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Special Commentary

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Is India Ready to Assume China's Mantle?

Executive Summary

With growth in China likely to slow further in the coming years, some observers wonder if India could take over China's role as the world's most important developing economy. On one hand, India has strong demographic factors in its favor. However, India has never achieved the same rate of capital deepening as China, and there are a number of impediments that may hinder the development of the Indian industrial sector. The Indian economy may have a difficult time achieving supercharged rates of economic growth on a sustained basis unless structural reforms make industrial activity more viable in the country.

The Chinese economy was growing rapidly in the 1980s and 1990s, but it was not yet the economic powerhouse that it would become in the 21st century. India appears to be at the same stage of development as China was two or three decades ago. With enough economic reforms, India may eventually become more economically relevant than China. In our view, however, India is not yet ready to assume China's mantle as the world's most important developing economy.

Real GDP Now Growing Faster in India than in China

When China first opened up to the world starting in 1979, it accounted for only 3 percent of global economic output (Figure 1). Three decades of rapid economic growth have transformed the Chinese economy from an agrarian backwater into the world's second largest economy that today accounts for 17 percent of global GDP. However, real GDP growth in China has downshifted over the past few years after growing at an average rate of 10 percent per annum between 1980 and 2010 (Figure 2). Indeed, the 6.9 percent rate that was registered in 2015 was the slowest year of real GDP growth in China in 25 years, and many analysts, we included, look for Chinese economic growth to moderate further in the coming years.

Economic growth in China likely will moderate further in the coming years.

Figure 1

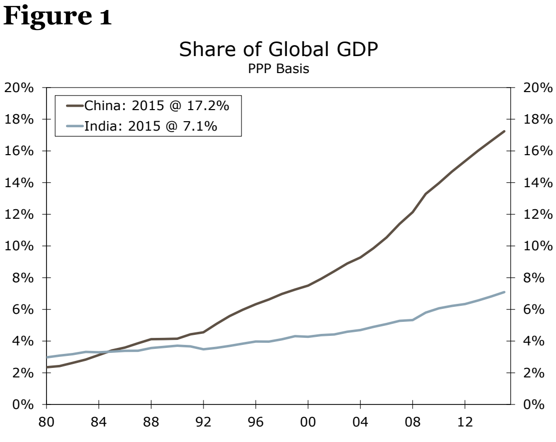
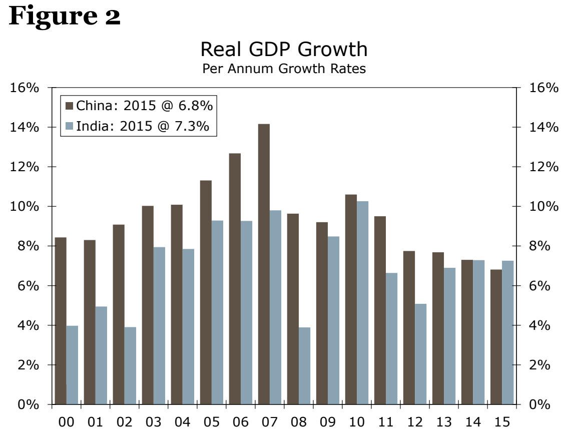


Figure 2



Source: International Monetary Fund and Wells Fargo Securities, LLC

Meanwhile, the Indian economy has gradually gathered strength over the past few years, and in 2015 it grew at a stronger rate than the Chinese economy for the first time since 1999. Today, India accounts for roughly 7 percent of global output, which is equivalent to China's share in the mid-1990s, and many analysts forecast that the Indian economy will gradually accelerate further in the coming years. At present, the Indian economy is the seventh-largest individual economy in the world with nominal GDP that exceeded $2 trillion in 2015. That said, India is a poor country with per capita GDP of roughly $1,700 at present.

Is India on the cusp of a "breakout"?

Is India on the cusp of a "breakout"? Could India assume the role that China has played over the past decade or two as the world's most important developing economy? Could India become an important engine of growth for the global economy in the coming years *à la* China over the past decade or so?

India Has Favorable Demographics

To answer those questions, let's look at the underlying drivers of growth in the Chinese economy over the past few decades. As we explained in a recent report, a country's potential economic growth rate is essentially the sum of its labor force growth rate and its labor productivity growth rate.[1] Between 1980 and 2010, which coincided with the rapid phase of Chinese economic development, the working-age population (i.e., individuals between 15 and 64 years of age) in China grew at an average rate of nearly 2 percent per annum (Figure 3). More workers meant that the Chinese economy could produce more goods and services, everything else equal. However, the working-age population in China has topped out, and the United Nations (UN) projects it will decline almost 15 percent by 2040.

The working-age population in India should continue to grow over the next few decades.

