Deloitte.

Competitiveness: Catching the next wave India

November 2014

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Executive summary

India's economy never fails to surprise. On the one hand the economy promises enormous long-term advantages, such as a young demographic base, growing incomes, an expanding (and globalized) middle class, an educated workforce, and a stable democracy. In theory, these factors are enough to propel the country to the league of major economic powers.

On the other hand, India arguably has not realized its full potential in the past few years with the economy strained by structural inadequacies and a general lack of consensus in policy making.

Moreover, growth has not come without challenges, including poverty alleviation, income distribution, urban planning, and environmental degradation. Policymakers also face greater demands and scrutiny from a more-educated population, especially a vocal middle class, which has been redefining India's economic, political, and social space.

In such a scenario, it is interesting to analyze where India's economy stands today and what are the alternatives for policymakers. With a new government, policy decisions and choices will determine the nature, pace, and success of economic growth in the country this decade and the next. This report examines in detail India's economic strengths, key growth drivers, challenges, policy debates, and myriad economic facets.

Competitiveness: Catching the next wave in India, a new report by Deloitte Touche Tohmatsu Limited, aims to highlight those industries that will help power the country's next wave of sustainable growth. These sectors include infrastructure and construction; banking, financial services and insurance (BFSI); wholesale and retail trade; automobile manufacturing; pharmaceuticals; and ICT (information and communications technology).

Introduction

On 24 September 2014, a satellite started sending back images of Mars to a control center on Earth. Interestingly, mission control was not based in the West or in Russia; it was in Bangalore, home to the Indian Space Research Organization (ISRO). The mission to Mars is a huge technological leap for India. India is only the fourth country in the world to put a satellite in the red planet's orbit, and it is the first to succeed on the first attempt. The mission's success, despite significant odds, perhaps best highlights India's potential and the myriad opportunities that its economy offers.

India emerged as a key player in global economic affairs in the past decade. It was among the few nations that managed to withstand the global financial crisis of 2008–09 and continued to post strong growth in the next two years. This raised hopes that by riding the advantage of a strengthened economy, India would emerge as a magnet for businesses across the globe, even as key advanced economies struggled to stay afloat. Sadly, that was not to be. Policymakers failed to take advantage of the good times to tackle challenges like outdated infrastructure, an overbearing bureaucracy, and a rigid labor market. As the economy hit these structural bottlenecks, growth slowed down. A general lack of policy direction did not help. Suddenly, the Indian economy was left rudderless in a rather turbulent global economic sea.

The election of a new and a stable government at the center for the next five years has brought some energy back to the economy. Promises of a more-efficient administration and policy emphasis on infrastructure, partnership with businesses, and better center-state coordination have renewed enthusiasm among investors. In addition, a recent high dose of foreign policy mixed with strong economic overtones and the launch of the "Make in India" campaign have put the focus back on India. With Brazil and Russia struggling, and Chinese growth moving to a lower trajectory, investors appear increasingly willing to back India's economy, a fact reflected by sharp inflows into Indian capital markets since May.

The current euphoria is certainly not misplaced. India's medium- to long-term economic fundamentals are solid. These include a large market with 1.25 billion people, many of whom are likely to move up the income ladder in the next 20–25 years on the back of strong GDP growth. India is also home to a young population, a key pillar of demand and the workforce. This market segment will be increasingly aware of developments in technology, lifestyles, and finance, thereby forcing businesses to innovate in the products and services they offer and their delivery. Innovation will also be required to cater to rural India, a market that is large and where median incomes are rising faster than in urban areas.

Macroeconomic and policy outlook

India's macroeconomic outlook, political and business environment, and focused policy direction play an important role in driving growth. India made substantial headway in the past decade, recording an annual average growth rate of 8.3 percent from 2004 to 2011. Robust growth, combined with strong demographics, helped India emerge as a new global economic player and brought recognition as one of four emerging nations with the potential to become an economic powerhouse by 2050.

However, over the past two years, the economy has been burdened with high inflation and fiscal deficits, currency and capital account volatility, and poor business investment and sentiments, which has caused growth to fall below 5 percent. And though restrictions on the import of nonessential goods has contained the current account deficit, it remains vulnerable to growing domestic demand, rising fiscal deficits, and global uncertainty (Figure 1). Structural factors such as poor infrastructure and capacity, labor market inefficiencies, lack of land acquisition reforms, and a poor distribution system often have resulted in supply bottlenecks, and are some of the primary reasons for inflation and poor investments in the economy.

In the medium term, fiscal issues and inflation will likely remain a challenge, though falling crude prices might bring some relief. There could be an upward pressure on the current account deficit going forward, if economic activities improve further. Global uncertainties with respect to growth in the United States and the Eurozone, geopolitical tensions in the Middle East and North Africa, a rise in interest rates in the United States, and a financial crisis in China may weigh on capital flows and business sentiment. Consequently, India's domestic currency might weaken. This could be advantageous as it might improve the economy's competitiveness and increase exports in the manufacturing sector. However, rapid currency depreciation will only aggravate inflation and the debt burden. That said, market optimism about an improving economy and expectations that the new government will usher in a period of significant fiscal and economic reforms should keep the equity and bond markets buoyant. Improved investor confidence will also be reflected in higher capital inflows and higher business investment in the near term.

Figure 1: Macro economic indicator

Variables\Fiscal Years	FY 2012–13	FY 2013–14	FY 2014–15 E#
Real economy			
GDP at factor cost (% y/y)	4.5	4.7	5.9
Real private consumption expenditure (% y/y)	5.0	4.8	4.0
Real total fixed investment (%y/y)	0.8	-0.1	5.5
Industrial Production, yearly average (%y/y)	1.1	-0.1	4.3
CPI-inflation (% y/y)	10.2	9.5	8.0
Twin Account			
Fiscal deficit (% of GDP)	-7.4	-6.9	-4.6
Current account deficit (% of GDP)	-4.7	-1.7	-2.2
Financial Economy			
10-yr yield (%), (FY average)	8.2	8.4	8.5
INR/US$, (FY average)	54.5	60.7	60.3
Equity index (% y/y, March eop)	8.8	14.5	30.4
Surveys			
Consumer Confidence: future expectation (Index, March)	103.9	114.9	-
Business Expectation Index (Index, March)	115.6	112.7	-
Capital flows*			
Net FDI (US$, billion)	19818	21564	36166.95
Net FPI (US$, billion)	26889	4822	41621.69
Net FII (US$, billion)	27582	5009	-

Source: Reserve Bank of India, August, September, 2014. The fiscal year (FY) in India begins on April 1.
E stands for expected projection for FY 2014–15, Deloitte projections using Oxford industry model
* Annualized figures of Q1 FY 2014–15

Note: The color maps indicate risk outlook of a variable based on projection for the FY 2014-15. Green indicates low risk outlook, yellow indicates neutral outlook, and red indicates high risk outlook.

The challenge of re-engaging with global investors

Much has been said about policy stagnation in India, especially over the past few years. However, the recent general election has established a stable government with a single-party majority for the next five years. The new government seems to have started on a proactive note, putting an emphasis on foreign policy as a key tool for economic development. The early September 2014 visit of India's Prime Minister Narendra Modi to Japan appears to have reinvigorated interest in the international investor community. Japan pledged US$34 billion in investments in infrastructure and manufacturing over the next five years.[1] China announced investment commitments worth US$20 billion in India over the next five years following the mid-September 2014 visit of Chinese President Xi Jinping to India.[2] Both China and Japan are eager to invest in infrastructure, a key priority for the Indian government. With respect to the United States, India has sought greater cooperation in technology, infrastructure, education, health, and sanitation. During his visit to the U.S., in addition to meeting with President Barack Obama and U.S. policymakers, Modi also met with more than 15 executives of the largest U.S. companies, as well as expat Indians (drawing close to 20,000 attendees), to reinvigorate their interest in investing in the government's new initiatives.

These visits have injected fresh energy into efforts to improve business links with the three largest economies. The government will also be on the lookout for collaboration with advanced economies in health, sanitation, and clean energy.[3] However, the challenge will be to reduce the cost of doing business in the country, including reducing the number of clearances required for new projects. It will take effort on the government's part to realize the prime minister's recent pledge of offering global investors a "red carpet" instead of "red tape."

Initial steps to ease investors' concerns

The new government has already taken steps to improve India's business environment and a more assertive Prime Minister's Office (PMO) should bring about faster decision making on reforms going forward. Among some of the early steps the government has taken has been to abolish ministerial groups set up by the previous government. Individual ministries will now be more empowered, with cross-ministerial interactions likely to be facilitated via the PMO and the cabinet secretariat. Businesses will likely also benefit from recent measures announced in the budget, which pushes for passing a uniform, countrywide goods-and-services tax, improving tax collection, and making it easier for companies to do business across state lines.[4] For example, the government announced it intends to roll out a uniform goods-and-services tax throughout the country in 2015.

[1] Wall Street Journal, "Is China ready to step up and invest in India," September 2014.
[2] Bloomberg, "Modi wins US$20 billion pledge from Xi amid border flare-up," September 2014.
[3] The Hindu, "Germany, India strategic partners with excellent economic relations," September 2014; Times of India, "Israel offers help in Ganga cleaning project," September 2014.
[4] Ministry of Finance, Government of India, "Key features of budget 2014-2015," July 2014.

A new focus on infrastructure—considered India's Achilles heel—was also evident in the recent budget. In particular, the government seems intent on developing "smart cities" and it has already reached out to leading nations such as Singapore, Japan, and China for guidance.

The focus on smart cities, including enhanced urban infrastructure, will have limited success if policymakers do not take cognizance of increasing housing demand and decreasing affordability in large cities. Given real estate's increasing attractiveness as an investment option for the wealthy, including the upper middle class, house prices in major Indian cities have soared. This has put housing out of reach for a large part of the population, thereby requiring innovative solutions in affordable housing—both in current cities and new ones that the government aims to develop.

Foreign investors have also applauded efforts to raise foreign direct investment (FDI) in insurance and defense. However, the easing of FDI limits by itself will not translate into more investment if hindrances to project clearances remain. Investors are cautious, waiting for greater clarity on key issues, such as retrospective taxes and public finances, which the government has pledged to address.

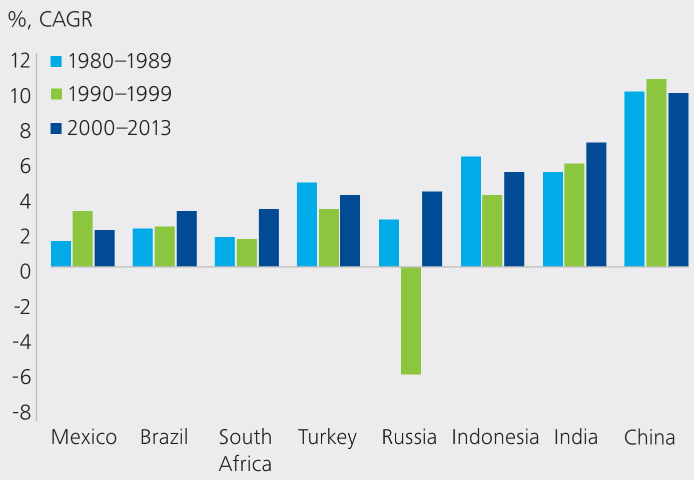
Toward greater prudence in monetary policy and banking oversight

The Reserve Bank of India (RBI) has also been on a "reform drive" over the past few years. Arguably, its most laudable effort has been to gradually move to an inflation-targeting mechanism for the conduct of monetary policy with the consumer price index (CPI) as a nominal anchor. This will help the central bank set interest rates by focusing on retail inflation rather than wholesale prices; the latter tends to under-report prices that consumers actually face. The RBI has also been keen to strengthen defenses against banking and financial-sector risks. For example, a few key recommendations by select committees include cyclical buffers for banks and higher buffers for systemically important banks.[5] The RBI is also prodding the government to promote better management of public sector banks, especially in light of rising nonperforming assets and recent scandals. Some of these initiatives could, however, lead to differences of opinion between the government and the RBI. For example, the RBI seems wary of the targeted speed of implementation of the Jan Dhan Yojana—the government's effort to ensure its population has bank accounts—even though it has strongly backed the initiative.[6] However, such friction should not deter either the RBI or the government.

[5] Reserve Bank of India, "Press release: RBI releases final report of the internal working group on implementation of countercyclical capital buffer framework in India," July 2014; Reserve Bank of India, "Framework for dealing with domestic systemically important banks (D-SIBs)—draft for comments," August 2014.
[6] ANI News, "RBI governor calls PM Jan Dhan Yojana biggest financial development," September 2014.

Figure 2: GDP growth in emerging economies

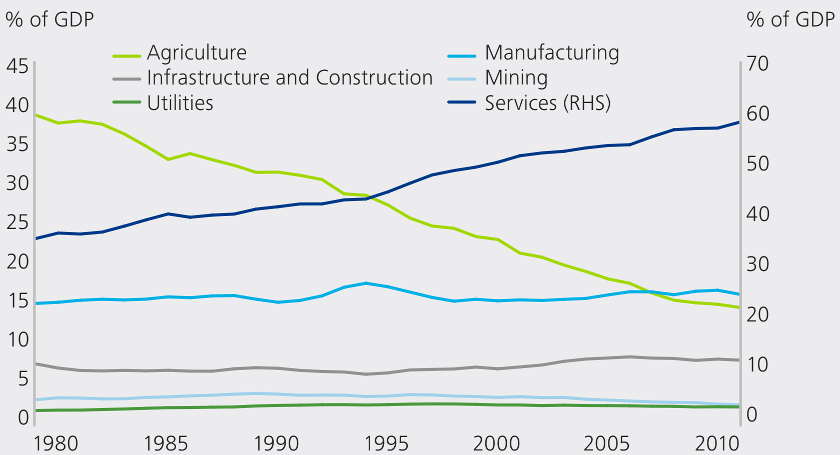
Historical growth trend



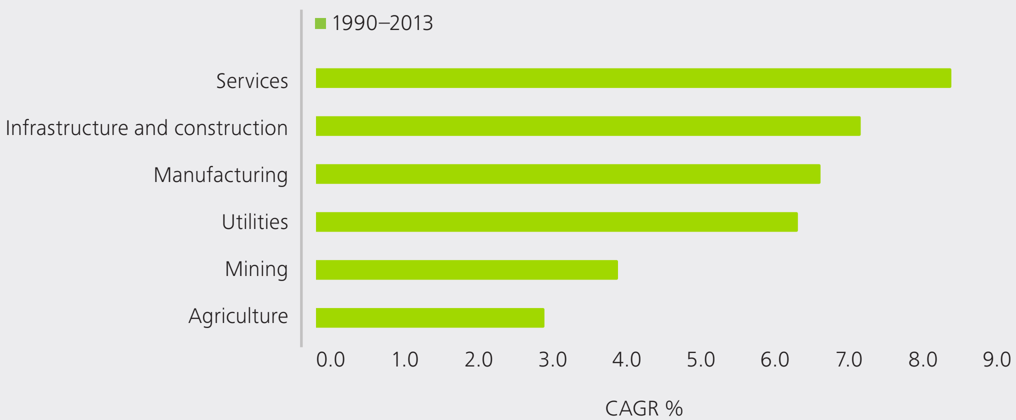
Source: Reserve Bank of India, August 2014, Oxford Economics (Global economic databank)
Note: Annual numbers for India are for India's fiscal years.

Figure 3: Changing economic landscape

Share of sectors in GDP



Growth sectors



Source: Reserve Bank of India, 2014
Note: Annual numbers for India are for the fiscal years for India. For India, the construction and infrastructure sector is included under services. However, for this study, construction and infrastructure has been considered a separate category.

A look back: growth unlike others

India embarked on the path of liberalization in 1991 and implemented wide-ranging reforms, opening the economy to greater competition and wider opportunities. The economy grew at an impressive rate of 6.5–7 percent over the subsequent two decades. As illustrated in Figure 2, India had the second-highest growth rate among leading emerging economies during 1990–2013. It currently ranks third-largest in the world, measured in purchasing power parity terms.[7]

A feature of India's growth model is that it has not followed Rostow's traditional growth model[8] of evolving from an agrarian economy to low-skilled, labor-intensive manufacturing, to high-tech manufacturing, and finally to a services economy. While perhaps unique, India's direct move to a services economy without strengthening its strong manufacturing base is proving problematic.

Since liberalization, the services sector has contributed the most to growth, though very few had anticipated this transition when economic reforms were rolled out.

As evident in Figure 3, the fall in agriculture's share of GDP has been offset by an equivalent rise in the share of the services sector. Meanwhile, the manufacturing sector, which is the largest source of employment to relatively low-skilled labor, has not taken off at the desired pace.

