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Allianz Research

India: A rising star

Executive Summary

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By 2030, India will be the second-largest economy in the Asia-Pacific region as strong macro-fundamentals and an improving business environment drive investment-led growth. Increased bank lending and capital expenditures from firms coupled with improving business conditions, are promising signs to accelerate economic growth in India. Moreover, the growing role of services and India's diversification out of the ICT sector will provide a competitive advantage, while India's manufacturing sector is also set to grow. We expect India's economic growth to average around +6.3 % p.a. until 2030, primarily driven by investments and consumer spending, and inflation to average around 4.8% p.a. well within the Reserve Bank of India's target range of 2-6% between 2021-2030. This rosy macroeconomic story is clouded with managing transformations which are game changers for the world, and for India: globalization, demographics, climate change, AI and technology, and conflictuality to name a few.

Five game-changers will shape India's mid-term economic outlook: foreign investment, trade, human capital, climate change and geopolitics. Each of them calls for an active and differentiated policy stance for India to make the best out of these transitions.

- **Foreign investments must become an even stronger growth driver.** Taking advantage of the geopolitical tailwinds and the growth differential with the rest of the world, India's capacity to attract foreign capital will be pivotal. The continuation of liberalizing reforms and an orderly internationalization of capital markets will be crucial for absorbing and harnessing large amounts of foreign investments.

- **Significant trade potential can be unlocked by reducing protectionist measures and making stronger alliances.** The average trade tariff stands at a high 18.1%, more than double the average of its main peers and compared to just 7.5% in China. Reducing tariffs to the average of its peers would mean USD80bn of additional exports to India per year, especially as only 3% of Indian consumer goods are imported today. By capitalizing on India's growing role on the international stage, increasing the number of free-trade agreements can enhance its position in global supply chains.

- **Demographics will be advantageous to India's growth story if coupled with policy reforms targeting broad measures of human capital development while keeping in mind regional disparities.** Artificial intelligence capabilities can play a crucial role in driving economic growth by enabling technological innovation, job creation, automation and global competitiveness, especially in sectors such as health care and education. From 2025 onwards, India will overtake China as the country with the largest labor force in the world, with the number of people aged between 15 and 64 expected to surpass the one billion threshold in 2026 — and remain above that mark until 2075. Though the average life expectancy at birth is set to increase from 67.7 years today to 77.9 years in 2050, and to surpass 80 years in 2062 in line with further improving living standards, India will continue to have a rather young population, with the share of people aged 65 and older remaining below 30% until the end of the century. However, the demographic dividend is already set to fade within the next ten years: The total dependency ratio is likely to start increasing from 2032 onwards, though it will remain below 50% until mid-century. To profit from its demographic dividend, India needs to implement further labor market reforms, especially to address a youth unemployment rate that is one of the highest in Asia. In the last decade, AI investments in India have soared, ranking the country sixth in the world (around EUR3.1bn, according to the AI Index Report from Stanford). In 2022, there were 57 newly funded AI companies in India. These and other developments, such as growth in research and development could make India a competitive and important AI player globally. However, low literacy rates and a fierce brain drain pose significant challenges to this technology revolution in India, which policymakers have to tackle urgently.

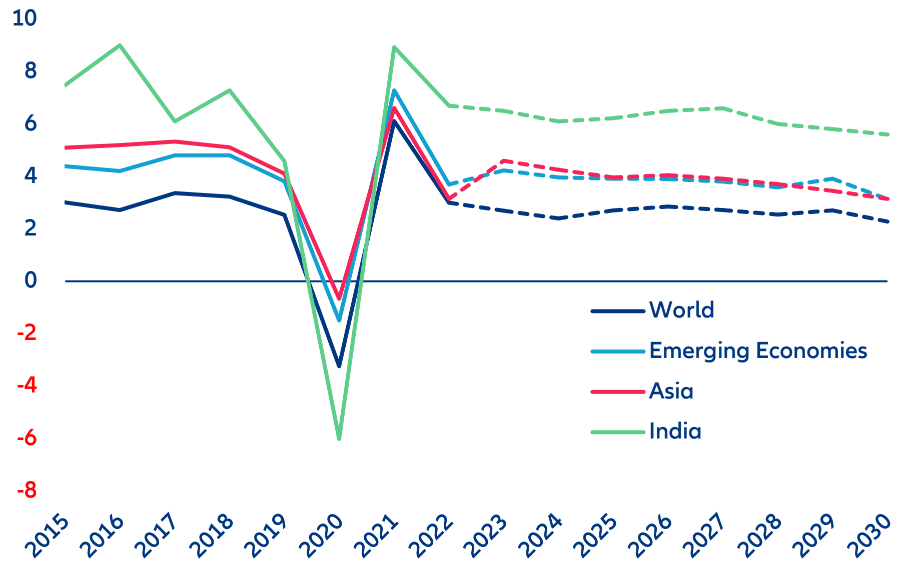
- **Climate change can be costly to the Indian subcontinent and poses a risk to the otherwise favorable long-term growth outlook.** Heat waves have already led a large number of deaths in India and put at risk the large share of the population employed in outdoor work in sectors such as construction which have limited access to affordable cooling infrastructure. While India lags behind its neighbor China in terms of mitigating the impact of climate change risks on GDP and its population, it is actively working towards reaching net zero in 2070, implementing measures such as waiving off transmission charges to attract investment in renewable energy especially in wind and solar..

- **India finds itself in a challenging (geo)political environment but stands to gain from its growing importance.** The Indian government has started to prepare for the 2024 elections but the risk of fiscal slippage remains contained. On the global stage, India tends to align more and more with the US although it has tried to maintain its historical stance of non-alignment and possesses the diplomatic power to be the bridge between the Global South and the West. Yet, its growing importance must be analyzed from a multidimensional perspective due to the growing costs and tensions to neighboring regions.

The new growth engine in Asia

Despite a moderation in 2023, India's economy remains resilient and outperforms that of its peers. Despite an expected slowdown in global growth in 2023 and rising geo-political tensions, the Indian economy has shown great resilience, consistently outpacing the average growth rate among emerging economies and Asian economies since 2021 (Figure 1). For FY23-24 (April 2023 to March 2024), we expect India to grow by +6.5% y/y – almost twice as high as the average growth rate in emerging economies and significantly higher than the average for Asia. The first quarter of FY23-24 (April-June) saw growth of +7.8% y/y, primarily driven by investments and private consumption, with a strong boost from the services sector. Only net exports showed some signs of weakness in the first quarter, in particular trade in goods. Early indicators including Purchasing Managers Indices (PMIs) suggest that demand in both the manufacturing and services sectors continued to accelerate through the second quarter of FY23-24.

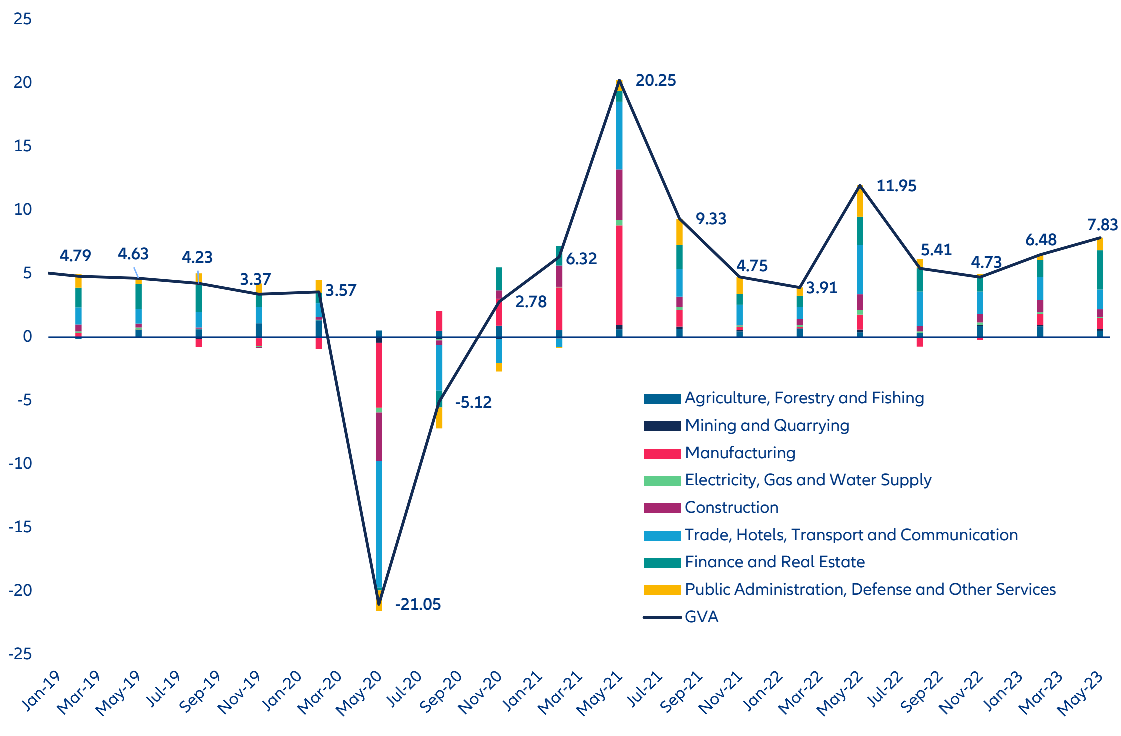
Figure 1: Real GDP growth, % y/y



Sources: Refinitiv Datastream, Allianz Research

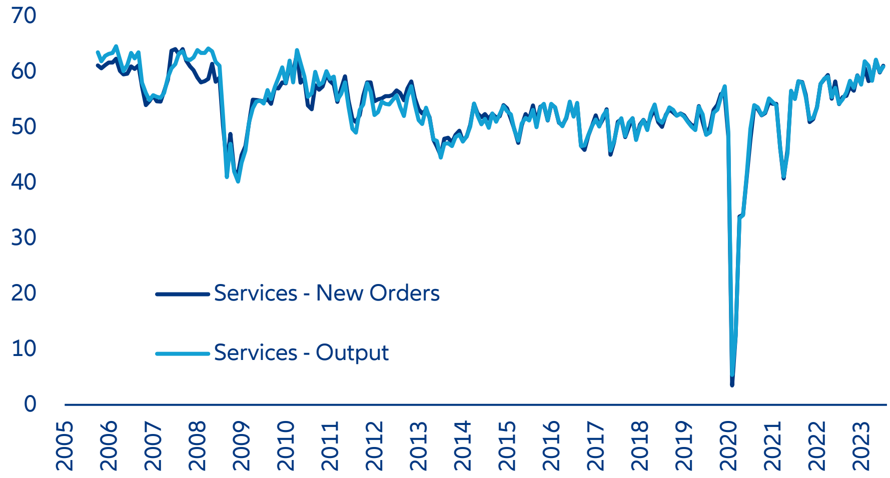
The services sector continues to be the main driver of growth, accounting for more than 50% of GDP. Diversifying away from traditional labels such as 'the hub of call-centers and IT solution providers', India is experiencing rapid growth and a structural transformation in the services sector. In terms of gross value added, finance and real estate services, public administrative and defense services and high-contact services such as services in trade, hospitality and communication were the largest contributors to growth in the first quarter of FY23-24 (Figure 2). Highlighting the strength of the services sector, the services PMI averaged at 60 over the first two quarters of FY23-24, well above the value of 50 that distinguishes between a phase of expansion and contraction, with a growth streak that has not been seen in the last 12 years (Figure 3). Moreover, the share of services in India's total exports has been gradually rising and stands at 43% as of August 2023 – this significantly contributed to India's resilience amid difficult external conditions, thanks to the resilience of the global services sector.

Figure 2: Growth in gross value added by sector, % y/y



Sources: Refinitiv Datastream, Allianz Research

Figure 3: Rapid expansion in the services sector



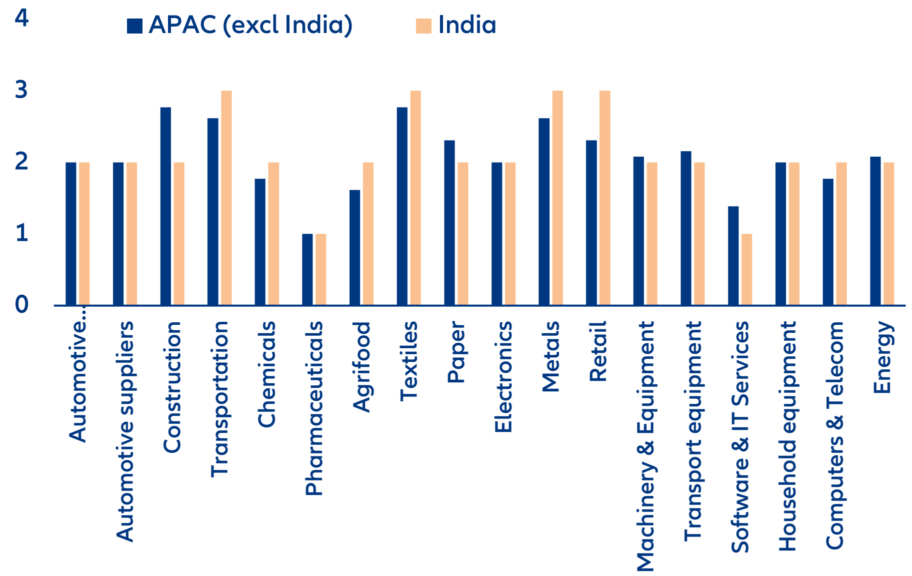
Sources: Refinitiv Datastream, Allianz Research

The pace of growth and structural transformation in the services sector has multi-dimensional implications for the economy. Developments in the services sector can lead to knowledge spillovers, increased labor productivity and domestic development in terms of improved access to healthcare, finance and a better standard of living. The case of Global Capability Centers (GCCs) is a prime example, with India home to the largest share of GCCs in the world. GCCs were initially set up by multinational firms to cut costs by outsourcing functions such as software and IT services. However, their roles have evolved over time and they contribute higher value-added services to their parent companies, such as R&D, design and auditing. GCCs have also contributed to India's growth through employment generation, spillovers of global best practices and development of labor productivity[1].

