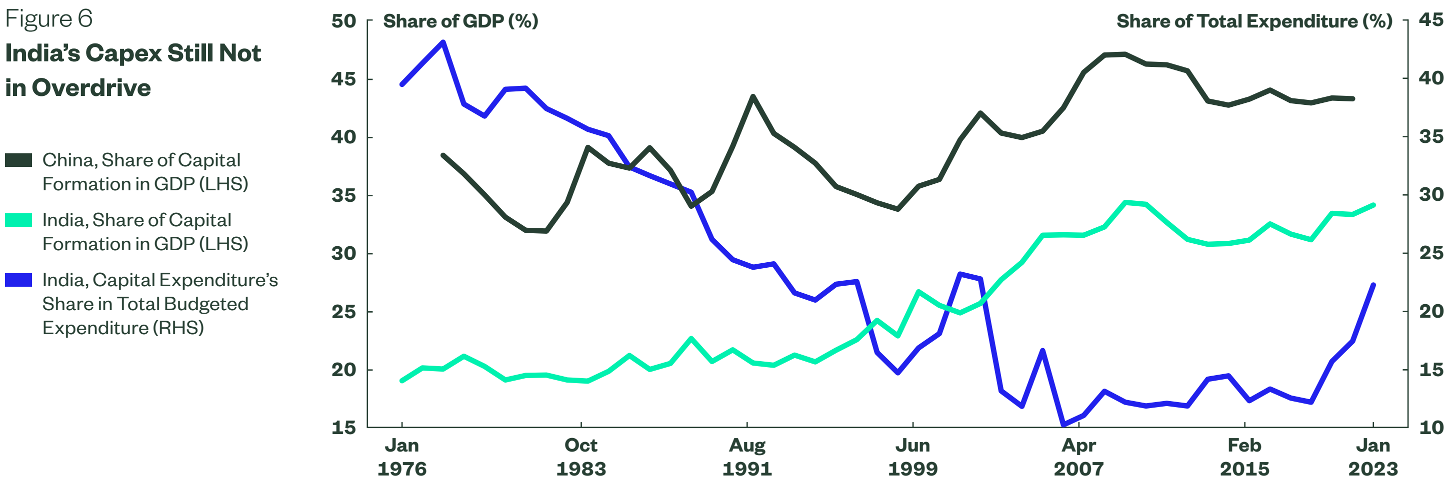
However, the deficit target for 2025 is achievable if the GDP growth keeps surprising to the upside and the government reduces its spending on subsidies. As such, the government has cut the budget on subsidies by 6.8% this year, and fiscal deficit has been showing a declining trend.[6] The government also has plans to borrow $170.4 billion through bonds, lower than what was expected in February 2024.

Capital Expenditure and Infrastructure Spending

The government's $1.3 trillion long-term infrastructure plan is already yielding some results. India has nearly doubled the length of its highways and the number of operational airports in the last decade. India's domestic air carriers have already placed orders for 1,120 new aircrafts, more than the total number of their current fleet. Railways are also witnessing massive change in scale — 94% of India's railway tracks are now electrified, far ahead of the US and of the European Union.[7]

At the macroeconomic level, capital spending's share of total expenditure has more than doubled in three years. Still, this is not in overdrive as the share of capital formation in real GDP is 35%, 10 percentage points (PP) below that of China's in 2022. These investments have been made in areas such as dedicated freight corridors (that aims to double the speed of freight) and India's first transshipment container terminal. This infrastructure push is reflected in the equities market, as the S&P BSE India Infrastructure Index has grown twice as fast as the benchmark index over the past five years.

Figure 6
India's Capex Still Not in Overdrive



Source: Macrobond, National Bureau of Statistics of China, Ministry of Statistics and Programme Implementation, Reserve Bank of India, State Street Global Advisors, as of April 10, 2024.

Opportunities

The government is aiming to grow the Indian economy by at least 7.0% YoY (compared with the IMF's forecast of 6.7% in FY 2024) to turn it into the world's third largest by 2027. This is not quite unrealistic in our view. India's economic growth and the resulting opportunities to markets could come from at least three spheres:

