India's Economy In World Top 5, But How Have We Really Fared Compared To Others?

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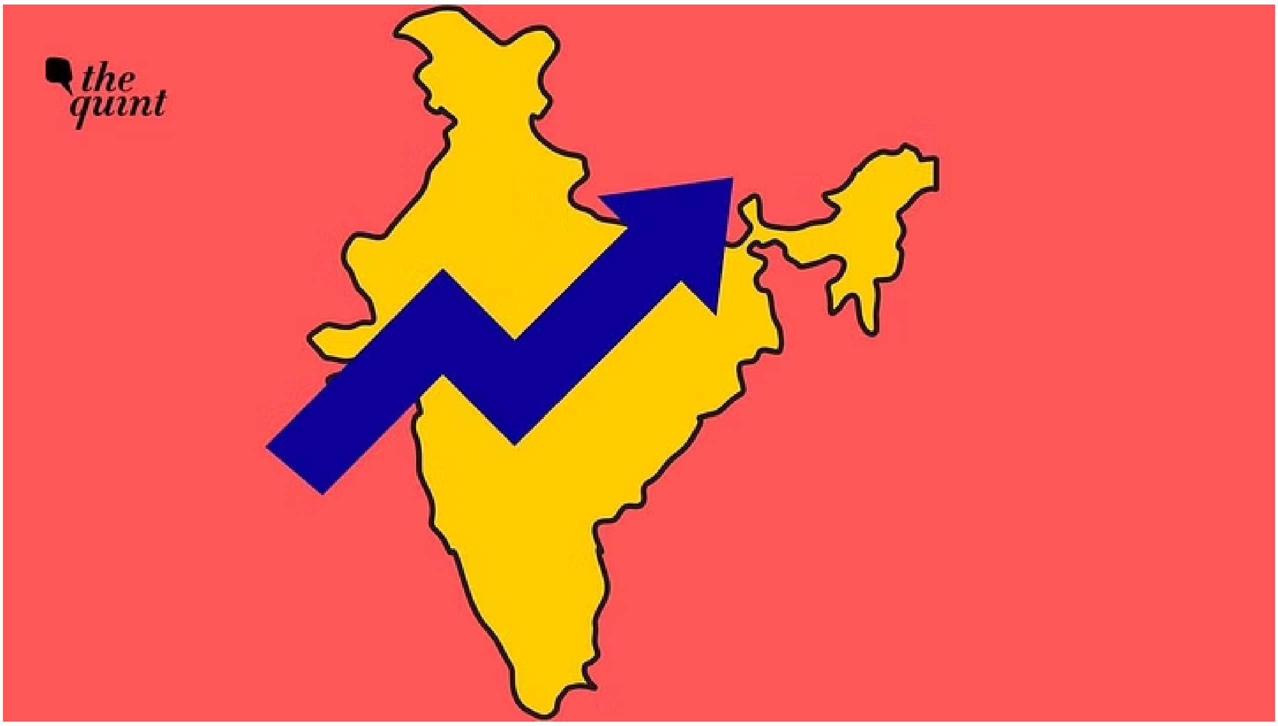
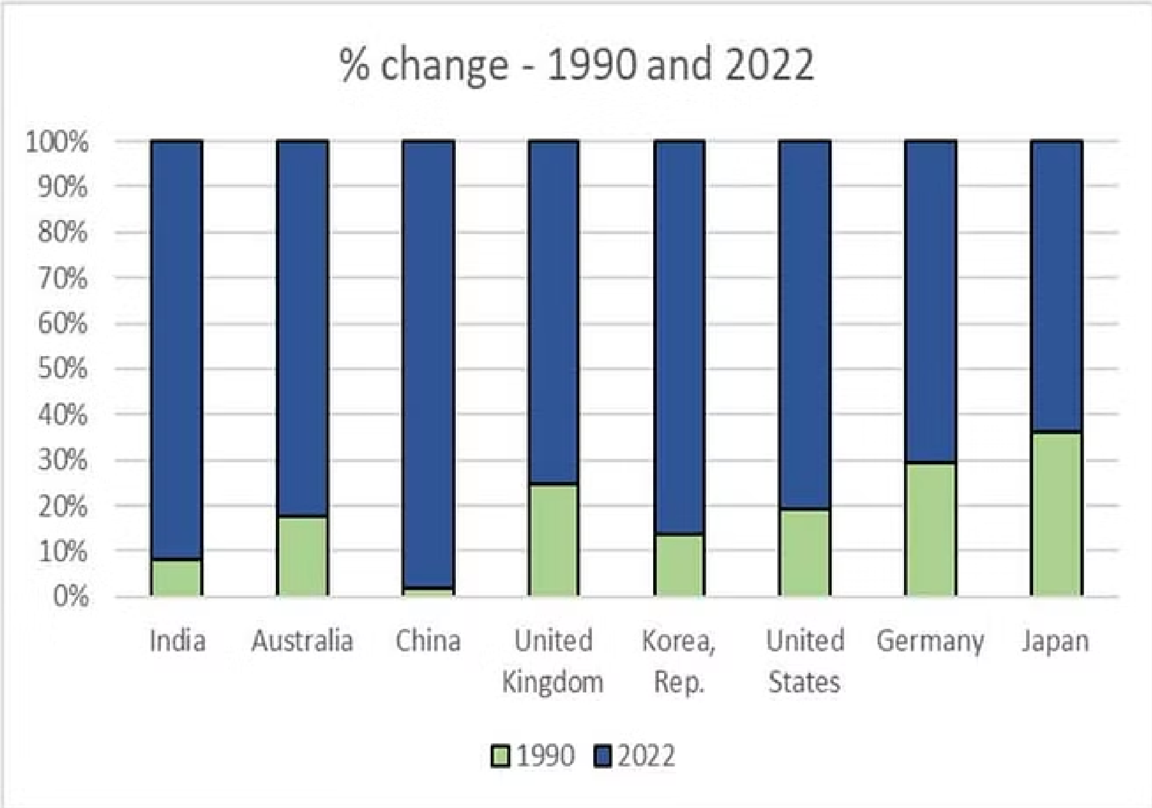


A few months ago, in September 2022, the International Monetary Fund or IMF announced that the Indian economy has surpassed UK to become the 'fifth largest economy' in the world. With a current GDP of 3.535 trillion dollars, India overtook in the second quarter of 2022.

