HSBC Global Research

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India's 'new' economy

Will exports and digital firms lead?

Free to View
Economics - India

- Two 'new' growth drivers have sprung up recently; India's high-skill exports have been gaining global market share
- New-age tech firms are growing rapidly and are likely to enhance GDP growth and create jobs over the next decade
- To be sustainable, both drivers need the 'physical' economy – infrastructure and manufacturing – to rise in tandem

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Two 'new' growth drivers have garnered attention in India. Exports have been growing briskly, and the growing ecosystem of the so-called new-age tech firms has become the talk of the town. But are they good enough to drive growth sustainably?

Exports. We find that high-skill exports (e.g. mobile phones, machinery, pharmaceutical products, and IT services) have gained global market share in what we call the 'trade diversification period' of 2017-19. Alas, low-skill and labour-intensive exports (such as textiles, and agriculture) have been weak. There is econometric evidence of a *net* gain, but it is small for goods exports and much higher for services.

We also find that the main driver of rapid export growth in 2021 is the impressive rebound in global growth (notwithstanding the hiccup caused by rising shipping costs). This period comes as a window to carry out reforms to diversify the gains into labour-intensive exports, helping India realise its full export potential. We will be watching three metrics – the rise in 'physical' FDI, the lowering of import tariffs, and the rise in manufacturing GDP share.

New-age tech firms. The stars seem to have aligned for India's start-ups. Global liquidity, rising risk appetite, and geopolitical changes have increased the supply of funds. A rapid rise in Indian new-age tech firms has raised the demand for funding. FDI, FII, VC and PE inflows are all on the rise. We estimate that 50% of FDI inflows into India are now 'digital' versus 20% a decade ago.

The economy-wide benefits are likely to be significant across a pro-entrepreneurship cultural shift, growth, and jobs. By increasing the consumption pie, e-commerce alone could add 0.25ppt to India's GDP growth per year for the next decade, as the penetration catches up with China (even if halfway). There is also likely to be some spill-over of 'digital' innovation into the 'physical' economy.

However, new-age firms will be major users of the 'physical' economy – especially infrastructure and manufacturing. Expanding public investment and the share of manufacturing in GDP will be key.

Bringing it all together, the two 'new' growth drivers have much in common. Both can be users of India's inherent endowment – its large and young labour force. Both stand to benefit from global changes that are under way. And they are also interrelated. But 'physical' economy constraints need to be addressed for sustainable gains. The recent rise in public capex is a good start; future increases will play an important role in supporting the 'new' drivers realize their potential.

This is an abridged version of a report by the same title published on 8-Sep-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

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Old economy, 'new' drivers

- Two new growth drivers have garnered attention in the pandemic period
- India's exports are rising faster than several peers', and new-age digital firms could be in the midst of a major catch-up
- Will these be dependable and sustainable drivers of growth?

As economies from around the world build back from pandemic-led disruptions, several could find new drivers leading the way.

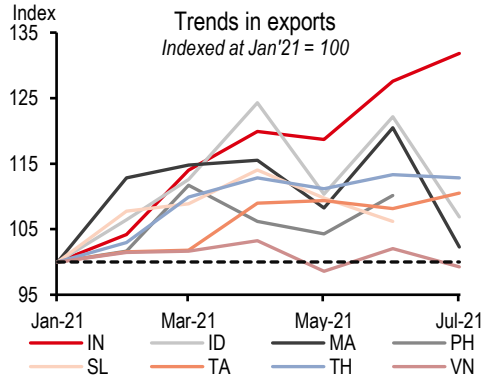
Two 'new' growth drivers have garnered attention

Two 'new' drivers have garnered attention in India – **exports have grown briskly** since the start of 2021, and the growing ecosystem of **new-age tech firms has become the talk of the town**[1]. But are they good enough to drive growth sustainably?

High growth in exports …

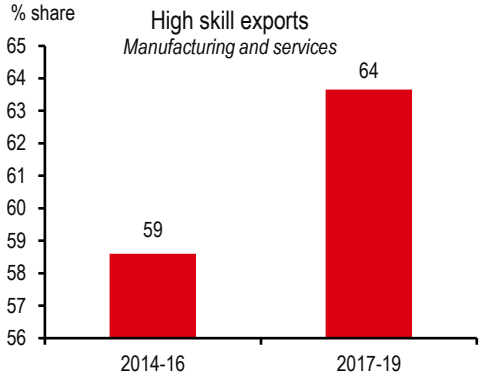
To be fair, exports had been an important driver of growth in the past (2004-2014). But ran into choppy waters thereafter[2]. And now, amidst the pandemic, exports seem to have re-emerged. Not only are they rising, they are outpacing the export growth of several Asian peers, particularly for high skill exports (see charts 1 and 2). True that rising shipping costs and shortage of chips globally could weigh on exports in the near term, but in this report we focus on the medium term.

Chart 1: India's exports have grown faster than its peers'



Source: CEIC, HSBC

Chart 2: High skill exports have done particularly well

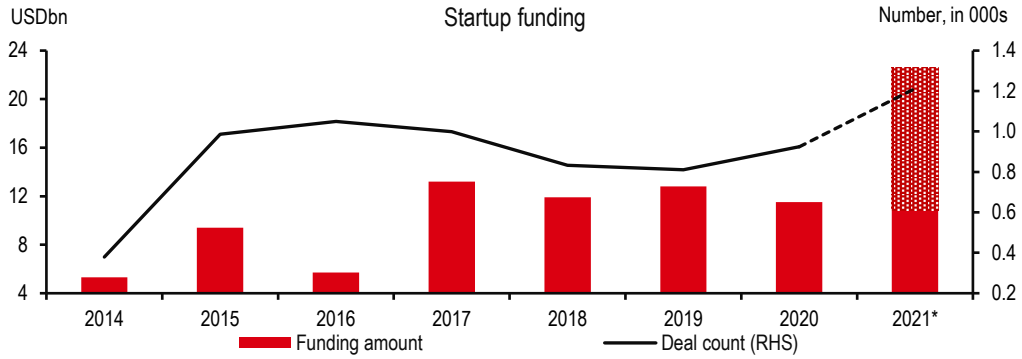


Source: CEIC, HSBC

1 Here we mainly allude to new technology-intensive services companies.

2 Exports grew 14% y-o-y in the 2006-2012 period, higher than GDP growth of 8%. Over the next 7 years, it slowed to 5% y-o-y, even as GDP growth was broadly unchanged.

