

<https://blog.en.erste-am.com/can-india-step-out-from-under-chinas-shadow/>

## Can India step out from under China's shadow?

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India has been one of the fastest growing economies in the world for several years. Its GDP growth numbers have been above those of [the emerging markets heavy weight China](#) since 2015. India is expected to maintain a growth rate of 7% in the coming years, whereas China seems to be heading for a decline below 6%.

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*Source: Bloomberg*

Protagonists of the election campaign for the parliamentary election held in spring highlighted the economic expectations for the country during their campaign: the then Indian Minister of Finance forecast the rise of India to become the third-largest economy of the world by 2030 (with a GDP of about USD 10,000bn), behind the USA and China. The high expectations are attracting investors from around the globe, and the stock exchange in Mumbai is booming. But, can the economy meet the high expectations, or will India remain the "future talent" forever?

### One of the biggest challenges

One of India's biggest challenges is the creation of an advantageous economic framework. Historically speaking, the federal state structure has led to a broad array of different frameworks, with every State having its own set of laws and economic policies. This divergence in legal systems in connection with the overregulation of the private sector and excessive bureaucracy have discouraged investors. China, on the other hand, has invested in infrastructure and opened up the country bit by bit towards a market economy. The results could not be any clearer: whereas 30 years ago, China and India were in the same ballpark with respect to GDP per capita, China's GDP per capita is now three times the size of its Indian equivalent.

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[It was this very fact that Nanendra Modi made the core of his parliamentary election campaign](#) in 2014. He promised changes by implementing overdue reforms and declared himself in favour of efficient, growth-oriented governance with the goals of the standardisation of the economic framework across India and job creation. In doing so, he hit the zeitgeist of the population who were hoping for reforms, and as a result his party achieved an absolute majority at the election – a first for any party in 30 years.

In his first term (2014 to 2019), Prime Minister Modi created a better environment for a competitive economic framework under the slogan "Make in India". In order to make trade easier across the States, he simplified and standardised the national value-added tax system. Many investment barriers were lifted, and the legal requirements for incorporation were minimised. Lending, especially by foreign financial institutions, has been made easier as well. The introduction of expedited insolvency procedures came as significant support to the stricken Indian banking system; previously, calling on and selling bad debt had been a very tedious process. In addition, distressed banks received capital injections from the government.

### Tackling the black economy

The government tackled the black economy, which the World Bank estimates to account for about 20% of GDP, with a rigorous demonetisation policy. Certain bank notes (86% of the circulating money supply, i.e. 12% of the Indian GDP) were declared void, and the conversion was strongly limited. Other fundamental data have improved significantly as well: the Indian central bank has managed to stabilise inflation, and the public budget deficit has fallen below 4% of GDP.

The results of the reforms are clear: In the World Bank's "Doing Business Index", which measures the regulatory environment of countries for businesses, India has jumped from 134<sup>th</sup> to 77<sup>th</sup> place within five years.

Unemployment, however, remains a big economic challenge. Despite the high economic growth rate, it has increased in recent years. We can see a chance of making better use of the existing potential in the manufacturing sector. In contrast to the service sector, the industrial sector is not growing at high rates. Here, too, the divergence between India and China over time is striking. The overregulation in the private sector in this context is one of the main reasons for the subdued growth in the industrial sector. Bigger companies in particular have to contend with a long list of regulations, which puts a brake on the sustainable growth of industrial production.

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The unemployment rate has been considered one of the biggest weaknesses in the first term of Prime Minister Modi. Despite all the reforms, both intended and implemented, the unemployment rate defied the efforts and increased. As a consequence of this development, observers in the run-up to the parliamentary election in spring 2019 expected Prime Minister Modi and his Bharatiya Janata Party (BJP) to experience significant losses. The results were surprising: Prime Minister Modi not only retained the majority in parliament, he even increased the number of seats.

We expect Prime Minister Modi to focus his second term on improving industrial production. This includes the modernisation of the (in some cases prohibitive) labour market laws and the so-called land reform, which is supposed to install a new set of regulations about the acquisition of industrial plants. A further focus of the reforms of Modi's second term will be the gradual privatisation of state-owned companies. This overdue step would facilitate the faster modernisation of central infrastructure projects (e.g. railways) in the country with the help of private investors.

In addition, the limitations on foreign investors with regard to the maximum investment in companies of selected sectors are to be reduced as well.

### The writings on the wall

There are many signs to suggest that both the government and society are up for deep-running reforms. The political framework seems favourable not the least due to the parliamentary majorities; in this environment, even socially contested reforms could be passed. In the absence of any negative developments of external factors such as the oil price or the exchange rate to the US dollar, India would have a realistic chance to shake its status of permanent future talent and to globally establish itself as strong economy.

Since the liberalisation of the Indian capital market, more and more companies have made use of the opportunity to place international bond issues. In doing so, they do not only issue "classic" corporate bonds, but also convertible bonds in euro and US dollar. Although government bonds continue to dominate the Indian bond market, the share of corporate bonds has been on the rise. India currently accounts for 4.5% in the hard currency corporate bond index by J.P.Morgan, with more than 65% of the bonds included commanding an investment grade rating. Generally speaking, the liquidity of the bonds is very good and allows for active investment management. In addition, India currently offers a higher risk premium relative to comparable companies in China and other Asian countries. For the coming years, we therefore do not only envisage a growing (issue) market, but also an ongoing stream of interesting investment opportunities.

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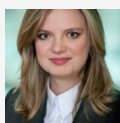
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