The country's new status was widely publicised by the government and across social media, calling this an 'extraordinary achievement'. India's Union Finance Minister Nirmala Sitharaman stressed the fact that India became the fifth largest from 11th in just a decade is something "Indians should credit and take pride in."

> While it is debatable to argue what the fifth largest economy tag means for India, according to IMF estimates, India's performance outlook is often compared quite loosely with nations such as the USA, China, Germany, and Japan despite the fact that each of them have done much better than India in improving the quality of lives of their citizenry and are much 'developed' on the human capability enhancement frontier, as Martha Nussbaum and Amartya Sen would argue.



Source: CNES Infosphere Team (Vol IV Edition 2)

% change- 1990 and 2022

Image: Namita Chauhan/The Quint

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Mapping India’s Growth Trajectory

Still, the nature of growth witnessed in India’s macro-economic landscape over the past three decades is second to only China in the large-scale emerging market economy front.

This article, extrapolating key findings from a recent Centre for New Economics Studies (CNES) research analysis undertaken by team InfoSphere, involving a detailed analysis of India’s growth trajectory over the last three decades, compares growth trends between India and other industrially developed economies across sectors like manufacturing, services, banking, etc. We try to identify sectoral performance results that have contributed most to India’s growth picture, and those that haven’t.

Post 1990s Reform: Agro, Manufacturing Sectors Lag Behind

Any critical macro-performance analysis for Indian economy since the 1990s contains two distinct analytical parts. It is pertinent to look at the nation’s macro-growth picture from both an income-side approach, and an expenditure-side approach. In this sub-section, we will look at these individually and see how the Indian economy has fared under these.

> When we look at the income components of the GDP, we see that the service sector has seen the maximum growth since the 1990s with the rate being as high as 15% in 2020. We have seen more employment and investment in the sector alongside direct and indirect foreign investment.

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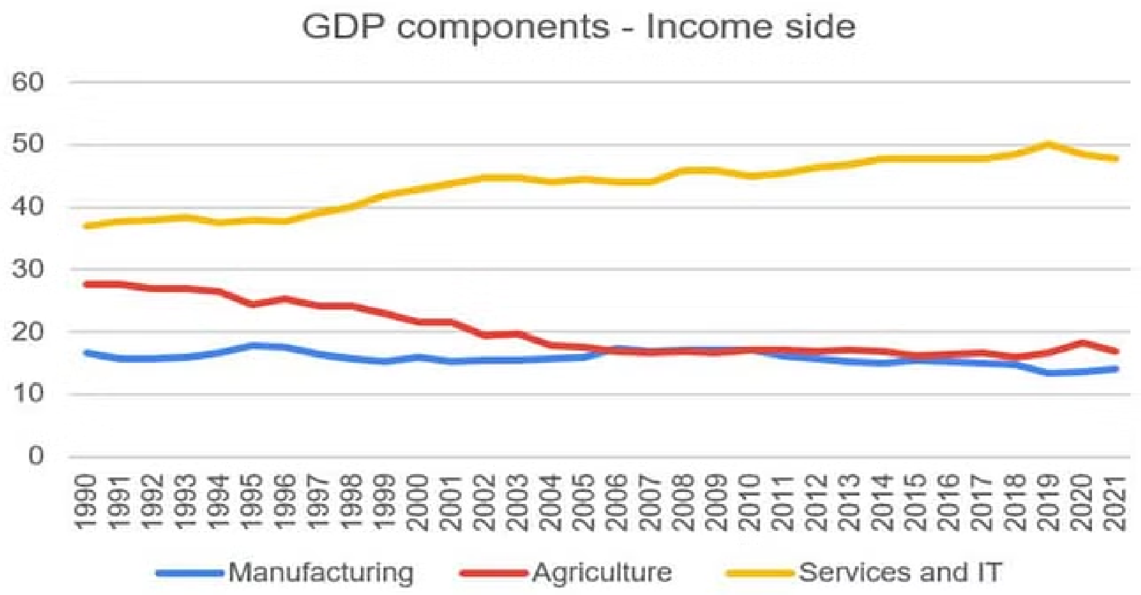