Chart 3: Investment in India's tech start-ups since 2015 could rise to more than USD80bn in 2021



*1H2021 is actual, 2H2021 is INC42's forecast from the *Funding report H1 2021*
Source: INC42, HSBC

In the few years before the pandemic, there were global talks around diversification of manufacturing, and a rejig in global supply chains. Did India benefit? Or is the current rise in exports primarily led by strong global demand coming out of the pandemic? If it is the former, exports could indeed become an important driver of domestic growth once again.

… and a rapid rise in new-age tech firms

India has also seen **rapid growth in new-age firms**, led primarily by the digital economy. There have been large foreign and domestic inflows at various levels – venture capital (VC) funding, private equity (PE) funding and inflows into equity markets. Funding to tech start-ups amounted to cUSD60bn between 2015 and 2020, and could rise to over USD80bn by end-2021 (chart 3).

Given the success of similar companies in US and China over the last decade, can India be in the midst of a major catch-up?

We try to answer all these questions in this report.

Winds of export diversification

- High skill manufacturing and services exports have clearly gained global market share in the 'trade diversification period'
- But low skill and labour intensive manufacturing exports have underperformed
- To gauge whether exports can become an important driver of jobs and growth, we are tracking three metrics

Investigating two periods

In the first two quarters of 2021, seasonally adjusted overall exports growth was 36% q-o-q (annualised), or 22% y-o-y. It is now 17% higher than pre-pandemic levels (see chart 4). Looking back further, the contribution of exports to India's GDP growth was on the rise even earlier[3].

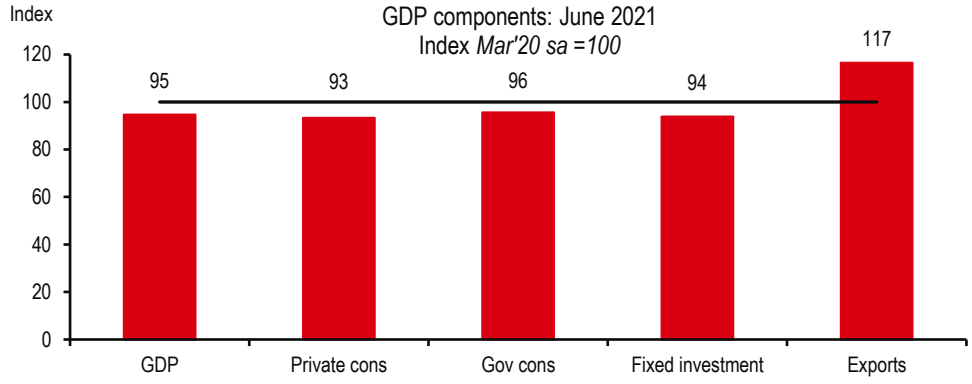
To get a better sense of what's going on, **we investigate two periods** separately:

We study exports over two periods

One, the few years leading to the pandemic, i.e. 2017-19: As the world attempted to diversify supply chains, did India benefit? We call this period the **'trade diversification period'.** We are careful to stop just before the pandemic, because the period after won't give us a clean read, as it has the pandemic-led disruption woven in.

Two, the year 2021: Global growth has recovered sharply after a big fall in 2020. Demand has been strong, particularly in developed economies. We call this the **'global rebound period'.**

Chart 4: India's export growth has been strong; 17% higher than pre-pandemic levels



Source: CEIC, HSBC

3 From 0.2ppt/year over 2014-16 to 1.2ppt/year over 2017-19

Chart 5 High-skill manufacturing and services exports make up c70% of the export basket now, versus under 60% a decade ago

Source: CEIC, HSBC

We also break down India's GDP exports into categories, such as high-skill manufacturing exports (comprising auto, electronics, machinery, pharmaceuticals, etc.), low-skill manufacturing exports (comprising clothing, textiles, etc.), services, agriculture, etc. Chart 5 outlines the sectors clearly. The classification is broadly based on a recent report by Subramanian and Chatterjee, 2020[4].

High-skill exports benefited in the 'trade diversification period'

We start with the first period, 2017-2019. We make sure to study India's export data across various metrics (percent of GDP, percent share in total exports, net of imports, and as a percent of global exports).

High-skill manufacturing and services exports rose over the 2017-19 period

Here are some takeaways –

- **There were clear improvements.** After falling in the 2014-16 period as a proportion of GDP, exports stabilised in 2017-19 (see chart 6). Annual growth in exports picked up in both value and volume terms.
- **The rise in non-oil-non-gold export volumes was sharp** and most encouraging (see chart 7)[5].
- **But the improvement was not uniform.** High-skill manufacturing and services exports grew much faster than low-skill manufacturing exports. The 2017-19 period intensified a trend that was already under way. High-skill exports have grown from 56% of total exports in FY13 to 62% in FY16, to 65% in FY19, **to c70% in FY21**.
- **High-skill exports rose particularly in**: (1) **Mobile phones**, where net exports have gone into positive balance after several years of significant deficit (see charts 8); (2) **machinery**, where the gains have not just been in value terms, but India has also gained global market share (see charts 9 and 10); (3) **pharmaceutical products**, where India has not just increased net exports, but also gained global market share (see chart 11 and 12); and (4) **autos and accessories,** where net exports have risen gradually (see chart 13).

4 Arvind Subramanian and Shoumitro Chatterjee, India's Export-Led Growth: Exemplar and Exception (October 2020)

5 This comes from our database of export volume which is created using the following method: (1) We group nominal goods exports into major categories such as agriculture, textiles, other exports, etc., and create a value index for each. (2) Next, we create a price index for these different groups using international commodity prices obtained from the World Bank (pink sheet) and domestic WPI index adjusted for exchange rate movements. (3) To obtain a volume measure, we divide the value index by the price index. We calculate the % y-o-y change in the volume index, as a measure of real growth.

- **Services exports,** particularly IT services exports have been gaining global market share gradually over the last two decades, and that trend continued, with global share rising from 9.5% in FY13 to 15.4% in FY20 (see chart 14).