[7] OECD, India: sustaining high and inclusive growth, Better policies series, October 2012
[8] W.W. Rostow, U.S. economist and political theorist, postulated a five stage model of development that every economy will likely follow as it grows. The fifth stage refers to mass consumption as the economy's focus moves away from production towards consumption. http://www.academia.edu/3596310/ Rostows_theory_of_modernization_development

Services sector

The services sector has been the fastest-growing of all the sectors, increasing at an annual pace of 7.5 percent during 1990–2013, followed by the infrastructure and construction sector[9] (Figure 3). Usually, growth in traditional services precedes growth in services that require state-of-the-art technology. However, in India, a sharp increase in income and private domestic demand among the rising middle class resulted in the need for services that could facilitate faster growth and support the rapidly expanding economy. Thus, some "technical" services such as banking, financial services, and insurance (BFSI) and information and communication technology (ICT) grew faster than traditional services such as health and education (Figure 4). In addition, rapid globalization and the advent of the Internet enabled services to be traded internationally, which, in turn, expanded services exports. The availability of skilled and English-speaking workers helped India ride the new wave of services exports—another phenomenon that does not conform to textbook growth theories.

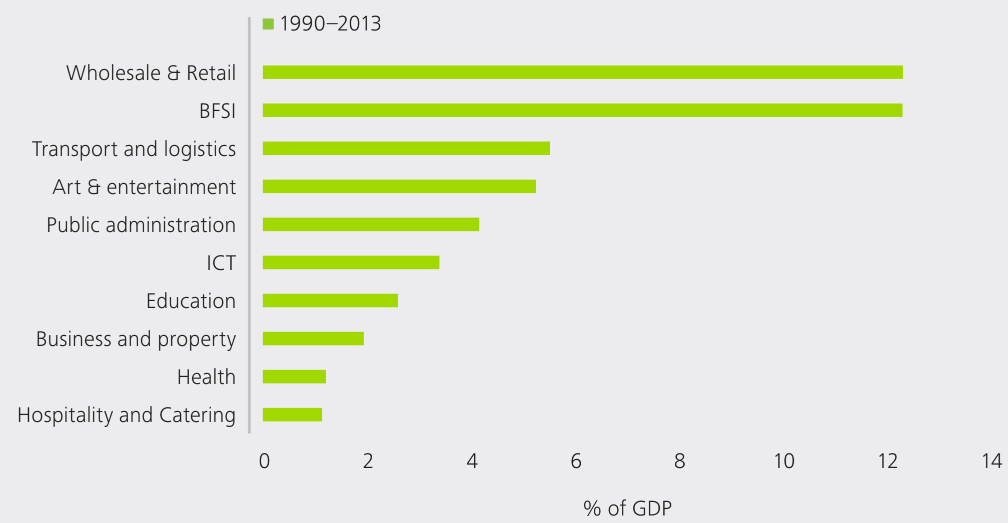
Manufacturing sector

The manufacturing sector, which, in most developing countries, helps the economy transition from agricultural work to highly skilled jobs, is generally a stimulus to the creation of small- and medium-sized enterprises. But in India, this sector has experienced only lackluster growth so far, with its share remaining constant at around 15 percent over the past three decades. The basic metals and metal products industry was the largest industry in the manufacturing sector during 1990-2013 (at around 3 percent of GDP), while the shares of all the other manufacturing industries remained below 2 percent of GDP (Figure 5).

Indian manufacturing is currently labor-intensive and primarily specializes in low-end industrial products, which are either engaged in assembly line production and/or require very little innovation. For example, low-scale industries, such as furniture manufacturing and repair and installation of machinery, were among the fastest-growing sectors over the last two decades (Figure 6). This is because, with the liberalization of trade and investments, India provided multinational companies (MNCs) with the opportunity to produce goods at a competitive cost. However, due to the lack of clear policies and poor investment in the sector, the gross value of manufacturing production increased without a corresponding increase in value addition. Regulatory constraints and bureaucracy also impacted efficiency. Onerous labor laws, along with delays and uncertainty in the implementation of policies, compelled businesses to avoid large-scale production, thus diminishing productivity growth. Restrictions on external trade also negatively impacted industrial growth and resource utilization efficiency.

[9] In India, construction is included under services. However, for this study, construction has been considered as a separate category. Services is net of construction activities.

Fig 4: Share of services sector in GDP



Source: Reserve Bank of India, August, and Oxford Economics (Global Industry Databank), September

Figure 5: Manufacturing sector's lackluster growth

Top five largest manufacturing sector	Share of GDP (%, 1990–2013)
Basic metals & metal products	3.2
Textiles, leather & clothing	1.9
Food, beverages & tobacco	1.8
Chemicals	1.5
Coke & refined petroleum products	1.4

Source: Oxford economics (Global Industry Databank), August, 2014

Figure 6: Sectors low in the value chain grew fast

Top five fastest growing manufacturing sector	CAGR (%, 1990–2013)
Furniture manufacturing	17.6
Transport equipment (excl auto)	12.6
Automobile manufacturing*	11
Electrical, optical, machinery and apparatus	9.2
Repair and installation of machinery & other manufacturing	8.2

Source: Oxford economics (Global Industry Databank), August 2014
*Includes only passenger vehicles, commercial vehicles and their components, excludes two and three wheelers

Inherent strengths that will unlock India's potential

Amid persistent global uncertainties, India's inherent advantages and economic strengths have helped the economy resist several external crises, such as the Southeast Asian crisis of 1997 and the global financial crisis a decade later. These strengths will contribute to India's growth and prosperity in the future, as well as help showcase the country as an attractive market for investment.

A demographic dividend

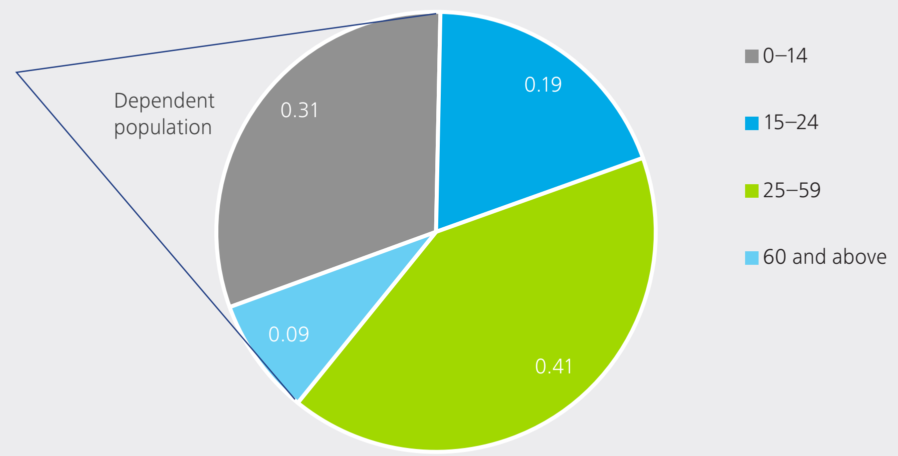
India's demographic advantage offers a strong edge to leverage opportunities essential for a vibrant and rapidly growing economy. A relatively young and growing population, a sizeable educated workforce, and an emerging middle class contribute to the country's competitive advantage. India has a large workforce; more than 60 percent of the population belongs to the working age group of 15–59 years, and another 30 percent is waiting to join the labor force in the next one-and-a half decades (Figure 7). The size of the Indian labor force is the second highest in the world, and will grow faster than China in the next 15 years (Figure 8).[10] According to studies,[11] the 40–49 age group is the most productive group because of its work experience. Nearly half of India's working population will belong to the 30–49 age group in the coming years, which implies that India will experience a boom in its most productive share of the population—at the same time that this segment of the population will be declining in China and in the United States.

A qualified, culturally diverse, and English-speaking workforce is also a big advantage for foreign companies looking to expand into India.

India ranks second, after China, with respect to the total number of students who graduate university every year (5.34 million in FY2014) and has the world's largest employable graduate population.[12] Around 25 percent of the workforce consists of domain experts such as doctors, lawyers, statisticians, chartered accountants, and mathematicians. In addition, absolute wage levels in India are low, which is a large cost advantage for foreign firms that want to locate production outside their country of origin. According to the Bureau of Labor Statistics (BLS), average hourly compensation costs for all employees in Indian manufacturing was US$1.25 in 2009 (Figure 9). Hourly compensation costs in the manufacturing sector in the United States were US$34.11.[13]

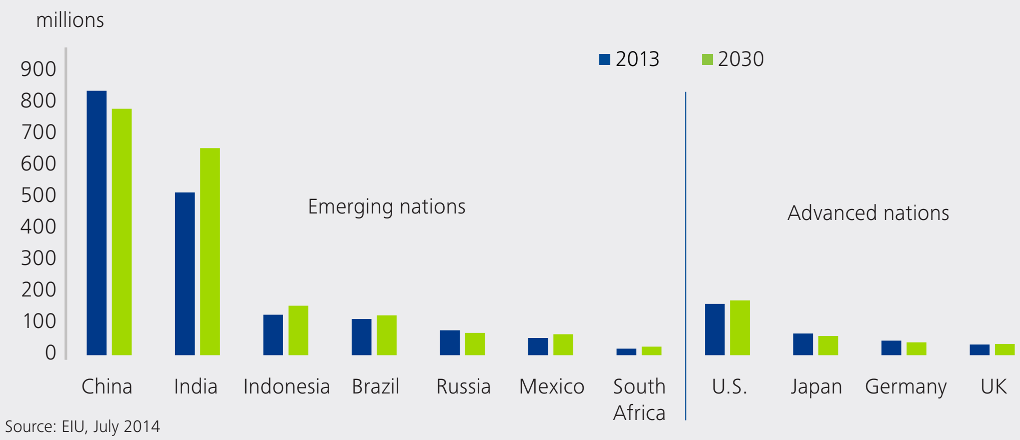
[10] Economic Intelligence Unit (EIU), July 2014, http://gfs.eiu.com/PastReports.aspx.
[11] James Feyrer (2007), Demographics and productivity: The review of economics and statistics, Vol. 89, no.1, Pages 100–109. http://www.mitpressjournals.org/doi/abs/10.1162/rest.89.1.100?journalCode=rest#.VCFM1v8rjC8
[12] NASSCOM, *Human capital leadership: world's largest, most diverse talent pool*, 2014, http://www.nasscom.in/knowledge-professionals
[13] Bureau of Labor Statistics, *Charting International Labor Comparisons*, http://www.bls.gov/fls/chartbook/chartbook2011.pdf, 2011.

Figure 7: Working-age population



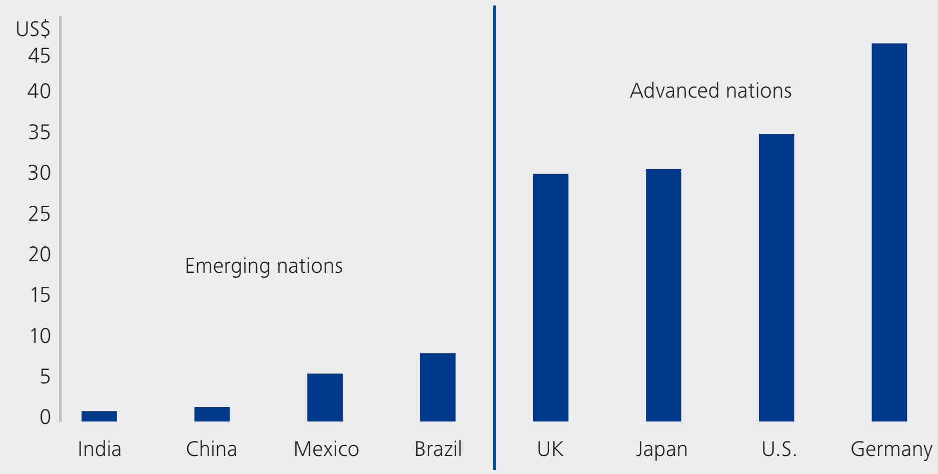
Source: Census of India, Ministry of Home Affairs, Government of India, 2011

Figure 8: India is projected to have the second-largest labor force* by 2030
Labor force projections



Source: EIU, July 2014
*Note: According to the EIU, the labor force or workforce is the number of people employed and self-employed plus those unemployed but ready and able to work. The grand total is sometimes known as the economically active population. It varies by country, but generally refers to people over 14 years. According to the data, China's economically active population will fall during 2013–2030, though it will continue to be the highest.

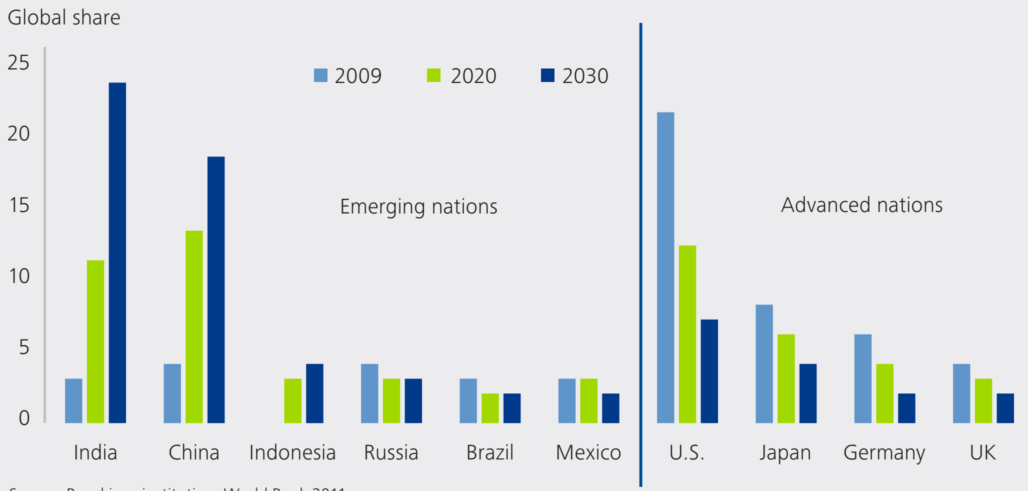
Figure 9: Average hourly compensation costs for all employees in manufacturing sector, 2009



Source: Bureau of labor statistics, 2009. Note: Data for China and India are not directly comparable with each other or with data for other countries due to differences in methodology.

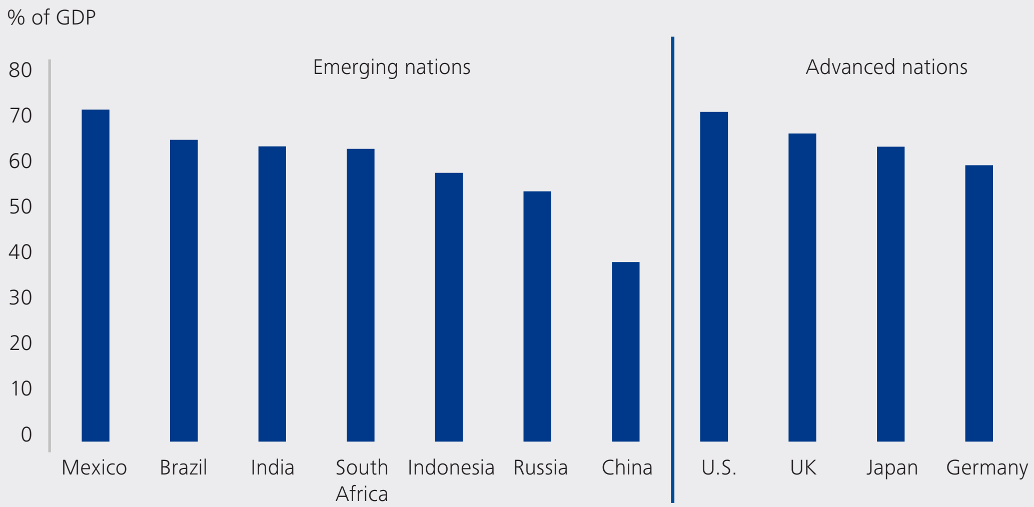
Figure 10: India set to be the next powerhouse of middle-class consumerism

Middle-class consumption in global share



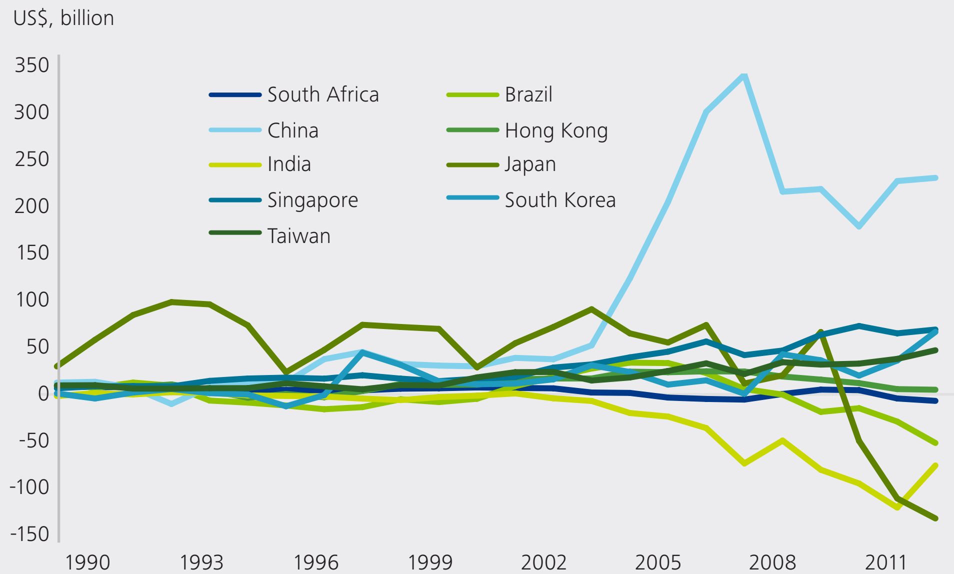
Source: Brookings institution, World Bank 2011

Figure 11: Share of private consumption in nominal GDP of key emerging economies



Source: Oxford Economics, Global Economic Databank, September 2014

Figure 12: Net exports of goods and services for key economies



Source: Oxford Economics, Global Economic Databank, September 2014

The other important aspect of India's demographic dividend is the boom of the middle class—the key to a high-potential domestic market. Currently, the middle class (currently defined as people earning between US$10 and US$100 per day in 2005 prices), is small—around 50 million people, or less than 6 percent of the population. However, rising income will likely spur the growing middle class and, according to the World Bank, India could add more than 1 billion people to the global middle class between now and 2039. In addition, by 2030, India will likely be the world's largest middle-class consumer market, accounting for 23 percent of global middle-class consumption, surpassing both China and the United States (Figure 10).[14]

However, there are some risks associated with a growing workforce if there are not enough productive jobs. Only 66 percent of the working-age population (15–59 years) is suitable or available for work, and only 30 percent of the total population has stable employment (defined as engaged in economically productive activity for over six months).[15] Lack of job creation, limited availability of vocational and on-the-job training, poor education infrastructure, low literacy, and skills mismatch make a large proportion of the working population unfit for work. Furthermore, close to two-thirds of the population resides in rural areas, which lack quality infrastructure and job opportunities. Job locations and excess employment in agriculture also contribute to 34 percent of the population being unemployed. These factors have resulted in poor labor productivity in the economy.