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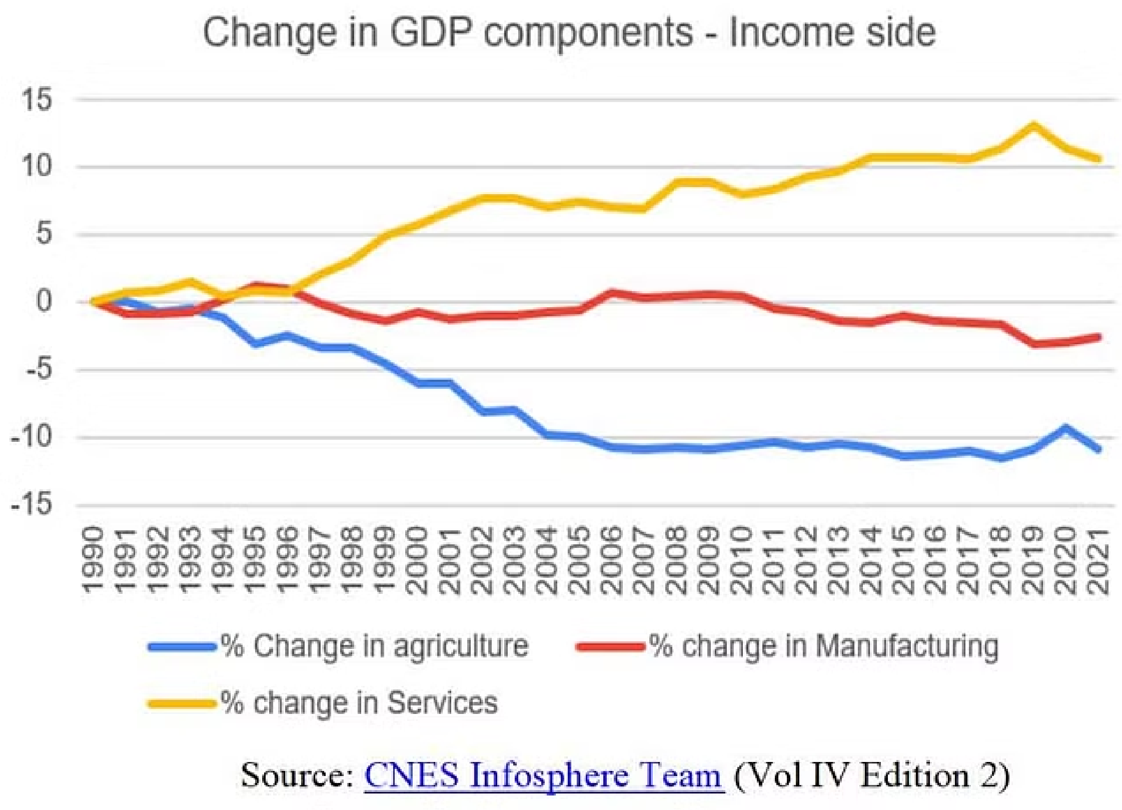
GDP components- Income side

Namita Chauhan/The Quint

On the other hand, we see agriculture and the manufacturing sector performance declines in terms of both size and growth rate. There is a negative growth rate in the manufacturing and agriculture sector (the rate here is -1.5%) highlighting how these components have shrunk overall as parts of the GDP.

> This trend is divergent of what 'Structural transformation theory' (i.e. discussing growth transition from agriculture to manufacturing to services argues for any nation's trajectory from one stage of development to another).

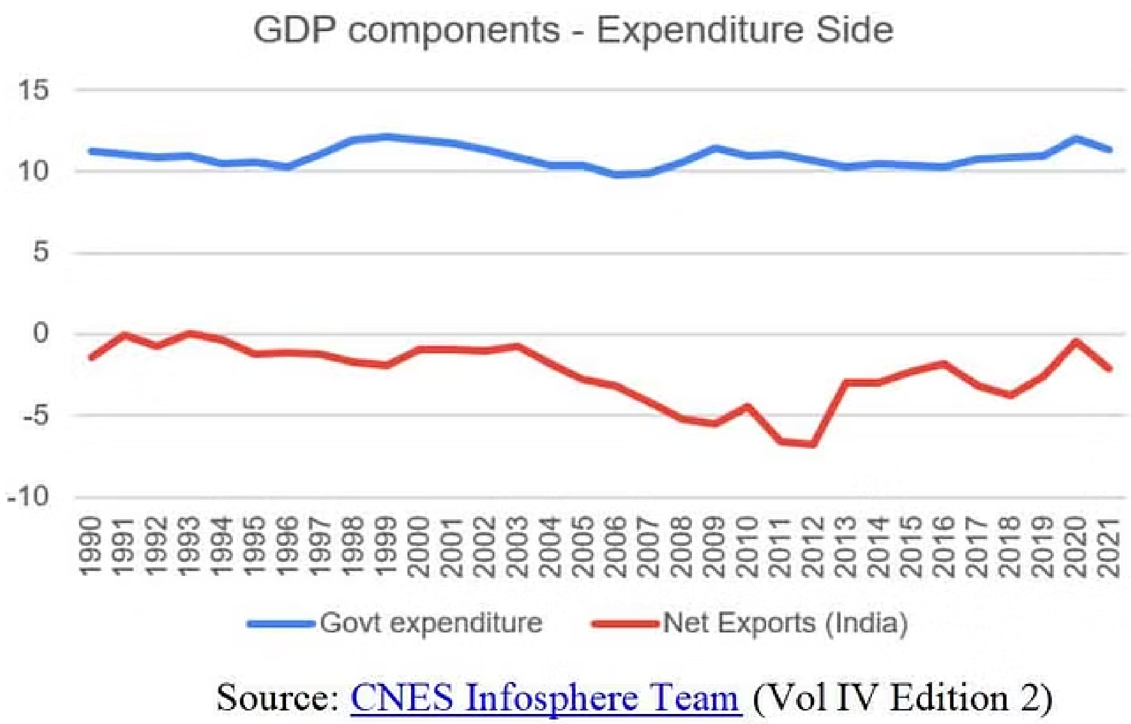
Generally, when countries rapidly grow, we do see a movement away from the agriculture as the sole driver of income in the nation which is visible from these graphs.