Indian corporates are often stronger than their peers in Asia. The overall non-payment risk in the next 6 to 12 months for sectors stands at an average of 2 (Medium), in line with the APAC average. Out of the 18 sectors we monitor, six are better ranked than the APAC regional rating: construction, machinery & equipment, transport equipment, software and IT services, energy and paper (Figure 4). In addition, India stands out for its shorter payment terms than most countries in the APAC region, with the notable exception of Australia. The latest financials show that Days Sales Outstanding (DSO) stand at 56 days of turnover on average, compared to 63 days globally and 66 days at the regional level (in China they stand at 75 days). In addition, India shows a low share of longer payment terms, with 42% of firms being paid after 60 days compared to 46% globally and 49% regionally. Yet, this average performance reflects two main types of payment behaviors: on one hand, shorter DSOs in construction and industries such as automotive, chemicals, electronics, metals, paper, machinery and transport equipment; on the other hand, longer DSOs in retail, textiles, hospitality, transportation and services (both B2B and B2C). India also stands out with a lower level of Working Capital Requirements (WCR), which means less financing needs at the national level, with average WCR standing at 75 days of turnover compared to 84 days globally and 89 days at the regional level. Importantly, India is 'outperforming' the region for all non-financial sectors, with retail, energy and to lesser extent agrifood and IT services as exceptions. Moreover, while business insolvencies did rebound from the 'artificially' low number of cases recorded in the wake of the Covid-19 outbreak (+10% and +52% in 2021 and 2022, respectively), they have not returned to 2019 levels. The latest figures show a recent boost of insolvencies in real estate and to a lesser extent construction that should contribute to a broadly stable number of cases for the full year 2023 (around 1,250 business insolvencies). At this stage, we expect a moderate upside trend for 2024 and 2025 (+5% and +3%, respectively) that would still leave the annual count well below the pre-pandemic level (1,350 cases in 2025 compared to 1,927 in 2019).

[1] https://www2.deloitte.com/ch/en/pages/strategy-operations/articles/global-capability-centres-value-proposition.html

Figure 4: Sector risk ratings, 1 = very low risk of non-payment in the next 6 to 12 months and 4 = very high



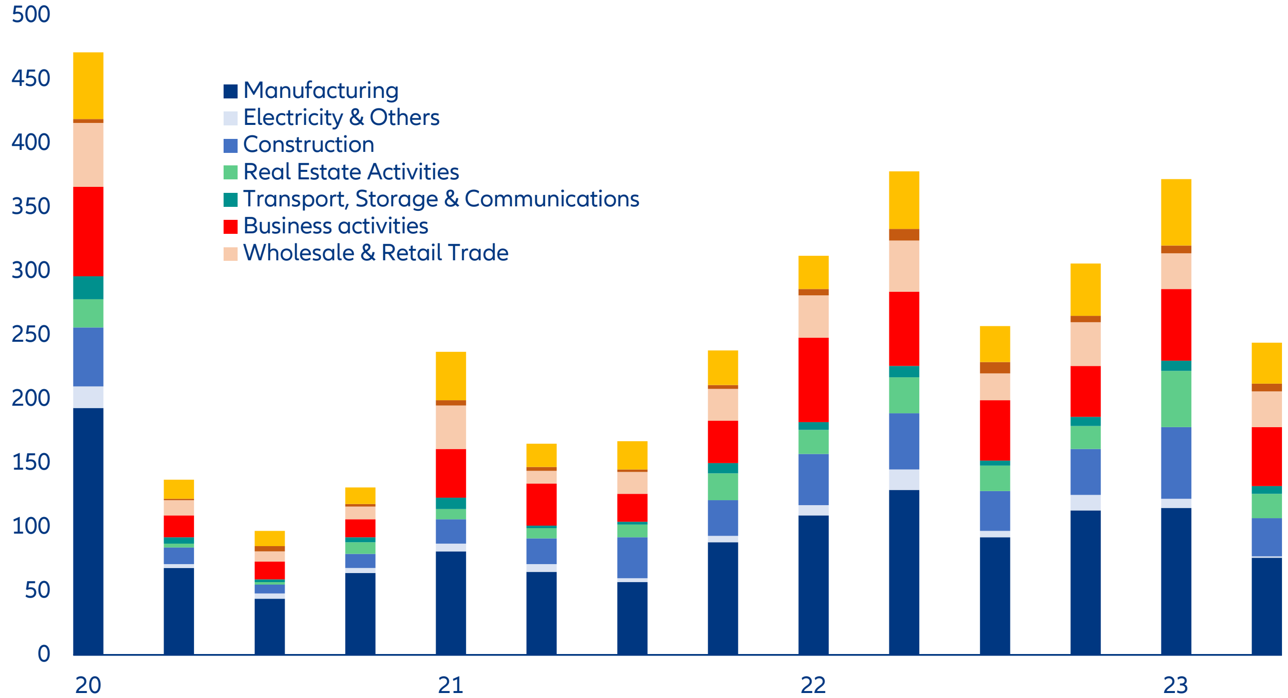
Source: Allianz Research

Figure 5: Working Capital Requirement (WCR), by sector, listed firms, Q1 2023 financials

	India	APAC	Global
Agrifood	**70**	68	67
Automotive	**55**	77	73
Chemicals	**76**	91	89
Commodities	**23**	57	44
Computers & Telecom	**99**	114	109
Construction	**76**	89	87
Electronics	**107**	133	128
Energy	**58**	36	35
Household Equipment	**96**	104	101
Machinery & Equipment	**91**	129	125
Metals	**71**	99	95
Paper	**59**	67	67
Pharmaceuticals	**102**	111	107
Retail	**68**	40	40
Financials services	**69**	62	61
Hotels & Restaurants	**7**	12	13
Other B2B services	**55**	58	59
Other B2C services	**29**	30	32
Software & IT services	**68**	67	64
Textiles	**92**	99	100
Transport	**24**	29	27
Transport Equipment	**131**	159	134
All sectors	**75**	89	84

Sources: Eikon/Refinitiv, Allianz Research

Figure 6: Business insolvencies by sector, quarterly numbers

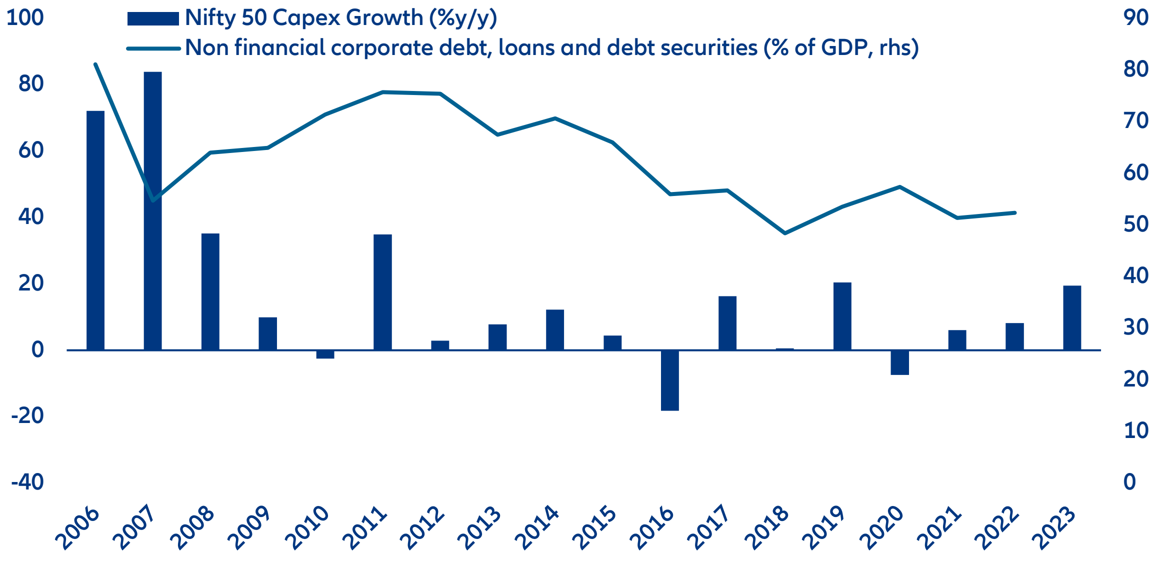


Sources: IBBR, Allianz Research

Deleveraged firms stand ready to increase their domestic investment and to meet rising demand. After a prolonged period of weak capital-expenditure growth between 2012 and 2021, corporates have begun to increase their spending and we expect this to accelerate further to meet rising domestic and foreign demand. The non-financial sector, particularly the private non-financial sector, has also deleveraged and its strong balance sheets reveal the ability to take on more debt. Over 10 years, non-financial corporate debt, loans and debt securities have decreased from 75% as a share of GDP in 2012 to 52% in 2022 (Figure 7). The significant +37.4% increase of government capital expenditure in FY23-24[2] from the previous year should induce additional private investment through investments in the workforce and infrastructure through public-private partnerships. Additionally, incentives from the government such as the extension of 50-year interest-free loans to state governments[3] by one more year will be an added tailwind for incentivizing and accelerating private investment.

[2] https://pib.gov.in/PressReleasePage.aspx?PRID=1895279
[3] Government to continue 50-year interest-free loans to states for another year

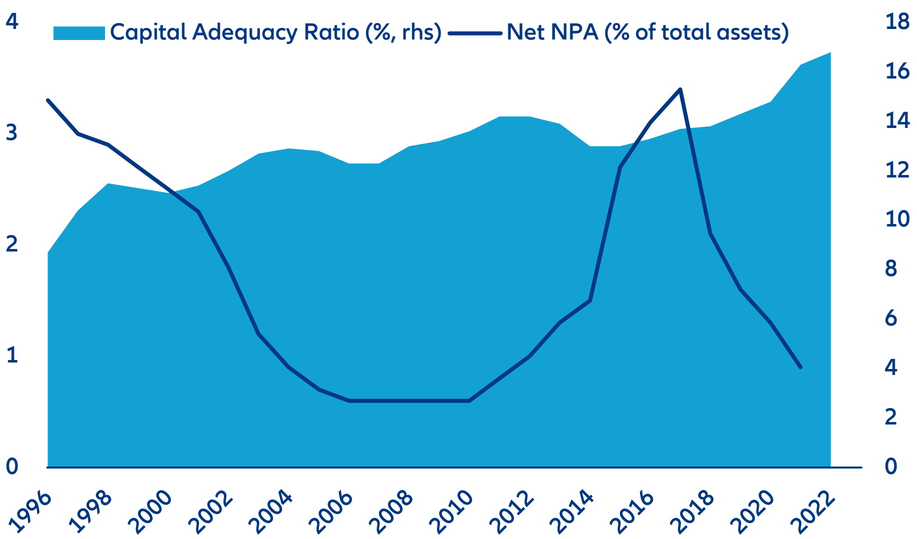
Figure 7: Capital expenditure growth of the 50 largest Indian companies listed on the national stock exchange and total non-financial corporate debt



Sources: Bloomberg, IMF, Allianz Research

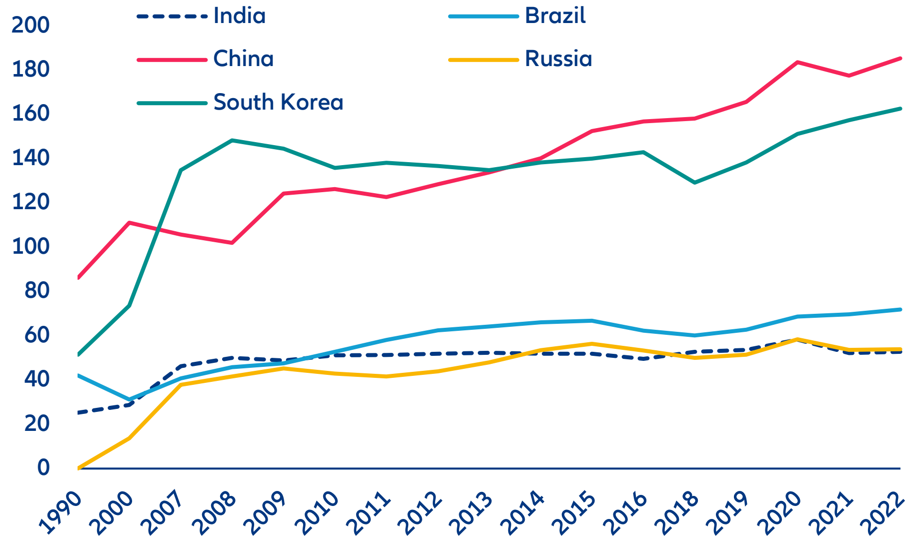
Domestic banks are well positioned to increase lending after a government cleanup of bad loans since 2014-15. After peaking at 3.4% in 2017, the percentage of non-performing assets relative to the total assets of scheduled commercial banks (SCBs) in India have progressively declined and remained at less than 1% in 2021. Moreover, with a strong and growing capital-adequacy ratio, banks in India continue to exhibit promising signs of resilience against financial stress: The capital adequacy ratio for SCBs has risen steadily since 2013 and rose to 16.8% in 2022 from 16.3% in 2021. (Figure 8). This should set the stage for increased credit to the private sector from current low levels (Figure 9).