While a large working-age population may not be sufficient to guarantee economic growth, it is necessary to sustain it. No growth driver is as certain as the availability of labor at a competitive cost. While improving labor quality and providing job opportunities for evolving demographics will be a challenge, India will have no dearth of labor supply with which to expand its production capacity.

Plentiful natural resources and strategic location

Another advantage for India's economy is its abundance of natural resources. Natural resources like coal (the fourth largest reserves in the world), iron ore (fourth in production),[16] and natural gas, among others—as well as the availability of extensive arable land and access to a wide network of fresh water sources—are important factors in the supply side of the economy. Access to these resources helps reduce import dependency and cuts costs. Though productive utilization remains a challenge, the availability of resources is an important potential source of economic growth and competitiveness.

India also benefits from its strategic location. Acting as a bridge connecting the East with the West, India's proximity to rapidly growing Southeast Asian countries (as well as China) and its strong oceanic connections have facilitated trade in all directions.

A growth model that suits its demographic advantages

A key characteristic that distinguishes India from emerging market peers like China and Russia is its domestic demand-led economic growth model rather than an exports-driven one.[17] For example, private consumption accounted for 61 percent of India's nominal GDP in 2013, compared to China's 37 percent and Russia's 52 percent (Figure 11).[18] The difference in growth models is also borne out of the differences in contribution of net exports to GDP of these economies. While net exports have been primarily negative in India, it is quite the opposite for China, Russia, and the "Asian tigers" who followed an exports-driven growth strategy (Figure 12).[19]

[14] World Bank, http://siteresources.worldbank.org/EXTABCDE Resources/7455676-1292528456380/7626791-1303141641402/7878676-1306699356046/Parallel-Sesssion-6-Homi-Kharas.pdf

[15] Census of India, Ministry of Home Affairs, Government of India, 2011

[16] Federation of Indian Chambers of Commerce and Industries; *Development of Indian Mining Industry – The Way Forward*; October 2013 http://www.ficci.com/spdocument/20317/Mining-Industry.pdf

[17] Rajiv Kumar and Pankaj Vashisht, "Crisis, imbalances, and India," Asian Development Bank Institute Working Paper Series, March 2011.

[18] Oxford Economics, Global Economic Databank, September 2014.

[19] Rajiv Kumar and Pankaj Vashisht, "Crisis, imbalances, and India," Asian Development Bank Institute Working Paper Series, March 2011; The Economist, "The export trap," March 2009. Asian tigers primarily refers to South Korea, Taiwan, Hong Kong, and Singapore.

India's demand-led growth model has occasionally proved beneficial, especially during times of global economic turbulence. For example, in calendar year 2009, real exports of goods and services fell 7.7 percent as external demand was hit due to the global economic downturn. However, a 6.9 percent rise in domestic private consumption helped India's economy grow by a healthy 6.5 percent that year.

Most importantly, India's internally focused economic model works well with its large domestic market. India was the third-largest economy in the world in 2013 in terms of purchasing power parity, and tenth in terms of nominal GDP (in US$).[20] These estimates, however, appear small relative to India's potential. India's nominal GDP is slated to be about US$15 trillion by 2040, more than 8.5 times that in 2013. Interestingly, rural and semi-urban areas will be key drivers of India's economic strength in the coming years, providing markets for a wide range of products and services. For example, the value of rural India's consumer goods market is expected to rise to US$100 billion by 2025, from US$12 billion now.[21]

A further strength of India's growth model is its lack of dependence on commodity exports. India's economic growth is not tied to global commodity prices as it is in Brazil and Russia, two major commodity exporters.

Both countries have seen growth slow this decade due to easing commodity prices. The two countries also find themselves increasingly uncompetitive in manufacturing and services as complacency during the commodity boom resulted in delays in investment and reforms. India has avoided this fate and, despite slowing growth, can look to strong internal factors—such as its demographic dividend and growing middle class—to rejuvenate growth.

Democratic institutions and independent central bank

India's strong democratic norms and a credible central bank have also played an important role in developing economic resilience. India has firmly rooted democratic institutions; the people of India elect its government and the transfer of power is generally orderly. Consequently, the risks of political failure have been much lower in India than in many other emerging nations. At the same time, functional independence of the RBI to monitor and regulate the financial system has ensured a healthy credit market. It was the forward-looking monetary policy, strict regulation of the nonbanking or shadow banking system, and close vigilance over the credit-creation process by the RBI that limited the exposure of the Indian banking system to the global financial crisis of 2008.

[20] International Monetary Fund, World Economic Outlook Database, September 2014.
[21] Harvard Business Review, "The globe: Unlocking the wealth in rural markets," June 2014.

Catching the next wave

India has had a good run so far. In the past two decades, it has prospered on the shoulders of the services sector, which boomed due to strong demographics, policy initiatives, and international opportunities. However, as India rides the inevitable waves of its business cycle, the underlying economic structure is rapidly changing.

This is evident from the increasing structural bottlenecks arising from demographic trends such as a growing population and lack of employment opportunities or skills mismatch, as well as from growing pressure on energy, natural resources, and infrastructure. There is a growing realization among economists, policymakers, and industrialists that India needs a growth strategy that can address the nation's long-term challenges and push the economy to new heights. The Indian economy needs to identify those sectors that can reap the potential benefits of demographic dividends and tap resources efficiently. In addition, it needs to overcome technology and efficiency barriers and invest in high-end research and development activities to move up the value chain. These structural changes will require the economy to seek new opportunities, advance technology, and improve efficiency.

The services sector is likely to continue to be the most significant contributor to growth in the coming years. Growth drivers such as a rising population, increasing income, and a consumption boom will increase demand for these sectors. Furthermore, rapid urbanization and changing consumer preferences will also have an impact on those industries driving growth.

That being said, there is a general belief that manufacturing will also drive growth in India, as the new government has indicated that revving up the manufacturing sector, including addressing structural bottlenecks and improving governance, is one of its immediate priorities.

The sectors we have identified as key long-term growth drivers for India's economy for the next 25-30 years are: infrastructure and construction; banking, financial services, and insurance (BFSI); wholesale and retail; automobile manufacturing; pharmaceuticals; and information and communication technology (ICT).

Future growth sectors

Infrastructure and construction: Building growth brick-by-brick

Profile

To support sustained, overall economic growth, India needs to robustly grow its infrastructure and construction sector.[22] Growth in infrastructure and construction not only generates substantial direct employment, but also fuels demand and growth in linked sectors and to generate externalities.[23] For example, a study of Indian manufacturing reveals that during 1972–1992, growth of road and electricity-generation capacity accounted for nearly half the productivity residual growth of India's registered manufacturing sector.[24] In other words, competitiveness of the economy and its sectors hinges crucially on the progress of this sector.

Key challenges

Rapid economic growth and a rising population have placed immense pressure on India's infrastructure. The country suffers from chronic power cuts, insufficient and poor roads, and congested ports, which have prevented economic development from reaching its potential and has adversely impacted the quality of living. The infrastructure in India is suffering from deficits in capacity, funding, and efficiency. A large number of projects have been ongoing for 30 to 40 years without completion.[25] In fact, there was a spillover of 553 projects into the 11th five-year plan[26] from the previous plan periods. The World Economic Forum's latest global competitiveness index (2014–15) ranks India's infrastructure 87 out of 148—the poorest rank among leading emerging economies[27] (Figure 14).

Securing financing for this sector is a major challenge. Until recently, infrastructure investment in India was financed almost entirely by the public sector. It depended heavily on government budgetary allocations and the internal resources of public-sector infrastructure companies. Together, they accounted for 48 percent of total infrastructure funding. However, due to a rising fiscal deficit, government finances are now severely constrained.

To fill the gap, the financial system—including commercial banks, nonbanking financial companies, and insurance companies—have stepped up lending to this sector by unwinding their excess investments in government securities. However, rapid growth in bank credit to infrastructure has resulted in a greater concentration of risks for banks and asset-liability mismatch. Moreover, because of rapid lending to infrastructure and construction projects, banks are now close to reaching the set exposure-ceiling limits.

The private sector has now emerged as a significant driver of investment in the infrastructure and construction sector. Private investment constituted about one-third of infrastructure investment in the 11th five-year plan and is projected to be 50 percent for the 12th plan period through public-private partnerships (PPP).[28] However, there are several factors that make it difficult to attract private investment. One, the development of efficient, low-cost, quality infrastructure involves high costs upfront and a long gestation

[22] This sector primarily comprises the construction of roads, railways, aviation facilities, and ports; civil engineering projects like irrigation and water projects; and housing and nonresidential buildings (Figure 13). This sector grew 8 percent during 1998–2013.

[23] Victor Osei (2013), "The construction industry and its linkages to the Ghanaian economy—Polices to improve the sector's performance," Bank of Ghana, Research Department, vol. 1, no. 1, March, pp. 56–72, http://www.eajournals.org/wp-content/uploads/THE-CONSTRUCTION-INDUSTRY-AND-ITS-LINKAGES-TO-THE-GHANAIAN.pdf.

[24] Charles R. Hulten, Esra Bennathan, and Sylaja Srinivasan, "A study of the Indian manufacturing industry," World Bank Economic Review 20, issue 2 (May 2006), pp. 291–308, http://elibrary.worldbank.org/doi/abs/10.1093/wber/lhj007.

[25] Planning Commission, Government of India, Faster, sustainable and more inclusive growth: An approach to the 12th five-year plan, October 2011, http://planningcommission.gov.in/plans/planrel/12appdrft/appraoch_12plan.pdf.

[26] Five-year plans are economic programs carried out through a five-year period to support agriculture production, industrialization and development of the social sector of India. This has been carried out since Independence and executed by Planning Commission of India. The 11th five-year plan was for the period 2007–12.

[27] World Economic Forum, The Global Competitiveness Report 2014-2015; September 2014 http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2014-15.pdf Page 16

[28] Deloitte, Indian infrastructure A trillion dollar opportunity, 5th PEVCAI, 2014, http://www.deloitte.com/assets/Dcom-India/Local%20Assets/Images/Thumbnails/infra/Deloitte%20Background%20Paper_27Jan_Final2.pdf

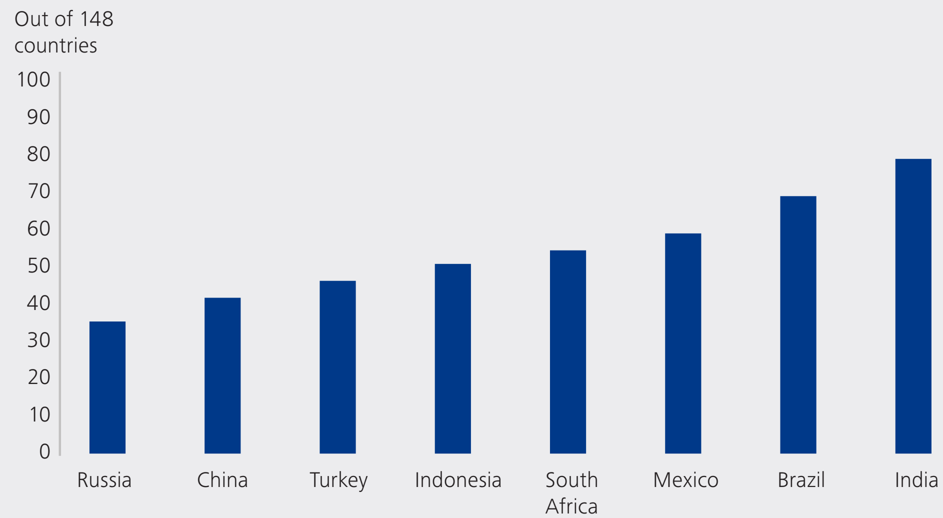
Figure 13: Sector profile

Roads	The national highways, with a length of 76,818 km, comprise only 2 percent of the road network but carry 40 percent of the road-based traffic. More than 70 percent of freight and 85 percent of the passenger traffic in the country is being handled by roads.
Railways	The Indian Railways (IR) runs the fourth-largest railway network in the world. It has a total route network of about 64,600 km spread across 7,146 stations and operates more than 19,000 trains every day. During 2012–13, over 30 million passengers traveled by trains on a daily basis in India and around 1,009.7 MT of freight was transported via trains.
Ports	There are 12 major ports and approximately 200 non-major ports, accounting for 95 percent of the country's total trade in terms of volume, and approximately 70 percent in terms of value.
Civil aviation	Currently, India has the ninth-largest aviation market in the world. Total passengers handled at Indian airports during the 11th plan period grew at an average annual rate of 11.5 percent, while cargo grew at an average annual rate of over 11 percent.
Construction	The real estate industry is the second-largest employer of India, after agriculture. Fifty percent of the demand for construction activities in India comes from the infrastructure sector, while the rest comes from industrial activities, residential and commercial development, etc. In recent years, commercial and retail spaces have become potentially attractive investment options, especially in larger cities. Seven cities (Bengaluru, Chennai, Hyderabad, Kolkata, Mumbai, the national capital region (NCR), and Pune) cater to 75 percent of the total demand for commercial real estate.

Source: Deloitte Touche Tohmatsu India Private Limited (DTTIPL) and Federation of Indian Chambers of Commerce and Industry (FICCI), February, 2014 "Indian Logistics: Focus on infrastructure creation to sustain and drive growth."

Figure 14: India's infrastructure challenge

The global competitiveness index—Infrastructure



Source: World Economic Forum, 2014–15

period. Second, policy paralysis in the form of changing regulatory environments, clearance delays, lack of structural reform, and policy uncertainties discourages private investment.

Growth potential

The government has adopted a three-pronged approach to address the sector's problems, which includes modifying the regulatory framework, speeding up clearances and removing execution bottlenecks for existing projects, and reviving the capital-expenditure cycle by awarding new projects.[29]

In addition, various reforms over the past few years have looked to liberalize rules and regulations, provide tax incentives and concessions, and simplify rules. The establishment of the Committee on Infrastructure (CoI) has been a major step in this direction. The government is also actively pursuing PPPs to ensure availability of long-term funds and encourage accountability and better management of projects.

The latest budgetary and policy plans from PMO indicate that the government is focused on improving infrastructure and construction activities in the economy. For example, the government will soon lay out its plans to convert 100 cities into "smart cities" through large-scale private sector participation.

In addition, it has set the target of providing all houses in India with toilets, water, power, and fuel by 2022. It is also set to substantially ease norms for foreign investment in the construction sector, and is considering the removal of restrictions on size and minimum capitalization for this project. The government has already set directives to review the progress of central rural schemes to build basic rural infrastructure, including the convergence of corresponding ministries. It is also planning to allow 100 percent FDI in several areas of railways, which will likely result in modernization and expansion of railway projects, create more jobs, and improve quality of service.