Change in GDP components- Income side

Image: Namita Chauhan/The Quint

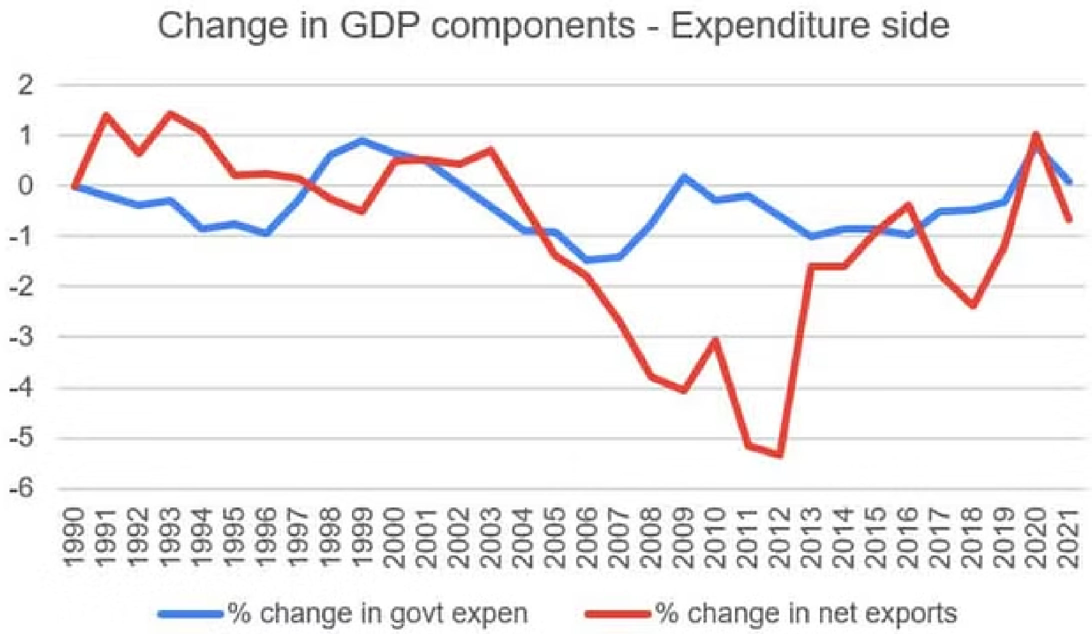
Now, we analyse the expenditure side; the two components seem to remain the same over time: a) Government spending and b) Net exports. Both have not seen major changes as being part of the GDP over time (this could be because their sectional growth is directly proportional in magnitude as well to the GDP).



GDP components- Expenditure Side

Image: Namita Chauhan/The Quint

However, we observe high volatility in net exports over time, and the trade deficit has only worsened from 2002 to 2012 (meaning we are importing way more than what we are exporting). This is still the case (read here for more on India's trade dynamics)



Source: CNES Infosphere Team (Vol IV Edition 2)

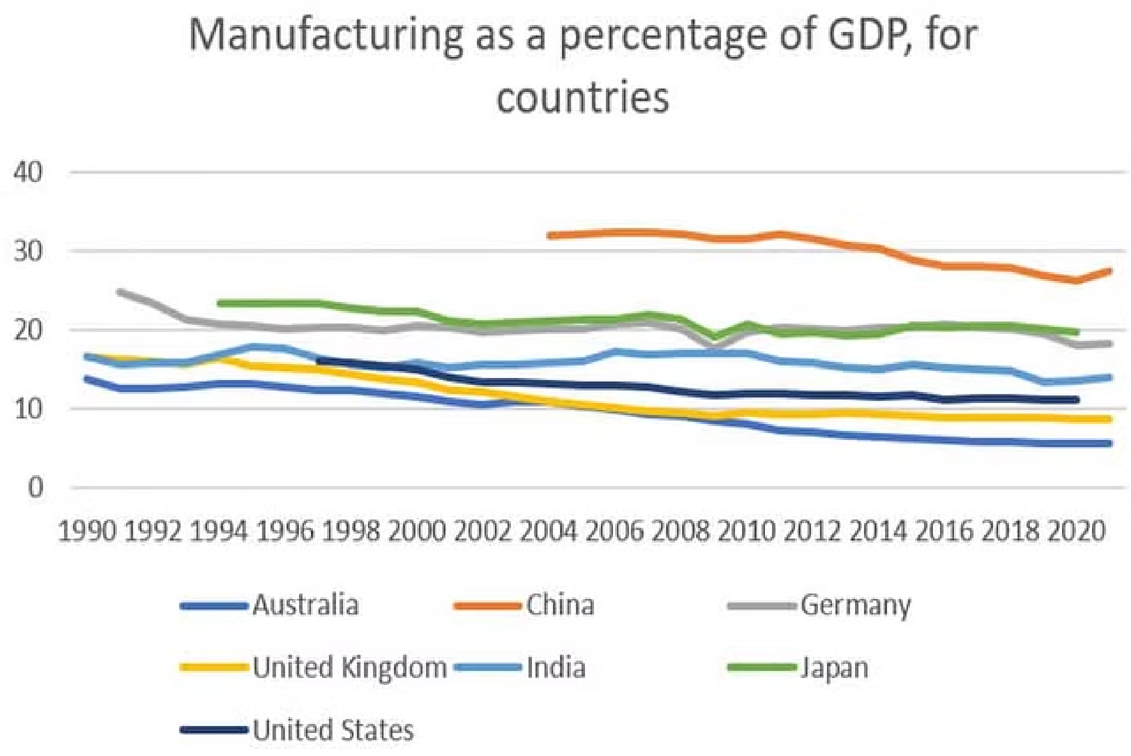
Change in GDP components- Expenditure side

Image: Namita Chauhan/ The Quint

The Manufacturing Conundrum

To understand what has really contributed to India's urban-biased service- led growth model, it is necessary to observe all sectors one at a time. Diving deep into the manufacturing sector growth story for other industrial nations like Australia, China, Germany, UK, and India, we see that Germany and China have the largest share of GDP contributed by manufacturing.

