Waiting *for a* Modi Miracle

By Daniel Twining

Despite impressive growth figures, all is not well.

India is the shining star in the emerging-market pantheon. This is quite a transformation—only a few years ago Chinese growth was rampant while India looked to be falling ever further behind, with growth bottoming out below 5 percent. Today the tables have turned. India is the world's fastest-growing major economy: according to the Asian Development Bank, it grew 7.6 percent last year, and will grow 7.4 percent this year and 7.8 percent next year. While this is not the 9–10 percent annual GDP expansion India clocked a decade ago during the emerging-market boom years, it is perhaps more impressive in light of today's broader global slump. By contrast, China's "official" rate of growth was 6.9 percent last year, with a target of 6.5 percent this year and sinking; actual growth is likely lower as the economy slows, the workforce shrinks, and overcapacity and excessive leverage take their toll. Meanwhile, both the Russian and Brazilian economies are contracting due to the commodity bust and gross political malfeasance.

In this light, India's expansion is counter-cyclical as the rest of the emerging world slows down. "India is a light in a gloomy world economy," argues the *Financial Times'* Martin Wolf. The country is better-governed than its emerging-world peers; its income levels remain so low that its upside potential is greater than that of any other major market. Its infrastructure and investment requirements are such that India attracted more foreign direct investment in 2015 than any other country, including the United States and China, and could easily absorb more global investment capital

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than any other economy for years to come. To boot, India will soon possess the world's largest workforce, creating a demographic boon that could power rapid growth for decades. But its singular supply of raw human capital is also the country's Achilles heel: India's long-term performance hinges on its ability to productively employ a labor pool approaching one billion people.

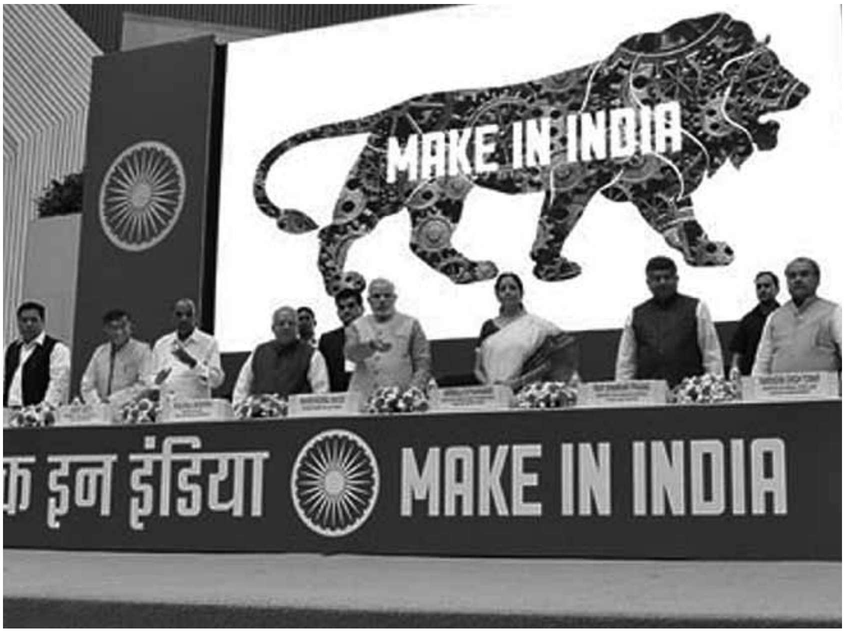
Over the past few years, despite slowing global growth, India nonetheless has benefited from global tailwinds. As one of the world's largest energy importers, the collapse in the traded price of oil has been a windfall, enabling the government led by Prime Minister Narendra Modi to slash energy subsidies and reduce the current account and fiscal deficits. The plunge in commodity prices that hollowed out government budgets in countries such as Brazil and Russia has not negatively impacted India, since it is not primarily a commodity exporter.

Lower import prices have helped contain inflation, supporting the Reserve Bank of India's quest for price stability. RBI Governor Raghuram Rajan is on his way to meeting an official inflation target of 5 percent. This is an accomplishment in a rapidly growing country that suffers from structurally high rates of inflation, and creates space for interest rate cuts to boost economic activity. Nor is India heavily exposed to the Chinese market: strategic wariness between the competitive Asian giants has limited economic interdependence between them, so China's growth slowdown has not rocked India as it has other Asian markets.