Road ahead

These government initiatives will likely open up immense opportunities for strong growth in the infrastructure and construction sector. In addition, growing income, rapid urbanization, and rising demand for modern infrastructure by the emerging middle class will provide a further boost to the sector's growth.

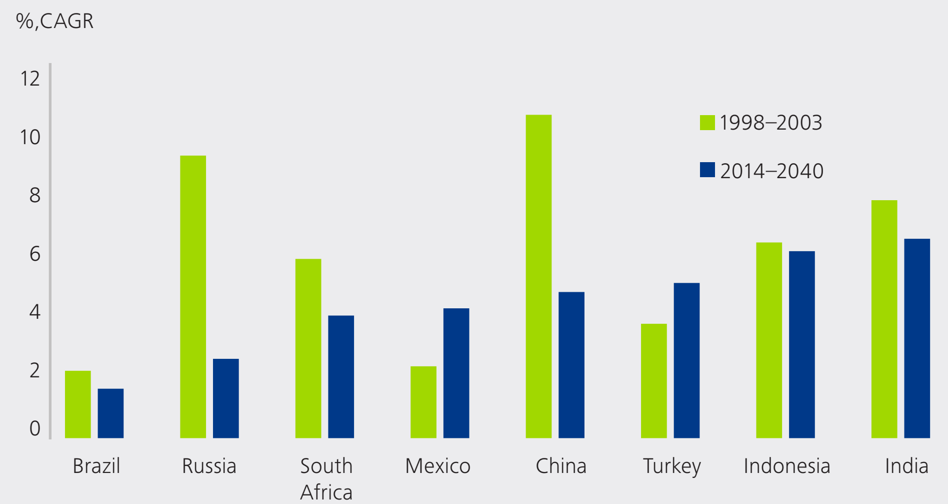
That being said, removing the bottlenecks that have delayed infrastructure projects is crucial, as is resolving the financing issues in PPP infrastructure projects (particularly equity funding) through more realistic and practical fund-rotation policies. Offering long-term insurance and pension funds, domestic and foreign, through appropriate credit-enhancement mechanisms would help too.

Much has been learned over the past 10 years as to what attracts the private sector to infrastructure projects. These key principles now need to be embedded into the strategy of new infrastructure opportunities to ensure efficiency and effectiveness. This includes providing "principle-based flexibility" within the framework of a competitive and transparent process. For example, embedding clearly defined principles of renegotiation within a long-term contract and implementing more open dialogue with the private sector prior to finalizing bidding documents will certainly help achieve larger and faster project completions.

It is also important that the government invests more in building quality infrastructure and ensures its regular maintenance, which will not only improve efficiency and utilization of resources, but also encourage private sector participation, which is crucial for a robust growth in this sector.

Given that it is a large untapped market, there is huge demand and revenue potential—if enough investment seeps in. While some challenges may persist, the infrastructure and construction sector is expected to have the strongest growth among leading emerging economies in the coming decades (Figure 15), with India poised to be world's third-largest construction market by 2025.[30]

Figure 15: Huge demand potential will drive growth in the sector
Growth trend in infrastructure and construction sector, value-added output



Source: Oxford Economics (Global Industry Databank), September, 2014. For India, Deloitte projections using Oxford model

[29] Deloitte, *Indian infrastructure A trillion dollar opportunity*, 5th PEVCAI, 2014, http://www.deloitte.com/assets/Dcom-India/Local%20Assets/Images/Thumbnails/infra/Deloitte%20Background%20Paper_27Jan_Final2.pdf.
[30] Deloitte, Infrastructure and construction sectors: Building the nation, January 2014, http://www.deloitte.com/assets/DcomIndia/Local%20Assets/Documents/Thoughtware/2014/Infrastructure_and_Construction_Sectors_Building_the_Nation.pdf.

Banking, financial services, and insurance (BFSI): Set to leverage future prosperity

Profile

On 28 August 2014, the government of India launched the Jan Dhan Yojana, an effort to promote financial inclusion in a country where 41 percent of households do not have access to banking services.[31] The initiative's aim is to open 75,000,000 bank accounts by January 2015. The launch itself set a record, with 15 million accounts opened on a single day across 77,000 locations.[32] The program reflects the myriad opportunities and challenges in India's banking, financial services, and insurance (BFSI) sector. While BFSI has been a key driver of economic growth in the past decade, the sector still has not spread to the larger population, where many people still depend on noninstitutional savings and credit.

Since the unleashing of economic reforms in India in 1991, the BFSI sector has benefitted from fast economic growth, rising incomes, a growing middle class, product and services innovation, and financial literacy.

For example, per capita income (in purchasing power parity nominal US$ terms) went up by about 362 percent from 1991–2013.[33] Within this period, the size of the middle class has also increased—between 2001–02 and 2009–10, the share of the middle class rose to 12.8 percent of total households (about 153 million people) from 5.7 percent.[34] Over the years, bank penetration has also increased and services have improved, especially with the advent of private banks. And though the spread of ATMs in India is still low (94 per million people) relative to advanced economies, the country has come a long way from just one ATM per million people in 1987.[35] Growth in the BFSI sector has been facilitated by the emergence of a salaried middle class with growing demand for multiple savings instruments, as well as increased use of Internet and mobile banking for services ranging from money transfers to equity trading.

From 1990–2013, the BFSI sector expanded at a real average annual rate of 9.2 percent, well above wider GDP growth of 6.5 percent (average annual) during this period. Banks have played a key part in this expansion. For example, commercial bank credit grew at an average annual rate of 18.7 percent from 1991 to 2014 even as commercial bank deposits gained 17.4 percent every year on average.[36] Businesses, in particular, have depended heavily on banks, given the absence of a well-developed debt market and the limited presence of venture capitalists and private equity. Growth in banking has been complemented by a surge in demand for asset management and insurance products as both high-net-worth individuals and the middle class search for higher returns beyond traditional instruments such as bank deposits and National Savings Certificates. For example, assets under management (AUM) of mutual funds stood at about INR 9.9 trillion (US$163.2 billion) in June 2014, 21 times the amount in 1993 when private sector funds were first allowed into the industry.[37]

[31] Reserve Bank of India Bulletin, "Financial inclusion in India: An assessment," January 2014.
[32] Business Line, "All you wanted to know about Jan Dhan Yojana," September 2014.
[33] Oxford Economics, Global Economic Databank, September 2014.
[34] Rajesh Shukla (National Council of Applied Economic Research), "How India earns, spends, and saves," 2010; Christian Meyer and Nancy Birdsall (Center for Global Development), "New estimates of India's middle class," November 2012.
[35] RBI Bulletin, "Banks in India: Challenges and opportunities," July 2014; Deloitte Center for Financial Services, "Growth opportunities for financial services in India," October 2012.
[36] Reserve Bank of India, "Scheduled commercial banks—Select aggregates," September 2014.
[37] Association of Mutual Funds of India, "MF history," September 2014; Business Standard, "Mutual funds' assets rise 9% in June quarter," July 2014.

Key challenges

As the BFSI sector prepares to scale up services and spread into rural markets, technology should be a focus area. Data security will be a big challenge, especially with the expected growth in Internet and mobile banking transactions. Innovations in savings, investment, and payments services present another challenge, especially in a world where gadgets (mainly smartphones) are set to assume a greater role. Banks and financial institutions will also have to address increasing demands for customization of products and services for both households and business; their work will be made more challenging by the increasing financial sophistication of their customers. Foreign technology and expertise may address these issues. Further easing of FDI in pensions and insurance will be another important step. The new government has made a positive start by hiking FDI limits in insurance to 49 percent from 26 percent in the budget for 2014–15.[38] Among other measures, foreign banks will be encouraged by moves to allow them to open wholly owned subsidiaries. To incentivize banks to take this up, they will be treated on par with domestic banks.[39]

Greater private-sector participation in the BFSI sector is also needed. While new banking licenses would help, so would greater disinvestment of public-sector units. Public-sector banks account for 70 percent of total banking assets in India.[40] Similarly, in the insurance space, Life Insurance Corporation of India dominates the life insurance segment with a more than 70 percent market share.[41] Along with disinvestment, there must be more accountability and transparency in the management of public-sector banks.

Recent cases of fraud related to small investors point to the desperate need for regulatory oversight; people in rural areas and small towns are particularly vulnerable.

While the Securities and Exchange Board of India has done a commendable job, its role needs to be strengthened. This is especially true given that capital markets in India are set to become more integrated with the global economy amid the expected gradual easing of capital account convertibility as the economy matures. In that light, it is worth mentioning the importance of improving efficiencies in equity markets and developing a sound bond market. The latter would help in generating a dependable reference yield curve for financial markets while providing greater funding opportunities for businesses ranging from small or medium enterprise (SMEs) to infrastructure projects.

[38] Ministry of Finance, Government of India, "Key features of budget 2014–2015," July 2014.
[39] Reserve Bank of India, "Scheme for setting up wholly owned subsidiaries by foreign banks in India," September 2014.
[40] Reserve Bank of India, "Bulletin: Volume LXVIII, Number 9," September 2014; Indian Banking Association, "Key business statistics," September 2014.
[41] Insurance Regulatory and Development Authority, "First year premium of life insurers for the period ended 30th June, 2014," August 2014.

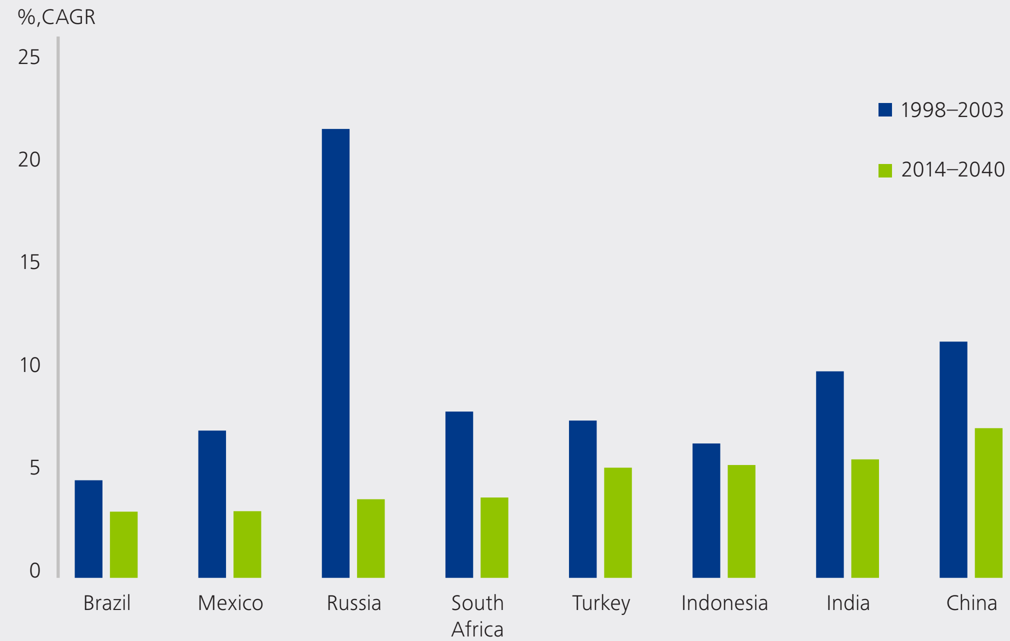
Growth potential

Growth in the BFSI sector is likely to remain strong, given expectations of strong economic growth, rising incomes, expansion into new markets, and greater financial innovation. The sector's real average annual growth is expected to be 5.7 percent over 2014–2040 (Figure 16).[42] During this period, India's share of the global BFSI market will likely rise to 11.7 percent from 6.7 percent, highlighting the importance of the sector not only from a growth perspective, but also in terms of market size.[43]

There are quite a few segments within the BFSI sector to monitor in the coming years based on expected movements in GDP, household wealth, and demographics.

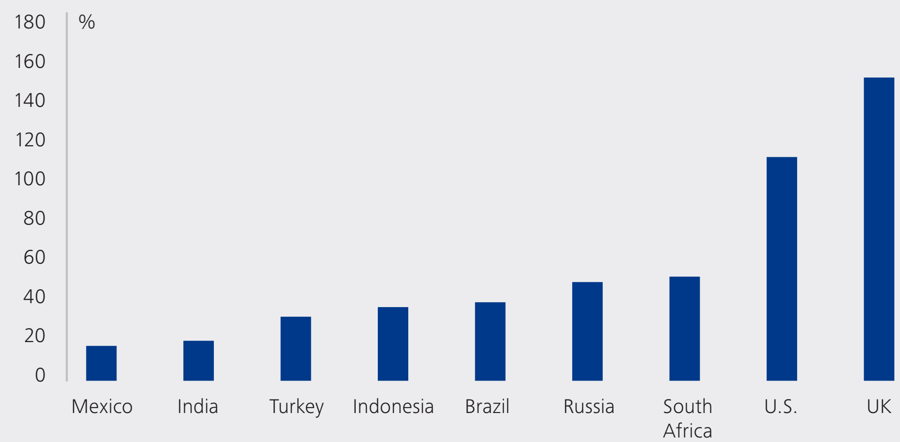
- *Retail banking.* Retail banking has been a key growth driver of the BFSI sector in the past two decades, given the household sector's growing demand for housing, vehicles, and personal credit. And even the global downturn of 2008–09 and slowing domestic economic growth have failed to dampen demand. For example, commercial bank loans to households grew at an average annual rate of 12 percent during FY 2007–2014.[44] The strong pace of expansion is likely to continue, given that household debt is expected to rise in India because of rising demand for credit. Currently, average household leverage in India is lower than many other emerging economies (Figure 17).[45] A young population with rising incomes and more nuclear families will drive up demand for housing in the medium to long term. Consequently, the mortgage- and housing-related credit market, which is still relatively undeveloped in India, will turn out to be a key growth driver for banks and housing finance corporations in the future.
- *Benefits of greater financial inclusion.* The BFSI sector's penetration into India's rural market will be a big challenge. Yet, rural India, along with the urban lower-middle class, is arguably the sector's next big opportunity.[46] This is also a segment where incomes have been rising fast due to economic growth and welfare measures implemented by the previous government. Annual median per capita income in rural India increased at an average annual rate of 7.2 percent between FY 2005–2012, more than double the corresponding figure (3.2 percent) for urban India.[47] For BFSI providers, the rural market holds promise across key products ranging from loans to insurance, likely in "micro" amounts for each household or business. For example, micro-finance and micro-insurance could be the focus areas in rural locations; these products can be linked to crop insurance and other innovative savings schemes as well. The challenge, however, will be to innovate to keep costs low and to ensure commercial viability. The spread of mobile banking will help. The Jan Dhan Yojana will also help the BFSI sector by bringing more of the rural population into the formal economy.
- *Managing the rising wealth of households.* According to the Deloitte Center for Financial Services, total high-net-worth households (more than US$1 million) in India are set to almost triple from 2010 to 2020 to about 700,000 households, with their total wealth holdings rising by more than five times during this period.[48] This segment will constitute the most prominent demand for sophisticated wealth management products in India. As a result, the Indian market is likely to see a greater proliferation of new asset classes like hedge funds, commodity funds, and private equity in the medium term to long term. Among those interested in such asset classes will be people of Indian origin who seek higher returns outside the countries in which they work. Apart from high-net-worth individuals, the rise of the middle class in India will also add to asset management opportunities. The Organization for Economic Cooperation and Development (OECD) estimates that by 2039, the middle class will constitute as much as 90 percent of India's

Figure 16: CAGR (historical and forecasts) for the BFSI sector across key emerging economies, value-added output



Source: Oxford Economics (Global Industry Databank), September 2014. For India, Deloitte projections using Oxford model

Figure 17: Comparing household leverage in India to key emerging economies, U.S., and UK
Total household liabilities/disposable personal income



Source: Economist Intelligence Unit (Data tool), September 2014

[42] Oxford Economics, Global Industry Databank, September 2014.
[43] Oxford Economics, Global Industry Databank, September 2014.
[44] Reserve Bank of India, Sectoral deployment of non-food gross bank credit outstanding, September 2014.
[45] Economist Intelligence Unit, Data tool, September 2014.
[46] Office of the Registrar General and Census Commissioner, India, "Census of India: 2011," September 2014.
[47] The Hindu, "An inclusive growth policy," April 2014.
[48] Deloitte Center for Financial Services, "Growth opportunities for financial services in India," Deloitte Development LLC. October 2012.

population.[49] A sizable segment of this population is likely to be financially literate and will seek higher returns among a wide array of accessible (and affordable) asset classes.

