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Economics Group

Special Commentary

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Will India Continue to Realize Strong GDP Growth?

Executive Summary

Real GDP in India grew 7.4 percent on a year-over-year basis in Q3 2015 as growth in domestic demand remained strong. Looking to the near term, real GDP growth in India should remain in the 7 to 8 percent range over the next two years or so. India has low trade exposure to China, which likely will continue to decelerate, and low inflation means that the central bank does not need to tighten policy anytime soon.

Looking further ahead, strong demographic trends in India should continue to support solid economic growth. However, there are a number of structural issues, including low labor force participation among females, inadequate infrastructure, rigid labor markets and corruption that may impede the ability of the Indian economy to reach its true economic potential. The Modi government has been able to enact some reforms since coming to power 18 months ago, but more reforms likely will be needed if the country wants to achieve double-digit rates of economic growth on a sustained basis.

Domestic Demand Continues to Pace Indian GDP Growth

Growth in the service sector remained strong in Q3.

Recently released data showed that real GDP in India grew 7.4 percent on a year-ago basis in Q3 2015 (Figure 1). Not only did the outturn represent a strengthening in growth relative to the previous quarter, but it was a bit above the consensus expectation as well. A breakdown of the GDP data into its sectoral composition showed that the service sector, which contributed 5.0 percentage points to the 7.4 percent overall GDP growth rate, continues to be the primary driver of the Indian economy (Figure 2).

Figure 1

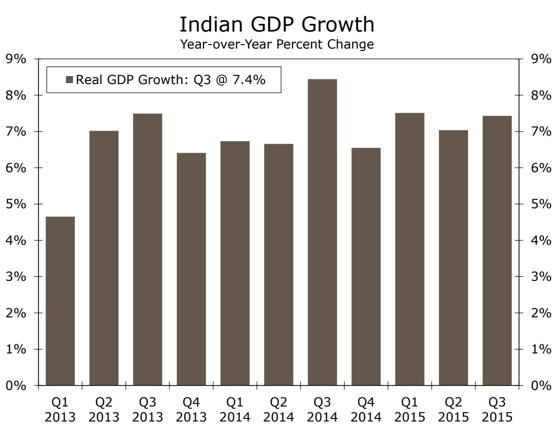
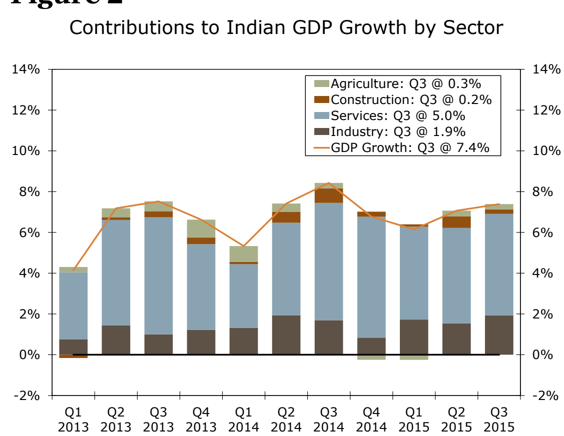


Figure 2



Source: CEIC, IHS Global Insight and Wells Fargo Securities, LLC

That said, the growth contribution coming from the industrial sector strengthened to 1.9 percentage points in Q3 from 1.5 percentage points in Q2. Fixed investment spending

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accelerated during the quarter, which offset the drag on the industrial sector emanating from the 4.7 percent year-over-year decline in real exports of goods and services.[1] In sum, growth in domestic demand is pacing overall GDP growth in India at present.

Real GDP growth should remain strong over the next two years.

Looking to the near term, we forecast that real GDP growth in India will remain strong through 2017. Indeed, we project that the Indian economy, which historically has lagged the Chinese economy, will grow faster than its large neighbor over the next two years (Figure 3).[2] There are some factors that should keep Indian GDP growth well supported in the short run. First, India does not have much economic exposure to China. About 5 percent of India's exports, which represents only 1 percent of Indian GDP, are destined for China. Some developing countries with significant trade exposure to China are facing strong economic headwinds due to the slowdown that is under way in the Chinese economy. India does not have this problem.

Second, CPI inflation in India has receded significantly over the past two years (Figure 4). Consequently, the Reserve Bank of India (RBI), the country's central bank, has been able to reduce its main policy rate by 125 bps this year. Although the CPI inflation rate is likely to rebound a bit in 2016, it probably will not rise so much as to induce the RBI to tighten policy anew.[3] Given the lags involved between reductions in interest rates and their effects on economic activity, Indian GDP growth should remain supported by lower interest rates for the foreseeable future. Growth in domestic demand, which has been the primary driver of real GDP growth in India recently, should remain solid, at least in the near term.

Figure 3

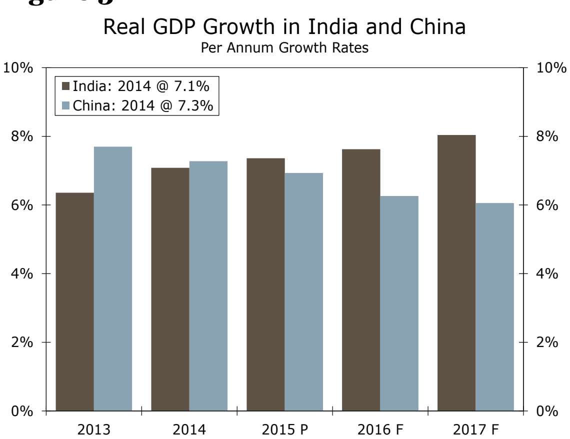
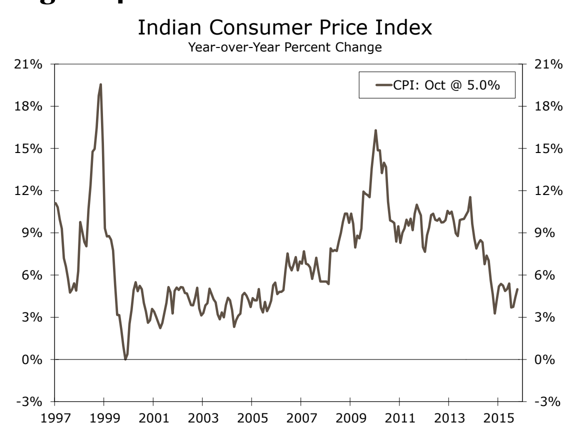


