Economics

India: Rising growth potential

DBS Group Research **13 October 2010**

We anticipate India's potential GDP growth to rise from an estimated 8% at present to 9% over the next five years [1]. We discuss here some of the key drivers – the favourable demographics, the low base and the constructive outlook for structural reform.

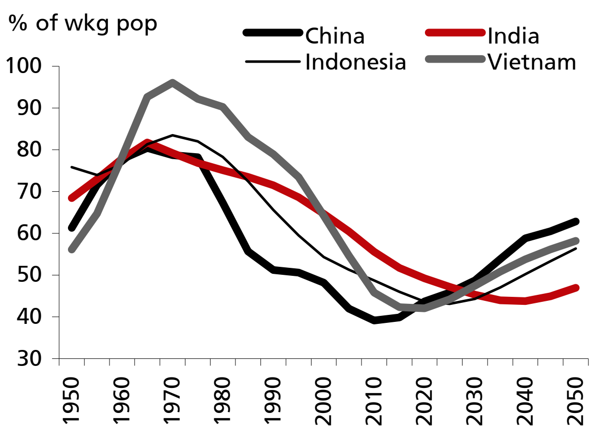
Demographics - some of the best in the emerging markets

Savings rate to rise

India has one of the most favourable demographic profiles amongst developing Asian economies as well as amongst the BRIC economies (Chart 1). The comparison is most stark with China which has a 'compressed' demographic transition due to the one-child policy. The UN population projections estimate India's working-age population to grow by 1.8% each year in the next five years, in excess of the total population growth of 1.3%. This will lead to a fall in the dependency ratio (number of children and aged as a share of working-age population) to 52% in 2015 from 56% in 2010. Demographic transitions are powerful phenomenon that affects the long-run economic growth rate. Intuitively, a larger share of working-age population should imply larger disposable incomes, lower expenditure on old age related expenditure and greater availability of resources for investment in education. These in turn support greater consumer spending even as it leads to a larger pool of national savings (and tax revenues) which facilitates investment spending. The resulting virtuous cycle of greater consumption and investment helps support a higher level of potential GDP growth. Not surprisingly, cross-country econometric studies show that a fall in the dependency ratio is positively correlated with savings rate and per capita income growth [2].

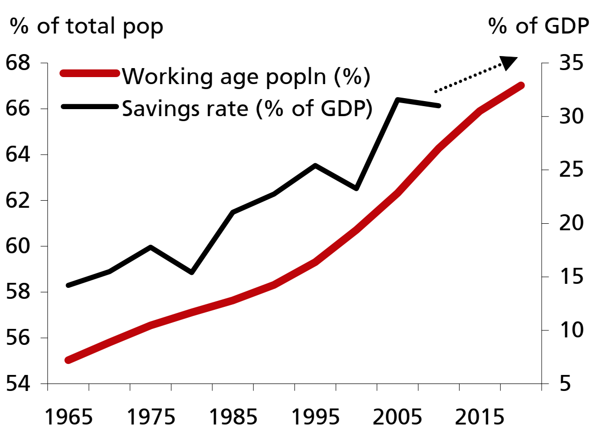
In the case of India, the impact of improving demographics is evident in the savings rate (Chart 2). The national savings rate has steadily risen in the past four decades. In the most recent decade, the rise in savings rate is even steeper as it is also supported by corporate savings generated by economic reform and growth since 1991 (Chart 3). Looking ahead, the continued reduction in the

Chart 1: Dependency ratios: a comparison (Asia)



Source: World Population Prospects, UN

Chart 2: Savings rate vs working age population



Source: UN, CEIC, DBS estimates

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Chart 3: Gross domestic savings - private corporate

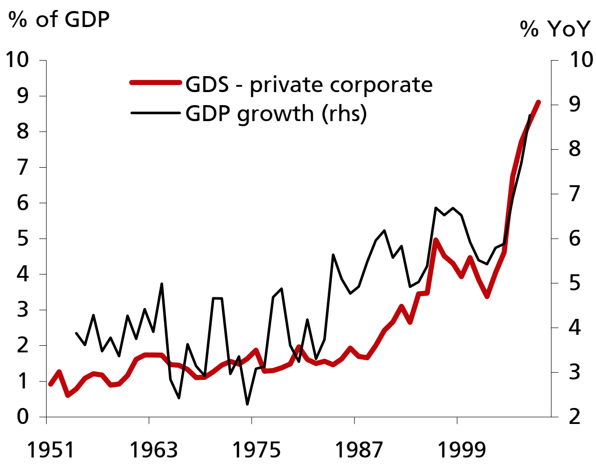
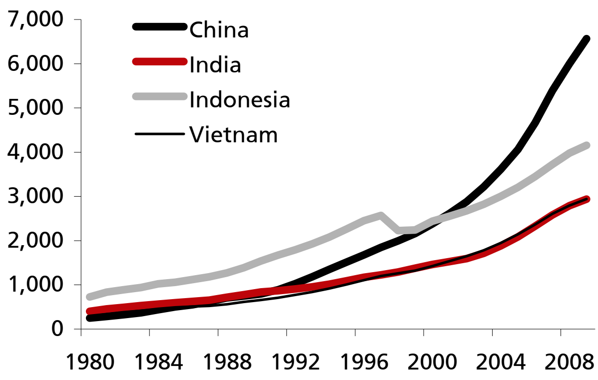


Chart 4: Per capita income (current intl dollar)

Purchasing power parity adjusted



Source: IMF

dependency ratio should by itself lift the savings rate by 3 percentage of GDP by 2015. When combined with the expected rise in disposable incomes, corporate profits and financial deepening, the actual rise in the national savings rate should be much larger.