- *The growing business of managing risk.* The rise of the middle class in India has also heralded new opportunities for insurance providers. This is apparent from the 15.7 percent average annual growth in life insurance premiums (in US$ terms) from 1990–2013. While life insurance premiums grew by 16 percent, nonlife premiums expanded by 14.5 percent on an average annual basis during this period.[50] Still, there is strong growth potential given that insurance penetration (premiums as a percentage of GDP) and insurance density (premiums per capita) are low relative to many global peers (Figure 18), thereby leaving ample room to catch up in the medium term to long term. Both life and nonlife segments will benefit in the coming years, with growth in the latter likely to be driven by growing demand for home and vehicle insurance. There will also be a change in insurance for businesses in the future, likely due to greater proliferation of small- and medium-sized enterprises, which could also lead to innovations in employee insurance products, which, until now, has been limited to relatively large firms.

The road ahead

While growth in the Indian BFSI sector is likely to remain strong, underpinned by expectations of strong economic recovery, the growth paradigms for the next decade will be significantly different.

The RBI has liberalized the entry of new banks by 'On-Tap' licensing. In the first round, two new banks have been granted in-principle licenses, including a leading micro-finance company. RBI is in the process of inviting new applications for differentiated banking licenses with niche business models focusing on either regional geographic markets or niche products, as in the case of Payments Banks. These new banks will not only target financially excluded customers who are not yet serviced by incumbents, but will also increase the competitive intensity of the Indian banking sector by offering better services and value propositions across the board. Moreover, the innovative strategies of niche banks, such as the Payments Banks, which combine technology and low-cost operating models, could further cause dents in the profitability of the industry, which has historically enjoyed spreads as high as 3 percent.

A rise in nonperforming assets will further exert pressure on profitability, especially for public sector banks, as the industry's capital funds continued to decline over the last year. Public sector banks will need additional capital to comply with the Basel III norms. According to government estimates, the banking industry will require require INR 2.4 lakh crore (US$40b) of equity capital by 2018 to meet these norms.[51] These challenges will make consolidation inevitable. The government, as the majority shareholder of public sector banks, is already considering merging smaller banks.

New growth opportunities from financially excluded segments could offer a panacea to banks. The Jan Dhan Yojana policy intervention could give the required boost by creating new market segments.

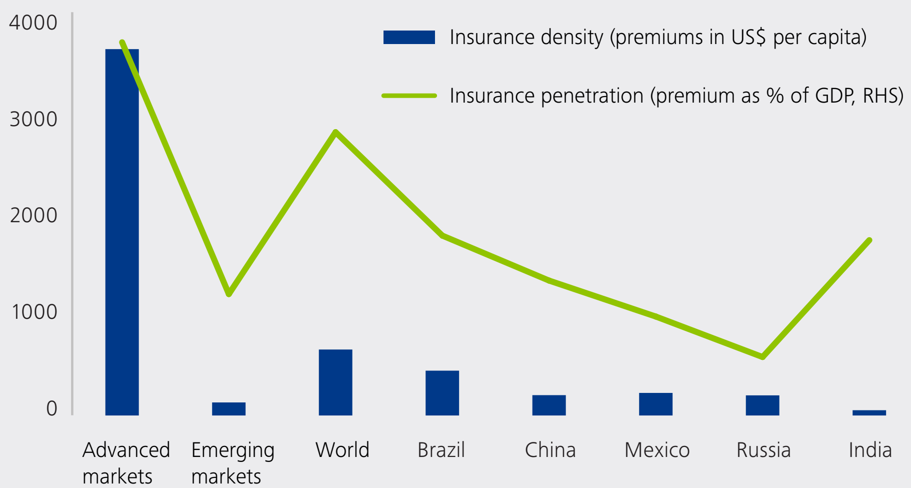
By extending banking services to excluded customers, the government is aiming to improve the formal financial savings, reduce leakages through direct benefit transfer, and reduce the use of cash, all of which will result in significant business opportunities for banks. Banks also have a unique opportunity to introduce digital banking and payment services, thus providing speed, security, transparency, and cost efficiency.

Foreign banks have made significant contributions to the Indian banking sector by providing capital and global best practices, as well as grooming Indian talent. However, they have adopted a wait-and-see policy due to actively expanding regulatory restrictions. With the announcement of a new roadmap for foreign banks, discussed above, and the pace of structural changes in the Indian market, foreign banks can no longer afford to sit on the fence, and will have to solidify their plans and commitment if they want to participate in India's growth story.

In the insurance sector, the long-pending decision to increase the cap on FDI in the Indian insurance sector is a great opportunity for global insurers who want to improve their market position and diversify their operations in India. The new policy announcement is expected to trigger new M&A and an inflow of capital as insurers take up the option to increase their stake to 49 percent.[52] Given that the Indian insurance sector has witnessed muted growth in recent times, this will further enable the industry to bring in product innovation, along with more transparent customer servicing and claims settlement processes.

While there are short-term challenges in terms of capital adequacy and asset quality, the medium- and long-term attractiveness of the BFSI sector remains strong.

Figure 18: India's insurance density and penetration compared to key emerging markets



Source: Oxford Economics (Global Industry Databank), September 2014

[49] OECD Development Center (Homi Kharas), "The emerging middle class in developing countries," January 2010.
[50] Swiss Re, Sigma Explorer, September 2014.
[51] http://www.thehindu.com/business/Economy/finmin-mulling-raise-in-stake-in-banks-up-to-52/article6404967.ece
[52] Forbes; July 2014 http://www.forbes.com/sites/saritharai/2014/07/10/india-increases-foreign-investment-limits-in-defense-and-insurance-sectors-to-49/

Wholesale and retail trade: Indians set to go on a shopping spree

Profile

On any given weekend, the activity and energy exhibited in shopping malls throughout India's large cities was once only associated with pre-festival shopping for family and friends. That is no longer the case. From the bargain hunter to the high-end customer, everyone appears to be on a shopping spree. The advent of organized retail (licensed retailers such as corporate-backed supermarkets and retail chains), coupled with the dynamics a young population influenced by changing lifestyles, higher disposable incomes, brand consciousness, and technological advancements has redefined the retail experience in India.

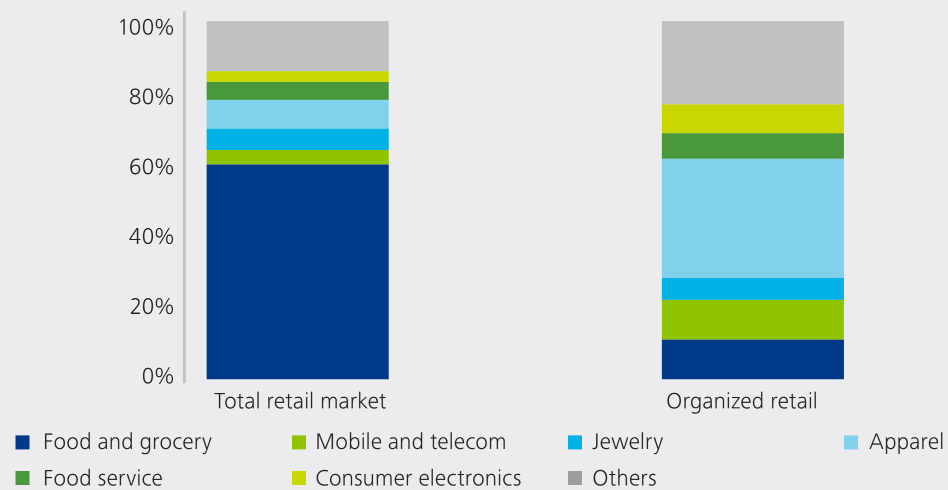
The increasing presence of organized retail, however, cannot mask the dominance of unorganized retail (low-cost retailing such as local "mom-and-pop" shops and street carts) in the country. Familiarity, accessibility, and easy payment terms still dominate shopping decisions. This is particularly true in rural areas. Nevertheless, given the strong pace of economic expansion expected in the future, the reach of organized retail is set to increase.

With it will come challenges related to supply chains, inventories, and rural markets. Provided policymakers facilitate the sector's growth and reach, the retail industry is set to drastically alter the retail landscape for India's shoppers, and play a prominent role in India's future growth.

With respect to growth, wholesale and retail trade grew at 8.6 percent during 1990–2013. It was one of the key growth drivers of the Indian economy during this period and, in value-added terms, had the largest share in GDP (12.4 percent).[53] Like other parts of the economy, the sector has benefitted from fast economic growth, rising incomes, a growing middle class, product and services innovation, and financial literacy. Per capita income (in PPP nominal US$ terms) went up by about 362 percent between 1991 and 2013.[54] Within this period, the size of the middle class also went up: between 2001–02 and 2009–10, the share of the middle class increased to 12.8 percent of total households (about 153 million people more) from 5.7 percent.[55]

Food and groceries dominate the retail sector in India, with a share of 60 percent. In organized retail, apparel leads with a share of 33 percent (Figure 19).[56] However, organized retail also currently accounts for only 8 percent of India's retail sector, much lower than advanced economies like the United States (at 85 percent).[57]

Figure 19: Comparison of shares in total retail and organized retail



Source:Deloitte Touche Tohmatsu India Private Limited , September 2014

[53] Oxford Economics, Global Industry Databank, September 2014.
[54] Ibid.
[55] Rajesh Shukla, "How India earns, spends, and saves," National Council of Applied Economic Research, 2010; Christian Meyer and Nancy Birdsall, "New estimates of India's middle class," Center for Global Development, November 2012.
[56] Deloitte Touche Tohmatsu India Private Limited. , "Indian retail market: Opening more doors," January 2013
[57] Deloitte Touche Tohmatsu India Private Limited. , "Indian retail market: Opening more doors," January 2013; India Brand

Growth potential

In the next quarter of a century, India's economy is likely to power ahead at an average annual growth rate of more than 5 percent.[58] This will force household incomes up, thereby boosting demand for wholesale and retail trade. Real personal disposable incomes are likely to rise at an average annual rate of 5 percent during 2014–40.[59] In addition to rising incomes, a number of factors that will add strength to wholesale and retail trade in India. First the growing middle class is set to make up about 90 percent of India's population by 2039, up from between 5 and 10 percent in 2009–10.[60] In addition, India's young population (by 2020, India will have the world's youngest population with a median age of 29 years),[61] keenly aware of global trends and retail developments, will drive retailers to innovate in product and service offerings and delivery. Furthermore, organized retail, especially segments like household furnishings, will benefit from urbanization and the proliferation of nuclear families. Finally, Internet penetration has aided online retailing with the presence of close to one million retailers in e-commerce portals.[62] Riding on these positive developments, the wholesale and retail trade sector will likely grow at an average annual rate of 6 percent over 2014–40 (Figure 20).[63]

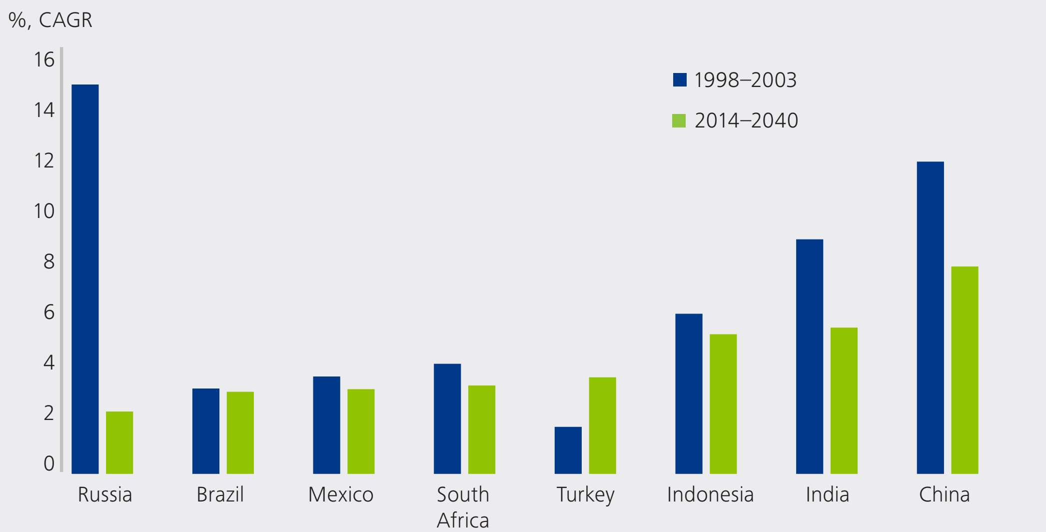
The prime beneficiary (as well as a driver) of this surge will be organized retail.

According to a Deloitte India report, this segment is likely to increase its share in the wider retail market to 20 percent by 2020.[64] Organized retail will, however, have to cope with policy uncertainty related to foreign direct investments (FDI) in multibrand retail in the near term. It will also face challenges related to customer service, supply chains, and skilled professionals. Moreover, a young and affluent population, despite being a growth driver, will also be more demanding, especially given their awareness of global standards. This will force organized retail chains to innovate. For example, the spread of online retail is forcing brick-and-mortar chains to create online portals to cater to the online retail consumer.

As modern retail gathers pace in the country, there are numerous investment opportunities for both domestic and foreign retail players to explore.

- *The lure of the rural market and challenges.* A big opportunity, as well as challenge, for retailers is the rural market.[65] Organized retail is present mostly in urban India (85 percent) even though rural areas make up about 55 percent of the total retail market. Currently, about 69 percent of Indians reside in rural areas.[66] This is also a segment where incomes have been rising fast due to economic growth and welfare measures put in place by the previous government. For example, annual median per capita income in rural India went up at an average annual rate of 7.2 percent during FY2005–2012, more than double the corresponding figure (3.2 percent) for urban India.[67] Many retailers and fast-moving consumer goods (FMCG) companies have been quick to identify the potential of rural India. They have innovated with products and delivery, while at the same time devising strategies to cater to the relatively affluent among India's villages. Of the 600,000 villages in India, about 10,000 generate 50 percent of rural GDP.[68] It is this segment that FMCG companies are targeting—and other retailers are likely to follow suit.

Figure 20: Comparison of shares in total retail and organized retail, value-added output



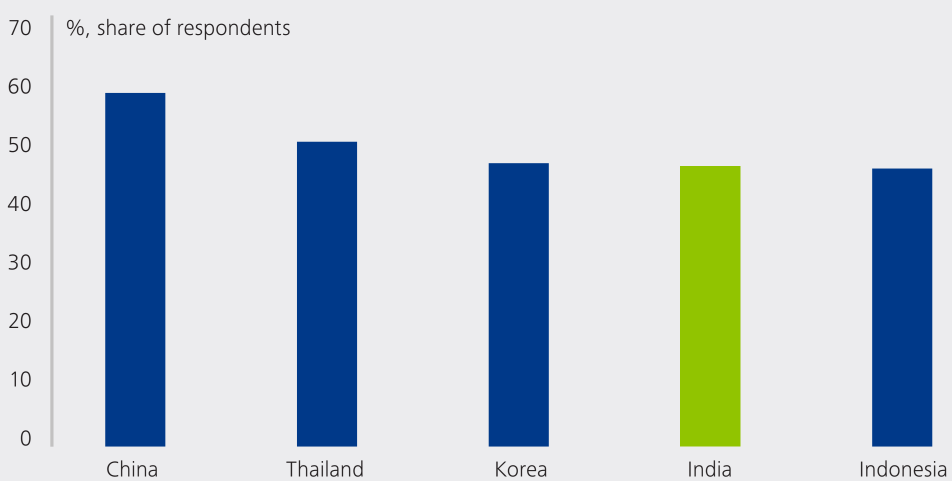
Source: Oxford Economics, Global Industry Databank, September 2014. For India, Deloitte projections using Oxford model

[58] Oxford Economics, Global Economics Databank, September 2014.
[59] Ibid.
[60] Homi Kharas, "The emerging middle class in developing countries," OECD Development Center, January 2010. Middle class families tend to be smaller, which is why the proportion of middle class population (5-10 percent in 2009-10) is lower than middle class households (12.8 percent in 2009-10).
[61] "India's youth challenge," New York Times, April 2014.
[62] India Brand Equity Foundation, "Retail industry in India," June 2014.
[63] Oxford Economics, Global Industry Databank, September 2014.
[64] Deloitte India, "Indian retail market: Opening more doors," January 2013.
[65] Surajit Dey, Dr. Sameena Rafat, and Puja Agarwal, "Organized retail in the rural market in India," IOSR Journal of Business and Management, December 2012.
[66] Office of the Registrar General and Census Commissioner, India, "Census of India: 2011," September 2014.
[67] "An inclusive growth policy," Hindu, April 2014.
[68] "FMCG companies eye rural creamy layer for growth," Times of India, June 2014.