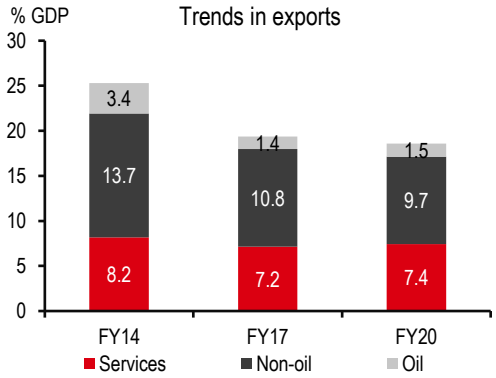
Low-skill exports fell further in the 'trade diversification period'

But low-skill exports fell

On the other hand -

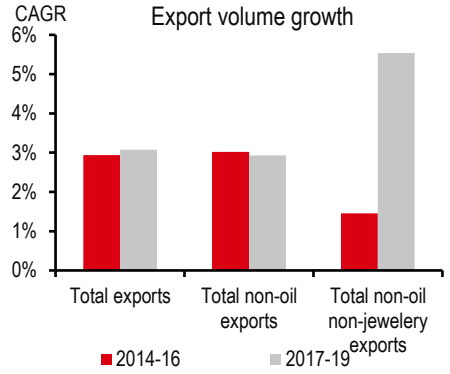
- **Low-skill and labour-intensive manufacturing exports have fallen** from 44% of total exports in FY13 to 38% in FY16, to 35% in FY19, **to c30% in FY21**[6].
- Sector-wise, the following categories saw a fall over this period: (1) consumer **electronic white goods**[7], where the trade deficit has widened and the share in global exports has fallen (see chart 15); (2) **clothing and textile**, where exports have fallen both as a share of GDP and India's exports (see chart 16); and (3) **agriculture**, where exports have fallen as a percentage of GDP (see chart 17). Jewellery exports too, have been weak over this period.

Chart 6: After falling for a few years, exports stabilised in the 'diversification period'



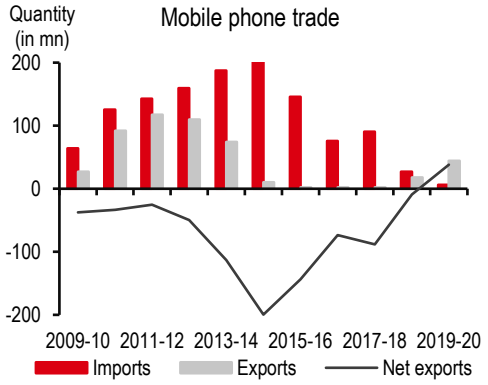
Source: CEIC, HSBC

Chart 7: Annual growth in exports picked up both in value and volume terms



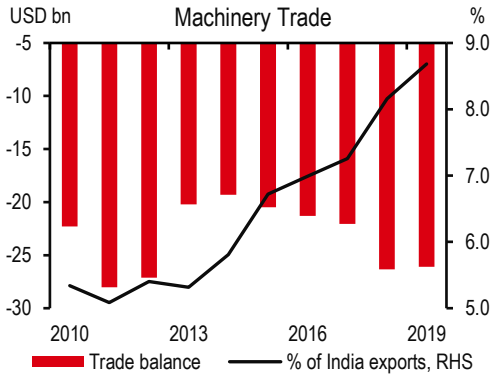
Source: CEIC, World Bank, HSBC calculations

Chart 8: Mobile phones: Net exports have gone into positive balance after several years of significant deficit



Source: Ministry of commerce and industry, PIB, HSBC

Chart 9: Machinery: Gains have been in value terms …

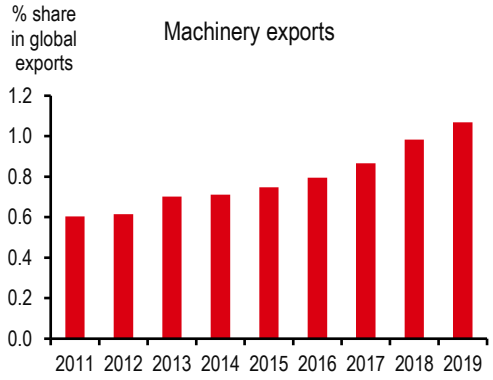


Source: International Trade Centre, HSBC

6 These include low-skill manufacturing, agriculture and minerals exports.

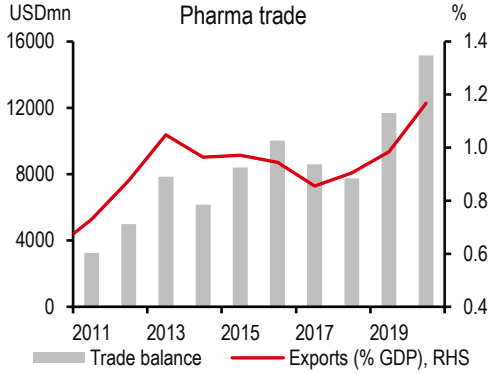
7 These include refrigerators, washing machines, dish washers, office machines, air conditioners etc.

Chart 10: … along with a rise in global machinery market share



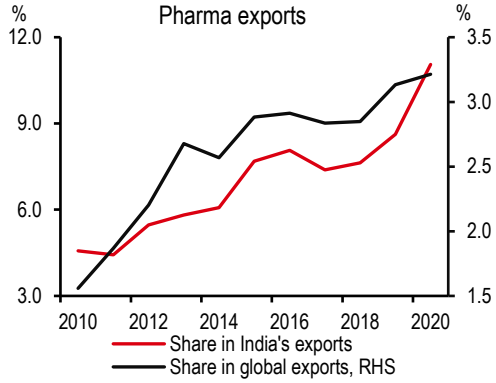
Source: International Trade Centre, HSBC

Chart 11: Pharmaceuticals: Net exports have risen …



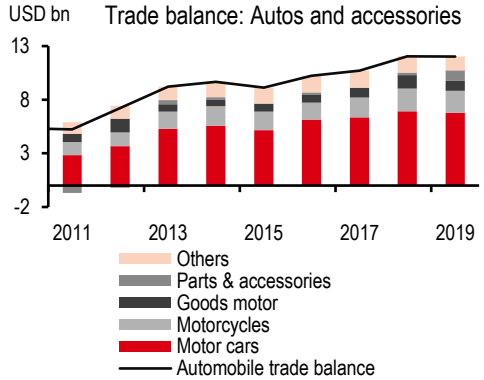
Source: International Trade Centre, HSBC