Figure 8: Balance sheet indicators of domestic banks



Sources: Refinitiv Datastream, Allianz Research

Figure 9: Domestic credit to the private sector, % of GDP



Sources: World Bank, BIS, Allianz Research

However, India will not be the next China, at least in the medium term. China is currently five times larger than India in terms of economic output and we do not expect India to be the next China for the following reasons: first, India cannot replace China as the world's manufacturing hub. China currently accounts for 30% of the total global value added from manufactures whereas India's manufactures account for only 3% of the total global value added. Additionally, India is reliant on China for critical imports such as semiconductors and pharmaceuticals. Second, India lags behind China significantly in terms of infrastructural development. For instance, the length of rail lines grew by +68% in China between 2008 and 2021 while it grew by a mere +6% in India. Third, China is ahead of India in terms of research and innovation. In 2021, 26 267 patent applications were filed by residents in India, while China had crossed this threshold 20 years earlier in 2001. In fact, non-resident Indians filed for more patent applications than residents, highlighting that significant talent and potential lives outside the Indian borders. Fourth, institutions and bureaucratic barriers including corruption cause significant delays in the creation of goods, services and thereby revenues. Structural differences in the strength of the labor force are also part of the many reasons that limit India's chances of replacing China - first, the female labor force participation rate is almost three times higher in China relative to India and second, low literacy rates in India limit the number of job-seekers available for vocational work especially in the manufacturing sector.

Five game-changers for India's medium-term outlook

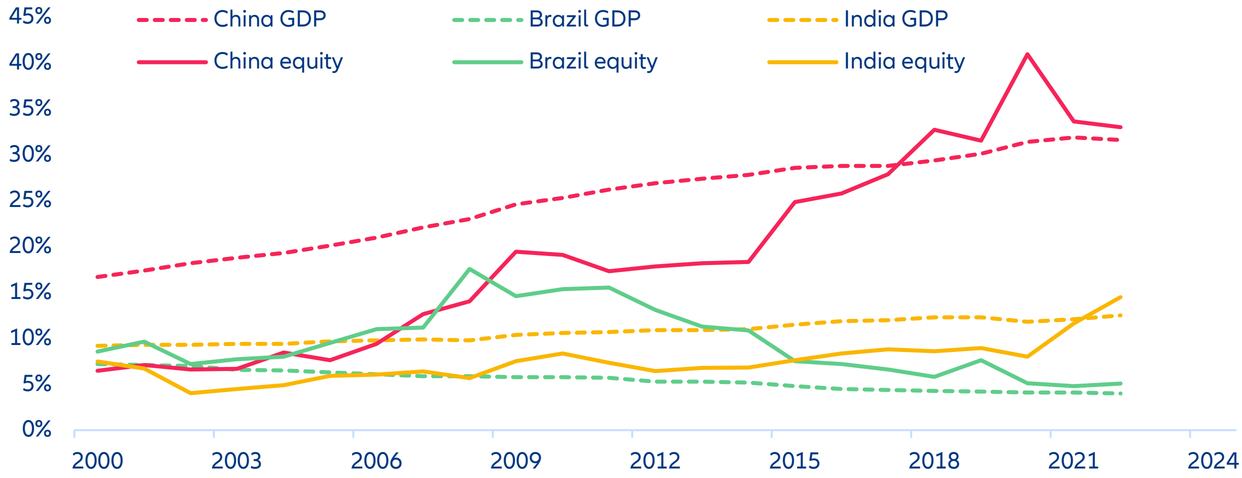
Foreign investments will remain a key growth driver

Taking advantage of the geopolitical tailwinds and the outstanding growth forecasts, India's capacity to attract foreign capital will be pivotal. This applies not only in terms of Foreign Direct Investments (FDI), of which India is already an important recipient, but also in boosting the functioning of its still underdeveloped capital markets, where foreign investors still play a minor role.

In spite of the recent expansion of India's capital markets, there is a lot of potential to tap. In terms of size, India's capital markets are among the largest, but their relative international importance is low even when compared to other EM peers. While progress has been made, as proven by the recent approval to be included in the JPM major local currency EM sovereign bonds index[4], India's capital markets still face challenges in becoming as internationally integrated as those of some other major economies. One major issue is India's historically low level of internationalization due to factors such as foreign-ownership restrictions, taxation complexities and currency controls, which have deterred foreign investors. However, India has been actively working to increase the internationalization of its capital markets by implementing reforms such as the Foreign Portfolio Investment (FPI) route, easing restrictions in certain sectors, and trying to boost international financial centers such as GIFT City[5].

[4] Read our analysis on what this means for India's bond market here: What to watch I October 13, 2023 (allianz.com)
[5] GIFT city (Gujarat International Finance Tech city) refers to India's ambitious project of establishing a fintech hub that eventually becomes a global financial center.

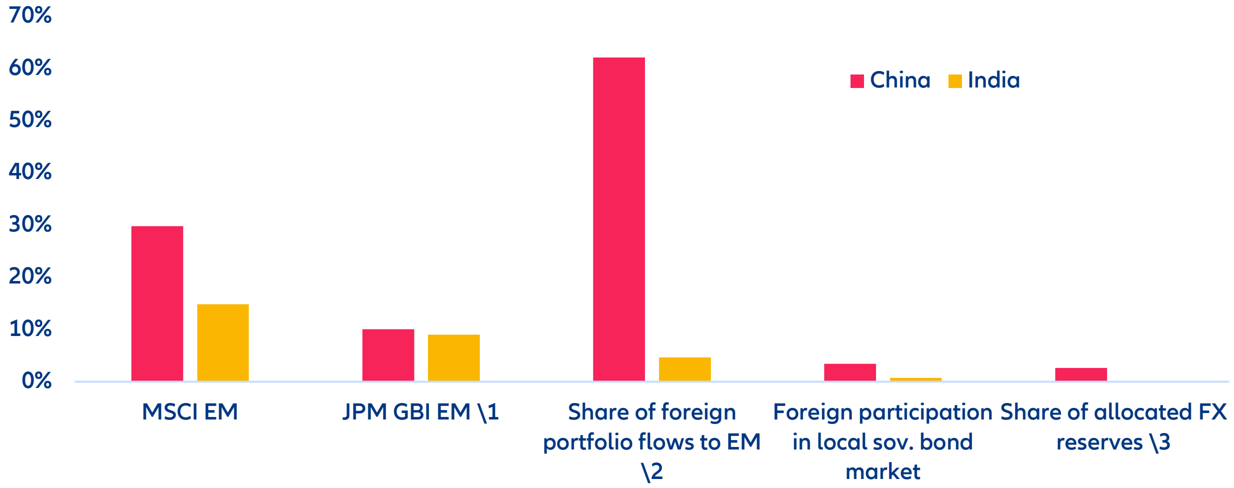
Figure 10: Share of equities and GDP in India, China and Brazil



Sources: MSCI, LSEG Datastream, Allianz Research. Note: the shares of EM GDP are calculated as a % of the GDP of all EMDEs combined, while the MSCI only include a handful of EMs.

The current environment offers multiple advantages for India, but being 'the new China' is not the right target. China's financial markets are larger, deeper and more developed than India's, and have benefited from the support of a financially much stronger government, as well as a currency with growing global importance (Figure 11). For now, India should focus on improving elements such as market liquidity (especially in the bond market) and currency convertibility, addressing regulatory complexity (including taxes and cross-border investment regulations) and preventing disorderly growth of its markets that could lead to financial (and real estate) bubbles or, worse, the deterioration of foreign confidence. The lingering clouds over one of India's major conglomerates may actually turn out to be a timely reminder of these risks, at a time when India has been overperforming global equity markets. The competition for foreign investment will be fierce as other financial hubs such as Singapore, Hong Kong, Shanghai and the UAE are already well-positioned in terms of infrastructure, regulatory environment and market access, while Latin America and Indonesia's attractiveness is growing again, offering diversification in terms of growth opportunities.
But China does not need to be the goal in any case as events since 2021 have proven. The continuous frictions between some degree of free enterprise and state control have not played out well for many companies aiming to expand abroad and left cross-border investors in a highly uncertain situation. Investors will be more wary about these risks.

Figure 11: Comparative analysis of the weights of India and China in key financial indicators

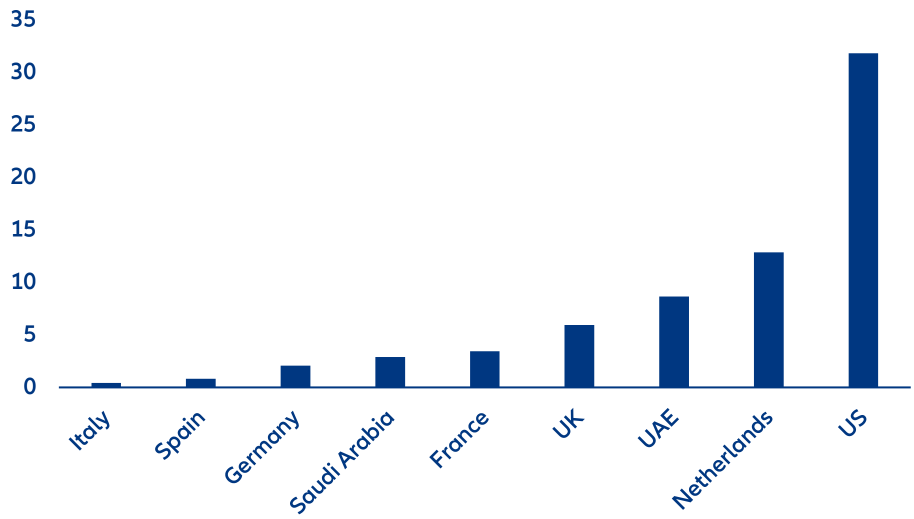


Sources: IIF, LSEG Datastream, Allianz Research. Notes: \1 India's inclusion approved but to start only in June 2024, it would only attain the % showed in early 2025. \2 Calculated as the share of accumulated foreign portfolio flows to all EMs reported by the IIF. \3 INR is not reported separately.

Nonetheless, India is on a good track in terms of foreign direct investment (FDI) inflows, which have been rapidly increasing since the country launched economic liberalization reforms in 1991. Total FDI flows to India have increased by about 550 times from USD0.13bn between 1991-1992 to USD71bn between 2022-23. FDI flows between 2019 and 2023 signal increasing interest from the West (Figure 12) and strategic partners in the Middle East – some of the largest flows of FDI came from the US (USD32bn), the Netherlands (USD12bn), the UK (USD6bn) and France (USD3bn) in the West and from the UAE and Saudi Arabia in the Middle East. Our forecasts of export gains for 2024 (Figure 13) highlight the importance of these economies as strategic export markets for India and the relevance of the India-Middle East-Europe Economic Corridor (IMEEC) for India. With Indian demographic dynamics and non-oil trade relations contributing to increased interests, the UAE is considering investing close to USD50bn in India primarily in infrastructure and state-owned assets, although the exact timeline size of investments has not been finalized. Apart from the economic benefits that will be enjoyed by India, if concrete announcements are made before the 2024 elections, it can be a further boost to the popularity of the Bharatiya Janata Party (BJP) that currently rules the central government.