- *Online retail is on its way up.* Online retail amounted to 8 percent of organized retail in India in 2013. Apart from strong demand, aggressive discounts and innovations, such as cash on delivery, have been attracting more consumers into the online retail segment. The online segment's share in organized retail is likely to go up to 18 percent by 2018.[69] Growing Internet penetration and more secure modes of payments have also aided online shopping. An online shopping survey from MasterCard in the Asia Pacific region between November and December 2013 revealed a sharp rise in online shopping preferences in India.[70] Among respondents, the share of those who had shopped online increased to 80 percent in 2012 from 53.1 percent in 2013; during the same time, the percentage of Indians who had shopped online in the past three months went up to 87.8 percent, from 70.9 percent. Greater prominence of online retailers is also attracting major global players to India. Amazon, for example, has already launched operations in India. Increasing smartphone use and innovations in mobile payments will further add to the lucrativeness of the sector in India.

- *Improving supply chain infrastructure.* Given that modern retail is still at a nascent stage in India, the supply chain infrastructure—including processing units, warehouses, cold storage units, and related logistics—have yet to be developed. While this will involve investment cost in the short term, it will yield significant returns in the medium to long term. For example, with improved supply chain, food and grocery retailers will be able to pick up produce right from the fields. Moreover, higher penetration of organized retail will reduce the role of the middleman, ensuring better prices for farmers and lower cost for retailers. Capital flows into the sector will also benefit from the government stipulation that 50 percent of FDI into multibrand retail be directed to back-end infrastructure.

Figure 21: Asia-Pacific countries with the highest rate of smartphone shopping



Source: MasterCard Online Shopping Survey, February 2014

Key challenges

Policy ambiguity continues to cloud the FDI space in multibrand retail, with the bulk of concern focused on the impact of FDI on the unorganized sector ("mom-and-pop" stores). However, the government is likely to adopt a more pragmatic approach as it pays more heed to the urban middle class, which favors the entry of global multibrand retail majors into India.

Another challenge is the stipulation of cross-state approval, which poses limitations for multibrand retailers, as well as the uncertainty from sudden changes in local government. The 50 percent FDI infrastructure requirement (mentioned previously) and the rule that 30 percent of sourcing must come from small- and medium-sized enterprises are likely to impose a heavy cost on retailers, especially those outside the food and grocery space.[71]

This does not mean retailers have nothing to be optimistic about from the new government. They will surely be enthused by the government's commitment to bring in a uniform goods and services tax by 2015.[72] The focus on creating smart cities and developing infrastructure would also benefit retailers by helping ease real estate and transportation costs. Clarification of some of the rules related to FDI would go a long way in driving growth in the sector and the wider economy.

Road ahead

Each of the retail formats that exist in the Indian market place today offers something 'special' for the consumers. From convenience (pan kiosks) to discounts/bargains (modern retail) to the comfort of shopping from home (online), each of these formats caters to various need states.

The Indian shopper will continue to shop across all these formats depending on the occasion and category being purchased. In fact, shoppers will sometimes physically visit stores and then consult their smart phones, comparing the retail prices with prices online. As Internet penetration goes up and more shoppers have smartphones, the convergence between the physical and the online world will keep on increasing.

However, the story changes as one moves out of the urban and semi-urban areas and moves down the chain to the rural markets. With lower internet penetration, the importance of online diminishes and the physical stores play a more critical role in providing goods and services to the rural shopper.

The point remains that India is not a homogeneous market; it is an aggregation of markets including wholesale retail, multibrand retail, single brand retail, neighborhood stores, and online retail that vary across population, income, development indices, and connectivity. Different retail formats, therefore, are needed to cater to these different sets of markets. While all these formats will likely continue to exist in the future, their growth rates, as well as relative importance to the sector, will differ. This will put more pressure on retailers to innovate to compete and offer something special to shoppers.

[69] CRISIL Opinion, "e-tail eats into retail," February 2014.
[70] MasterCard Online Shopping Survey, "Chinese consumers are most avid online and smartphone shoppers in Asia-Pacific," February 2014. http://newsroom.mastercard.com/asia-pacific/press-releases/chinese-consumers-are-most-avid-online-and-smartphone-shoppers-in-asiapacific-mastercard-online-shopping-survey/
[71] Deloitte Touche Tohmatsu India Private Limited , "Indian retail market: Opening more doors," January 2013.
[72] Ministry of Finance, Government of India, "Key features of budget 2014–2015," July 2014.

Automobile manufacturing: Adding wheels to growth

Aside from the services sector, there is a general belief that manufacturing will also drive growth in India. In fact, according to Deloitte Touche Tohmatsu Limited's 2013 Global Manufacturing Competitiveness Index, India ranked fourth in terms of global manufacturing competitiveness,[73] and the Index suggests that India's current ranking will likely improve to second in the next five years.[74] The new government has indicated it will focus on addressing structural bottlenecks, improving governance, and including the manufacturing sector in policy decisions. Moreover, after a prolonged drought of capital investment in the sector, investments are expected to pick up as past challenges are addressed. A focused and comprehensive manufacturing strategy and infrastructure development may unlock the potential of India's manufacturing sector.

Profile

Small-vehicle production is one segment, in particular, in which India is rapidly establishing itself as a manufacturing hub. There are as many as 12 multinational players in original equipment manufacturing (OEM) currently operating in India, making it one of the top-10 automotive production sites in the world.[75]

The government's auto policy adopted in 2002 caused a revolutionary and historic growth in the Indian automobile sector, with concessions for MNCs to establish manufacturing hubs in India of affordable cars, two wheelers, and tractors. This resulted in a large number of MNCs entering into the Indian market, leading to impressive growth and employment opportunities. In addition, the policy helped transform the sector by encouraging innovative designs and research and development (R&D) of automobiles powered by alternative energy sources. In 2003, a core group on automotive R&D was established to identify priority areas for extensive research and design of automobiles in India. The Automotive Mission Plan 2006–16 has continued to build the ecosystem in the sector, working to make India a global automotive hub, with an emphasis on the export of small cars, medium-sized utility vehicles, two- and three-wheelers, and auto components.

Key challenges

The automobile manufacturing sector posted strong growth in production for a few years following the global financial crisis, primarily due to domestic demand. However, in the past two years the sector has had to deal with a sluggish market as both domestic and export demand fell (Figure 22), owing to a significant slowdown in the overall economy, a poor investment cycle, and low consumer confidence. The rising cost of ownership, driven by high fuel prices and interest rates, has impacted consumer demand. In addition, lack of a clear policy and poor quality infrastructure (roads and ports) has suppressed growth in this sector.

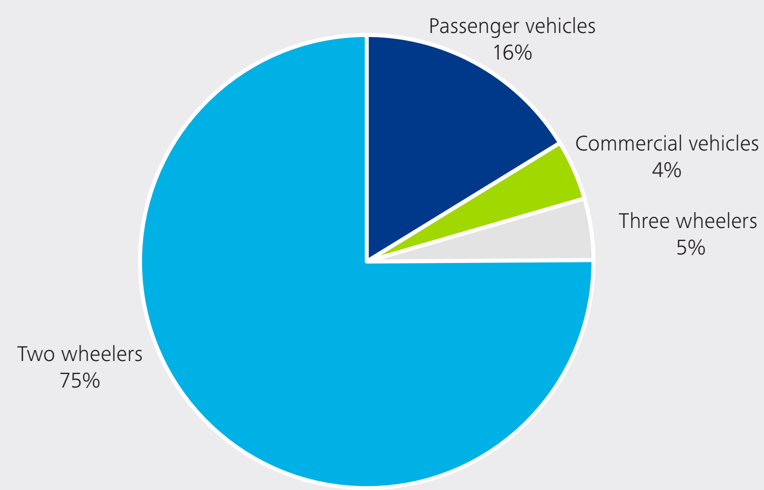
Energy costs and availability are also some of the challenges that the sector faces. Crude oil prices escalated sharply in 2011 due to political tensions in Libya and Iran sanctions in 2012.[76] Currency depreciation and volatility due to the reduction of quantitative easing by the U.S. Federal Reserve in 2013 further contributed to higher domestic fuel prices. Moreover, the RBI kept tightening credit conditions and kept interest rates high to contain inflation. Consequently, interest rates on automobile loans peaked. Low income growth and high fuel costs, together with high interest rates, have impacted demand in this sector for the past two years.

The entry of new players in commercial vehicles has also intensified competition. Rising demand for better technology, increased efficiency, and improved safety features in automobiles have pressured existing market players to expand their product portfolios at competitive prices.

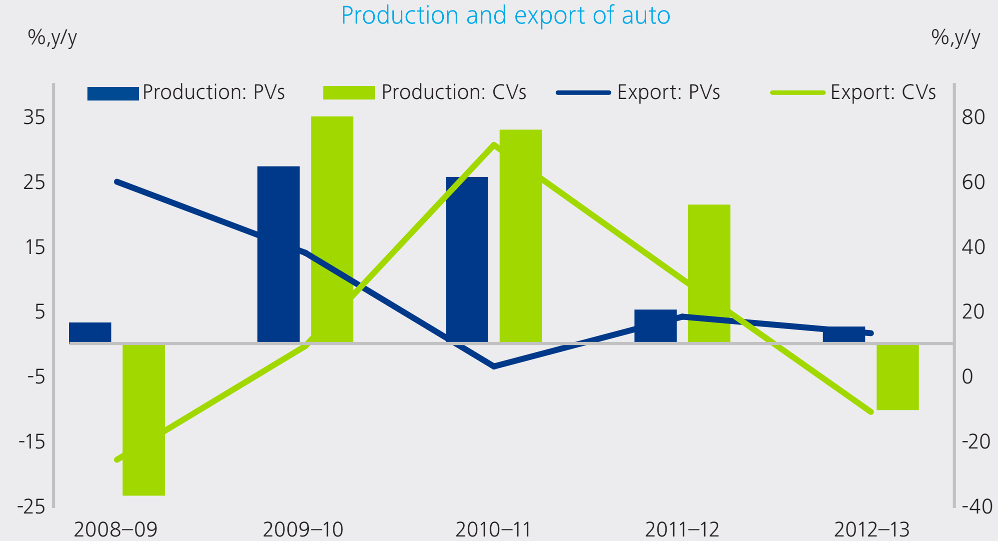
[73] Deloitte Touche Tohmatsu Limited (2013), Global Manufacturing Competitiveness Index, http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_pip_GMCI_11292012.pdf
[74] Ibid.
[75] Consulate General of India; Business Opportunities in India; http://cgijeddah.mkcl.org/WebFiles/BUSINESS-OPP-IN-INDIA.pdf
[76] Energy Information Administration (EIA, 2012), Crude oil prices peaked early in 2012, August, http://www.eia.gov/todayinenergy/detail.cfm?id=7630

Figure 22: Historical trend in Indian automobile industry

Market share in total automobiles produced



Production and export of auto



Source: Society of Indian Automobile Manufacturers, September 2014
This sector comprises manufacturers of passenger vehicles (PVs), commercial vehicles (CVs), and the automotive components of these two segments. Together, they account for approximately 20 percent of the total number of automobiles produced in India (Figure 22), with production of PVs about 3.5 times that of CVs.

Growth potential

The automobile sector is poised to grow as structural changes and major customer, technology, and societal trends transform this industry globally over the next decade.

Government plays a crucial role in all major markets, but is particularly key to the future of the auto manufacturing sector. Clear policy direction, incentive packages to boost investment, environment and energy policies, and the nature of continued support are some of the factors that mold the automotive sector. The Indian government has been supportive, initiating a number of reforms such as fiscal measures, tax relief, reduction of export tariffs, changes in banking policies, and reforms in equity regulations and foreign exchange.

Furthermore, the government's recently unveiled Shramev Jayate Yojana initiative is aimed at revamping labor reforms and helping facilitate the "Make in India" campaign.

These labor reforms should help the auto sector, as almost 50 percent of the sector employs contract labor and tensions often surface because of ambiguity in contracts.

Furthermore, the government's emphasis on infrastructure development, and recent decisions relating to subsidy and deregulation of fuel prices, should also facilitate a robust growth in the auto sector. Port access and capacity are challenges affecting auto exports. Modernizing port facilities and making more space available for loading will also bring down costs. Furthermore, improving the quality of roads will potentially reduce cargo movement from railways, which, in combination with the implementation of a goods and services tax (which will facilitate intrastate border crossings), will accelerate growth of the trucking sector.

Road ahead

A Deloitte Touche Tohmatsu[77] study predicts a massive shift in the automotive competitive landscape, with China and India emerging as major players. These markets will look to join Europe, Japan, Korea, and the United States as the centers of design and manufacturing for OEM and their suppliers. The drive has already begun with large MNCs quickly moving their manufacturing units for auto parts into India.

Younger demographics, low labor costs, and a plentiful supply of engineers are capable of turning India into a global hub for auto manufacturing as customers around the world become more cost-conscious. A stable government over the next five years will be a crucial factor in improving investment sentiments and attracting global automobile manufacturers to establish factories and R&D centers in India.

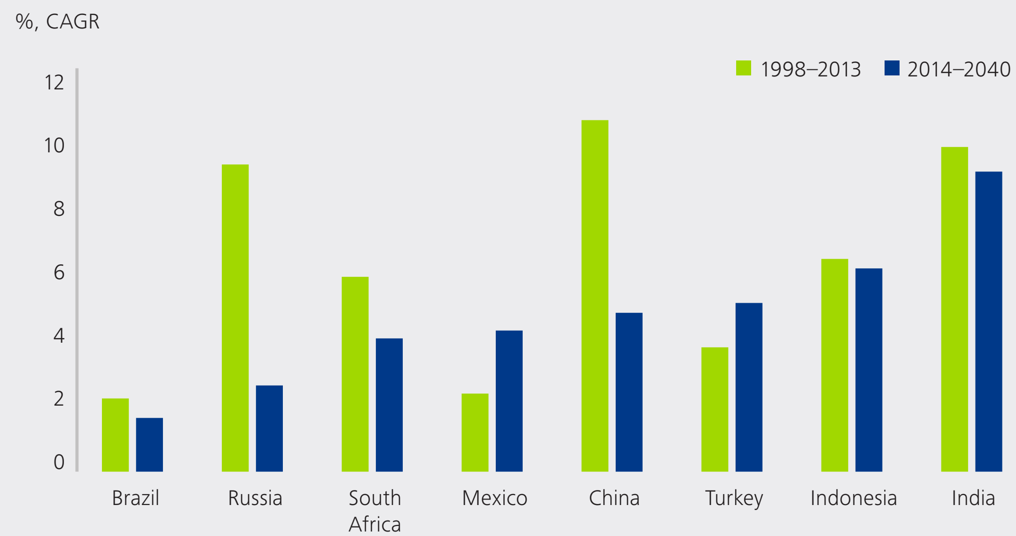
Thanks to the expanding middle class, rising buying potential is another important factor that could compel manufacturers to move their units closer to the consumer demand.

According to a report by Deloitte India,[78] the Indian market is likely to scale up to the third position in terms of demand by 2020. This expectation has already led to a number of key global OEMs establishing their operations in India. With better economic growth, this trend is expected to accelerate in the coming years.

Some of the other economic factors that could spur future growth in the automotive sector are interest rate cuts, a fall in global crude oil prices, excise duty concessions, and a pick-up in industrial activity levels, especially in mining and the infrastructure and construction sectors. All these factors will be key drivers of growth in auto manufacturing, and India is expected to grow the fastest in the sector among leading emerging economies during 2014–40 (Figure 23).

Figure 23: Demand and production will drive the sector growth

Growth trend in automobile manufacturing, value-added output



Source: Oxford Economics (Global Industry Databank), September, 2014. For India, Deloitte Touche Tohmatsu India Private Limited projections using Oxford model

[77] Deloitte Touche Tohmatsu (2009), A new era: Accelerating toward 2020—An automotive industry transformed, http://www.deloitte.com/assets/Dcom-India/Local%20Assets/Documents/A%20New%20Era%20-%20Auto%20Transformation%20Report_Online.pdf

[78] Deloitte Touche Tohmatsu India Private Limited , Driving through the consumer's mind: Consideration for car purchase, February 2014, http://www.deloitte.com/assets/Dcom-India/Local%20Assets/Documents/Thoughtware/2014/Driving%20through%20consumers%20mind.pdf

Pharmaceuticals: Toward healthier growth

Profile

The Indian pharmaceutical market was almost nonexistent up until the 1970s. Today, India has gained immense importance and carved a niche for itself in the pharmaceutical domain. In fact, India is one of the top-five emerging pharmaceutical markets, and is projected to surpass other leading emerging economies in the 21st century as a global center for end-to-end drug discovery and innovation. Its market size has grown at an estimated compound annual growth rate (CAGR) of 13 percent during FY 2009–2013. The country's pharma industry accounts for about 1.4 percent of the global pharma industry in value terms and 10 percent in volume terms.[79]

From April 2000 to September 2013, the sector attracted large-scale outsourcing of research activities from global companies and FDI worth US$12 billion. During this period, domestic companies also strengthened their global position in the manufacturing and R&D areas. Generic makers are signing distribution and marketing contracts so their products reach foreign regulated and developing markets. Domestic companies currently supply 20 percent by value of the global market for generic medicines—for which, about 40 percent of the generic and over-the-counter drugs are consumed in the U.S.[80] Within India, the urban market is the biggest contributor to this sector's growth. According to IMS Health, urban areas[81] account for about 83 percent of total industry sales, while the rural market accounts for only 17 percent.[82]

Key challenges

Low spending on health care and poor health infrastructure in India have restrained the growth of this sector. Total health care expenditure in India was only 3.9 percent of GDP in 2013 (of which government spending accounted for only 1 percent), compared to 8.9 percent for Brazil, 6.2 percent for Russia, and 5.2 percent for China.[83] According to the World Health Organization, the doctor-patient ratio in rural areas is 1:20,000, versus the urban ratio of 1:2,000. Limited affordability and insurance coverage, low awareness of diseases, poor basic hygiene and living conditions, and shortage of skilled workforce pose major hurdles to growth. Domestic and international pharmaceutical companies operating in India face issues ranging from the new Drug Price Control Order, which prescribes a ceiling on the prices of several essential medicines, to drug and clinical trial quality, patent issues, regulatory pressures, and misclassification of medical devices. Delays in drug approvals following the new regulatory controls are prompting multinationals to rethink their strategy of conducting clinical trial activity in India.