Chart 12: … along with a pick-up in global pharma market share



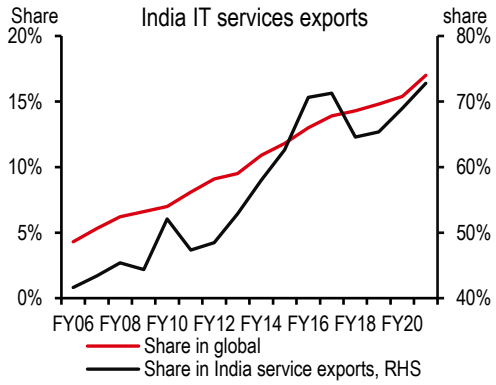
Source: International Trade Centre, HSBC

Chart 13: Autos and accessories: Net exports have risen gradually



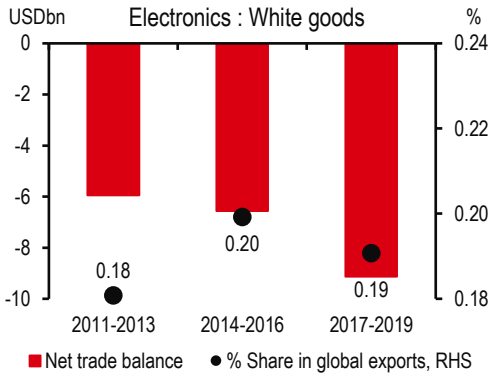
Source: International Trade Centre, HSBC

Chart 14: IT services: Exports have been gaining global market share consistently



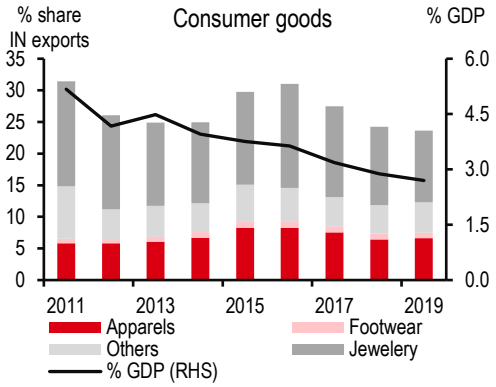
Source: Nasscom, CEIC, HSBC

Chart 15: Consumer electronic white goods: Trade deficit has widened and the share in global exports has fallen



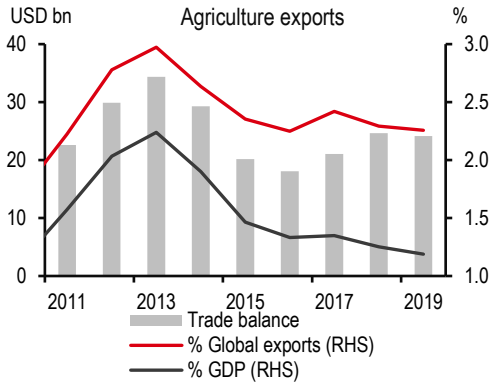
Source: International Trade Centre, HSBC

Chart 16: Apparels: Exports have fallen as a percentage of GDP



Source: International Trade Centre, HSBC

Chart 17: Agriculture: Exports have softened as a percentage of GDP and global exports

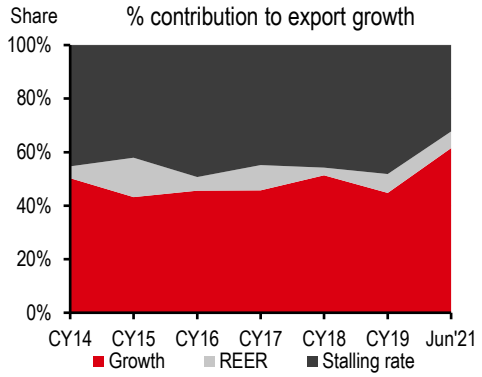


Source: International Trade Centre, HSBC

Chart 18: Alas, the net gain in goods exports was small

Source: UNCTAD, HSBC

Chart 19: 2021: Global growth is explaining a large share of the export performance



Source: HSBC estimates

Overall, did India gain in the 'trade diversification period'?

All of this shows that India gained in high-skill manufacturing and services exports, and that too across various metrics. Sadly, it lost out on low-skilled, labour intensive, and electronic white goods exports. **What was the net impact?**

There is evidence of 'net' gain …

Our long standing export model has done a good job in explaining trends in India's export growth. It is a simple three explanatory variable model, comprising world growth, exchange rates and stalled capex projects (an indicator of growth bottlenecks), as drivers of exports over long periods.

Between 2014-16, this model was able to explain c75% of the trends in export growth. But in the 2017-2019 period, the explanatory power fell to under 70%[8]. This implies that **something else was playing a role in driving export growth**[9].

8 A more competitive rupee partly was one of the explained drivers of export growth in this period.

9 In an alternative model, we insert a 'diversification dummy' that switches on from 2017. That dummy variable had a positive sign and was statistically significant implying that something different was indeed going on from 2017 onwards.

This could be a number of things – the winds of diversification aiding export growth, or the new Production Linked Incentive (PLI) scheme of the government (in which the export incentive programme was made more effective[10]). It's hard to disentangle the two. But it's worth asking how much did India eventually gain?

… but more for services than goods exports

The net gain in goods export was small. India's share in global *goods* exports rose, but only in the second decimal place, and lower than the gain in the market share of IT *services* exports over the same time (see chart 18).

Will the exuberance of 2021 last?