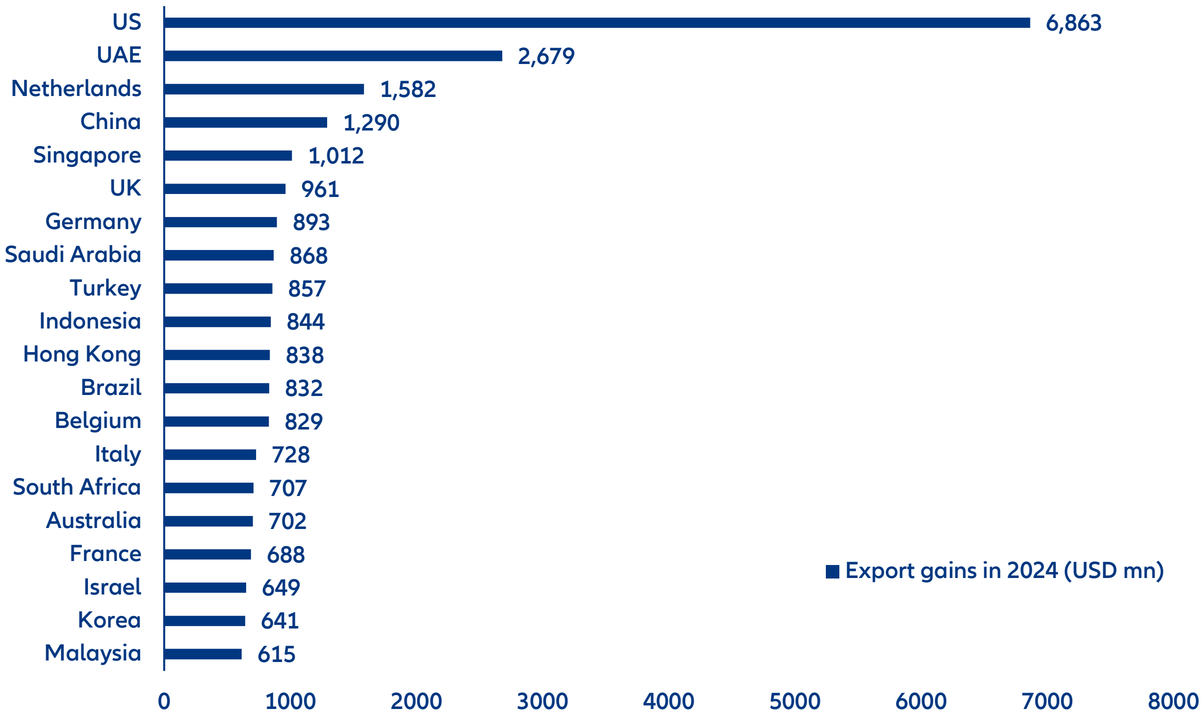
From 2014 onwards, policies incentivizing domestic production capacities reinforced the liberalization process and eventually also led to an improving business environment, further enhancing FDI inflows. The first two decades of liberalization had focused on attracting FDI, mainly through trade and capital market reforms while the overall business environment had remained relatively weak. This changed with the "Make in India" campaign and the "Ease of Doing Business Plan" introduced in 2014. Since then, government policies have focused on improving the environment for domestic manufacturing. A number of indicators suggest that this has been successful. The World Bank's annual 'Ease of Doing Business' surveys show that India hovered between rank 122 and 142 out of over 180 economies from 2006 to 2017 and then experienced a rapid improvement to rank 63 in 2020. Likewise, after remaining stable for two decades, some of the World Bank's annual 'Worldwide Governance Indicators' experienced a significant improvement following 2014, namely political stability and the absence of violence, government effectiveness and regulatory quality (Figure 14). That said, the latter survey also shows that there remains a lot of room for further improvement, especially with regard to the rule of law and control of corruption. Nonetheless, the enhanced business environment has gone hand-in-hand with intensified FDI inflows over the past decade (Figure 15).

Figure 12: FDI flows to India from 2019-2023, USD bn



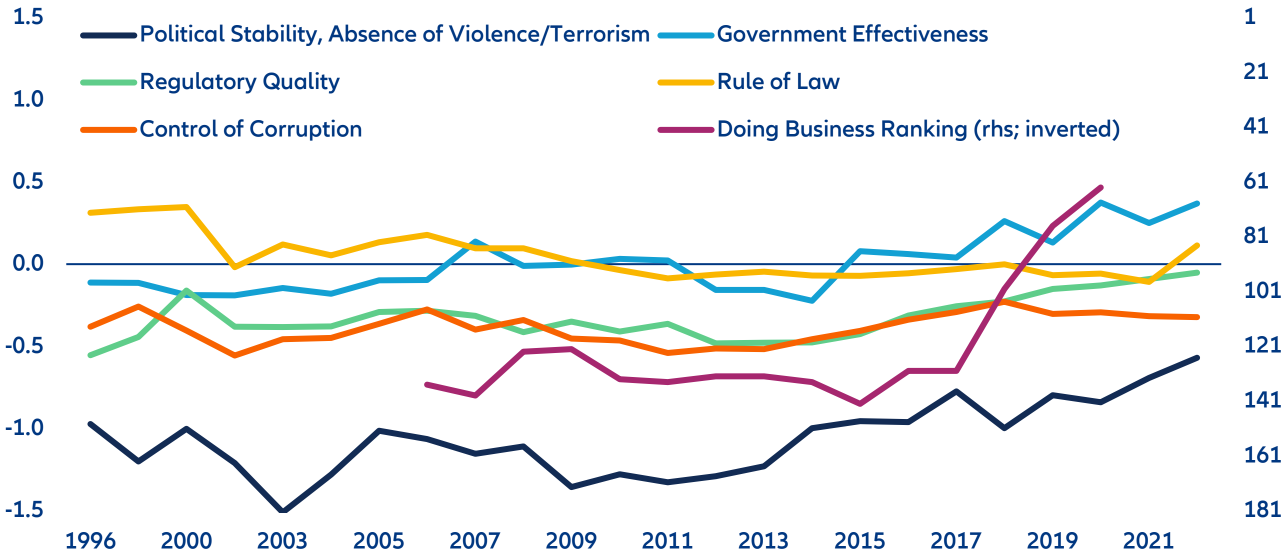
Sources: Refinitiv Datastream, Allianz Research

Figure 13: Forecasts of export gains for India in 2024



Sources: Refinitiv Datastream, Allianz Research

Figure 14: Selected business environment indicators for India



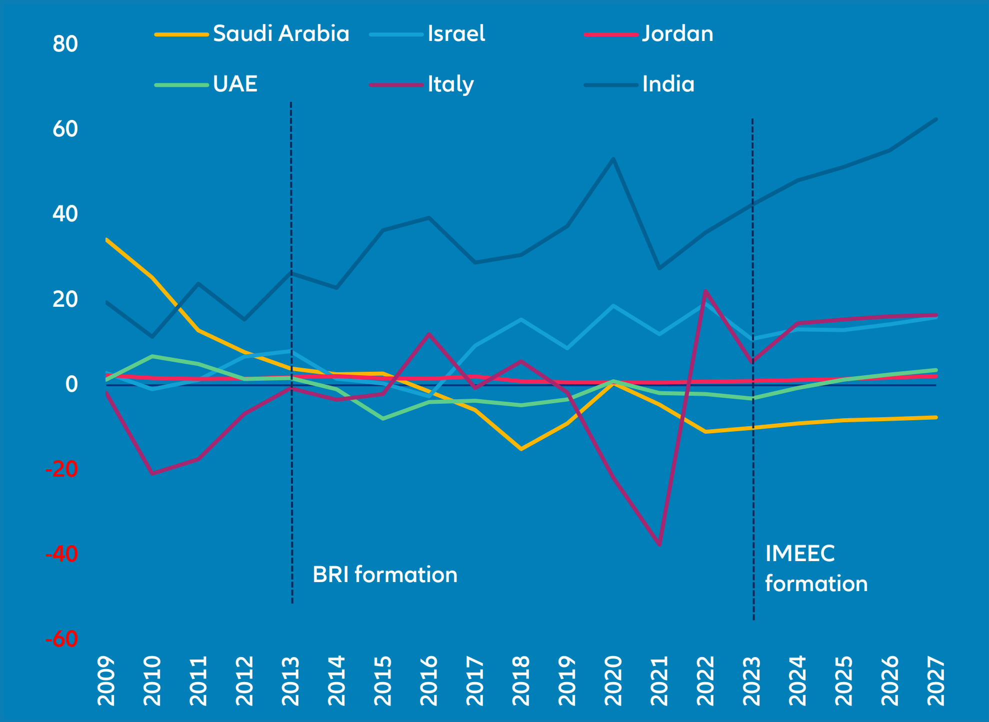
Sources: World Bank, Allianz Research
Note: The five governance indicators (Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law, Control of Corruption) range from approximately -2.5 (weak) to 2.5 (strong). The Ease of Doing Business Rankings for 2006-2008 have been recalibrated to take account of the smaller number of countries in the surveys of those years.

The bridge between Asia and Europe – the India-Middle East-Europe economic corridor faces challenges ahead due to the Israel-Hamas conflict.

A promising trade route that will connect India and Europe. With the objective of accelerating trade and securing supply chains, and to improve economic integration among participating members, a memorandum of understanding for the creation of an economic corridor was signed by leaders of Saudi Arabia, the UAE, India, the EU, France, Germany, Italy and the US in New Delhi at the G20 summit. The proposed corridor, often looked at as a counter to China's 'Belt and Road Initiative (BRI) is set to bring India to a key position in terms of geo-politics and global trade, and will significantly increase trade potential going forward. For instance, the transport time between India and Europe is estimated to be reduced by -40% through this corridor[7]. It is also expected to accelerate inflows of foreign investment to India (Figure 15). Apart from benefits in terms of trade and finance, it was set to enhance geopolitical ties, especially between the US, Israel and Saudi Arabia, until the recent conflict between Israel and Hamas cast a shadow over this ambitious project.

[7] The Economic Times

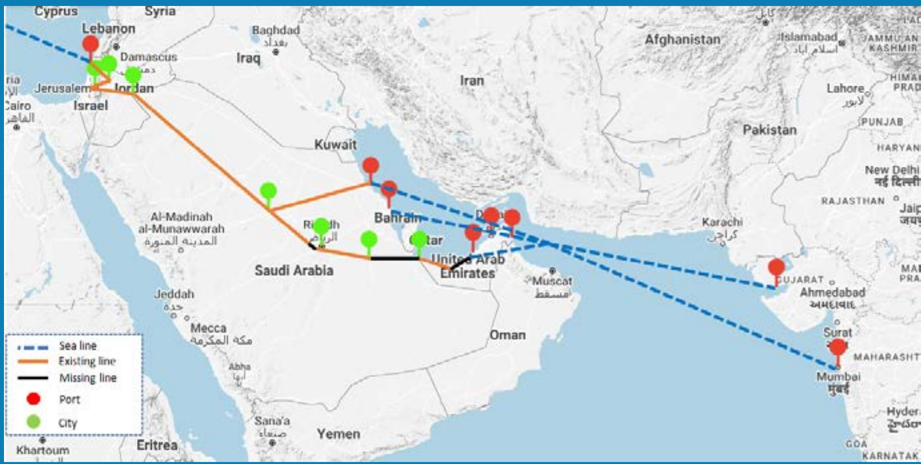
Figure 15: Net inflows of foreign investment, USD bn



Sources: Refinitiv, Allianz Research

IMEEC was welcomed by India and its partners as a major change in the Eurasian power equation, limiting China and turning the momentum back to India and the West. The signatories to the IMEEC agreed to convene in November to announce an action plan. To complete the program, an investment of over USD17bn is deemed necessary. In the midst of the frenzy, more prudent voices went mostly unnoticed. The latter warned against unreasonable expectations in light of prior Western infrastructure programs such as the American BUILD and Build Back Better World programs, the EU's Global Gateway and the G-7's PGII. They all have failed for now in mobilizing the necessary investments to seriously challenge the BRI. While the details are still being worked out, the investment required for IMEEC is still uncertain. Furthermore, transport economists cited potential logistical issues as a result of products having to be reloaded twice: first from ships to railways and again from railway to ships. Transport time savings of up to 40% do not necessarily make trade more cost-effective than the traditional Suez Canal route. Exposure to developments on the Hormuz Strait and the fact that the main port of call on the European mainland would be Athens' Piraeus (controlled by China) seem to lend little credibility to the route.

Figure 16: India-Middle East-EU corridor options



Sources: Google Maps, National sources, Allianz Research

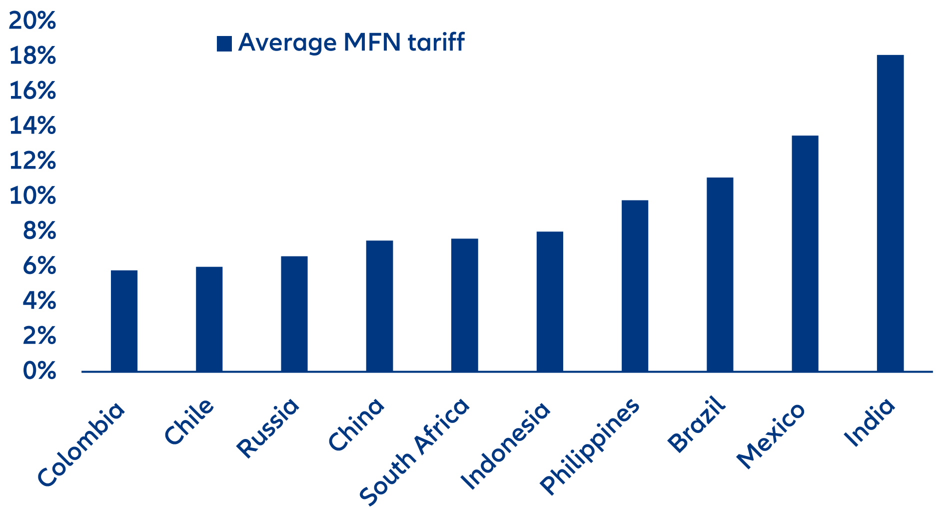
The conflict between Israel and Hamas will likely slow progress. Despite not having formal diplomatic relations historically, an added benefit from the IMEEC corridor was the potential of improved geo-political ties between the US, Israel and Saudi Arabia. But the current conflict in Gaza is likely to delay the progress of this ambitious project. If the conflict escalates further, there do not seem to be alternative routes. First, the Haifa port owned by an Indian conglomerate is located in Israel, which is a key component to connect India and Europe. Second, alternative routes through Iraq and Turkey are likely to be costlier due to factors such as poor infrastructure and high levels of insecurity in these regions.