Over the past two decades, India has been slowly catching up to China in terms of working-age population. India's working-age population is no longer growing in excess of 2 percent per annum, as it did over the past few decades, but the UN projects that it will breach 1 billion individuals by 2030. With about 250 million people joining the ranks of the working-age population in the next two decades, the rate of potential GDP growth in India should remain strong, everything else equal. Moreover, labor force participation among females in India is low.[2] If more females enter the labor force, then growth in the economically active population would exceed growth in the working-age population until the rate of labor force participation between males and females equalizes.

Figure 3

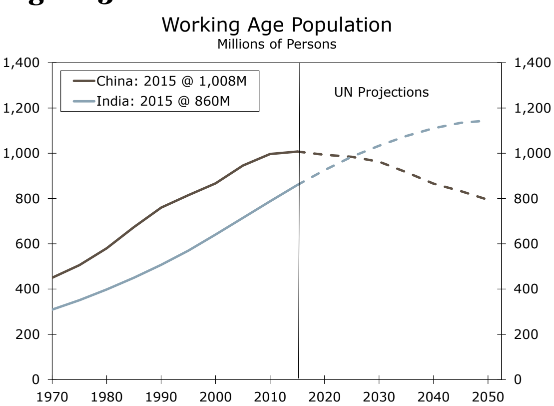
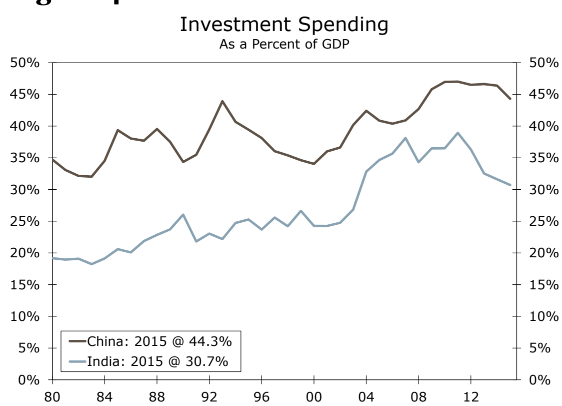


Figure 4



Source: United Nations, International Monetary Fund and Wells Fargo Securities, LLC

[1] **See "Does China Face a Japanese-Like 'Lost Decade'?" (March 15, 2016), which is available upon request.**

[2] **According to the World Economic Forum, there are nearly three times as many males in the Indian labor force than females. See *The Global Competitiveness Report 2014-2015*, World Economic Forum, Geneva, 2014.**

Can India Invest Enough?

As noted earlier, not only does the potential GDP growth rate of an economy depend on its labor force growth rate but also on its productivity growth rate. While there are a number of factors that influence productivity growth, investment is an important determinant of productivity growth. Giving workers more capital tends to increase the amount of output they can produce, everything else equal.

Capital spending has been very strong in China, with the investment-to-GDP ratio rising from 30 percent or so about 30 years ago to more than 45 percent at the beginning of this decade (Figure 4). Although there is some evidence of overinvestment in recent years, there is little doubt that strong capital spending, which contributed to rapid economic growth in China, transformed the country from an agrarian economy into an industrial powerhouse over the short course of a few decades.

The investment rate in India is not as high as in China.

The marked rise in the investment ratio that started in India at the turn of the century contributed to the acceleration in the Indian economy which occurred at that time. However, the country's investment ratio has subsequently receded. Although the International Monetary Fund (IMF) forecasts that the investment ratio in India will edge higher over the next few years, it does not foresee the ratio returning anytime soon to 35 percent, which marked the low point for China during its emergence phase. Although an investment rate of 30 percent to 35 percent of GDP is "high," it would not be high enough to produce the supercharged rates of economic growth that characterized the Chinese economy between 1980 and 2010.

India will need to do a better job of attracting FDI in the coming years.

Foreign direct investment (FDI) represents an important component of overall investment spending, and in this regard, India still has a long way to go. As shown in Figure 5, FDI in China averaged $34 billion per quarter between Q1 2010 and Q3 2014 (latest available data). During that period, India received only one-seventh as much FDI as China. India is currently attracting FDI at roughly the same rate as China did in the mid-1990s. Not only is the absolute amount of FDI flowing into a country important, but the technology transfer that accompanies FDI is an important source of "know how" for developing economies that are trying to rise up the value-added ladder of global production. India will need to do a better job of attracting FDI in the coming years to help achieve the same sorts of supercharged growth rates on a sustained basis that China was able to realize over the past few decades.