While India's administrators have enjoyed a favorable set of global conditions supporting growth, they have also done some things right at home. Finance Minister Arun Jaitley has reduced a dangerously high fiscal deficit inherited from the previous administration to only 3.5 percent in the 2016–2017 fiscal year, restoring stability to government finances. The government's current budget forecasts nominal GDP growth of 11 percent this year, as against 8.6 percent last year, and anticipates revenue growth of 17 percent over the fiscal year. International Monetary Fund Managing Director Christine Lagarde has praised the government's channeling of investment into infrastructure development and cleanup of bank balance sheets weighted down by bad loans.

The prime minister's sound instincts have been stymied by politics.

Corruption is down after the go-go years of the late Congress Party-led administration, when stunning amounts of money washed through Indian politics. Although not taking the big-bang approach investors had hoped for, the Modi administration has opened key sectors of the economy to greater foreign investment, including defense, manufacturing, insurance, civil aviation, agriculture, and broadcasting. A financial inclusion initiative has given millions of the country's poorest citizens, many resident in the 600,000 rural Indian



Prime Minister Narendra Modi's *"Make in India" campaign seeks to ramp up manufacturing in an agriculture- and services-dominated economy in which factory production generates only about 15 percent of GDP. But changes in the structure of the world economy mean there may not be adequately large export markets for Indian manufacturing to service. India also will have difficulty integrating into global supply chains in manufacturing because of enduring high labor and transport costs, and the country's exclusion from key trade groupings such as APEC and the Trans-Pacific Partnership.*

villages which are un-banked, access to the formal banking system, making them stakeholders for the first time.

Yet despite headline growth figures, all is not well. Exports have fallen for fifteen straight months as global demand contracts. Industrial output has fallen for three months running. Credit growth is slowing as Indian banks grapple with portfolios of non-performing loans that will take years to unwind; many need to be recapitalized with public funds. Worrisomely in a country with India's development needs, capital investment is declining.

Businesses are still struggling with excessive regulation in nearly all sectors, a holdover from the days of the "License Raj." Modi's administration has not privatized underperforming state-own companies. Ironically for a center-right government that campaigned against the welfare-statism of its leftist Congress Party predecessor, Modi's bureaucracy has actually raised subsidies for workers in agriculture and other uncompetitive rural sectors, rather than liberating market forces—although at least these are increasingly being done through direct transfer rather than through the middlemen who formerly skimmed off much of the benefit. Nonetheless, the government's unconvincing campaign to double incomes in the unproductive farming sector by 2022, rather than investing in the more productive urban economy, reflects what the *Business Standard*'s Shekhar Gupta calls "a hard swing to old Congress-style agro-povertarianism."

Modi won a resounding mandate from the Indian electorate in 2014 on a campaign platform of "growth and governance." Yet his record in office is not that of a free-market liberal but of a developmental nationalist who wants to use state power to catalyze growth, including through incremental reform, rather than rolling back the state in big-bang style to free the private sector. Both the Japanese and Chinese models of state capitalism resonate with him, despite the radically different composition of the Indian economy and less supportive global conditions than India's Asian peers enjoyed during their periods of economic takeoff.

Even if it expands substantially, manufacturing may not save India.

Indian Headaches

Low-cost mass-manufacturing employment was key to the development of Asian tiger economies, from Japan and South Korea to Malaysia and China. But changes in the structure of the world economy, including global supply chains centered on China, the advent of innovations such as digital printing, and the "re-shoring" of advanced manufacturing in developed economies like the United States mean there may not be adequately large export markets for Indian manufacturing to service. India also will have difficulty integrating into global supply chains in manufacturing because of enduring high labor and transport costs (India is only 5 percent cheaper for manufacturing than higher-income Mexico), and the country's exclusion from key trade groupings such as APEC and the Trans-Pacific Partnership which are reorienting supply networks and patterns of intra-Asian trade.

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Unfortunately, the prime minister's sound instincts to at least reform the state's administration of the economy, if not to decisively liberate the economy from the state, have been stymied by politics. Although his Bharatiya Janata Party enjoys a majority in the lower house of the Indian parliament, it lacks a majority in the upper house, whose composition is determined by state elections that occur on a rolling basis. Setbacks for Modi's party in the Delhi and Bihar state elections of 2015 did not deliver the upper-house majority he was hoping to assemble to pass meaningful reforms.

