Letter n°84

Where does India stand?

"The world flatters the elephant and tramples on the ant" Indian proverb.

China's slowdown, and the resulting concerns about global growth, have prompted us to turn the spotlight on India.

India can take pride in having a population today greater than that of China and being the world's largest democracy.

However, from a political standpoint, Indian democracy is becoming less and less of a model, and from an economic perspective, while India's GDP has recently surpassed that of the United Kingdom and France, it remains a poor country.

In order to provide an overview of the situation in India, we will analyse the political framework, the challenges in harnessing the demographic advantage, and finally, the numerous obstacles to development.

The political framework:

Modi, 73, was reelected in 2019 and has control over both houses. New elections will be held in 2024 and he is currently the favourite. While the Supreme Court recently invalidated the sidelining of the Gandhi descendant in the election race, the opposition is divided, and Modi exercises control over the media. According to the Reporters Without Borders ranking, as of 2023, the country is ranked 161st out of 180 in terms of press freedom (China ranks 179th).

Modi, in power since 2014, pursues a policy with populist, nationalist, and authoritarian undertones. This populism aims to address the frustration of a portion of the population due to the economic take-off not resulting in sufficient development of the middle class.

Modi's primary targets are religious minorities, specifically Muslims and Christians. Muslims make up 15% of the population but hold only 5% of the seats in Parliament. Initially, in August 2019, Modi revoked the autonomy of Kashmir and its 7.5 million predominantly Muslim inhabitants. Subsequently, with the Supreme Court's decision to grant Hindus the right to control the Ayodhya site, Modi had a mosque demolished to replace it with a Hindu temple. Finally, with Modi's imposed citizenship law aimed at blocking the naturalisation of Muslims, over 2 million Muslims lost their Indian citizenship.

India's difficulties in exploiting its demographic advantage:

The main advantage of India, especially when compared to China, is its demographic expansion. However, the country struggles to reap all the benefits from it.

Population growth:

- Total population:

In 1845, before Queen Victoria became the Empress of India in 1876, India had a population of only 130 million. Today, it has more than eleven times that number.

This demographic explosion is recent, as in 1950, the census reported less than 380 million inhabitants.

This expansion, a significant difference from China, is projected to continue at a rate of 1.2% per year. As a result, India, with an average of 2.8 children per woman, is one of the youngest countries on the planet. By 2050, India's population will exceed China's by over 350 million, and by 2100, by 650 million.

This demographic dynamic impacts the median age. India's median age is only 28 years, while Russia's is 39 and China's is 37, with rapid aging.

- Working-age population:

While China's working-age population is declining, India's, which was around 870 million in 2019, is growing and is projected to reach 1 billion by 2050.

The 4 challenges difficult to overcome:

- Challenge of education funding:

The country still has a 30% illiteracy rate compared to China's 5%, and it allocates only 2.7% of its GDP to education. While the percentage of out-of-school children has indeed dropped from 50% to 10% since 1980, the quality of teaching and teachers is poor for all but the elite. Teacher absenteeism is high, as is student absenteeism, and these will risk squandering the country's demographic advantage. The literacy rate for women, according to the UN, remains low at 70%.

- Challenge of managing the working-age population transition:

The agricultural sector, accounting for only 15% of the GDP, still employs over 50% of the population. Rural migration is significant and necessary, but the country struggles to create jobs in industry and services.

- Challenge of reducing the unemployment rate:

Approximately one in five young people under 25 worldwide is Indian. There are 900 million people of working age, but only half of them are part of the workforce, and the number of formal jobs doesn't exceed 60 million!

To absorb the youth entering the job market, it would be necessary to more than double the annual job creations to reach 10-12 million. This is unprecedented, and labour force participation rates remain very low. This is especially true for women's labour force participation, at 24% in 2022 compared to 60% in China, 57% in the United States, and 47% globally on average.

The unemployment rate is at its highest in the past 45 years, and the government has not found a path towards more inclusive employment growth. While the service sector represents over 50% of the GDP, it only provides 28% of the jobs. The IT sector generates 40% of export revenues, around $200 billion, but employs only 5 million workers.

- Finally, the challenge of urban planning:

The urbanisation rate is still only around 40 to 50%, and according to the UN, nearly half of the urban population in 2020 lived in slums. This is a challenge because, according to the government, the urbanisation rate is expected to reach 73% by 2036, and the growth of the middle class will have a significant impact on pollution. In 2022, India already had 16 out of the world's 22 most polluted cities (IQAir report). As ***Subrahmanyam notes in Is 'Indian Civilization' a Myth?***: "Bangalore, an idyllic city, has become an ecological dumpster."

Another example of challenges related to urbanisation is automobile. The car penetration rate in India is only 2%, compared to 12% in China, 56% in the European Union, and 79% in the United States. The inevitable increase in the number of cars will exacerbate problems.

As a preliminary assessment of this economic take-off driven by demographic expansion, the poverty rate has been reduced from 48% in 1993 to 13% in 2015 (World Bank report), and the GDP per capita has multiplied by 4 since the beginning of economic liberalisation in 1991. According to World Bank data for 2020 in terms of purchasing power parity, it reached $6500. However, this figure remains below the global average.