Figure 4



Source: CEIC, IHS Global Insight and Wells Fargo Securities, LLC

Will India Reach Its True Economic Potential?

There are some longer-run factors that should help to support economic growth in India. As shown in Figure 5, the country's investment and savings rates accelerated noticeably at the beginning of the previous decade. Stronger growth in investment spending means that India was adding to its capital stock at a faster rate, which is a major determinant of an economy's potential growth rate. In that regard, Indian GDP growth averaged 5.7 percent per annum during the 1990s, but 6.9 percent per annum between 2000 and 2009.

Secondly, favorable demographics trends should help to support economic growth in India for the next few decades. Whereas the working-age population in China is currently topping out, the United Nations (UN) forecasts that it will continue to grow 1 percent of more per annum through 2030 (Figure 6). Indeed, the UN projects that the working-age population in India will grow

[1] **Growth in fixed investment spending strengthened to 6.8 percent in Q3 2015 from 4.9 percent in Q2.**

[2] **Real GDP data in India under the new methodology go back only to 2012. Therefore, we can show only a short time series in Figure 3.**

[3] **We estimate that the Indian consumer price index will rise 5.0 percent in calendar year 2015, and we forecast that CPI inflation in India will edge up to 5.5 percent in CY 2016 and 5.9 percent in CY 2017.**

20 percent between now and 2030, whereas it will shrink 5 percent in China. Everything else equal, there tends to be a direct relationship between growth in the working age population and economic growth because more workers can be used to produce more goods and services.

Strong labor force growth should help to support economic growth in the long run.

That said, low participation in the labor force by females, if maintained at its current low level, would impede the ability of the Indian economy to reach its true economic potential.[4] The low rate of labor force participation by females is one of many structural problems that the Indian economy faces. For example, infrastructure in India is notoriously poor, the labor market is rigid, and corruption is rampant.[5] These and other structural economic problems may inhibit the willingness of Indian businesses to invest. As Figure 5 shows, the gross investment rate in India has receded in recent years, although it remains above the rates of the 1990s.

Figure 5

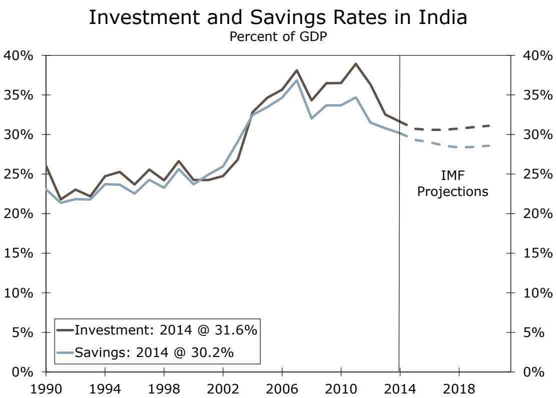
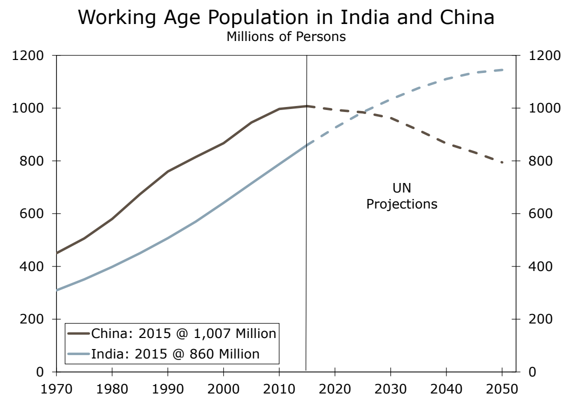


Figure 6



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

The International Monetary Fund (IMF) forecasts that the Indian economy will grow 7 to 8 percent per annum between now and the end of the decade. Achieving annual growth rates on the order of 10 percent or more, however, may remain out of reach if, as the IMF projects, the country's investment rate does not rebound. Prime Minister Modi won the premiership in May 2014, due in large part to his promise to reform the Indian economy to achieve stronger rates of economic growth. The government has been able to enact some reforms over the past 18 months, and growth has subsequently edged higher (see Figure 1). However, more reforms likely will be needed if the country wants to achieve double-digit rates of economic growth on a sustained basis.[6]

More reforms likely will be needed if the country wants to achieve double-digit rates of economic growth on a sustained basis.

4 According to the *Global Competitiveness Report*, there is only one woman who participates in the Indian labor force for every three men. See *The Global Competitiveness Report 2014-2015,* World Economic Forum, Geneva, 2014.

5 Among 144 countries, India is judged to be #90 in terms of "quality of overall infrastructure," #113 regarding "flexibility of wage determination," and #93 when it comes to "irregular payments and bribes." See *The Global Competitiveness Report, op cit.*

6 For further reading see "Is an Economic Renaissance in India at Hand?" (December 2, 2014), which is available upon request.

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