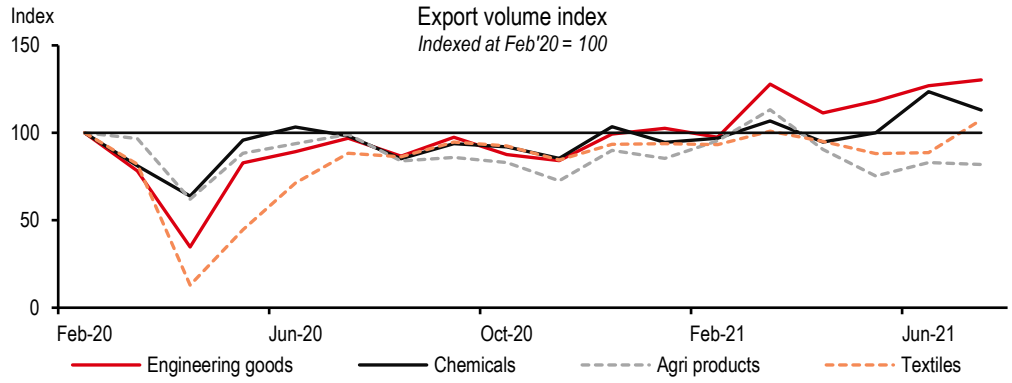
Global growth rebound is a main driver of the rise in exports in 2021

As mentioned before, exports have soared in the first half of 2021. Plugging back our export model, we find that the spurt in global growth in this period explains a lion-share of the export performance in 2021 (see chart 19). While the exuberance is across the board, there are some hints of high-skill manufacturing exports (like engineering goods and chemicals) outperforming some low-skill exports (such as agriculture, leather articles) see chart 20.

India has a good opportunity to make most of rising global demand, notwithstanding the hiccup caused by rising shipping costs and chip unavailability hurting some exports.

This period is also a good time to carry out the necessary reforms to ensure that exports don't fall back down when global growth normalises.

Chart 20: High-skill manufacturing exports continue to outperform some low-skill exports in 2021



Source: CEIC, World Bank, HSBC

Realising India's export potential

India needs reforms to raise its labour-intensive exports

There is a lot to be positive about. Export diversification is an ongoing process and more gains could follow over time. The PLI scheme was a success for electronics and could help raise exports in other sectors too, even if selectively. Furthermore, when one export sub-group does well, it can inspire other groups to do well; a phenomenon called the demonstration effect. Finally, India continues to gain global market share in services exports.

Yet it is clear that India is not utilising its biggest endowment, labour, fully. Labour-intensive exports in agriculture and textiles remain weak, and haven't shown signs of benefiting from the changing winds of diversification.

10 The focus this time around was to select a few sectors and give the relatively large firms in the sectors a significant subsidy, rather than spreading it too thinly across many firms in many sectors

If India wants to realise its full export potential, and make it a driver of higher growth and job creation, its needs to diversify gains across the export basket.

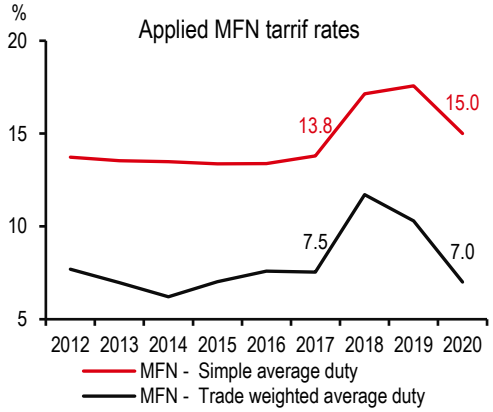
What ails labour intensive and low skill exports? The ecosystem, that comes in the way of small manufacturing firms growing over time into medium and large ones, thereby not gaining economies of scale benefits. There are many aspects to this, ranging from infrastructure deficiencies and access to finance, to high regulatory burden and lack of skilled labour (more on this later).

We are tracking three metrics to gauge if exports will realise its full potential

How do we track this sector? We will be watching three metrics (two leading indicators, one coincident indicator) to gauge if this sector is picking up:

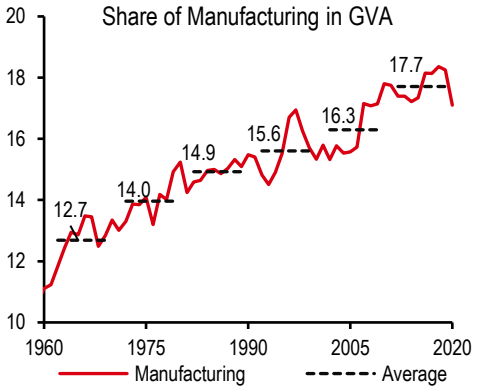
- **Rise in 'physical FDI':** FDI into new-age tech firms has been rising (more on this in the next section), but FDI into the physical economy can help ease the supply-side constraints that the overall economy faces.
- **Tariff rates**: A move from an import substitution mind-set to an export promotion one is key. The good news here is that after rising for a few years, tariff rates have softened a tad recently (see chart 21).
- **Manufacturing growth**: The proof of the pudding is in the eating. A rise in the share of manufacturing in India's GDP will mean that the ecosystem ailing India's low-skill labour-intensive exports, is improving (see chart 22).

Chart 21: Tariff rates have softened a tad, after a recent rise



Source: WTO, HSBC

Chart 22: India's share of manufacturing remains low at under 20%



Source: CEIC, HSBC

New-age firms at the fore

- India's new-age digital firms are growing rapidly, attracting global capital along the way
- We estimate that e-commerce alone can add 0.25ppt to India's GDP growth per year over the next decade
- For these firms to realise their full 'digital' potential, the 'physical' economy needs to rise in tandem

Dizzy supply, solid demand

The supply of global risk capital has risen …

The stars seem to have aligned. The supply and the demand for risk capital into Indian start-ups have risen.

The world is awash with liquidity as central banks have stepped up to support growth (see chart 23). There is appetite to put money into growing businesses. Venture Capital funding has risen sharply at a global level (see chart 24).

More stringent rules surrounding internet companies in some other countries could potentially direct more funds to India.

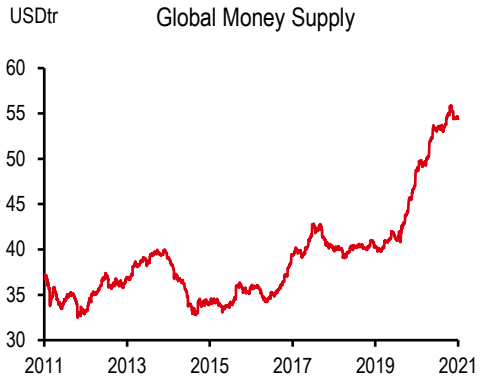
… around the time new tech firms have sprouted

New Indian firms have sprouted at a rapid pace (see chart 25), largely in the digital economy, aided by a young population, rapid smart phone adoption, and a digital payments revolution. As they grow, these firms have demanded funds at various levels. FDI, FII, VC and PE inflows are all on the rise (see chart 26 and 27).