The persistence of many obstacles to development:

In power since 2014, Modi faces difficulties in reforming taxes, streamlining land consolidation, loosening the labour market, reducing unproductive subsidies, restructuring state-owned enterprises, privatising them, and overcoming pollution problems.

The key factor for growth remains consumption, accounting for a high percentage of GDP at 64%, a level close to the 70% observed in the United States, higher than Japan's 57%, the European Union's 54%, and China's 38%.

To better understand the development constraints, we will first examine the overall shortcomings of the country, then the shortcomings of the private sector - including businesses and the financial sector - and finally the shortcomings in agriculture.

The overall shortcomings: 4 stand out in particular.

- The challenging state of public finances and insufficient savings:

Public finances offer little manoeuvrability, even though external debt is low and foreign exchange reserves approach $600 billion. The country's credit rating given by Fitch is BBB-. More than $25 billion in privatisation revenues have been projected, but the outcome is uncertain.

The country is indebted and has recorded significant budget deficits, exceeding 5% of GDP in recent years. To increase revenues, Modi has implemented various reforms:

The introduction of VAT in July 2017 was a key tax reform, but implementation was somewhat complex with four rates ranging from 5% to 28%, a dozen exemptions, and a plethora of forms to fill out.

In order to boost revenues, there has also been a push to increase the number of taxpayers subject to income tax, which was just 1% before, and to broaden the tax base. The income tax collection represents barely 15% of GDP, a percentage lower than the average of emerging economies and among the lowest in the world.

Additionally, nearly 80% of banknotes were withdrawn to curb tax evasion. However, in a country where nearly 60% of households do not have bank accounts and where the informal economy is estimated to account for over 20% of GDP, the growth was temporarily penalised.

- Weakness in infrastructure:

Undoubtedly, in recent years, Modi has stimulated public investment in port, road, and railway infrastructure, and has constructed many roads. This year, he aims to allocate 3.3% of GDP to various projects, but the country's high level of debt poses an obstacle to realising these investments, and compared to China, India spends less than half the percentage on infrastructure.

Reducing subsidies on fuel prices has allowed the government to free up investment capacity for infrastructure.

Transport and electricity infrastructure are inadequate, which hampers development and firm productivity. Railway transport companies invest insufficiently as they maintain fares too low and, while trying to compensate with higher freight rates, they divert traffic to roads and saturate the network.

Many electricity companies are not profitable because they still offer electricity for free, or almost free, to farmers.

1/4 of the population lacks access to electricity. To address this shortfall, numerous nuclear power plants would need to be built, but the country lacks capital.

- The persistence of administrative obstacles:

In various business environment rankings, India consistently receives low scores, especially an 85th rank for the corruption perception index related to construction activities.

Many infrastructure projects are stalled due to challenging expropriations, and labour regulations hinder layoffs. Both of these reforms were part of Mr. Modi's agenda but haven't been finalised.

Other hindrances to development include social rigidities, with 16% still classified as "Untouchables," and assaults against religious minorities.

Overall, however, according to the World Bank's Ease of Doing Business ranking, the country has moved from the 142nd place in 2015 to the 77th in 2020.

- A deplorable healthcare system:

Public health expenditures account for only 1% of GDP; the majority of healthcare expenses are private, and the black market for obtaining oxygen exacerbates inequalities.

The example of the COVID-19 crisis was illustrative: with the Serum Institute of India being the world's largest vaccine manufacturer, the country was unable to adequately care for its population during the pandemic.

Shortcomings in the private sector: 4 main ones can be highlighted.

- The challenging development of the industry:

In 1750, India accounted for between one-fifth and one-quarter of global industrial production. By the eve of the 1914 war, it had dropped to 1.3%. Meanwhile, the colonial power, England, saw its share rise from 2% to 13%.

Today, the industry (manufacturing + construction + utilities + mining) is underdeveloped, representing only 27% of GDP compared to 59% for services and 14% for agriculture. Within the industry, manufacturing has fallen to 13% of GDP, the lowest level since the late 1960s.

In 2019, Modi lowered the corporate tax rate from 30% to 22% in hopes of boosting investment. In vain. He also subsidised the industry with $27 billion to enhance the country's self-sufficiency, but this did not prevent a recent stagnation in private investment.

The low capacity utilisation rate, just over 70%, doesn't encourage companies to invest. Companies are burdened with high debt and sometimes have to prioritise deleveraging over investment.

- Weakness in research expenditure:

The country lacks skilled labour, and while there have been notable successes in the automobile, steel, petrochemical, and generic pharmaceutical industries, India has not achieved a true industrial revolution like China has.

Research and development expenditures do not exceed 1% of GDP, not even half the percentage of China or a quarter of South Korea's, and unsurprisingly, India doesn't even account for 1% of international patents, far behind China's 5%.

- Insufficient concentration:

The Indian industry suffers from the small scale of companies. In China, half of the companies have more than 200 employees, while in India, only 10% do. A McKinsey study estimates that only 270 companies have turnovers exceeding $125 million, while there are nearly 7700 such companies in China, around 3500 in Russia, and 1300 in Brazil.