We see that manufacturing growth as a contributor to a nation's overall GDP growth has been declining at similar rates for all countries as they progress towards a global economy which is built largely on Services and Informational Technology. India's case can be categorised more as a classic example of a nation experiencing premature deindustrialisation, as elucidated here.



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Manufacturing as a % of GDP, for countries

Image: Namita Chauhan/ The Quint

> China's case for much of 1990s and early 2000s was unique though. It has seen the largest contribution to its GDP from manufacturing-led growth, with 30% of its GDP derived from that sector alone, also allowing China to export more manufactured goods than any other nation in the recent past (Vietnam, Bangladesh don't come anywhere near the Chinese volume.)

A Key Indicator for Capital-Invested Growth: GFCF

A factor which plays an important factor within the manufacturing sector is how much a country is spending on fixed capital, say in driving infrastructural growth which ultimately helps bring more private investment into a sector/nation. Using Gross Fixed Capital Formation (GFCF) as an indicator, we analyse how spending on fixed capital changed between 2000 and 2021 for developed countries. Higher GFCF as % to GDP suggests greater investments in areas of infrastructure.

Except for China and India, investments in fixed capital in all other developed economies declined over the last two decades. Timeline also matters. Stages of industrialisation were different timeline-wise for early industrialisers like UK, Germany, Australia, US, Japan.

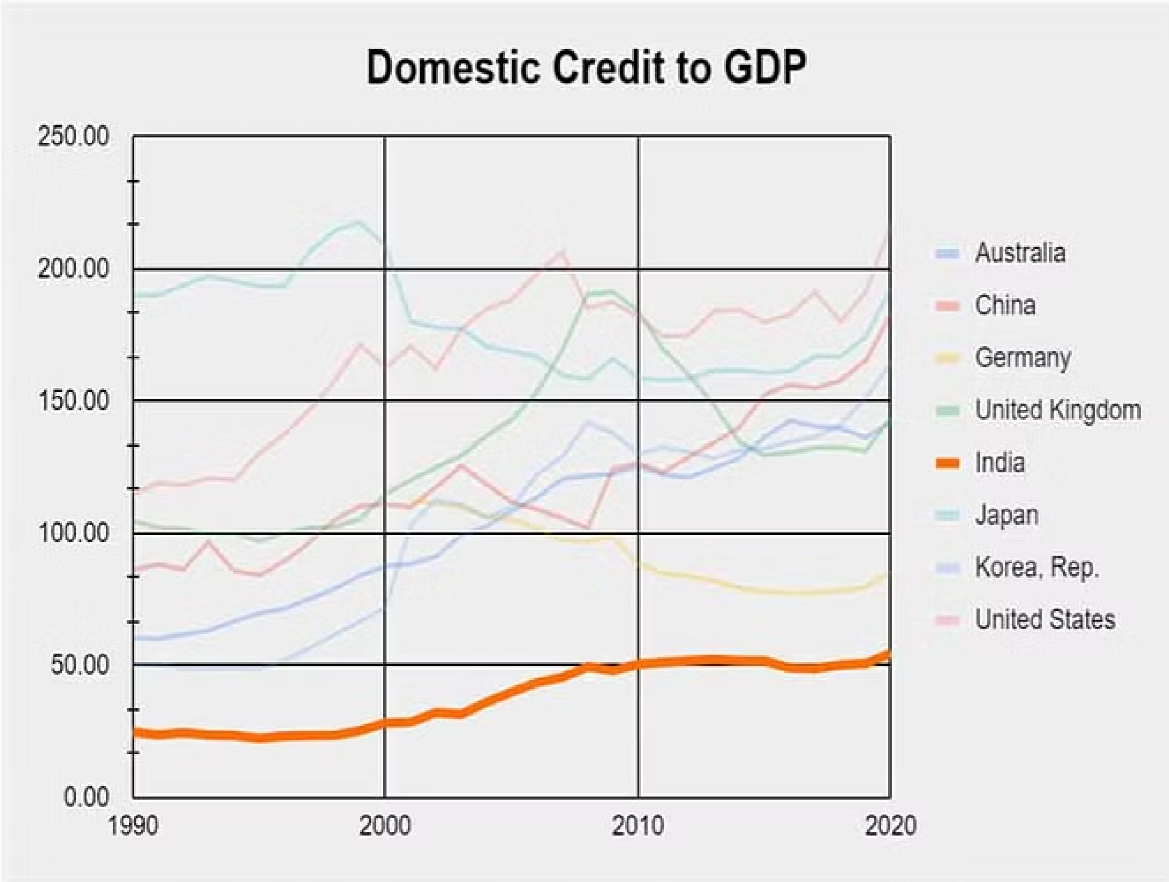
Still, the decline of each of these nations' manufacturing growth combined with a fall in gross fixed capital formation (as % of GDP) explains why each of the nations have pivoted to globalise their manufacturing supply chains, for cost-benefit reasons to nations like China and India.