Most consequential among these is a nation-wide Goods and Services Tax, which would replace a labyrinthine set of state and local levies that stymie commerce, including through customs-style controls at state borders within India. Implementing GST would be like India doing a free-trade deal with itself. Although the minority Congress Party has so far banded together with regional-party opponents of GST to block its passage, governing officials are hopeful for a political deal on GST this year.

Beyond the low-hanging fruit of GST lies a set of urgent but longer-term imperatives for Indian reform. These are driven by the extraordinary demographics of a country in which two-thirds of the population is younger than thirty-six and half are younger than twenty-five. India's economy needs to generate as many as twelve million jobs annually, or one million new jobs each month, to absorb its growing workforce. No other country faces a challenge on this scale. India's success or failure on this front will determine whether it can power its own Asian economic miracle.

India's workforce was under 500 million in 2005; it will number one billion by 2022. Over the next decade alone, India's economy will need to absorb nearly 350 million new workers, a number greater than the population of the United States. India needs to create nearly 17 percent of all new jobs on Earth every year, given its scale. In fact, India today is producing only a fraction of that number of new jobs in the formal sector of its economy. Recent estimates are that India is creating 5.5–7.0 million jobs (including self-employment) annually, nearly all in the informal sector.

Prime Minister Modi's "Make in India" campaign seeks to ramp up manufacturing in an agriculture- and services-dominated economy in which factory production generates only about 15 percent of GDP. Low-cost mass-manufacturing employment was key to the development of Asian tiger economies, from Japan and South Korea to Malaysia and China. But changes in the structure of the world economy, including global supply chains centered on China, the advent of innovations such as digital printing, and the "re-shoring" of advanced manufacturing in developed economies like the United States mean there may not be adequately large export markets for Indian manufacturing to service. India also will have difficulty integrating into global supply chains in manufacturing because of enduring high labor and transport costs (India is only 5 percent cheaper for manufacturing than higher-income Mexico), and the country's exclusion from key trade groupings such as APEC and the Trans-Pacific Partnership which are reorienting supply networks and patterns of intra-Asian trade.

This leaves India's domestic market, potentially the world's biggest as a new class of consumers rises numbering in the hundreds of millions. Yet India's sheer inefficiencies constitute roadblocks to the country's ability to produce mass employment along these lines. To wit: between 2005 and 2010, when India's economy was growing at annual rates approaching 10 percent, manufacturing, elsewhere a primary generator of employment growth, actually shed 5 million jobs. India's fabled information-technology industry only employs some 40 million workers. Even if the sector grows, it will make only a marginal contribution to India's employment challenges.

Eighty-five percent of Indian manufacturing output comes from micro-, small-, and medium-sized enterprises (SMEs) with fewer than fifty workers. Ninety-five percent of India's SMEs are micro-enterprises; companies are disincentivized to grow by India's punitive labor laws. One solution to India's employment challenge would be to unleash the potential of small-scale enterprises through de-regulation so that they can hire more workers and grow.

Despite its challenges, India does not have high levels of unemployment—the official jobless rate is under 3 percent. This is because more than 90 percent of employment occurs in the informal sector of the economy. Many people in the informal sector are either under-employed or engaged in low-productivity activities like homestead agriculture, shopkeeping, and transportation.

India is the world's fastest-growing major economy.

India also has a low labor force participation rate of only 58 percent. This means that if a million people between the ages of fifteen and fifty-nine enter the picture every month, fewer than 600,000 of them will actually seek employment—one reason why India has stumbled along despite not creating anywhere near the headline figure of twelve million jobs per year. Moreover, the labor force participation rate of Indian women is only 23 percent, putting it on par with socially conservative Middle Eastern countries. One key to development in India is liberating women to work.

Manufacturing employs only 15 percent of the workforce, services employ under 30 percent, and agriculture provides work for 50 percent. Two hundred million Indian workers are self-employed: as Manish Sabharwal, the chairman of Teamlease, India's largest employer, puts it, "The poor cannot afford to be unemployed, so they are subsistence self-employed." Reportedly, 100 percent of net job creation since 1991 has come from the informal sector. This means that the formal sector has actually shed jobs. There is no more damning indictment of India's employment laws.