Growth potential

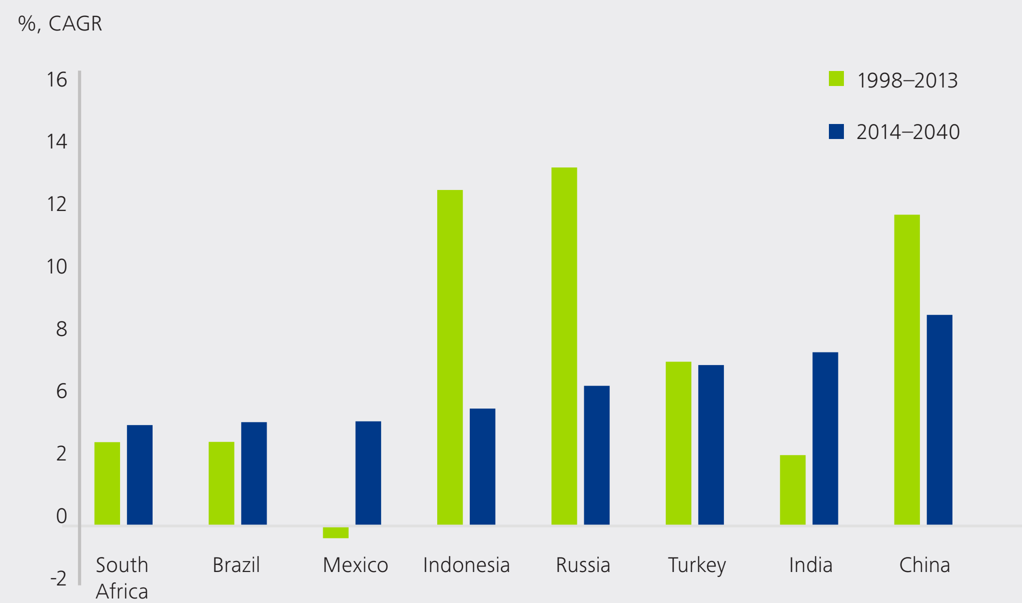
India's pharmaceutical sector will strongly benefit from a favorable macroeconomic environment, increasing purchasing power, and awareness of and demand by the rising middle class. The sector is already witnessing large acquisition activities, growth in health care insurance coverage, and innovation in health care products and services. There is also growing demand for medical tourism.

The changing profile of health problems, rise in early detection of acute diseases, and increasing availability of treatment facilities have boosted the demand for drugs and quality medications. The need for health care diagnostic facilities in the metropolitan areas has also risen, due to a rising middle class that is now more aware of the benefits of such utilities. Additionally, this sector has started to penetrate rural markets, as well as urban. Although a large proportion of the rural market still remains untapped, it represents a huge growth opportunity for pharmaceutical companies.

Road ahead

In India, generics account for about 75 percent of the drug market, and they will continue to dominate the market in the medium term to long term.[84] However, the sale of patented products may pick up in five years to 10 years with the improvement and implementation of patent laws and increased reach of health insurance to the public. With better public awareness of common ailments and the ease of availability of products everywhere from post offices to local department stores, the over-the-counter segment is expected to be one of the potential growth drivers for the sector. The government has unveiled "Pharma Vision 2020," with a goal to make India a global leader in end-to-end manufacturing. These initiatives will help boost investments in this sector. Significant investments by multinationals and PPPs for strengthening health infrastructure will propel the pharmaceutical sector to new heights. The Indian pharmaceutical industry is projected to surpass other leading emerging economies in the 21st century as a global center for end-to-end drug discovery and innovation (Figure 24).

Figure 24: Growth trend pharmaceutical sector, value-added output



Source: Oxford Economics (Global Industry Databank), September, 2014. For India, Deloitte Touche Tohmatsu India Private Limited projections using Oxford model

[79] India Brand Equity Foundation; August 2014 http://www.ibef.org/industry/pharmaceutical-india.aspx
[80] Ministry of external affairs, government of India, "Pharmaceuticals", India in Business, Investment and technology promotion (ITP) division. June, 2014, and India Pharma Summit 2013–14, "Enhancing India's global role in supply of generic medicines," jointly organized by World Health Organization and Federation of Indian Chambers of Commerce and Industry.
[81] The cities in India are categorized on the basis of a grading structure devised by the Government of India. Cities with population more than 4 million are categorized as Tier I, while cities with a less than a million are categorized as Tier III–IV. This system helps the authorities to allot House Rent Allowance (HRA) to the employees of the public sector, posted in different cities across the country.
[82] IMS Health, "Moving annual total," 2010.
[83] Deloitte Touche Tohmatsu India Private Limited., "Sustainable strategies for a healthy India: Imperatives for consolidating the health care management ecosystem," June 2013, http://www.deloitte.com/assets/Dcom-India/Local%20Assets/Documents/Thoughtware/AIMA-June2013.pdf
[84] *Industry Report, Healthcare: India*, The Economist Intelligence Unit, July 2014.

Information and communications technology: Speeding on the digital highway

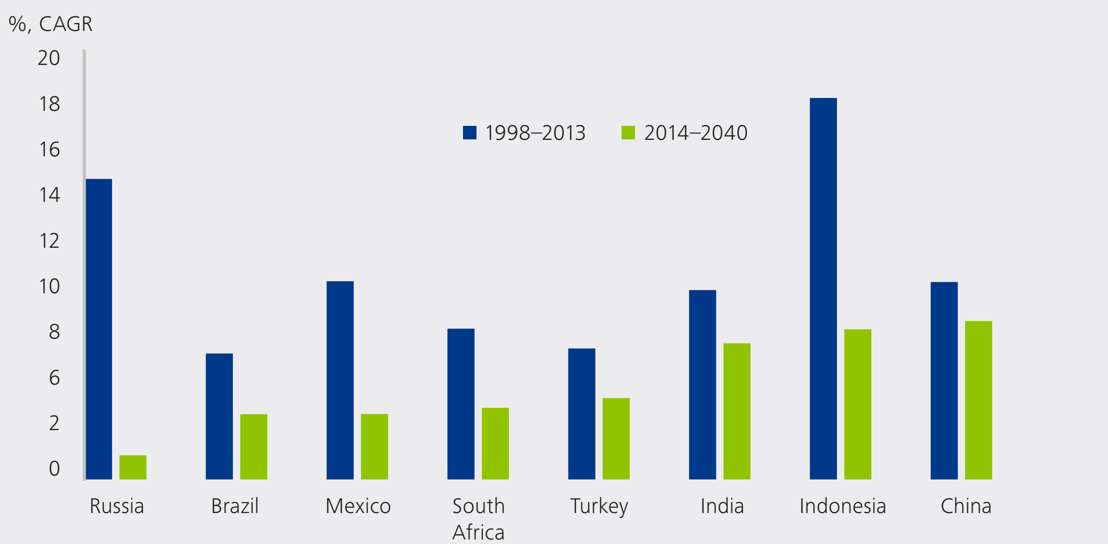
Profile

India's information and communications technology (ICT) industry is rapidly growing in importance. From 1990 to 2013, the sector grew at a real average annual rate of 8.6 percent, outpacing GDP growth of 6.5 percent. ICT comprises two key subsectors: information technology-business process management (IT-BPM) and telecommunications. Total revenue for IT-BPM in India in FY 2014 was estimated to be US$118 billion, of which nearly 73 percent was exports.[85] IT-BPM is also the largest private sector employer (3.1 million people) in the country, and has helped India emerge as the world's largest sourcing market, with a market share of 55 percent in 2013.[86] In addition to IT-BPM, economic reforms since 1991 have helped change the telecommunications landscape in India. The country has the world's second-largest mobile subscriber base (900 million) and the third-highest Internet subscriber base.[87] One sector that is gaining prominence is online and digital services, which partly overlaps with telecommunications—a substantial portion of online access happens via mobile devices; plus the communication service providers are the telecommunications companies themselves. The total e- commerce market (which excludes digital marketing and other support ecosystem segments) is around US$10 billion, poised to grow up to US$43 billion by 2019.[88]

Key challenges

Continuing slow economic growth in Europe, a key export market, will be a concern for India's IT-BPM sector in the near term. In FY 2014, the United Kingdom and continental Europe accounted for 29 percent of India's IT-BPM exports, second only to the United States' share of 62 percent.[89] However, on the positive side, continued economic weakness could force European firms to outsource more and move noncore operations to cut costs. Another challenge for IT-BPM firms in India is rising costs, both real estate and personnel.[90] And although firms have expanded into tier II and tier III cities to cut costs, scaling up in some of these cities might not be easy due to infrastructure-related bottlenecks.[91]

Figure 25: CAGR (historical and forecasts) for the ICT sector across key emerging economies, value-added output



Source: Oxford Economics (Global Industry Databank), September, 2014. For India, Deloitte Touche Tohmatsu India Private Limited projections using Oxford model

Furthermore, the availability of a contiguous spectrum for provisions of mobile services is another challenge. A large part is held today by the defense department. On the external front, limited access to major markets, such as China, and the emergence of global competitors, such as the Philippines, in the business-process outsourcing segment are key concerns.

Growth potential

The ICT sector in India is projected to grow at a strong average annual rate of 7 percent over 2014–40, due to both growing domestic and external demand.[92] Indian IT firms could benefit if offshoring becomes more commonplace in Europe.[93] Apart from traditional software exports, this could drive up European investments in global in-house centers, more commonly referred to as captive centers, in India.

As India's economy expands, IT spending by both businesses and consumers is likely to increase. This will aid the wider ICT sector, which will also benefit from greater penetration of computing technology, smartphones, and the Internet in both urban and rural areas.

Online services including e-commerce would be a key growth driver, which will also drive growth in a large number of downstream and support industries like web and mobility as a result of enterprise software and logistics.

Another opportunity in the telecommunications sector is the rural market, where mobile penetration is currently low (40 percent).[94] While the rural market provides tremendous potential for growth, the challenge would be to ensure that ARPU (average revenue per user) doesn't drop further). One way would be to ensure relevant content, such as education, healthcare, and agriculture, is made available to the rural consumers in their local language via mobile apps.

Road ahead

Technological changes are inevitable in the global ICT arena, offering both challenges and opportunities for Indian firms. One example is the social, mobile, analytics, and cloud services space, which Indian firms are increasingly embracing.[95] Moreover, even as large firms with multiple capabilities emerge, the market will increasingly accept small businesses with specialization in a particular technology, leading to greater market competitiveness. Hardware is another area that Indian and global firms could focus on, in line with the government's "Make in India" drive. Opportunities in the public sector will also emerge as the Indian government focuses on creating smart cities and digital governance.

As innovations in ICT intensify in the coming years, Indian policymakers would do well to take note of the impact of technology on incomes and wealth. As in the developed world, ICT advancements will weigh on economic equality in India by favoring skilled labor more than unskilled and semi-skilled ones. However, it is also worth noting that ICT will increasingly reduce hurdles for entrepreneurs and skilled individuals to develop and market their wares. The sector will also aid efficiency and/or affordability in fields as diverse as online education and agriculture.

[85] NASSCOM, Strategic review 2014: The IT-BPM sector in India, February 2014.
[86] NASSCOM, Strategic review 2014: The IT-BPM sector in India, February 2014.
[87] Deloitte Touche Tohmatsu India Private Limited, CII, and MITSOT, Telecom: Enabling growth and serving the masses, September 2014; India Brand Equity Foundation, Telecommunication, March 2014.
[88] http://articles.economictimes.indiatimes.com/2014-08-21/news/53073057_1_travel-portals-yepme-dressberry
[89] NASSCOM, "Exports: ~13 percent growth—US$10 billion added," September 2014.
[90] The Economist, "India's outsourcing business: On the turn," January 2013.
[91] BusinessLine, "Rising costs challenge India's tag as low-cost outsourcing destination," September 2013.
[92] Oxford Economics, *Global Industry Databank*, September 2014.
[93] The Times of India, "Fortress Europe lowers its offshoring walls," May 2014.
[94] Deloitte Touche Tohmatsu India Private Limited, CII, and MITSOT, Telecom: Enabling growth and serving the masses, September 2014.
[95] Livemint, "SMAC is the new flavor of IT services companies," February 2014; NASSCOM, *Strategic review 2014: The IT-BPM sector in India*, February 2014.

Policy challenges and opportunities

Throughout this report, the important role of the government and policymakers in India's success story has been reiterated. Their activities and influence, working in conjunction with business, are crucial in helping India on its path to prosperity.

Skills and Talent Development

To become a major competitive player in the global economy, it is critical that government, industry, and business work together to develop and deliver appropriate training to create a workforce which possesses technical capabilities, as well as varied skills that are consistent with the demands of the marketplace.

India's National Skill Development Policy (NSDP) 2009 attempts to address this need within the larger context of the country's vision of "sustainable inclusive growth." In line with the policy, central ministries and state governments across the country are implementing multiple initiatives toward skills building, including the National Skill Development Agency (NSDA) and National Skill Development Corporation (NSDC), which have implemented initiatives in viability gap funding, knowledge creation, and institutional development.

With the establishment of the industry-backed Sector Skill Councils (SSC), progress is being made in defining job roles and aligning industries. The role of industry in defining acceptable standards of training curriculum through SSCs should assist in creating a globally acceptable workforce, while also assuring availability of requisite talent for those setting up industries within India.

While these initiatives are set to address the low levels of employability of graduating students, the employability of skilled youth is also dependent on the quality of employment opportunities. Additionally, industry may need to raise awareness of the value of vocational careers as a viable alternative among students.

Additionally, there must be new models of investment support from government and industry to deliver manufacturing-related training, along with financing schemes for students that can make courses more broadly affordable. This will help training organizations, both in private and government sectors, expand their reach through sustainable models for training delivery. Moreover, development opportunities must be accessible to youth from all regions of the country—as well as to school and those currently not in employment, education and training.

Coordinated action in skills and talent can result in significant strides in India toward inclusive growth. It has the potential to target youth in all parts of the country across the rural-urban divide and to impact the living standards of young people and their families across a wide section of society.

Trade/Business process facilitation

The increasingly integrated global economy has prompted multinational firms to want to compete more intensively in the Indian market. In order to stay competitive and realize its full potential as a leading G20 economy, India must further liberalize trade and investment, and create a trade policy framework that fosters competitiveness and innovation systemically across sectors, both domestically and internationally. Continuing trade-restrictive barriers that place foreign entrants at a competitive disadvantage will ultimately work against the continued growth and sustainability of the Indian economy.

Trade facilitation boosts trade by reducing costs and delays for traders through measures that provide predictability, simplicity, and uniformity in customs and other border procedures. A more seamless trade-facilitation process across the global trading system allows for greater participation in those wanting to do business around the world—which is particularly helpful for SMEs and developing countries.

Furthermore, it is crucial for India to establish a smart regulatory infrastructure that enables efficient and effective business operations. There are estimated to be more than 40 regulations that need to be complied with for operating a business, not counting the sector-specific ones. Many of these regulations have not been updated over the years and, consequently, some of their provisions are not in line with current business practices. The added complication is that around 60 to 70 percent of these regulations are administered by the individual state governments, with some falling under the remit of the local government, which are separate democratically elected bodies. Many of these organizations lack adequate capacity to administer their respective regulations effectively in terms of skilled manpower and IT-enabled efficient business processes.

The central government has already taken some promising steps to simplify the overall regulatory framework by updating regulations within its purview to remove restrictive provisions and ease compliance requirements. It is also taking steps to move to a fully automated transparent system for key central government compliances, and is developing IT-based systems that can be used by interested state governments to streamline their compliance processes. Many proactive state governments have also simplified their own regulations through adoption of self-certification and increased applicability thresholds for compliance requirements.