Unlocking India's trade potential: A lot remains to be done

India remains one of the most protectionist emerging economies, with average customs duties more than double those of its emerging market peers. Like China or Brazil, India's exports to the EU and the US face customs duties of 4.4% and 4.3% on average, respectively. But India's average trade tariff on imports stands at more than double the average of its peers at 18.1%, compared to just 7.5% for China for example (Figure 17). If India brought its average tariff down to the level of its peers, it could see an additional USD80bn of exports per year, especially as only 3% of consumer goods are imported today. In addition to high tariffs, non-tariff trade barriers in the form of anti-dumping measures, trade finance, local value-added incentives and tax-based export incentives have hit trade partners such as China, the US, Germany, the UK and France the hardest. Between 2008 and 2023, India announced 1,890 such interventions, out of which 1,033 are still in effect. This shows that there is still room to improve India's protectionist stance[8]. In the same period, Brazil announced 1,524 measures, while Malaysia announced 289, Mexico 288 and Thailand 192. On the bright side, the number of measures being announced in India every year has been declining since 2020.

[8] Global Trade Alert

Figure 17: Average Most Favored Nation (MFN) tariff on imported goods by country

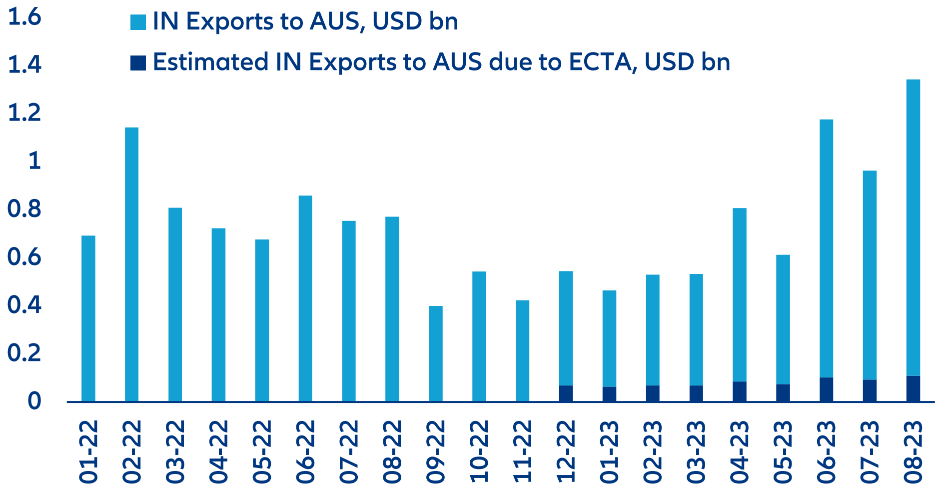


Sources: WTO, Allianz Research

India can capitalize on its strategic position by increasing the number of Free-Trade Agreements (FTAs) to induce significant trade benefits. Between 1998 and 2011, India signed multiple FTAs but they were mostly focused on Asia, including countries such as Sri Lanka, Afghanistan, Thailand, Singapore, Bhutan, Nepal, South Korea, Malaysia, Bhutan and Japan[9]. Recently, India has begun negotiating FTAs with countries in the West such as the UK, Canada and Israel, highlighting a significant divergence in its foreign trade policy[10]. The UK is the seventh largest export market for India; reducing the average tariff faced by India's exports to the UK from 3.5% to below 1% could bring annual export gains of around USD400mn, on top of the USD11bn of annual total exports to the UK. As of today, there are 13 FTAs in place, with the most recent agreements made with the UAE (the Comprehensive Economic Partnership Agreement) and Australia (the Economic Cooperation and Trade Agreement - ECTA). Our estimates suggest that the ECTA has led to an additional USD0.7bn in total Indian exports to Australia so far (Fig 18) and should continue to increase going ahead, given the reduction in average custom duties from 7.2% to 1.1%. Overall, Indian exports to Australia increased by close to 20% in 2022. Further, the tariffs imposed by India on Australian exports will be close to 0% by 2026.Looking ahead, increasing awareness of FTAs among exporters and addressing shortcomings in future bilateral and multilateral trade agreements (such as widening the scope to include a larger share of trade in services, for example) can bring even greater benefits to India.

[9] Indian Economic Survey 2015-16, Chapter 8
[10] Free Trade Agreements (FTAs) by India: Review and Implications for Future (Divesh Pandey and Meera Unnikrishnan)

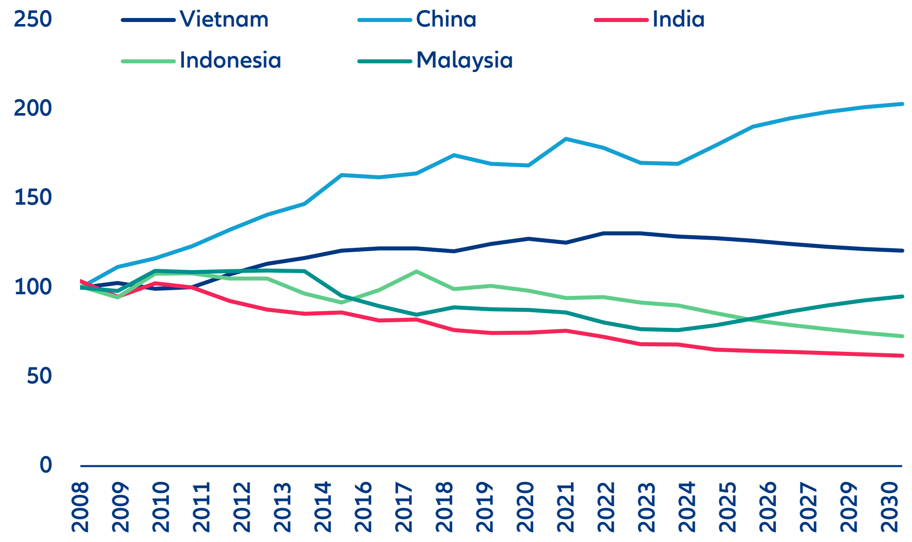
Figure 18: Indian exports to Australia



Sources: Reserve Bank of India, Allianz Research

India could be China's plus one. Firms around the globe aiming to diversify away from China to reduce costs and increase supply chain resilience also known as the China-plus-one strategy, can be leveraged by India to attract significant benefits, mainly through the revitalization of the manufacturing sector. India's talent pool and demographic advantages coupled with lower unit labor costs relative to its Asian neighbors (Figure 19) make it an attractive choice for re-shoring operations. Moreover, economic reforms and initiatives by the government to revitalize the manufacturing sector such as the Production Linked Incentive – a scheme that incentivizes firms to increase domestic production – will be contributing factors for multinational firms to choose India to be China's plus one. The share of high and medium skill-intensive manufacturing sectors out of the total was 64% in India in 2022, and grew by +5pp from 2016, outpacing China, Malaysia, Indonesia, Thailand and Vietnam in terms of growth. Through knowledge spillovers, efficiency gains and innovation, high and medium skill-intensive manufactures can further accelerate the manufacturing sector in India.

Figure 19: Unit labor cost, index (2008=100)

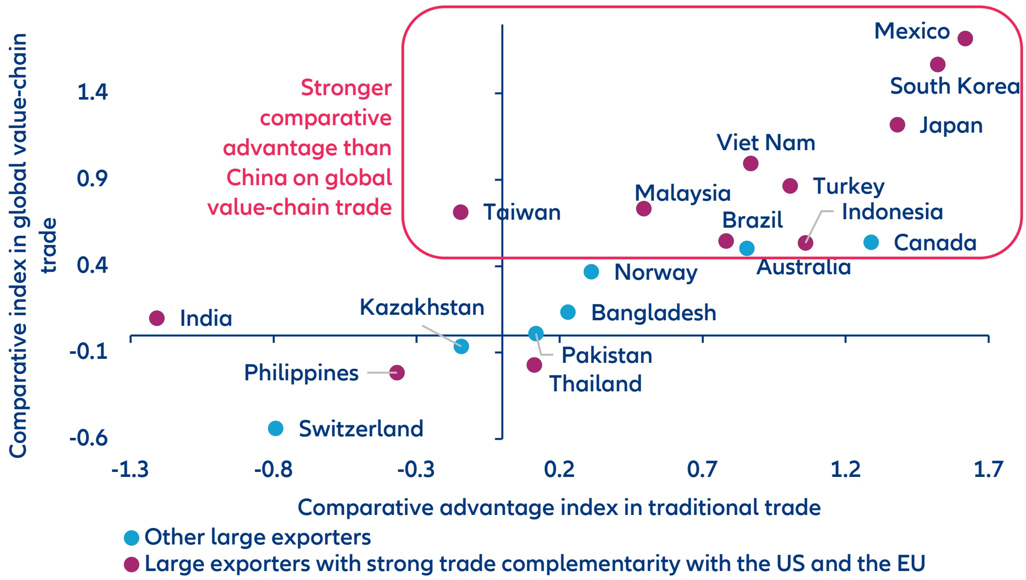


Sources: Reserve Bank of India, Allianz Research

India is very close to China when it comes to the competitive advantage in terms of traditionally traded goods in the global value chain (GVC, Figure 20). Additionally, its trade complementarity with the US and the EU is strong and the growing geopolitical ties make it a more favorable trade partner compared to China. India's exports to the US and Europe grew much faster than those of China from 2020 to 2022.

However, India remains significantly distant from its peers such as Mexico, South Korea, Vietnam and Japan in terms of GVC-adjusted comparative advantage, which leaves room for further improvement through efforts to reduce trade barriers, enhance infrastructure and develop human capital, as well as through research and development[11].

Figure 20: Comparative advantage indices



Sources: World Bank (WITS), Allianz Research

[11] Jones, L., Demirkaya, M., & Bethmann, E. (2019). Global value chain analysis: concepts and approaches. J. Int'l Com. & Econ., 1

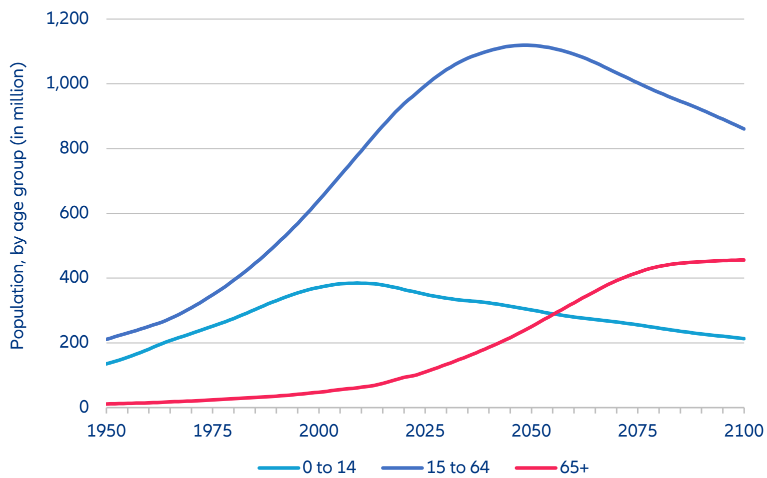
Demographics could play a significant role in accelerating economic growth if complemented by the right reforms

India's working-age population will be twice as large as that of Northern America and Europe combined. India has already overtaken China as the most populous country in the world, with a third of its population of 1.4bn concentrated in three states: Uttar Pradesh, Maharashtra and Bihar. Until 2063, India's total population is expected to continue to grow to 1.7bn, before gradually declining to 1.5bn by the end of the century. Though India, like China, has six urban agglomerations with more than 10mn inhabitants each (Delhi, Bengaluru, Chennai, Hyderabad, Kolkata and Mumbai), the total degree of urbanization is still rather low, with only 29.2% of the population living in urban areas[12].

From 2025, India will also overtake China as the country with the world's largest labor-force potential. The number of people aged between 15 and 64 is expected to surpass the 1bn threshold in 2026 and remain above that mark until 2075, peaking at 1.1bn in 2048. That is, India's working age population will almost be twice as large as the number of people aged between 15 and 64 in Northern America and Europe combined, which already peaked at 736mn in 2011 and is set to decline to around 660mn by 2050. Furthermore, external migration still hardly plays a role in the development of the working age population as most migration happens within the same state. The development of the working age population reflects the development of the fertility rate. Since the mid-1960s, the fertility rate has declined from 6.0 children to 2.0 children in 2020, with fertility rates on the state level reaching from 1.4 in Delhi, Tamil Nadu and West Bengal to 3.0 in Bihar. Assuming that the birth rate will decrease further to 1.7 children in the long term, the number of births is expected to decline from 23mn today to 19mn per year by 2050. As a result, the number of children aged between 0 and 14 years is set to decline further from around 360mn today to 301mn in 2050 and 255mn in 2075.

In line with further improving living standards, the average life expectancy of a newborn in India is expected to increase further from 67.7 years today to 77.9 years in 2050, and to surpass 80 years in 2062, reaching 82.3 years in 2075. However, it will take until 2050 for the median age in India to reach that of China today (38.5). And although by 2100, India's median age is set to increase to 47.5 years this will still be below Japan's median age of 48.7 years today. The average further life expectancy of a 65-year-old is expected to rise from 13.1 years today to 21.0 years in 2075. As a result, the number of people aged 65 and older is also expected to increase from around 100mn today to 250mn in 2050 and around 2056 the number of 65-year-olds and older is expected to surpass the number of children aged between 0 and 14 years, reaching around 420mn in 2075 (Figure 21).