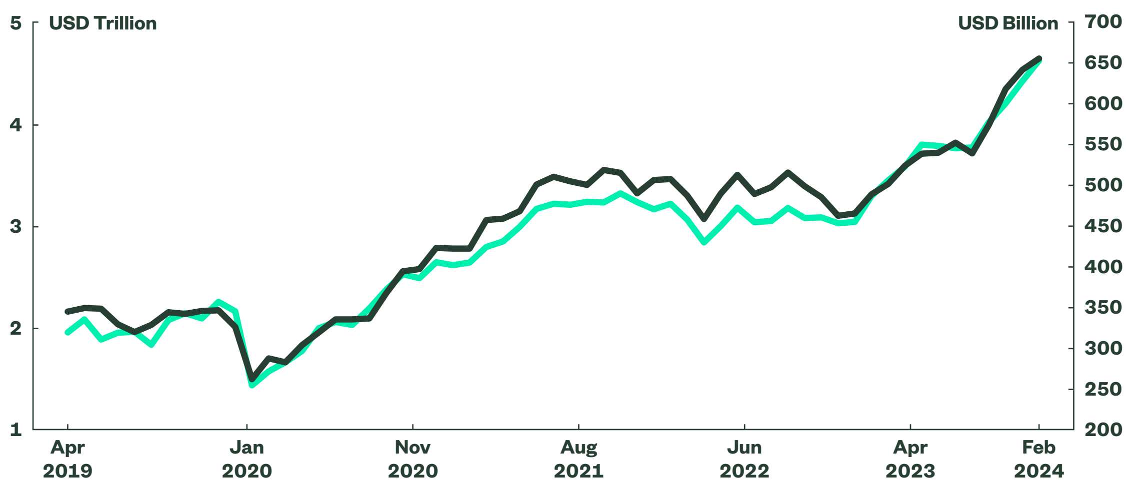
1. An evolving manufacturing ecosystem that is aided by a 'China + 1' strategy as global companies look to diversify their supply chains
2. A higher domestic participation in markets
3. A continued push for infrastructure, especially in digital

India is seen benefiting from evolving supply chains as the world looks for a 'China + 1' strategy. The US import of chemicals, computer, and electronic parts and electrical equipment from China had fallen by $51.5 billion in 2023, while the same figure from India had risen by $6.8 billion.[8] There is potential for further growth as investments in such high-tech industries have been growing. According to data from McKinsey, the average annual cross-border greenfield investment inflows rose 54% between 2015–19 and 2022–23 to $87 billion.[9]

The domestic participation in Indian equity markets through mutual funds is another advantage, as the industry's assets under management (AUM) grew by 31% YoY in January 2024 to $634.5 billion, a key reason why India has continued to outperform its emerging market (EM) peers. All this could mean that India could be a significant beneficiary of investments flowing into EM. As such, India's weightage in the MSCI EM Index has risen by 10 pp to 18.2% in 2024.

Figure 7
Domestic Mutual Funds Driving Indian Stock Markets Higher

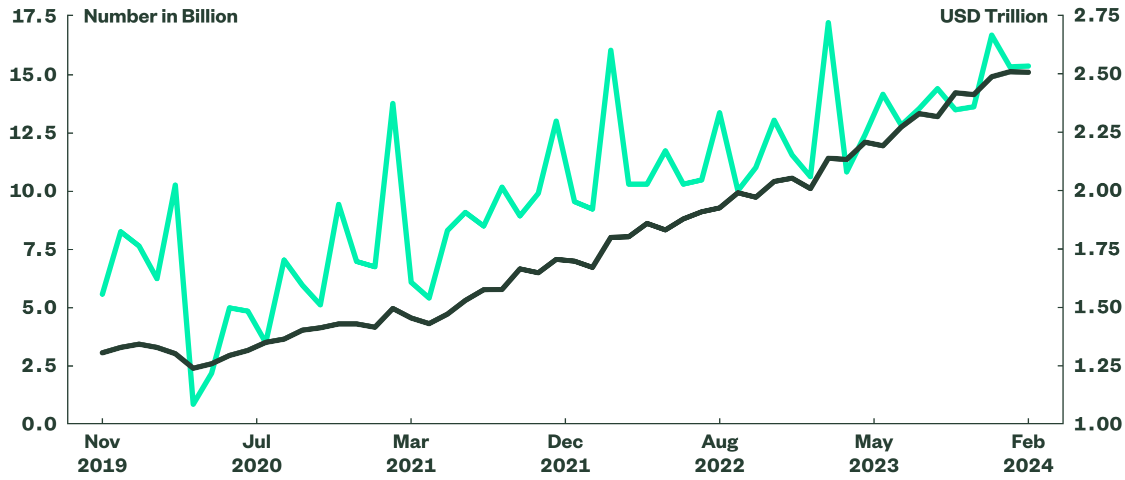
National Stock Exchange of India, Market Cap (LHS)
Assets Under Management, Mutual Funds, India (RHS)



Source: Macrobond, Association of Mutual Funds in India, World Federation of Exchanges, State Street Global Advisors, as of March 12, 2024.

Digital infrastructure is a distinctive driving force behind many consumption-related enablers. These infrastructural capabilities range from a nationwide optical fiber grid (over 84% of India's governing institutions are connected via this grid) to the unified payments interface (UPI), through which the lion's share of India's financial transactions takes place. UPI has zero transaction fees and nearly 15 billion monthly transactions are made through it with a transactional value of over $2.50 trillion (Figure 8). In comparison, FedNow, an instant payment service in the US, costs nearly a dollar per transaction, even after a $25 monthly fee was waived off this year to encourage adoption.