Going forward, the government should institutionalize and scale up these initiatives through suitable mechanisms that will incentivize both state and local governments to achieve minimum service levels. Regulatory policies should continue to focus on opening India's labor markets, providing easier access to financing, taxation, and bankruptcy laws that support meaningful risk taking. Creating better collaboration and sharing across industries and regions remains critical, as does additional incentives for knowledge sharing across institutions and infrastructure, industries, and geographies which are needed for establishing the sustainable innovation ecosystems.

Energy and infrastructure

This sector has attracted substantial interest and investment in last decade, particularly with the public private partnership (PPP) model. However, more recently, difficult financial scenarios, stalled projects, policy paralysis, shorter project pipelines, and reduced market capacity have impacted the sector's growth. Delays in environment and forest clearances have caused time and cost overages and stalled projects. While developers were struggling to expedite their projects and arrange funds for new projects, banks and financial institutions saw their balance sheets dwindling, which led to tightening of purse strings. As of 31 March 2014, more than US$100 billion worth of energy and infrastructure projects were stalled.[96]

This lack of clarity on key policy decisions adds to uncertainty, especially related to natural resources. For example, the recent court verdict quashing the allocation of 214 coal blocks allotted since 1993 and the deferral in gas pricing policy will be a setback for firms heavily invested in the wider power and energy sector.[97]

The government needs to replace current procedures with more transparency. Doing so will create greater clarity for rules especially when they come up for review by the legislature and the judiciary. Furthermore, a "single window" clearance mechanism, which is currently being explored for manufacturing, could also be considered for the energy and infrastructure sector, along with better inter-ministerial and center-state coordination. The recently announced PPP institute can also work toward such a goal. A focus on clarity and stability in the regulatory framework and in the domain of taxation would enhance investor confidence. For long-term stability, emphasis should be on better preparation of projects and enhanced due diligence by stakeholders. Along with a focus on energy and connectivity, policies should also focus on infrastructure for industrial water supply and waste management.

The pricing of natural resources and infrastructure services needs to adopt a balanced approach. While natural resources are allocated and priced by the government in a transparent and scientific manner, pricing of natural resources should take into account their impact on cost of other industries. The long-term, cross-subsidized pricing of infrastructure services should also be gradually phased out. Development of a well-defined renegotiation framework for existing and future contracts is another key action point. For addressing immediate financial concerns, the government is already considering asset reconstruction funds and relaxing equity lock-in conditions for developers. In order to address asset-liability mismatch, long-term instruments and dedicated funding institutions need to be brought in and supported through a robust institutional and policy backbone.

[96] Livemint.com, "India opens the funding tap for infrastructure projects", July 2014.
[97] The Hindu, "Supreme Court quashes allocation of 214 coal blocks," September 2014; Business Standard, "Decision on gas price deferred till November 15," September 2014.

Conclusion

As India's policymakers try to prepare the economy for the next decade, it is worth asking two questions.

Does India have what it takes for a giant leap?

And will policymakers be able to lead the economy to greater heights?

The answer to the first question, we believe, is "yes." India is a large market with rising purchasing power, a strategic location with links to fast-growing economic regions, and a young population eager to take part in the nation's development.

On the back of these strengths, the economy is likely to grow at a fast pace in the medium term to long term. This will be a major draw for domestic and foreign investment which, in turn, will improve the pace of job creation and overall productivity. However, physical capital will not be enough, especially when it comes to improving labor productivity, a major drawback for India. More investment in education, research, vocational skills, and health is required. After all, a labor force unprepared for better machinery and technology will not be of much help to the economy.

The answer to the first question is nevertheless conditional on the response to the second question. Policymakers play a crucial role in creating a positive business environment. In India, recent policy moves such as the RBI's shift to an inflation-targeting framework, along with the new government's focus on fiscal consolidation, have helped improve business sentiment. Another positive indicator is the government's initiatives to upgrade ties with major economies, ease decision making, develop infrastructure, and promote manufacturing. Businesses are watching whether the government keeps its promise of reducing its direct presence in the economy and instead turns into a facilitator.

However, it's still a long road ahead for the government. While it has made the right gestures, it has yet to lay out a clear roadmap, especially for tough economic reforms. The government is likely to find that the journey is a tough one with political compulsions and inertia getting in the way. Change is never easy, but the government can draw comfort from the economy's inherent strengths. They will serve as a solid base from which policymakers can steer India's economic ship to catch the next wave of growth and prosperity.

Appendix

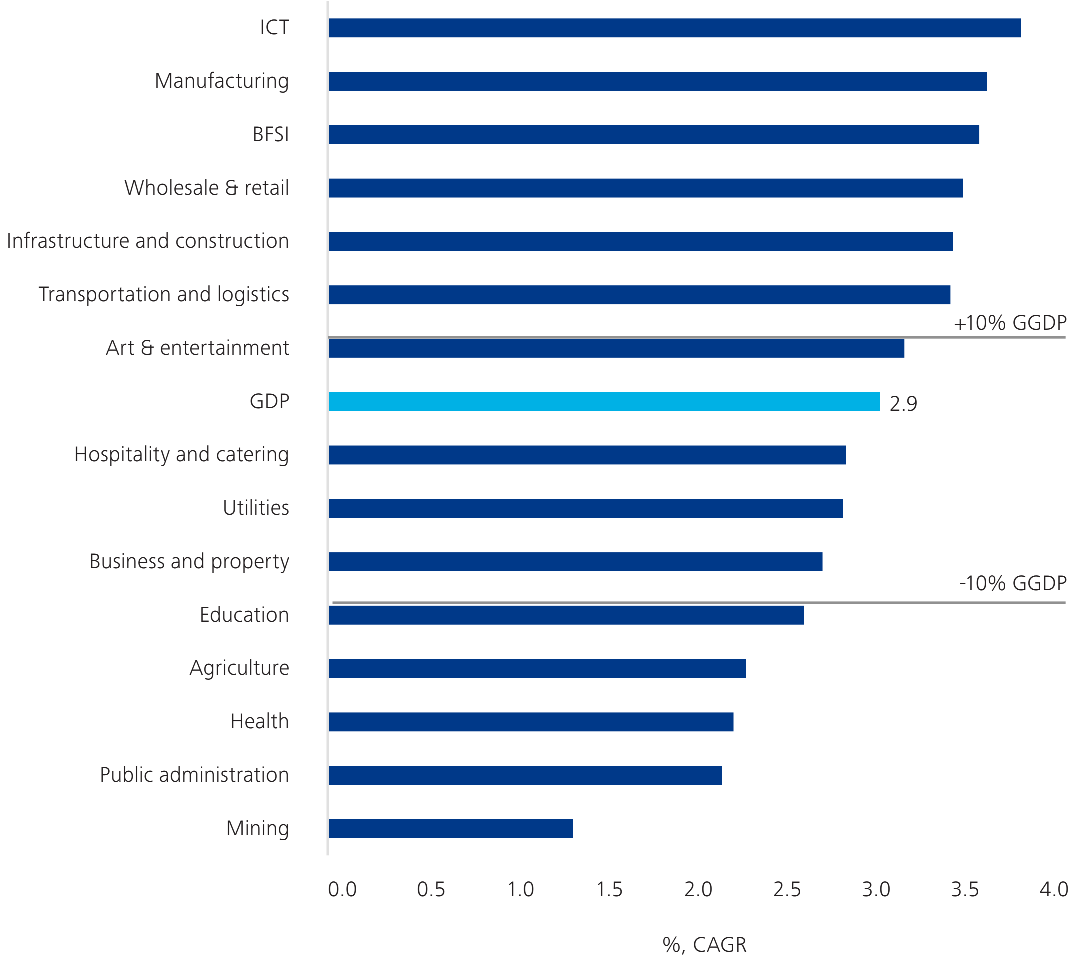
Methodology

Assumptions: A quantitative model has been used to derive the outlook for the Indian economy.[98] The Oxford Economics' industry model serves this purpose, using underlying assumptions from Deloitte. Most of these assumptions such as demographic dividend, stable democracy, and a large market have been touched upon in previous sections. Other assumptions include positive impact of stable governance and better macroeconomic management, primarily lower inflation and healthier public finances as discussed earlier. In order to identify the key sectors driving India's future prosperity, three quantitative approaches were considered:

1. Simple growth analysis across sectors within India vis-à-vis the world;
2. Relative growth analysis across sectors within India; and
3. Comparative growth analysis across sectors and across leading emerging peers.

Approach 1:
It is important to recognize global opportunities and India's advantages over the rest of the world. According to global growth projections, ICT, manufacturing, BFSI, wholesale and retail services, and infrastructure and construction will be some of the fastest-growing sectors—each of which is expected to grow 10 percent faster than global GDP.

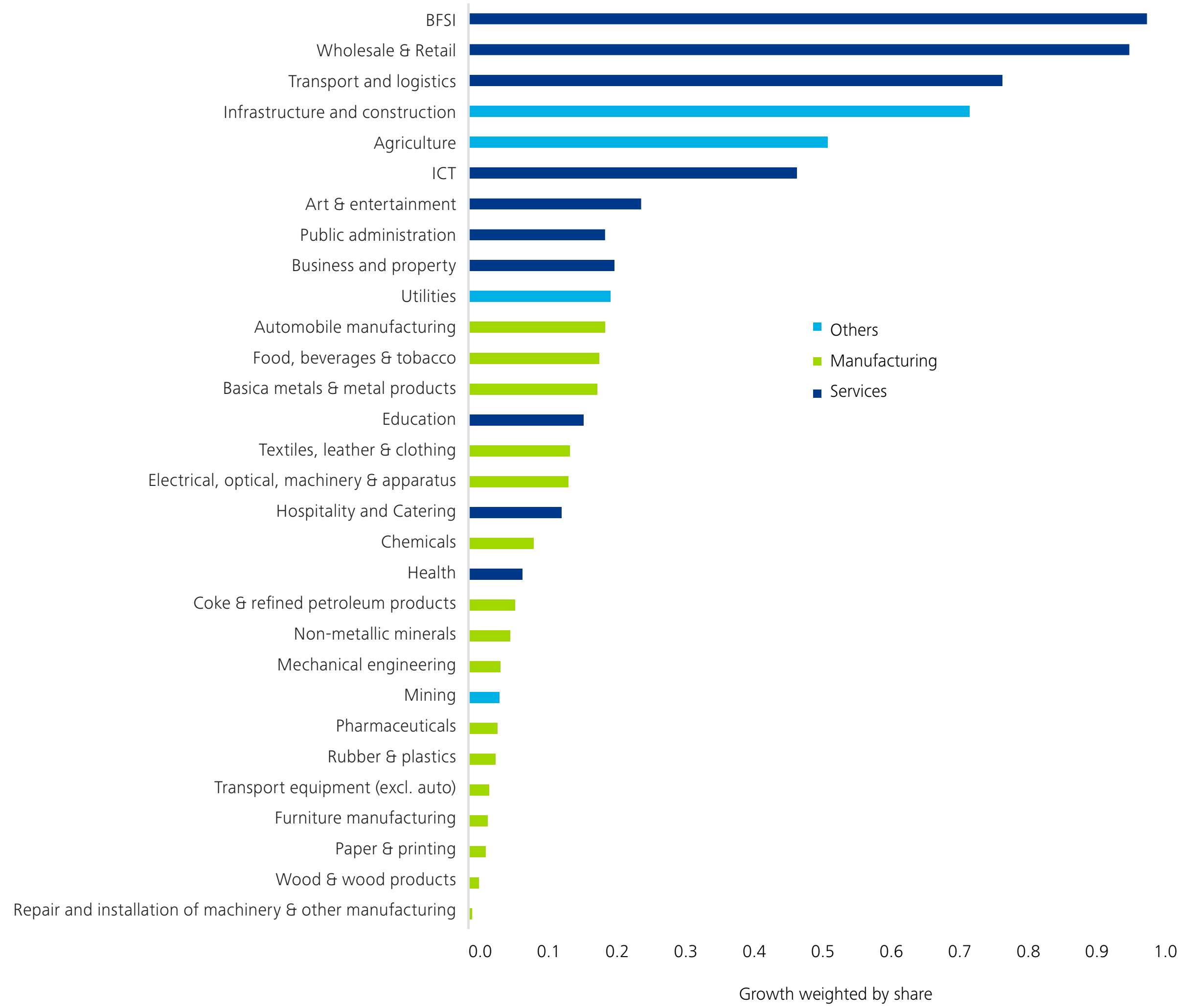
Figure 26: World—projected growth in sectors, 2014–2040



Source: Oxford Economics (Global Industry Databank)

Approach 2:
However, comparing simple growth is not exhaustive because the relative size of each sector differs significantly. Thus, relative weighted growth is computed for each sector, where growth of these sectors is weighted by their contributions to total GDP (Figure 27).

Figure 27: India: the next big sectors during the period 2014-2040
Relative weighted growth



Source: Deloitte Touche Tohmatsu India Private Limited projection, using the Oxford Industry Model

[98] Most of these assumptions such as the demographic dividend, stable democracy, and a large market have been touched on. Other assumptions include the positive impact of stable governance and better macroeconomic management, primarily to lower inflation, and healthier public finances. Given the ruling party's majority in Parliament and recent moves to streamline decision making, the model also assumes positive impact of governance on policy implementation, economic reforms, and infrastructure development.

Approach 3:
Relative growth across sectors alone is not enough to determine where India's advantage lies vis-à-vis its peers; one has to also consider whether these sectors will attract investment and help India gain an edge over other emerging economies. An ideal way to evaluate sectors across economies would be to compare their comparative advantage based on sector-specific factors such as productivity, cost competitiveness, availability of skills, and policies and regulations. However, unavailable or inaccurate sector-specific data on these parameters make it difficult to precisely measure sectors' comparative advantage across economies.

This report proposes an alternate method to estimate the comparative advantage of India by comparing relative weighted growth of the sectors of India vis-à-vis other leading emerging peers over the period 2014–40.

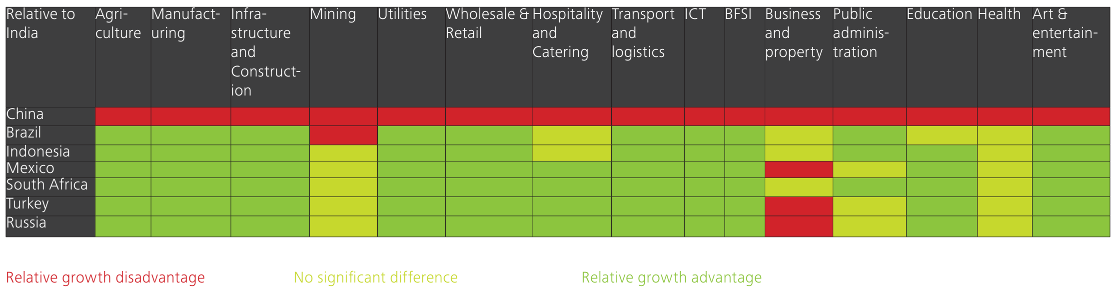
The relative weighted growth for each sector in India can be estimated for the projected period 2014–2040 by subtracting the relative sector growth *(j)* of another emerging economy *(i)* from the relative growth of the same sector in India, where relative growth is measured by growth of the sector *(j)* weighted by its share in the respective country's GDP.

In other words, India's relative growth advantage in sector *j* vis-à-vis country *i*,

Equation 1
gadv(India,i)j=gIndia,j∗ShareIndia,j-gi,j∗Sharei,j
(where *g* = growth in sector *j*, *Share*= share of sector *j* in GDP of the country)
such that:
if *gadv(India,i)j>0*, India has a relative growth advantage in the sector *j* when compared with country *i*;
if *gadv(India,i)j<0*, India has a relative growth disadvantage in the sector *j* when compared with country *i*;
and,
if *gadv(India,i)j=0*, India has no comparative advantage or disadvantage.

Figure 28 compares the relative growth advantage of India with respect to a few selected emerging economies based on Equation 1.

Figure 28: Relative growth advantage over emerging-economy peers: period 2014–2040



Source: Oxford economics (Global Industry Databank), Deloitte Touche Tohmatsu India Private Limited projection for India only, using the Oxford Industry Model

The three approaches suggest that India's opportunity lies in the following sectors:

Figure 29: Key sectors as suggested by the approaches

Approach 1	Approach 2	Approach 3
Automobile manufacturing Pharmaceuticals Infrastructure and construction ICT	BFSI Wholesale and retail Transport and logistics Infrastructure and construction	Agriculture BFSI Infrastructure and construction Transport and logistics Wholesale and retail

While data from credible sources have been used in this analysis, it is also true that, like every other forecasting process, these projections have their limitations. The underlying assumptions on structural reforms and the government's policy direction are subject to change over the next 26 years. Thus, these quantitative analyses can only be used to propose a hypothesis and cannot be conclusive.

For more information

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