A breakdown of FDI inflows into 'digital' and 'physical' shows that about 50% is going into digital, versus 40% five years ago, and 20% ten years ago (see chart 28). As mentioned earlier, between 2015 and 2020, cUSD60bn has been invested in India's tech start-ups, and this number is expected to rise by USD20bn in 2021.

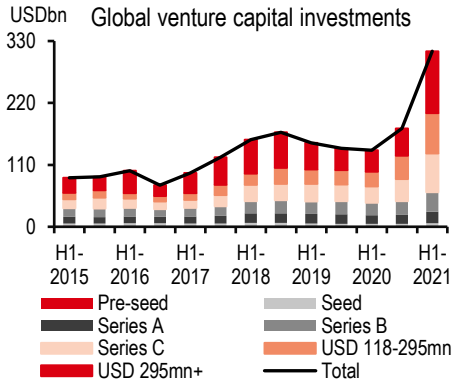
These new-age firms are fast innovating and spreading into new sectors. So far, some of the main sectors are fin-tech, e-commerce, ed-tech, enterprise-tech, media and entertainment, consumer services, healthcare and logistics.

Chart 23:The world is awash with liquidity



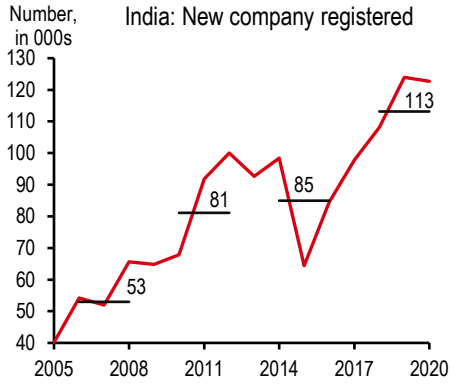
Note: Global money supply index sums up M2 for the Eurozone, China, United States, Japan, South Korea, Australia, Canada, Brazil, Switzerland, Mexico, Russia, Taiwan
Source: Bloomberg, HSBC

Chart 24: Venture capital funding has risen at a global level



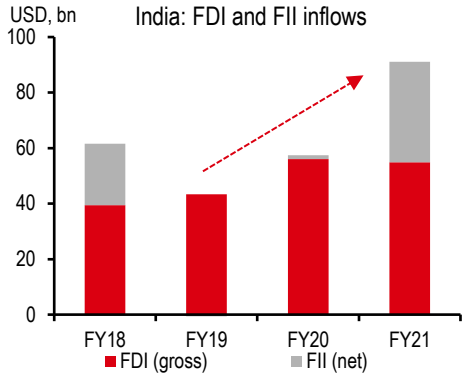
Source: Dealroom.com. Note: Figures have been converted to USD using 1EUR=1.18USD

Chart 25: New company registrations have picked up pace in India



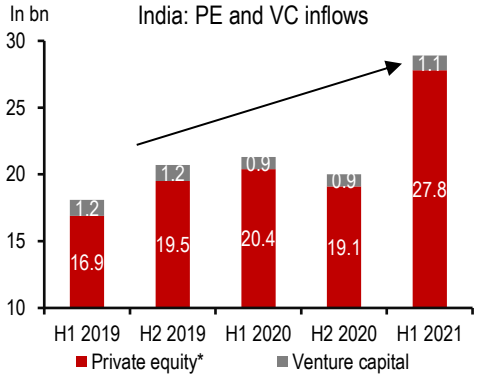
Source: CEIC, HSBC

Chart 26: FDI and FII inflows have increased



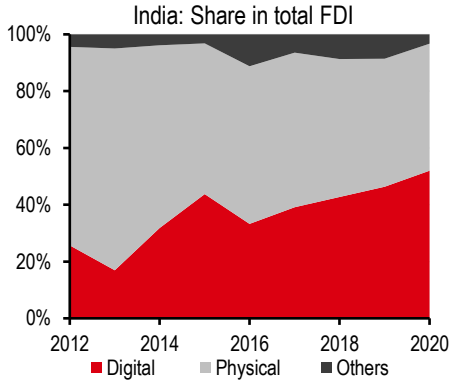
Source: CEIC, HSBC

Chart 27: Private equity and venture capital funding is rising



Source: IVCA. Note: Private equity excludes real estate investments

Chart 28: 50% of FDI inflows are going into digital sector



Source: CEIC, HSBC

Economy-wide benefits: culture, jobs and capex

These digital start-ups are likely to benefit the economy in many ways:

Culture. The entrepreneurial culture it nurtures in which failure is not looked down upon, can become an important secret sauce for growth for many years.

Jobs. Some people are nervous that a digital economy will be a jobless one. We beg to differ. Let's consider e-commerce. Provided that the wage outlook remains positive, the convenience of buying online can increase India's consumption demand over time. A larger labour force may then be needed to cater to this demand.

Will the convenience factor be significant? We believe yes. A study of why e-commerce grew more rapidly in China than in the US points to structural differences between the two markets. E-commerce helped overcome China's lack of organised retail, therefore accelerating its adoption. On the other hand, the US already had a strong organised retail infrastructure and e-commerce merely acted as a supplement.

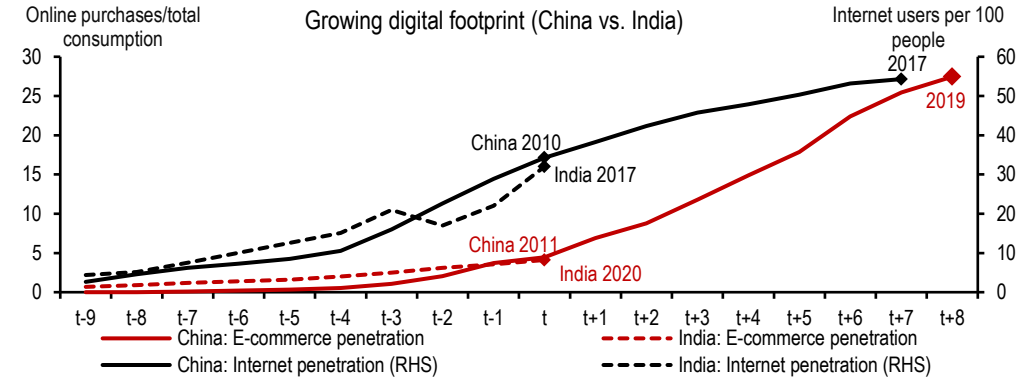
New-age tech firms can add to jobs, capex, and GDP growth

India's glaring lack of organised retail suggests that its experience will be closer to China's. In fact, data suggests that India's experience with e-commerce is running around a decade behind China's (see chart 29)[11].