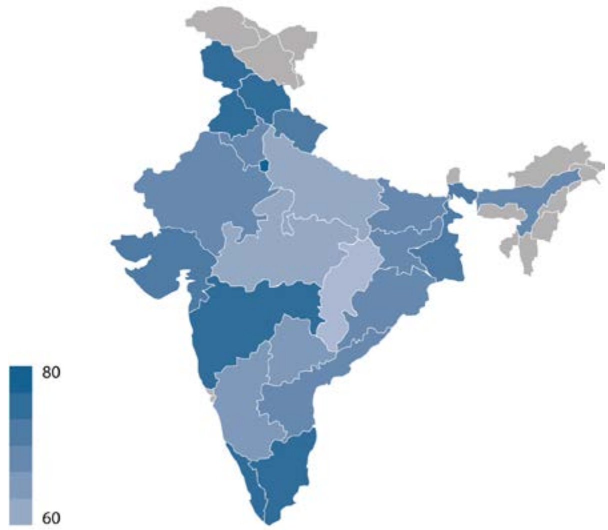
Figure 21: Population by age group (in mn)



Sources: UN Population Division (2022), Allianz Research

[12] See UN Population Divsion (2018): World Urbanization Prospects. The 2018 Revision, and Ministry of Statistics and Programme Implementation (2023): NSS Report No. 589: Multiple Indicator Survey in India, p. 19.

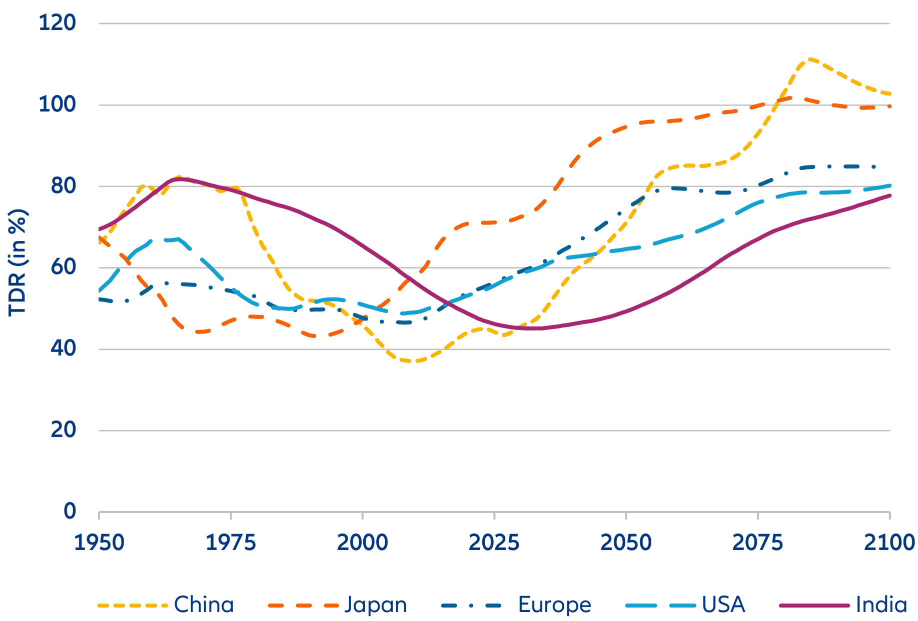
Figure 22: Average life expectancy at birth, by state (in years)



Sources: Reserve Bank of India, Allianz Research

In contrast to China and Japan, India can still benefit from a demographic dividend, which is characterized by a declining total dependency ratio: The number of economically dependent people of the age groups 0 to 14 and 65 and older combined per 100 people in working age is set to decrease further from 47.5% today to 45.1% in 2032. Afterwards it is expected to increase gradually but to remain below 50% until mid-century (Figure 23). In China and Japan, the increase of the total dependency ratio will be mainly driven by the growth of the age group 65 and older. In India, the share of people aged 65 and older of the total population is set to increase to 'only' 30% – compared to around 40% in Japan and China – by the end of the century as India's fertility rate fell below the reproduction rate of 2.1% only in 2021.

Figure 23: Total dependency ratios (age groups 0 to14 and 65 plus combined in percent of age group 15 to 64)

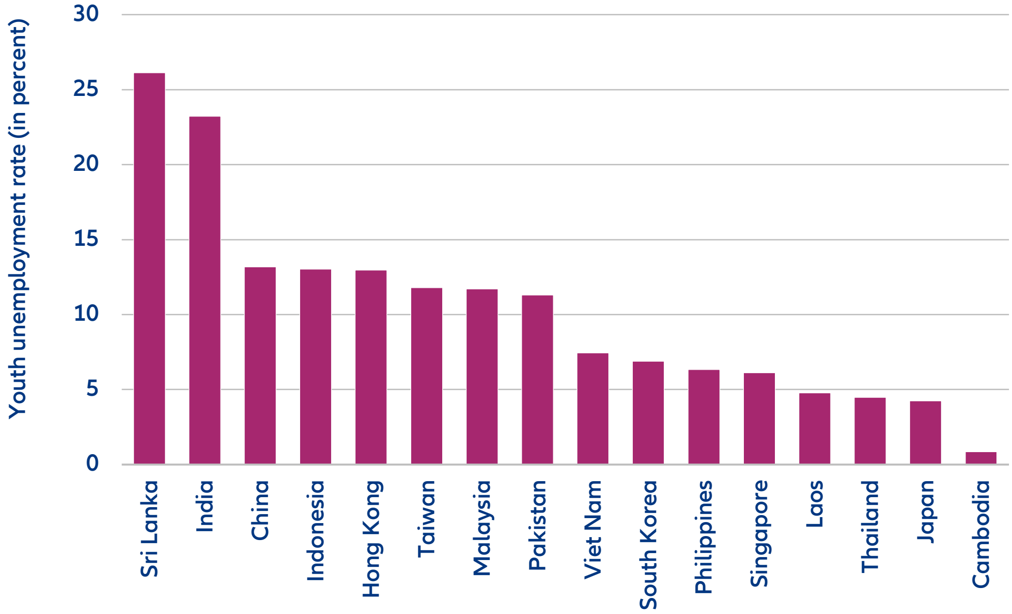


Source: UN Population Division (2022), Allianz Research

However, to profit from its demographic dividend, India needs to further improve its education system and above all to reform its labor market, first by addressing the issue of high youth unemployment. In 2022, only 49.8% of the Indian population aged 25 and older had completed a lower secondary level of education, compared to 81.8% in Sri Lanka or 98.6% in Japan. Only 31.6% had completed the upper secondary level compared to 63.7% in Sri Lanka and 85.2% in Japan, while 12% held a bachelor's degree and merely 3% a master's degree. This is because India still has one of the highest shares of adolescents who are out of school: According to latest available statistics, this held true for 13.5% of children of lower secondary school age, compared to 5.8% in Thailand or 5.3% in Indonesia. Especially alarming is that 29.3% of the 15-24 year olds (30.2% in rural areas and 27.0% in urban areas) are not in education, employment or training (NEET), which is one of the highest figures among Asian countries[13]. Remote learning could close knowledge gaps but policymakers would first need to address limited internet access and digital skills – especially in rural India. Moreover, there is a vast divergence between states, with for instance almost 93% of 15-24 year olds in Kerala possessing basic digital skills, compared to just 25% in Assam[14] .

India's youth unemployment rate is also one of the highest in Asia. According to the latest ILO data, around 23% of the age group 15 to 24 were unable to find a job in 2022. This share was only higher in neighboring Sri Lanka, at 26% (Figure 24).

Figure 24: High youth unemployment rate

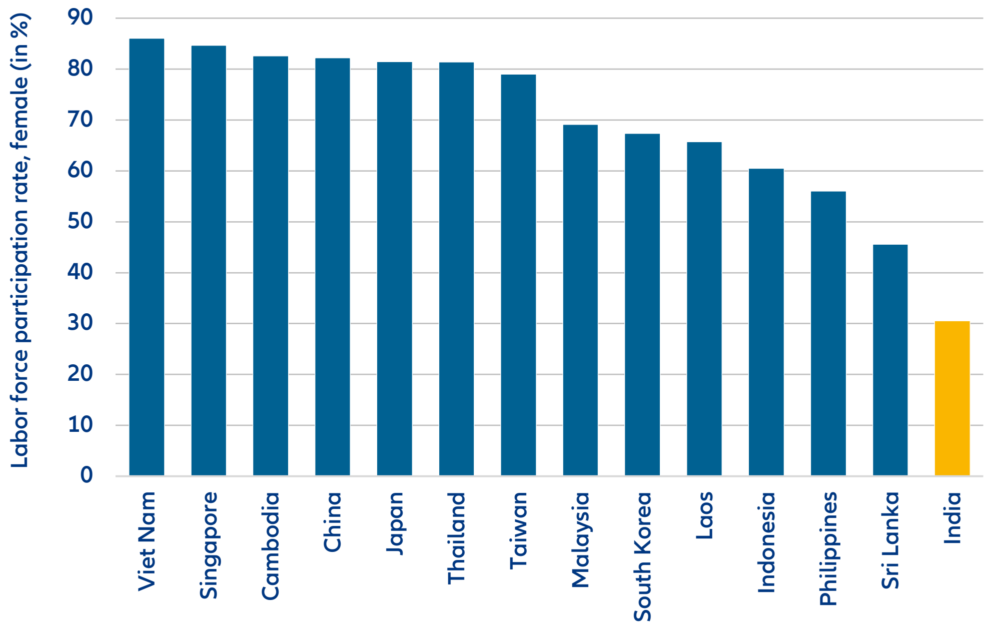


Source: ILO, Allianz Research

[13] See Ministry of Statistics and Programme Implementation (2023): NSS Report No. 589: Multiple Indicator Survey in India, p. 33 and A31, and World Bank (2023): World Development Indicators.
[14] See Ministry of Statistics and Programme Implementation (2023): NSS Report No. 589: Multiple Indicator Survey in India, p. 35 and A41

India also has one of the lowest female labor force participation rates in Asia. According to the latest Periodic Labor Force Survey by the Ministry of Statistics and Programme Implementation, in the period April to June 2023, the labor force participation rate of the urban female population aged 15 and older was merely 23.2%, compared to 73.5% for the urban male population. Furthermore, only 54.0% of the women active on the labor market, i.e., around 11% of all females in urban areas aged 15 and older, were regular wage or salaried employees, while 26.3% were own-account workers, 11.9% were helpers in household enterprises and 6.8% were casual workers. In contrast, 31.8% of the male population aged 15 and older were employed as regular or salaried workers[15]. The share of informal labor in the non-agricultural sector is not only comparatively high but also increased during the Covid-19 pandemic from 68.2% in 2017-2018 to 71.8% in the fiscal year 2020-2021[16].

Figure 25: Low labor force participation of women (age group 25 and older)



Source: ILO, Allianz Research

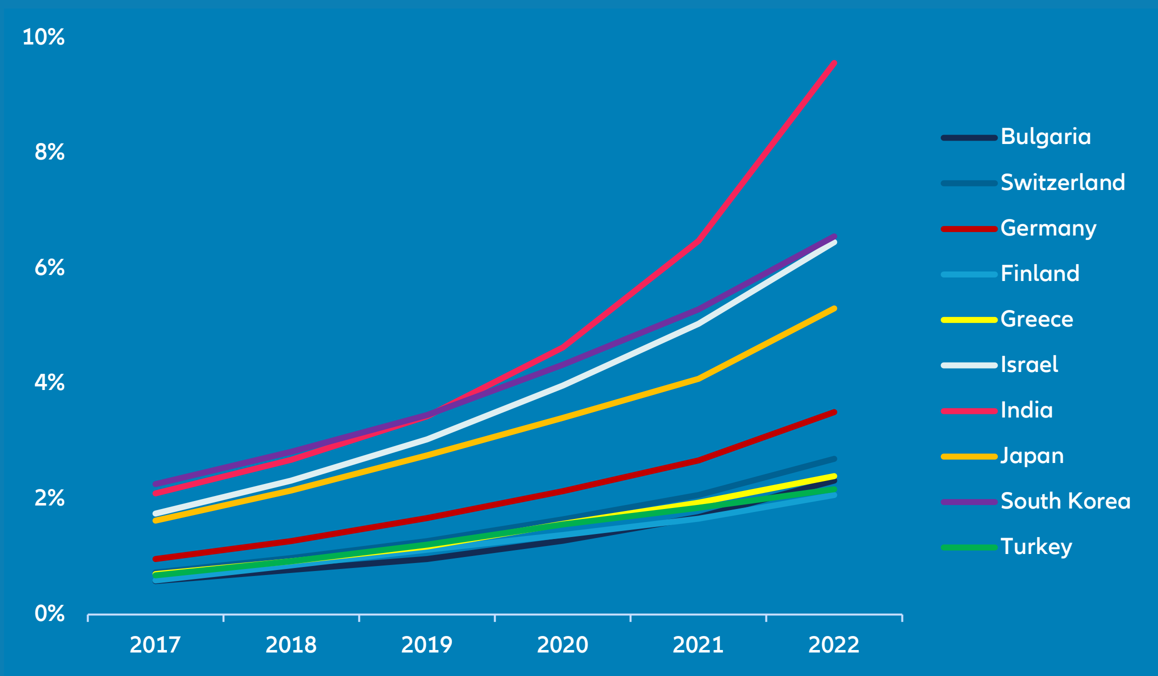
As a result, the coverage of India's social security system is still rather low. Only 42.5% of the older population and merely 31.5% of the labor force are effectively covered by India's pension system, compared to 100% and 85.4% in China, respectively.[17] As a result, having enough money in old age is one of the most worrying financial issues for 25% of the population aged 25 and older and 67% say that they are very worried about not having enough money for old age.[18] Government efforts to broaden the coverage of the Employment Provident Fund could help to cover this gap, alongside private pension provision. In fact, life insurance premiums have increased by an average +10.9% per annum during the last five years. In 2022, the average Indian spent around EUR62 on life insurance, with life insurance penetration reaching 2.8% of GDP. Given the retirement gap, we expect an average annual growth rate of around +13% over the next ten years[19].