Figure 5

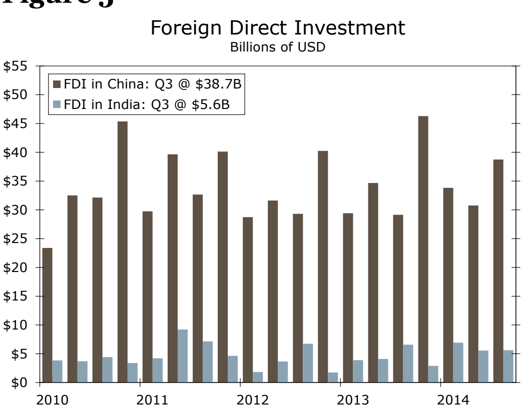
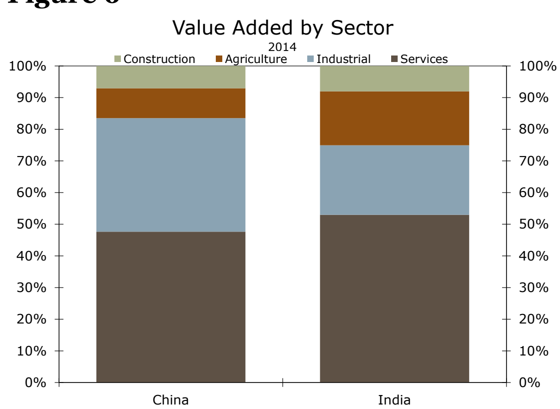


Figure 6



Source: IHS Global Insight, United Nations and Wells Fargo Securities, LLC

India Needs to Raise Its Game in Manufacturing

The current structure of the Indian economy makes it more difficult, everything else equal, for India to grow at the same pace as China did over the past few decades. For starters, the agricultural sector, which tends to be characterized by low productivity growth, accounts for

17 percent of value added in the Indian economy (Figure 6). The comparable ratio in China is less than 10 percent. More important, India has a small industrial sector (22 percent of value added) compared to China (36 percent of value added) and a large service sector, which accounts for 53 percent of value-added in the Indian economy. The service sector accounts for 48 percent of value added in China.

These differences in economic structure are important for GDP growth, because it is relatively easier to produce strong labor productivity growth in the industrial sector than in the service sector. As noted earlier, capital spending helps to lift growth in labor productivity, and the industrial sector lends itself more readily to capital investment than the service sector. Although sectoral productivity data for China and India are not readily available, the U.S. economy offers some insights. Between 1988 and 2015, labor productivity growth in the American manufacturing sector averaged 3.4 percent per annum. The comparable rate in the overall business sector in the United States was only 2.0 percent over that same period.

India needs a larger industrial sector.

India needs a larger industrial sector. The country does have an important attribute, namely its low cost of labor, which make it conducive for industrial activity, everything else equal. However, it also has a number of shortcomings that retard its industrial development. First, Indian infrastructure is notoriously poor. Among 144 countries, the World Economic Forum (WEF) ranks India 90th in terms of "quality of overall infrastructure."[3] The country is 103rd in "quality of electricity supply." Although labor costs are low in India, the country generally ranks poorly in terms of "labor market efficiency" with a #113 ranking in "flexibility in wage determination." In terms of overall competitiveness, the WEF ranked India #71 among 144 countries, placing it far below China (#28). Indeed, China's ranking places it in the company of many advanced economies in terms of overall competitiveness.

India will need to enact a number of structural reforms to improve its overall competitiveness. Although the reform agenda of the Modi government is moving forward, it is doing so at a slow pace. Unless the underlying structure of the economy improves, the Indian industrial sector may fail to develop quickly. If so, then labor productivity in India may remain constrained and, consequently, the rate of Indian economic growth may struggle to reach the double-digit rates that characterized China's economic transformation over the past few decades.

Conclusion

The rate of real GDP growth in China has downshifted over the past few years and many analysts, we included, look for further economic deceleration in China in coming years. China's rapid economic rise helped to push global GDP growth into the 5 percent per annum range between 2004 and 2007, the strongest four-year period for global economic growth since at least 1980. However, with the Chinese economy slowing, a return to those global growth rates seems unlikely unless another country emerges to take China's place. With India projected to become the world's most populous economy in the middle part of the next decade, could it assume China's mantle as the most important developing economy?

On the positive side of the ledger, India has favorable demographics. Its working-age population should continue to grow for the next few decades and the country could increase its economically-active population even faster if more females enter the labor force. Everything else equal, strong growth in the labor force corresponds with rapid economic growth. Strong growth in the Chinese labor force in previous decades contributed to the robust economic growth that the country experienced at that time.

Yet, China also achieved strong productivity growth via rapid growth in capital spending. Investment in India accelerated about a decade ago, but the country has never achieved the same rate of capital deepening as China. Moreover, there are a number of impediments that may hinder the development of the Indian industrial sector. Because labor productivity growth tends to be slower in the service sector than in the manufacturing sector, the Indian economy may have a

[3] **See *The Global Competitiveness Report 2014-2015, op cit.***

difficult time achieving supercharged rates of economic growth on a sustained basis unless structural reforms make industrial activity more viable in India.

The Chinese economy was growing rapidly in the 1980s and 1990s, but it was not yet the economic powerhouse that it would become in the 21^{st} century. India appears to be at the same stage of development as China was two or three decades ago. With enough economic reforms, India may eventually become more economically relevant than China. In our view, however, India is not yet ready to assume China's mantle as the world's most important developing economy.

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