The well-known development hubs of the country are paradoxically modestly represented in the stock market, whether it's the IT sector (information technology), which accounts for less than 20% of market capitalisation, or the pharmaceutical sector, which contributes only 5% to the index. The industry (automobiles, cement) is at 10%, which is weak. Such a picture is expected to evolve in the coming years with the increasing number of IPOs.

Overall, the market capitalisation is only one-sixth of China's.

- Limited openness to the outside:

Mr. Modi, a staunch supporter of "Make in India" and eager to reduce import dependence, has raised customs duties, a true protectionist barrier, to 18%, yet he has struggled to correct the relative weakness of exports and reduce the structurally high trade deficit.

India remains relatively closed to the outside world, exporting only $450 billion (compared to China's $3.36 trillion), accounting for only 2% of global trade and slightly over 3% of trade in services.

While it displays a current account deficit lower than the 5% recorded in 2012, it still hovers around 2% of GDP. Among the causes of this recurring deficit are the imports of 80% of the consumed oil, high-quality coke, and food items.

Opening up to foreign interests, allowing up to 49% foreign ownership in insurance companies, railway infrastructure, or cable networks, was aimed at attracting international investors, but for now, it has had limited effects. Multinational firms generate no more than $250 billion in revenue in India.

Since 2020, only a quarter of foreign investment applications in India have received the necessary administrative approvals. An indicative case is the recent decision by Foxconn to abandon a $19 billion project for semiconductor manufacturing in India.

FDI has increased in recent years, yet according to UNCTAD, it only amounts to $44 billion, and according to the Indian Central Bank, $56 billion.

Shortcomings in the financial sector:

Banks are burdened with non-performing loans, estimated to be between 10% and 15% of the total loans, with a much higher percentage for loans to local businesses.

The government aimed to recapitalise public banks, as they account for 70% of bank loans, and it sought to merge 10 public banks down to four, but this process takes time.

Compared to major economies, the financial sector is overrepresented in the stock market among the top market capitalisations. However, consumer credit is still underdeveloped, accounting for barely over 10% of GDP, in contrast to nearly 60% in China, 35% in South Africa, and 30% in Brazil. Similarly, mortgages account for only 10% of GDP, compared to 18% in China, 44% in Singapore, and 52% in the United States.

Low productivity in agriculture:

Agriculture in India employs 50% of the workforce but contributes only 15% to the GDP.

After the United States, India has the most cultivated hectares, but many of these lands are either in semi-arid areas lacking water, where high-yield seeds cannot be sown, or in frequently flooded regions. Moreover, monsoons are becoming later and less water-bearing each year.

As ***Joseph Boillot*** demonstrates in a recent book ***"Utopies made in monde",*** the land is depleted due to intensive exploitation of groundwater, cancer rates are rising due to widespread pesticide use, and some food products cannot be exported anymore because they are too degraded by fertilisers.

The model of the Green Revolution has shown its limitations as it requires subsidies, fertilisers, pesticides, and agricultural machinery. These costs, to be recovered, require extensive land use, which does not align with the reality of Indian agriculture.

On the face of it, yields have risen sharply, India is producing more and exporting rice and sugar. However, in real terms, farmers' net income has hardly risen over the past 20 years. Modi aims to eliminate intermediaries between agricultural producers and consumers, but this reform faces resistance.

Small farmers dealing with land consolidation, difficulties accessing credit, and expropriation have left their land, but they struggle to find alternative employment.

Malnutrition still affects one in two Indians, and a third of the world's malnourished children live in India.

Conclusion: "***It depends on us that the present delivers its promise of the future." Kant***.

This statement by Kant encapsulates Modi's ambition for his country since his appointment in 2014. However, progress has been slow, and Modi's track record is mixed:

- ***The slow pace of Indian catch-up***:

Despite the commendable growth in recent years, India's GDP per capita of $2250 ranks 165th globally according to the World Bank in 2021, barely more than a fifth of China's GDP per capita of $12550, ranking 79th globally.

The investment rate is below 30%, whereas emerging countries generally allocate over 35% of their GDP to investments, and China has historically invested 45% of its GDP.

This is due to inadequate local savings, around 30% of GDP compared to 45% in China.

It's also noteworthy that attracting foreign investors has been challenging, equivalent to 2% of GDP, accounting for 6% of international flows in 2020. Foreign investment stocks as a percentage of GDP only amount to 13%, which is on average half of other emerging countries.

As a consequence of the low investment rate, the unemployment rate, hovering around 30%, is very high. This percentage is underestimated as the informal economy affects 90% of the population, and the poverty rate is approaching 50%.

- ***A mixed track record for Modi:***

While the country currently experiences one of the world's highest growth rates, projected at 6% in 2023, Modi's track record is hindered by the absence of labour market liberalisation, the inability to develop the manufacturing industry, the challenge of attracting essential foreign investments for infrastructure development, insufficient spending on health and education, and the challenges of urbanisation. Therefore, it's difficult to be overly positive about the stock market, which is expensive at 22x earnings.

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