> China—the second largest economy in the world, significantly increased their investments in fixed capital formation to allow greater growth of infra-based private investment. India has been slow in that regard.

Financial Sector - Domestic Credit to Private sector

An important factor within the financial sector is how much money is raised within the economy as part of a new credit and investment cycle. A major source for raising capital is 'credit' and 'debt'.

When more money is credited in the economy, the investment levels increase as well. For our analysis, we used Domestic Credit, which refers to financial resources provided to the private sector in terms of loans, non-equity securities, etc.



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Domestic Credit to GDP

Image: Namita Chauhan/ The Quint

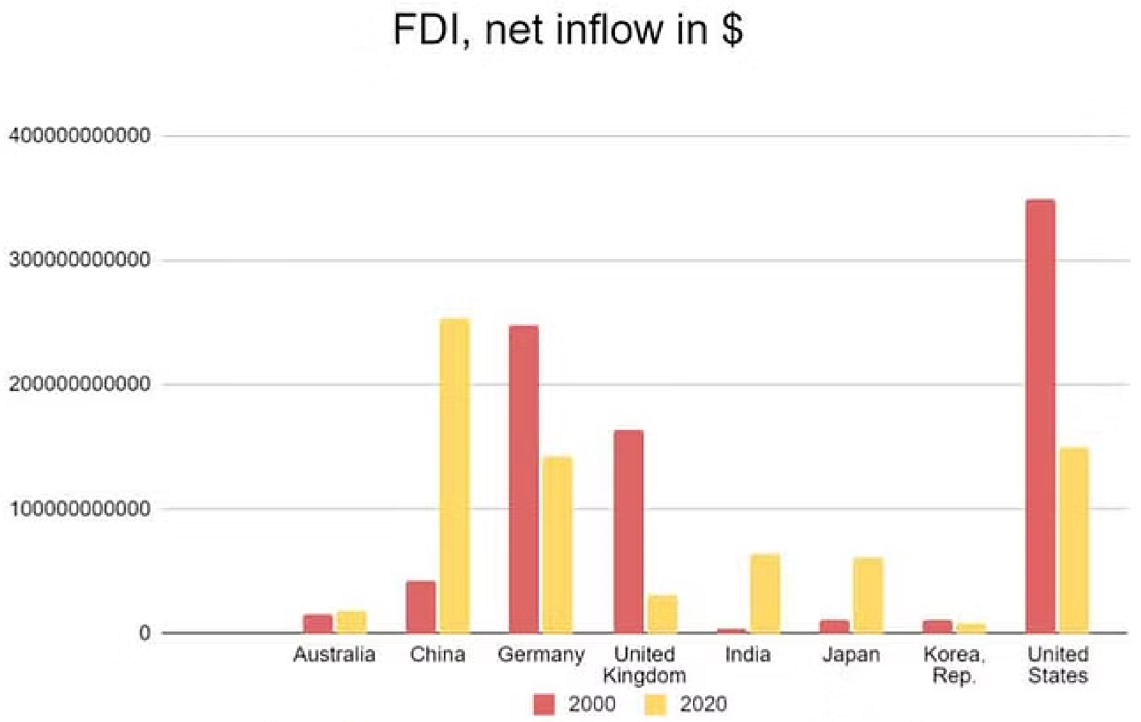
As evident from above, this is one sector India has particularly performed poorly compared to other developed countries. On one hand, Domestic credit to GDP in countries like the USA, China exceeded the 180% mark whereas, India's Domestic credit to GDP has been stagnant around 50% for the last decade. This suggests that compared to developed economies, not enough credit-based borrowing leading up to more private investment for expanding production capacity has been seen in India.

> This (the lack of credit-enabled domestic private investment) can also be cited as one of the key reasons why India's growth has remained at sub-par or sub-optimal levels for much of the last decade (from 2012-13 onwards).

Foreign Capital To Address Investment Gaps

When domestic private investment is low, the policy tends to pivot more towards attracting foreign capital to meet the overall saving-investment gap. Foreign direct Investments or FDI are a net inflow of inward direct investments made by non-resident investors.

In the last two decades, only India, China and Japan saw a net positive growth in the volume of FDI net (in)flows. FDI in most other developed countries like the USA have fallen considerably, catalysed by low-domestic interest rates.



Source: CNES Infosphere Team (Vol IV Edition 2)