Per capita consumption & investment – low relative to many emerging markets

Importance of low base

While structural reforms are critical to reap the demographic dividend, the importance of the low base cannot be exaggerated. India's per capita income level (adjusted for purchasing power differences) is one-half that of China's, a fourth of Brazil's and a sixth of Russia's (the so-called BRICs). Per capita income levels are also lower than the other key emerging market in the region, Indonesia (Chart 4). This income disparity is also reflected in the penetration rates of key durable goods such as passenger cars and mobile phones (Table). India is one of the fastest growing markets for these goods and this is not surprising given the relatively lower penetration rates of these goods in the Indian market. We think ongoing efforts to improve access to basic education and infrastructure should support continued strong growth in consumption. In the period, 2002 to 2009, private consumption grew at a 6.5% annual rate. There is little reason why this growth cannot be sustained in the next five years; indeed, the demographics suggest the growth rate could be exceeded. Equally important, the per head capital stock is low enough in India (a third of China's) that investors need not worry about underutilisation of capacity dampening return on investment, especially for infrastructure investment (one of the few advantages of prevailing bottlenecks).

Table: Penetration of consumer durables, 2009

	IN	VN	CN	ID	BRZ	KR	High inc ctries
Passenger cars per 1000 people	13	14	35	44	180	290	471
Mobile phones per 100 people	45	95	56	77	90	99	112

Source: World Bank, CEIC, DBS estimates

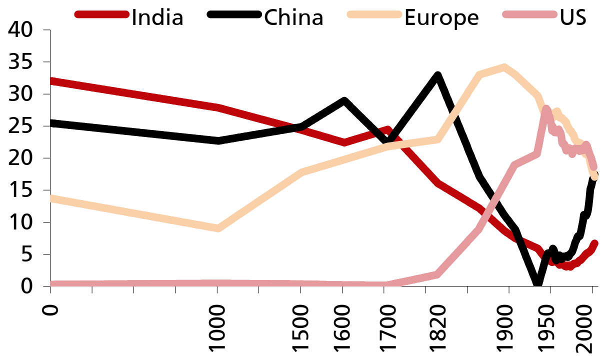
Structural reform: not as uncertain as it appears

Demographics and a low base significantly boost the growth potential of the economy. To realize the potential, continued progress on delivery of basic public goods (education, healthcare and infrastructure) is critical as is continued market liberalization. The government is making progress on all fronts and the outlook should improve over the next five years.

The prospect for reform may be judged in terms of the government's 'willingness' and 'ability' to pursue reform. A confluence of factors is in play – both carrots

Chart 5: Share of global GDP (%)

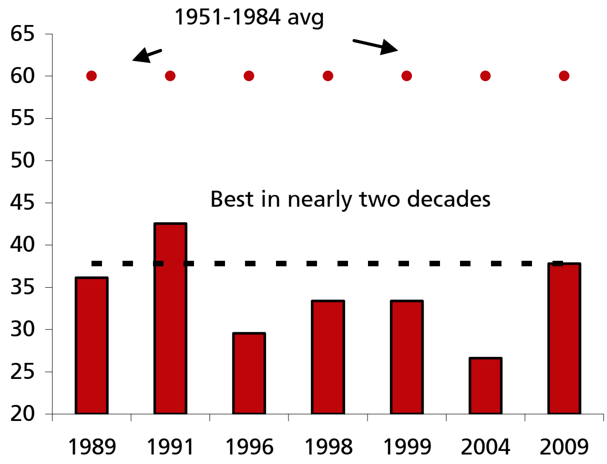
%, 1990 international dollar



Source: Angus Maddison, Historical Statistics of the World Economy, DBS

Chart 6: Best electoral performance in two decades

% of seats won by the largest party (Congress / BJP)



and sticks – increasing the willingness to reform. Foremost we think is growth begets growth as it transforms the mindset and aspiration of the people and the (political) leadership who have tasted its fruits. Thus the government is keen to not just maintain 8% growth but to raise it to 10% over the longer-term. Likewise, there is political consensus that openness and liberalization are the best means by which to eradicate poverty. Another important factor – and one that few other emerging markets share – is India's size and history as an economic and cultural center (Chart 5). The aspiration to regain its historic position is only strengthened by the dramatic rise of China.

Many push factors also point to reform. India's poor showing on basic development indicators – literacy, health care, power supply, security – is a factor fanning dissatisfaction. Rising internal and external security threats may seem negative for growth but do focus the government on development efforts.

Positive on structural reform

As for the 'ability' to reform, general election results in 2009 have created some room for reform – at least, the best India has had in two decades (Chart 6). India's political parties may be beginning to find the right policy mix that simultaneously supports growth and helps win votes (something the opposition right-wing BJP party could not do in 2004 elections).

Any outlook for reform also hinges on technology – a major force enabling and forcing change. Computers, internet and mobile phones are helping to overcome the basic infrastructure deficiencies that previously cut off less accessible regions of the country. Technology is even coming to the aid of India's governance and administrative challenges. The introduction of biometric national identity cards (the first national identity card) in the next five years should help target subsidies better, improve delivery of basic public services and help deal with bureaucracy, redtape and corruption.

All things considered, we are optimistic that the competitiveness of Indian economy will continue to improve over the next five years. Accordingly, we expect India's GDP growth potential to rise to 9% by 2015 from an estimated 8% currently.

Notes:

1. GDP growth averaged 7.5% annual rate between 2002 and 2009, which may be viewed as one full cycle.
2. See, for example, "The global impact of demographic change, IMF, 2006"

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