India's regulatory environment stifles formal job creation—making it almost impossible to fire employees or to grow a business. Aggressively rolling back restrictive employment laws would shift economic activity into the formal sector. Doing so would boost productivity, the long-term driver of economic growth. But the informal sector also has much higher capacity to absorb new entrants to the labor market. Given only marginal job

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growth in the formal sector, it is the informal sector's ability to absorb millions of unskilled Indian workers every year that prevents a social revolution.

Broadly, the services sector is less labor-intensive than the manufacturing sector: every one percentage point growth in manufacturing is estimated to create as many as thirty million new jobs. Every one percentage point rise in GDP directly produces about 1.5 million new jobs. India's increase in economic growth from 4.5 percent under the late Congress Party-led administration to 7.5 percent in 2015 constitutes progress but remains insufficient to absorb all new entrants to the labor force.

India faces a huge and chronic skills shortage. The Indian Institutes of Technology and other stars of the higher-education system are no substitute for the enormous requirement for vocational and skills training. Less than 30 percent of the workforce has completed secondary education, and less than a tenth has had any vocational training. It is estimated that 90 percent of formal-sector jobs in India are skill-based and require some vocational training. Apprenticeships are part of the solution, but India has only 300,000 apprenticeships, as against twenty million in China. So are training programs run by many companies—but these will not fill the gap created by the inadequacies of India's primary education system. Perversely, unemployment levels rise with the level of education, attesting to the lack of high-quality, wage- or salary-paying jobs in the formal sector of the Indian economy.

India's expansion is counter-cyclical.

Given political obstacles to labor law reform at the national level, key reforms that generate greater employment growth will come from the states. States like Gujarat and Tamil Nadu are manufacturing-friendly and attract foreign direct investments that boost employment. States like Rajasthan are experimenting with labor and land reforms that make it easier to do business than neighboring states, with encouraging results thus far. Competition between states could encourage employment-friendly reforms, while India's vast internal market also means workers can move to areas where there is work—as evidenced by the enormous slums in Delhi, Mumbai, and other metropoles, home to workers transitioning from farm to urban employment, albeit in the informal sector.

Building industry clusters—essentially, Special Economic Zones—each focusing on sectors like textiles or electronics could produce significant employment gains. The Delhi-Mumbai Industrial Corridor is one such endeavor. To succeed, however, such clusters must be backed up by sound infrastructure and low government interference. Investing in the soft infrastructure of development—sanitation, clean water, health, and education—will also improve to the quality of India's workforce. Modi seems to understand this with his "Build Toilets, Not Temples" initiative.

Construction has the highest employment elasticity outside of agriculture, with a one percentage point growth in construction increasing employment by more than 1 percent. From 2005–2012, both construction and manufacturing grew by 9 percent annually, but construction added twenty-five million jobs as against only six million in manufacturing. Two in three construction workers are unskilled or semi-skilled, making this a useful transition industry for people coming out of agriculture. In the services sector, India's enormous health and education requirements mean these sectors could absorb far more workers than the vaunted information technology industry.

Even if it expands substantially, manufacturing may not save India: both technological change and restrictive employment laws have encouraged automation (Ford's India factories are full of robots). That said, there is considerable scope for foreign direct investment in manufacturing to make a difference. Taiwan's Foxconn is opening a $5 billion plant in Maharashtra that will create fifty thousand new jobs. Its chairman estimates the company could have a factory in every Indian state within ten years. By 2020 he hopes to create one million new jobs in India.

Ultimately, as in other areas, India is likely to find a uniquely Indian solution to its employment challenges. They are daunting; but given good governance, there is no cultural or geographic reason India cannot move up the development curve like the many Asian tigers before it. Indian growth should be powered by the country's extraordinary demographic dividend, a vast internal market, and the ample productivity gains available to an economy with yawning infrastructure requirements and a per capita GDP that is only 11 percent of America's. If the next twenty years of growth in India look anything like the last twenty years of modernization in China—albeit in very different domestic and global contexts—the South Asian giant unquestionably will emerge as a powerful engine of the global economy. ◆