FDI, net inflow in USD

Image: Namita Chauhan/The Quint

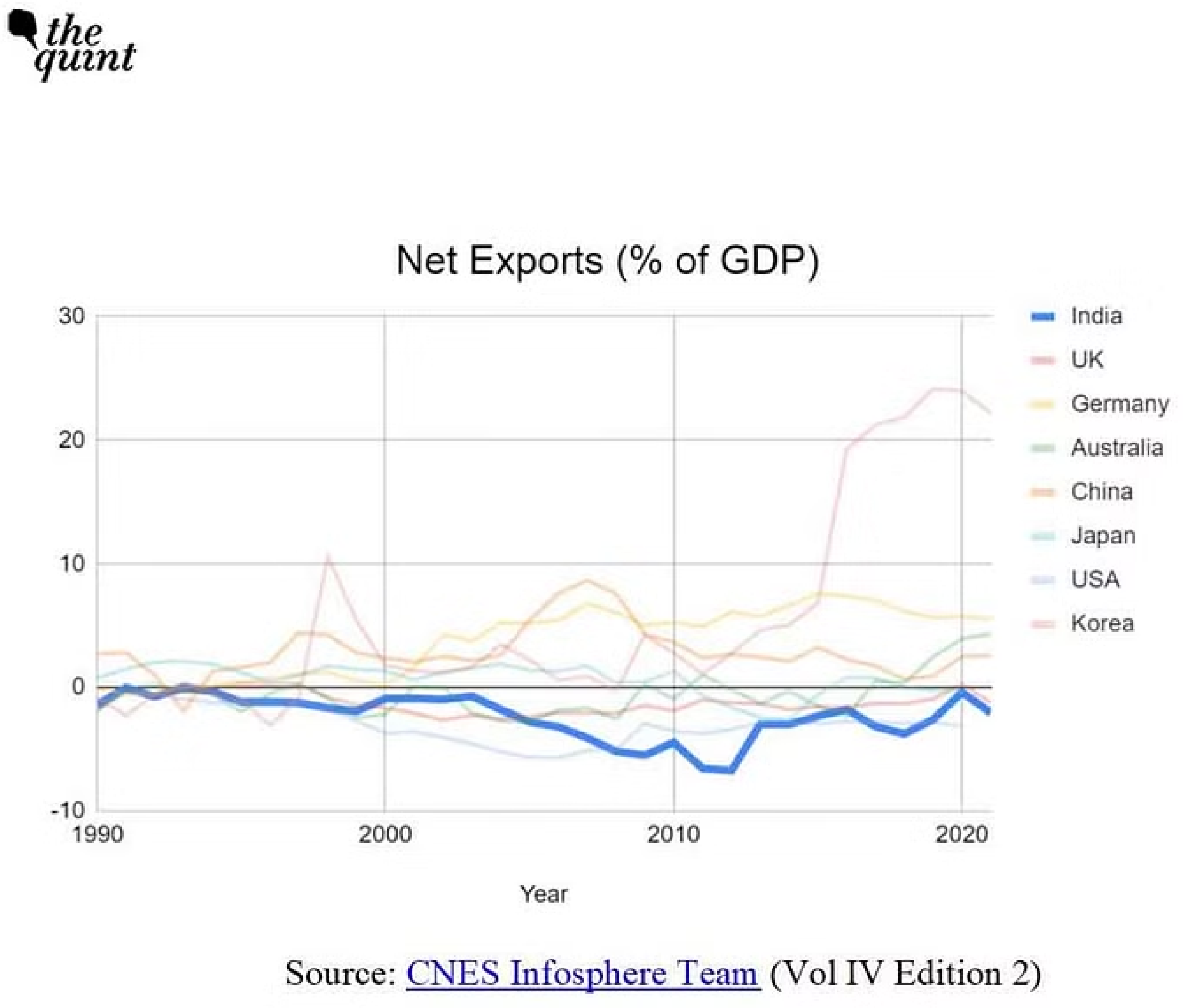
FDI's contribution to India's GDP increased by nearly 2.3%, whereas other developed countries experienced a decline in FDIs.

> This suggests India's presence as a potentially 'hot market' for foreign institutional investment and direct investment for foreign investors. Our over-optimistic stock market trends indicate this 'bullish' trend too.

Decline in Exports and Widening Trade Deficits

India's total export of 275,488,744.93 in thousands of USD and total imports of 367,980,363.48 in thousands of USD has led to a negative trade balance of -92,491,618.55 in thousands of USD. Its trade growth has been around -8.75% compared to a world negative trade growth of -3.91%.

Historical context is important in understanding current trends.



Net Exports (% of GDP)

Image: Namita Chauhan/ The Quint

Net exports present a measure of revenue generated from exports minus the expenditure on imported goods. For a long time now, India's net importer position has widened its trade deficit viz-a-viz other countries. Most of the other comparable economies have experienced net positive exports, suggesting more trade is augmenting their economy, not deducting from it.

Countries like South Korea and China in the emerging market spectrums too, even managed to significantly increase their net exports which have positively led to expansive growth possibilities. More details on India's foreign policy outlook on trade and its trade-centered relationship with partner nations is analysed here in detail.

Contribution of the Service Sector

The Service sector is one of India's largest and most important sectors from a growth perspective. Understanding the specific impact of the service sector requires looking both: the 'value added' by the services sector in % GDP terms and in 'absolute terms'.

Looking at the 'value added' by services in absolute terms allows us to contextualise the growth of services in the presence of rapid GDP growth, and then the comparison across countries becomes far more detailed.

If we look at it in 'absolute terms', India's absolute value added from services has grown far faster than countries such as the UK, Japan, Korea, etc. This is where the context of GDP becomes important. We need to therefore, look at 'services' as a percentage of GDP

India's no longer soaring above all other countries. In fact, India is decidedly average, lowest in terms of 'value added' by services as a % of GDP in 2021, outpaced by China somewhere in 2013.