[15] See Ministry of Statistics and Programme Implementation (2023): Quarterly Bulletin, statement 3 and 5 as well as detailed tables 2, 5 and 7.
[16] See Ministry of Statistics and Programme Implementation (2023): Sustainable Development Goals. National Indicator Framework, Progress Report 2023.
[17] See International Labour Organization (2023). Dashboard.
[18] See World Bank (2023): World Development Indicators.
[19] Sources: IRDA, Axco, IMF, Refinitiv Eikon and Allianz Research.

Can India tap the AI opportunity?

AI talent can play a crucial role in driving economic growth in India. A joint study conducted by Microsoft and the Internet and Mobile Association of India (IAMAI) reported that India's artificial intelligence (AI) market is expected to witness a growth of 20% over the next five years – the second fastest rate globally behind only China. Unsurprisingly, AI-related labor demand has been ballooning over the past five years: Job postings on LinkedIn that require AI skills have increased from 23% to almost 30%, according to data from the company. India is fortunate to possess a substantial population along with a high concentration of AI talent, which has the potential to enable technological innovation, job creation, automation and global competitiveness, especially in sectors such as health care and education. In the last decade, AI investments in India have soared and it is now ranked sixth in the world for the highest AI investments (~ EUR3.1bn, according to the AI index Report from Stanford). There were also 57 newly funded AI companies in India in 2022. These and other developments, such as growth in research and development, could position India as a competitive and important AI player globally. In the medium term, investment in re-skilling and upskilling will be crucial to future-proof India's workforce.

Figure 26: AI talent concentration by country



Sources: LinkedIn Economic Graph, OECD, Allianz Research
Note: This chart shows the concentration of AI talent, the percentage of LinkedIn members with AI skills or who perform an AI occupation (e.g. machine learning engineer) per country and in time.

However, India needs to go back to basics to continue profiting from its valuable human resources. The digital divide in India could stand in the way of tapping the AI opportunity. Only around 52% of the world's most populous country has internet access, while in rural areas internet access penetration stands at roughly 29%. At the same time, only 38.5% of schools have computers and an even lower 22.3% have internet access. Nevertheless, the public sector can utilize the power of AI to combat poverty: not only by improving food security with predictive climate models, but also by aiding a real-time policy assessment of community development in the areas of education, re-skilling, and up-skilling.

Moreover, another focus area should be the brain drain. Talent and youth are bountiful in India, but is it staying in India? According to data from LinkedIn, the brain drain is significant and growing, especially among workers with AI-related skills. In fact, India has seen the largest growth in emigration of AI talent since 2019. One in every 10 doctoral students in G20 countries comes from India, according to the OECD. By 2030, Indians are expected to account for 20% of the globally tertiary-educated population of 25–34-year-olds. To ensure that India benefits from its own talent, it needs pull policies to improve prospects, including by offering improved job opportunities through private investment and improving bargaining power for better remuneration and benefits, besides better education prospects for the children of young professionals and better infrastructure.

Figure 27: Between-country AI skills migration from 2019 to 2022, change in %

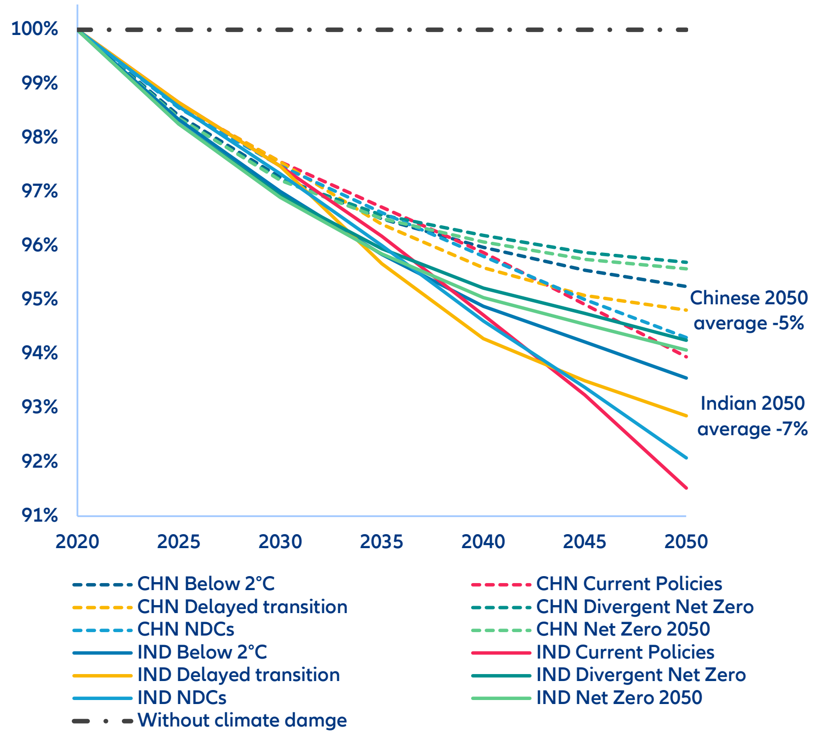
Sources: LinkedIn Economic Graph, OECD, Allianz Research
Note: This chart displays the net migration flows of LinkedIn members with AI skills from 2019 to 2022. The size of the red/blue bars indicates the magnitude of a country's AI talent losses/gains, respectively.

Climate change poses significant downside risks to growth via decreased labor productivity and increased (food) inflation

India could pay a heavy price amid rising temperatures. By 2050, areas of northern India could face heatwaves surpassing the critical 35°C wet-bulb threshold, posing a severe threat to human life. High temperatures already lead to 630,000 deaths in India every year, and this number could surge to 1.4mn per year by 2050.[20] Rising temperatures also come with a steep economic cost, reducing the number of daylight hours during which it is safe to conduct outdoor work. This poses a major concern for India, where a significant portion of the economy relies on labor working under heat-exposed conditions. As of 2017, work in these conditions contributed to roughly 50% of the nation's GDP, accounted for around 30% of its GDP growth and employed a staggering 75% of the labor force, equating to about 380mn individuals. With a lack of affordable cooling infrastructure, India also lags behind China in safeguarding its population from the adverse effects of heat stress. The population-weighted heat stress exposure is 100% for India, whereas it is just 20% for China.[21]

Labor-productivity losses due to climate change could push India's GDP down by -7% on average in 2050. Even if the global rise in temperatures is kept to 1.5°C (1.5°C Net Zero scenario), India will still experience a -6% GDP setback. When compared with China, India's projected losses are about 2% higher in 2050. If no climate policy action is taken and India sees temperatures rising by 3.0°C by 2100, the decline could reach as much as 9%. Figure 29 illustrates the influence of climate change's physical damages on GDP growth across various scenarios, while also factoring in the transition risks arising from regulatory shifts. The baseline GDP forecast, as projected by Allianz Research, suggests that India's GDP will surge by 300% in 2050 compared to 2020 levels. However, in the Net Zero 2050 scenario, this growth is moderated to around 270%, a decline largely attributed to the aforementioned 6% decrease in absolute GDP. Notably, the most pronounced impact is seen in the Delayed Transition scenario, where the GDP growth rate is curtailed to just 250%, a consequence of both physical damages and transition risks.

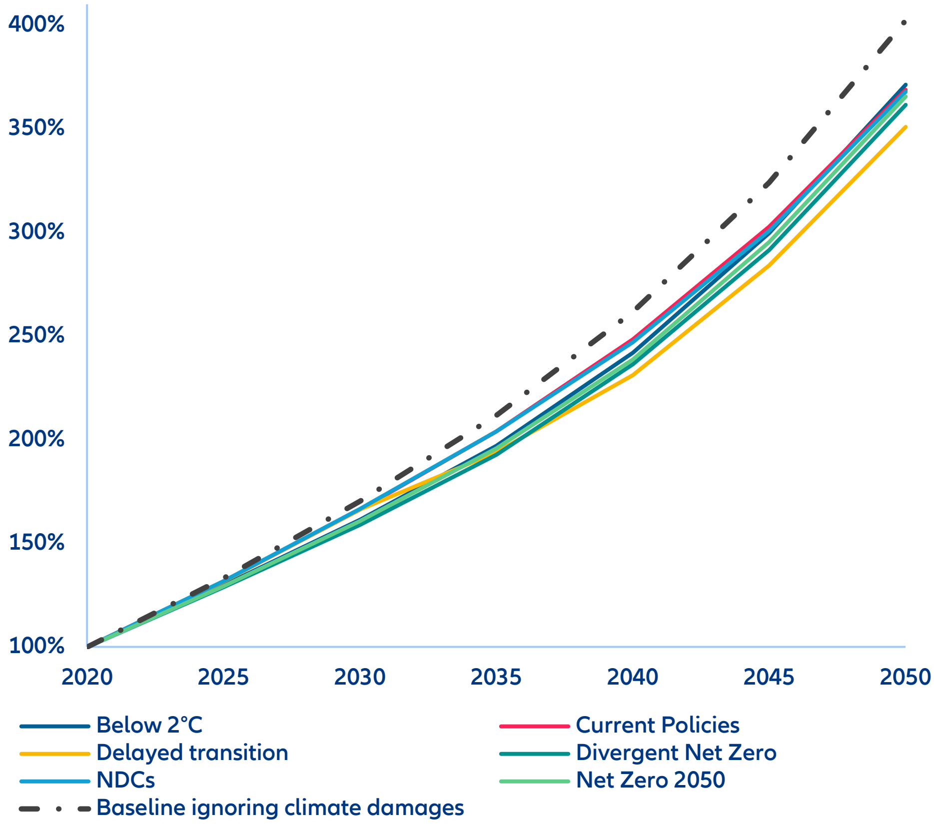
Figure 28: Climate change impact on real GDP in India vs. China



Sources: National Sources, Allianz Research
Note* NDC refers to Nationally Determined Contributions. Climate scenario definition are consistent with NGFS.

[20] Burgess, Robin, Deschenes, Olivier, Donaldson, Dave and Greenstone, Michael (2017) Weather, Climate Change and Death in India. Retrieved from: https://www.lse.ac.uk/economics/Assets/Documents/personal-pages/robin-burgess/weather-climate-change-and-death.pdf
[21] Space cooling, International Energy Agency. Retrieved from: https://www.iea.org/energy-system/buildings/space-cooling

Figure 29: Climate risk adjusted Indian real GDP using the upper 95% confidence interval for physical climate risk (but excluding tipping points and adaptation lags)



Sources: National Sources, Allianz Research
Note* NDC refers to Nationally Determined Contributions.

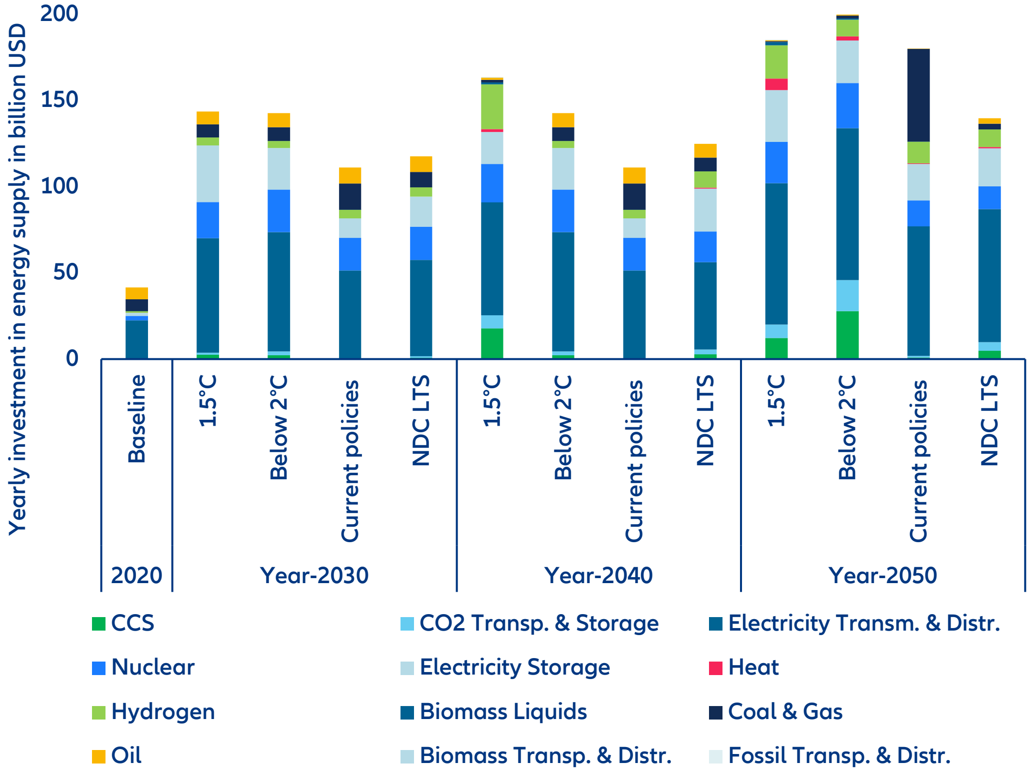
In this context, India has established ambitious goals for its energy transition. India is the third-largest emitter of carbon dioxide, trailing only China and the US. With a burgeoning economy and a growing population, India is under pressure to reduce its reliance on coal and cut subsidies for oil and gas. So far, it has argued against a hasty transition away from fossil fuels that could jeopardize economic growth and efforts to combat poverty, calling for substantial financial support from wealthier nations for a smoother transition. But India does have ambitious goals for the green transition: it has updated its emission-reduction target to -45% by 2030 (compared to 2005 levels), aims to create a carbon sink to absorb 2.5-3bn metric tons of CO2 and has set its sights on becoming a central hub for green shipbuilding by 2030. In 2022, non-fossil-fuel-based energy resources accounted for 25% of cumulative electric-power installed capacity in India, and the goal is to reach about 50% by 2030. India has also made significant strides in renewable energy, with 176GW of capacity reached as of 2023. This puts the country on a promising trajectory to achieve its target of 500GW in 2030[22]. To support this measure, it has implemented key policy measures such as permitting up to 100% of FDI in renewables and implementing the National Green Hydrogen mission to make India a global hub for green hydrogen. The International Energy Agency predicts that India could create 5mn tons of green hydrogen demand, thereby replacing grey hydrogen used in the refineries and fertilizer sector, resulting in abatement of 28mn tons of CO2.[23]