We go on to test the jobs impact econometrically. We find that real wage growth and real interest rates have explained India's consumption patterns rather well in the past[12]. But over time, an additional variable that captures the rise of e-commerce is growing in importance. We find that the online purchases to total consumption ratio, an indicator of e-commerce penetration is rising.

We marry this ratio with growth in real GDP, to get to a combination metric, which helps us determine whether the combination of higher convenience from shopping online and buoyant income outlook do indeed increase total consumption in the economy. All variables are significant and of the right sign (see chart 30). **Our model suggests that e-commerce can in fact raise overall consumption.**

Chart 29: India's e-commerce experience is running a decade behind China's

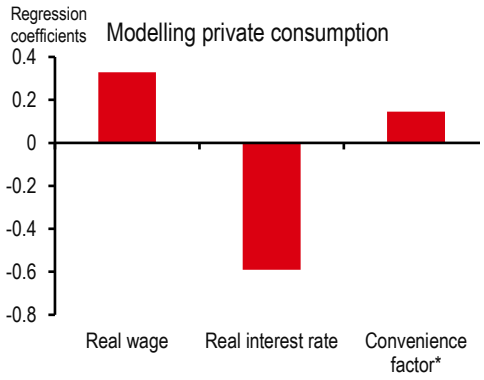


Source: CEIC, World bank, Industry sources, HSBC

11 To be precise, India is running 9 years behind China on e-commerce penetration, and 7 years behind China on internet penetration.

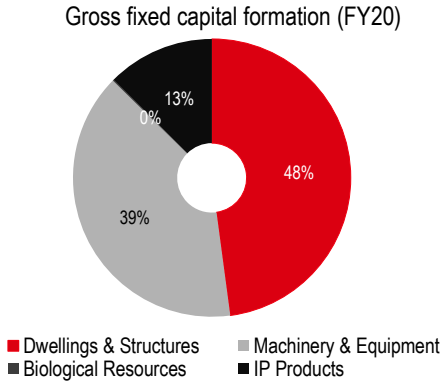
12 For our OLS model, we use three variables to explain real private consumption expenditure growth: (i) real wage growth, proxied by CPI deflated Aon India wage survey estimates, (ii) real interest rates, calculated by deflating the prime lending rate with CPI and (iii) convenience factor, calculated as e-commerce penetration multiplied by real GDP growth.

Chart 30: Regression results suggest that e-commerce can raise overall consumption



Source: HSBC estimates. Note: Convenience factor represents the interaction between online-to-total-consumption-ratio and real GDP growth

Chart 31: Share of intangible (i.e. Intellectual Property) and tangible investment



Source: CEIC, HSBC

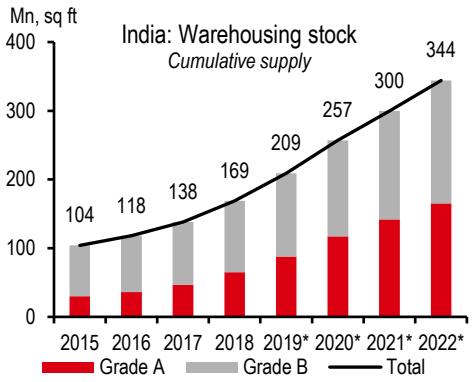
E-commerce can expand the consumption pie, requiring more labour to service it

A higher consumption pie will require more people to service it. In a previous report we found that e-commerce will lead to an increase in jobs across logistics & delivery, customer care, IT and management. True, several brick-and-mortar stores could shut. We modelled this carefully to find that, on net, e-commerce would create jobs[13]. Business-as-usual estimates suggest that India could have a shortfall of 24m jobs over the next decade. **E-commerce could fill half that gap.**

Capex. We believe these new-age firms will also do capex. Gross fixed capital formation can be broken down into tangible and intangible capex. The former mainly comprises dwellings & structures and machinery & equipment[14]. The latter comprises Intellectual Property (see chart 31).

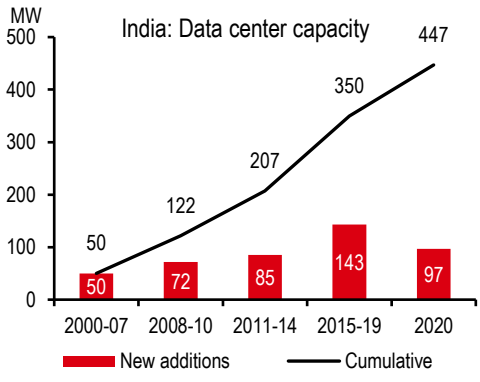
New age firms could contribute a bit to each of these categories, directly or indirectly. Demand for real estate could support investment in dwellings and structures. Capex in machinery in data centres could also be significant. And software to improve their business services efficiency could contribute to intangible capital. We are already seeing a rise in warehousing investment and data centres (see charts 32 and 33).

Chart 32: New age companies are investing in warehouses …



Source: JLL: *India Logistics and Warehousing – Tracing the lifecycle* (June 2019); HSBC

Chart 33: …and data centres



Source: JLL: *India's Data Centre Industry – Poised at the tipping point* ; HSBC

13 In our report we found that e-commerce could create 20m gross jobs over a decade. Some jobs would be lost. On net, it will create 12m new jobs.

14 Tangible capital also includes biological resources, but that is a very small share

GDP growth could benefit

Digital companies could raise India's GDP growth.

Here, we attempt to quantify some of the growth gains. We limit our analysis to the e-commerce sector, for which we have a workable model (explained above).

As mentioned before, India's e-commerce penetration is running a decade behind China's. We assume that **India can cover half of the gap with China in a decade**. As the consumption pie rises, so will GDP growth[15].

However, there is one complication that still needs to be addressed. The rapid rise in e-commerce over the last decade coincided with a sharp rise in personal credit growth. After having burnt their hands with industrial credit led bad loans, banks shifted focus to the still small personal loan market. Our regression may not be able to disentangle the impact of rising personal credit growth from the e-commerce convenience variable. We will have to net it off separately[16].