Figure 8
The Invisible Hand — India's Digital Infrastructure



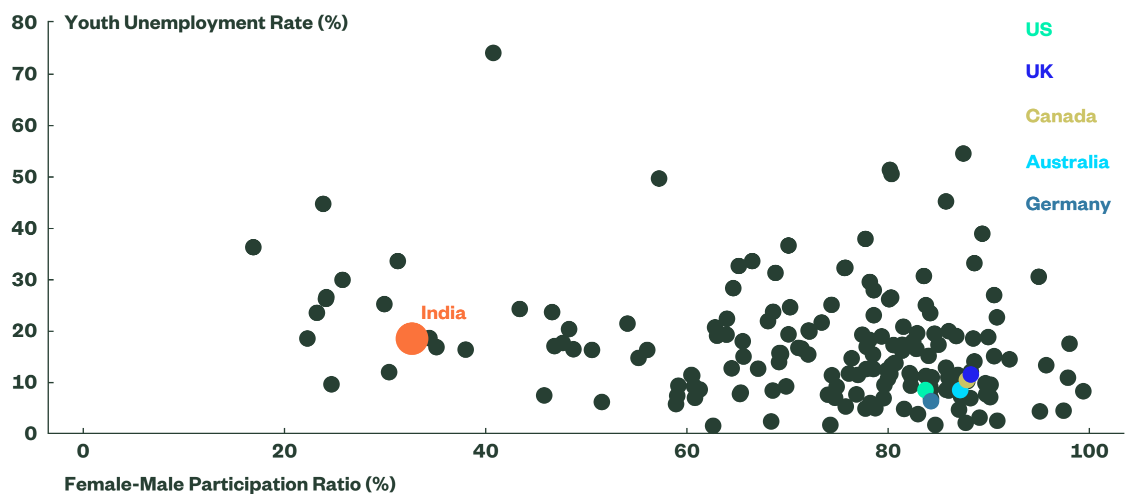
Source: Macrobond, Reserve Bank of India, State Street Global Advisors, as of March 12, 2024.

Risks

Global investors have often been skeptical about bullish stories of EM economies, and India has been no exception. Despite the current optimism around the Indian economy, there are at least three areas that need immediate improvement.

First, the labor market is clearly the Achilles heel of the Indian economy. Having a rising young population requires employment creation on a comparable scale, without which the demographic dividend is likely to turn into a liability. About 65% of India's population is under 35 years old and the employment opportunities for this cohort have been limited. Furthermore, the ratio of female-to-male participation was 32.7% as of 2023, and the youth unemployment rate was 17.9% as of 2022 — both of which are markedly poor when compared with advanced economies (Figure 9).

Figure 9
India's Achilles Heel — The Labor Market



Note: The chart plots the latest available data for different countries.
Source: World Bank, State Street Global Advisors, as of January 1, 2024.

Second, India's equity performance has attracted a large number of relatively unsophisticated retail investors into the market. According to the Futures Industry Association, 78% of equity options traded globally were from India.[10] This means that retail investors participating in speculative trading could be caught off guard in the event of unexpected volatility.

India's debt market is relatively underdeveloped as well. However, India's inclusion in key EM debt indices is likely to help develop the debt market, which then could act as a counterbalancing force to the equity market.[11]

Third, India's consumption-led economy requires more and more energy. Although the focus on renewable energy is increasing, India currently imports over 80% of its oil and nearly half of its natural gas. Indeed, the share of electric vehicles as a percentage of overall automobile sales more than tripled to 6.4% in 2023. However, a world with higher geopolitical tensions poses a significant risk to India with regard to its import bill, and hence, the country has to find a faster way to adopt renewable energy.

Finally, high quality and frequent macroeconomic data is essential for markets to continually measure and understand an economy. India's GDP data quality is ranked 93rd globally by World Economics and this issue needs to be fixed to ensure efficient capital allocation.[12]

The Bottom Line

If India addresses its systemic issues that we have highlighted above, the economy should continue to offer strong opportunities for global investors. The labor market is a primary factor — for India to reap its demographic dividend, its labor market needs to expand. Furthermore, thecountry's bond market needs to keep pace with its effervescent equity market — and for this to happen, India's capital markets need to open up further. Additionally, efficient capital allocation presupposes transparent and high-quality macroeconomic data — as India's capital markets expands further, this part of the equation will have to fall into place to gain the full confidence of institutional investors. Finally, to maintain its growth trajectory, India will need to find a more efficient way to transition from its current dependency on fossil fuels.

Endnotes

1 Krishna, K.L., Goldar, B., Das, D. K., Aggarwal, S. C., Erumban, A. A., & Das, P. C. (2022, August). India Productivity Report. Centre for Development Economics.

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10 Mandavia, M. (2024, March 11). Eighty Percent of the World's Stock Options Aren't Traded Where You Think. The Wall Street Journal.

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12 India's Data Quality Rating. (2023). World Economics.

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* Pensions & Investments Research Center, as of December 31, 2022.
† This figure is presented as of March 31, 2024 and includes ETF AUM of $1,360.89 billion USD of which approximately $65.87 billion USD is in gold assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated. Please note all AUM is unaudited.