To limit the global temperature rise to 1.5°C, India will need to invest USD143bn by 2030. Figure 30 shows India's investments in different energy sources and supply-chain stages by scenario[24]. At USD143bn in 2030, the investment needs under the 1.5°C scenario are more than three times the 2020 baseline. They are also 28% higher than in the 2030 current-policy scenario (which doesn't account for announced increases in climate ambition), the difference stemming from large additional investments in the

[22] Ministry of New and Renewable Energy (2023). Retrieved from https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1944696
[23] Birol. F, Kant. A (2022) India's clean energy transition is rapidly underway, benefiting the entire world. International Energy Agency.
[24] Scenario definition are consistent with NGFS. The NDC-LTS scenario reflects the announced national climate policy contributions (NDC) to as well as the long term climate policy targets (LTS).

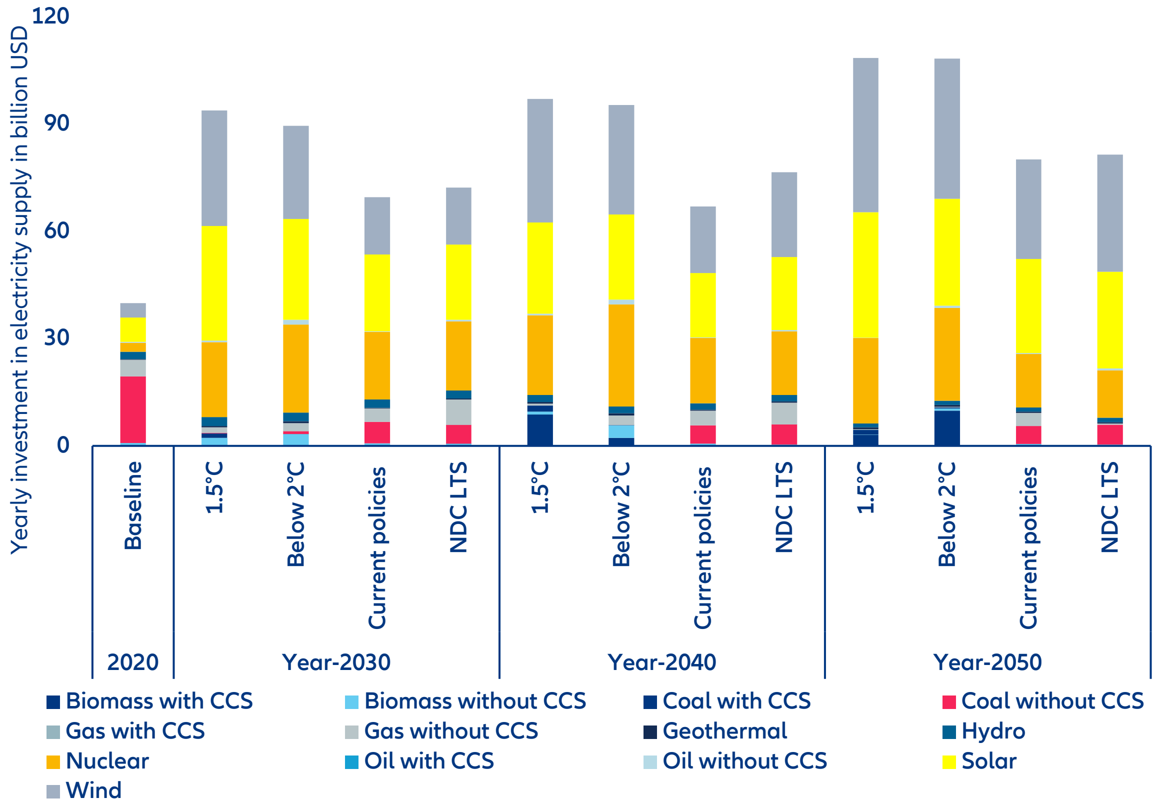
electricity sector. By 2050, yearly investment needs will increase to USD185bn under the 1.5°C target, adding up to a yearly average of USD144bn between 2020 and 2050. Figure 31 shows that, within the electricity generation, wind and solar energy will require the largest investments in the 1.5°C scenario, with yearly investment needs growing from USD64bn in 2030 to USD78 bn in 2050. Coal energy will gradually be phased out, requiring only 12% of investments in the NDC-LTS scenario in 2050 (which reflects the announced climate policy ambition), compared to 50% in the baseline.

Figure 30: Investments in energy supply



Sources: National Sources, Allianz Research
Note* NDC refers to Nationally Determined Contributions, LTS to long term targets.

Figure 31: Investments in electricity supply



Sources: National Sources, Allianz Research
Note* NDC refers to Nationally Determined Contributions, LTS to long term targets.

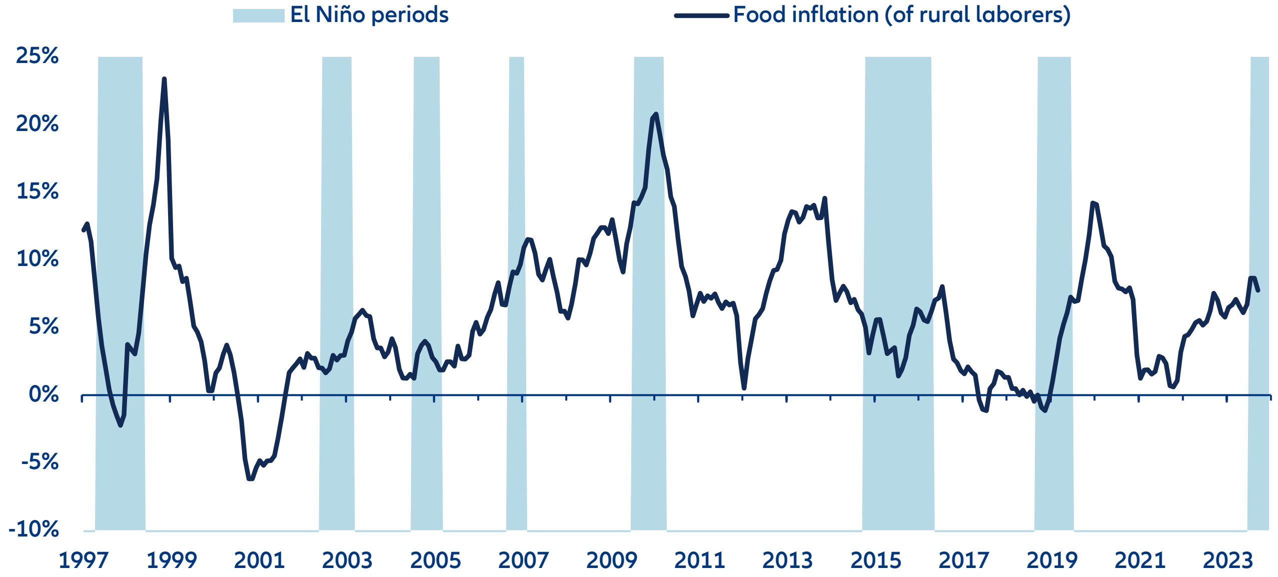
However, energy transition investments have recently been falling behind those of other major countries, and rising global interest rates, along with the Inflation Reduction Act in the US, are adding to the challenge. Despite India increasing its grid-connected wind and solar capacity by +44% from the previous year to 15GW, it still falls short of the trajectory required for the 2030 goal to triple its clean electricity capacity to 500GW. This would represent nearly two-thirds of its total energy mix, crucial for reaching its net-zero target by 2070. According to BloombergNEF, investment in renewable energy technology in India only grew by +4% to USD11.5bn last year, compared to USD12.7bn in 2017, and is considerably less than investments made by China and the US. Fiscal incentives such as the IRA in the US are also diverting capital from emerging markets, including India. India's fluctuating policy landscape – marked by import levies, court orders and uncertainty around state utilities' commitments – makes international investors wary. As a result, Indian projects must promise higher returns to offset risks. The International Energy Agency estimates that India needs USD160bn per year through 2030 for its energy sector to achieve net zero by 2070 – a sum triple what it currently attracts.

Meanwhile, reduced rainfall resulting from the El Niño phenomenon could significantly increase food prices in the next two years, a risk that could intensify further due to climate change. In India, El Niño supresses monsoon rainfall[25], resulting in lower agricultural output and triggering higher food prices, which make up about 46% of the CPI basket. Although other factors play a role, Figure 32 suggests that food inflation tends to rise especially during El Niño periods and often peaks a couple of months thereafter. The El Niño periods 1997-1998, 2009-2010 and 2014-2016 are considered to have been more severe and here the trend change in inflation appears particularly obvious. Significant temperature deviations from the long-term averages in Q3 2023 indicate that El Niño has arrived again in India and the probability that it will be a

[25] In 2009 for example, a weak El Niño led to a significant reduction in India's rainfall to 78.2% of the normal, the lowest recorded in 37 years.

severe one over 2023-2024 is estimated at 66%[26]. This poses some upside risks to our current overall inflation forecasts of 5.3% in 2024 and 4.5% in 2025. Looking ahead, upside risks to (food) inflation will re-occur with every El Niño appearance in the future. Moreover, the upside risks are likely to intensify if climate change increases the frequency and severity of the weather phenomenon.

Figure 32: Food price inflation in the context of the El Niño phenomenon



Sources: Refinitiv, United States Climate Prediction Center, Allianz Research

[26] Risks to global food commodity prices from El Niño – European Central Bank

The (geo)political outlook for India

Upcoming elections in 2024 are unlikely to lead to a rebalancing of political power. The Hindu nationalist Bharatiya Janata Party (BJP) won a second term in 2019 and Prime Minister Narendra Modi still commands the preference of the majority of voters, with a small majority of respondents in recent polls saying they want him in office for a third term. However, his popularity has decreased compared to the previous year, while the popularity of his main opponent Rahul Gandhi has been rising[27]. We do not expect significant economic risks in 2024 but the elections could put the fragile democracy to the test amid global geopolitical uncertainties.

Though parties tend to spend heavily in election years, the risk of fiscal slippage remains contained. India remains on a path of fiscal consolidation, which should reassure investors. The deficit target for FY23-24 is 5.9% of GDP, down 0.5% from the current FY22-23 target of 6.4%. Further reducing the deficit to 4.5% by FY25-26 implies a significant commitment beyond the next fiscal year. Capital investments should reach 3.3% of GDP or nearly three times the amount in 2019–20.

To ensure that gains from India's economic performance benefit its population of 1.4bn, Indian policymakers must focus on inclusive and sustainable growth, mindful of regional disparities. The aggregate numbers of economic progress often do not reveal the reality of regional disparities in terms of economic growth. While all regions have made significant progress since the 2000s in terms of health and income, a large proportion of the population remains poor based on measures of health, education and standard of living, especially in northern states such as Bihar, Jharkhand, Meghalaya and Uttar Pradesh[28]. Research shows that regions with high income and health levels concentrated mainly on the central and south-west coast of India. Policymakers have tried to improve development outcomes in the 'Empowered Action Group' states – states that rank relatively low in economic and human development indicators – and have achieved significant progress in Bihar, Chhattisgarh, Jharkhand, Madhya Pradesh, Odisha, Uttar Pradesh and Uttarakhand. However, stark differences in levels of income remain. For instance, in 2022, the standard of living in Goa was at least 9 times higher than that of Bihar[29] .

On the global stage, India possesses the diplomatic power to be the bridge between the Global South and the West. In the 1960s, India was one of the founding members of the Non-Aligned Movement (NAM) that chose to remain impartial in the then bi-polar world. This stance has helped maintain good geo-political relationships over time. Even today, despite its generally pro-American stance, India has abstained from taking sides, most recently by abstaining from the vote in the UN for a ceasefire in Gaza or to end the war in Ukraine. We expect this neutral stance to prevail as India works towards becoming a global super power.

[25] Modi Faces Test in State Polls Before 2024 General Elections
[28] National multi-dimensional poverty index – NITI Aayog, UNDP, Oxford Poverty and Human Development Initiative
[29] Ministry of Statistics and Program Implementation (MoSPI), India.

Our team

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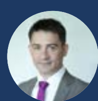

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