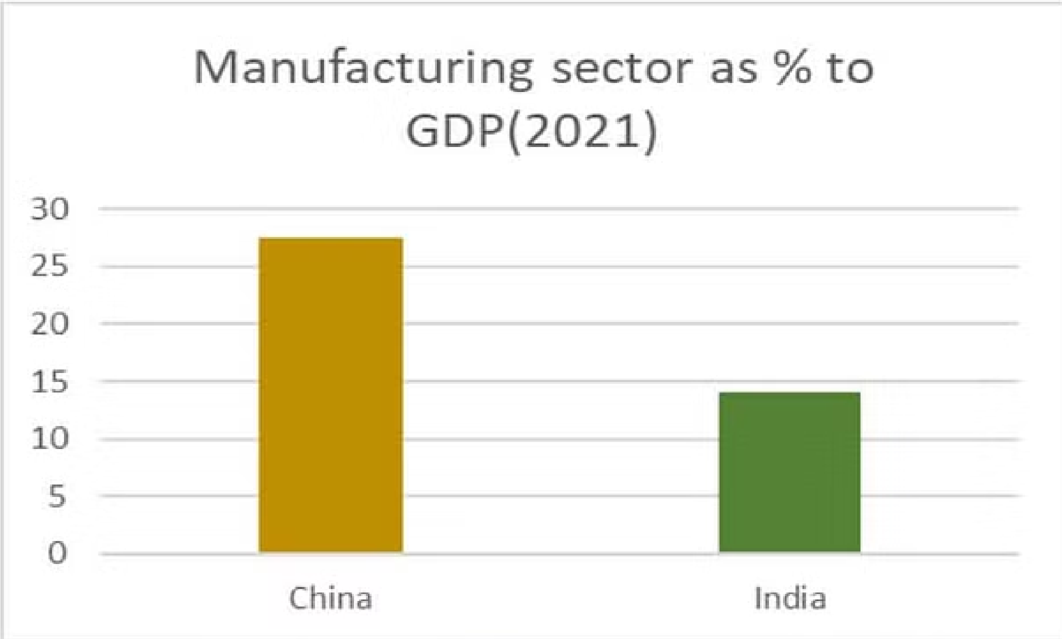
> This tells us that, as mentioned earlier, the 'absolute value added' of services for India has more to do with India's rapid GDP growth, rather than witnessing a proportionate increase in the performance of the services sector. In short, a lot more needs to be done in expanding the contribution of services, across groups, to India's potential GDP growth.

'India vs China' Growth Trajectories

In 1990, India's current GDP was greater than that of China. In the next three decades, China didn't just surpass India, it went on to become the second-largest economy in the world while driving more people out of poverty than any other nation on earth.

It is still intriguing (and fascinating for development studies scholars) to analyse how China experienced a 'quicker' path to economic prosperity while maintaining a higher level of economic growth rate than India.

The sector that played a major role here, no doubt, is the performance of the Manufacturing sector.



Source: CNES Infosphere Team (Vol IV Edition 2)

Manufacturing sector as % to GDP (2021)

Image: Namita Chauhan/ The Quint

In 2021, the manufacturing sector in China contributed 26.3% to its economy, which is roughly double of what it contributed to the Indian economy.

To figure out the causes for this major difference, we compared both the countries in terms of their GFCF and domestic credit provided to the economy. From 1990, China consistently had roughly four times of domestic credit to its GDP as compared to India.

Private investment drove manufacturing growth in China while in India, even though FDI flows increased, overall domestic private investment levels have remained significantly sub-par. MSMEs and small-scale firms remained 'small' and 'medium' scale in the absence of 'domestic credit' and/or supply of cheap loanable funds from the organised banking sector.

Greater levels of credit means more loans have been made available to the domestic private sector in China.

> Yes, in a publicly-regulated banking space, there are problems of high indebtedness, on discretionary power of providing loans to company 'A' against another, and of public-private corruption in China but the net effects of overall credit-fueled growth engineered its 'epochal' rise.

This is also evident as China's growth rate in GFCF over the last 30 years is substantially more than India's. Over the last 30 years, China managed to increase its investment in fixed capital by five times to India. This investment resulted in production on a larger scale, and it is here that China's manufacturing sector ended up contributing almost double to what it contributes to the Indian economy.

However, a greater production level would be of less use if they aren't efficiently allocated in both domestic and international markets. Since China has a reputation for cheap exports, it's important to signify the difference between China and India's export trends.

Our Infosphere team also used the Economic Complexity Index, which takes data on exports and ranks countries based on diversity and ubiquity of the products in their export basket. Hence, a country which has a more diverse basket and exports to a greater number of countries is ranked higher. For research, we compared how India and China's rank changed over the last two decades.

Post year 2000, the economic gap between India and China consistently increased. With China ranking in the top 20, it suggests that China is exporting a more diverse product basket and is exporting to a greater number of countries as well. However, India failed to keep up with China and substantially fell behind it on the index. This suggests that China's export levels and export revenue substantially increased, leading to higher growth.

However, greater export revenue does not mean greater value added to GDP (as we have argued before). Import expenses also need to be accounted for, and in many cases, countries have a deficit on their net exports.

For this, one needs to compare how net exports as % to GDP fared for both countries over the last three decades.

Except for one year, China consistently had positive net exports viz-a-viz India.

Interestingly, cheap labor is a factor which is commonly associated with China and India's manufacturing sector. While India has had access to cheap labor, in a labor surplus economy, it could not tap into the potential for expanding its manufacturing competitveness as much as China did.

India's Growth Measured On Value Over Absolute Figues

From our research, we could conclusively say that most of India's rapid growth is due to an increase in 'absolute value' added by the service sector of the country. In real terms, we are way behind and in human capability terms, there is no point even drawing a comparison between the 'top four' (largest growing nations) and India.

Sectorally, services are where our strength lies but most of the value added is disproportionally constrained to capital-intensive, urban-based, service-based sectors where 'value added' growth is becoming increasingly less for India as compared to other nations.

More importantly, it's not doing much to address the big elephant in the room: job creation for a largely young demographic working-age population base. Immediate policy interventions with short-medium-long term implications need to acknowledge these issues and address the pointed fault-lines sooner than later.

(This study was undertaken by the InfoSphere Team of Centre for New Economics Studies (CNES), Jindal School of Liberal Arts and Humanities, O.P. Jindal Global University. To see more of their work, please access their website here along with the most recent edition on inflation.)

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