Rising e-commerce, for example, could add 0.25ppt/year to India's GDP growth over the next decade

Using our estimate of the credit growth multiplier, we subtract off the growth impact of a more sustainable personal credit growth over the next decade. What we are left with is our clean estimate of e-commerce impact on growth.

We find that, over the next decade, if (a) India can close half the e-commerce penetration gap it has with China, and (b) banks continue to fund part of the consumption growth but in a more sustainable way while (c) growth and income prospects remain bright, **rising e-commerce penetration could add 0.25ppt per year to India's GDP growth.**

Let's put this in context. In a previous note, we explained that post-pandemic potential growth will likely fall from 6% to 5%. The rise of ecommerce, we calculate, can offset a quarter of the fall.

Where will the growth show up? A Cobb-Douglas production function framework shows that growth is driven by labour, capital and TFP. We think new-age digital companies will have most impact of TFP, via efficiency enhancing processes, followed by capex, and then labour.

But 'physical' economy limits can't be ignored

The digital and the physical economy will feed off each other.

Over time, the 'digital' economy will benefit the 'physical' economy in innumerable ways. This is a fast-evolving space. Examples include the rise in fin-tech providing better access to finance, especially to small firms; 'smart roads' and 'smart highways' using technology that maximises efficiency, and digitisation of supply chains that raise export competitiveness.

The 'physical' economy – infrastructure and manufacturing – needs to rise …

But the digital economy will also be a large user of the physical economy, especially infrastructure and manufacturing.

New age firms will be big users India's roads, ports, rails and other infrastructure. True that these firms will do some of their own capex, for instance in warehousing and data centres. But they will also be **large users of the capex they do not do.** Furthermore, they will also be intermediaries in the domestic trade of goods, which the physical economy manufactures.

And here-in lie the constraints. India's investment rate has fallen over the last decade. Public capex, which leads the infrastructure build-out in the economy, has been stagnant, even as

15 Private consumption makes up c60% of India's GDP (average of FY15-20)

16 Also, it may not be prudent to assume personal loan growth to be as rapid in the next decade as it was over the last decade. Instead it may be more sustainable to assume a personal loan growth estimate that is closer to nominal GDP growth, so as to avoid excesses

private capex, which uses the infrastructure, has risen (see chart 34). The 'physical' infrastructure needs to rise in tandem with the 'digital' economy, to enable it to reach its full potential.

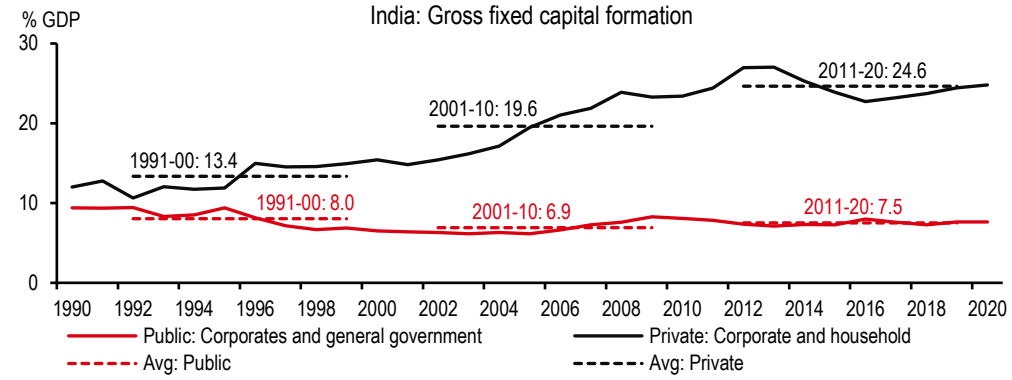
Similarly, sectors like e-commerce sell the products made in the 'physical' economy. If the consumption pie rises, but India's manufacturing sector does not keep up, and the digital economy relies on imported goods, it could hurt India's external finances, and become unsustainable.

… for the 'digital' economy to realise its potential

India's manufacturing sector has been sluggish (see chart 22). A breakdown of FDI tells a similar tale. Even as overall FDI inflows have soared, the rise has been limited to the 'digital' economy. 'Physical' economy FDI, has been sluggish at low levels (see chart 35).

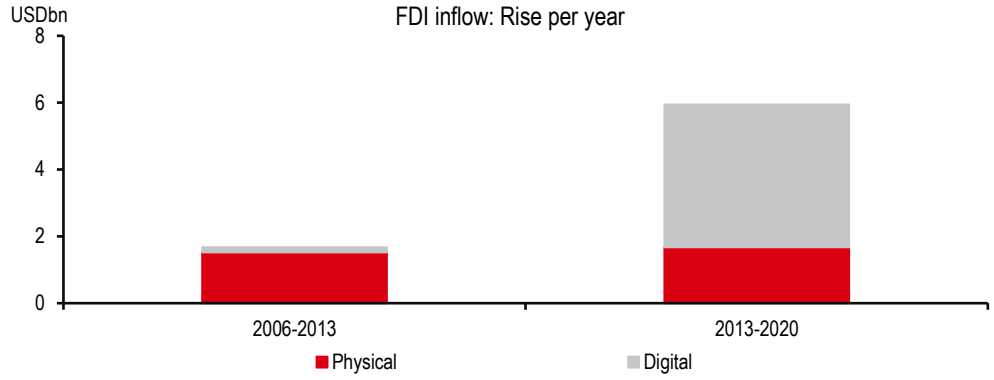
All told, the 'digital' dream is impressive, but for it to reach its potential, the 'physical' economy must rise in tandem.

Chart 34: Private capex has risen while public capex (focussed on infrastructure) has been stagnant



Source: CEIC, HSBC

Chart 35: FDI into the 'physical' economy has been sluggish



Source: CEIC, HSBC

Making new drivers succeed

- Exports and new-age firms can be efficient users of India's inherent endowment – a large and young labour force …
- … particularly if 'physical' economy constraints are eased …
- … around access to finance, good quality infrastructure, and lower regulatory burden

There are clear parallels between the two growth drivers, rising exports and the spread of new-age firms. Both can be growth enhancing for many years. Both are areas which can benefit immensely from India's inherent endowment – a large and young labour force.

The two growth drivers - exports and tech firms - have much in common

Both are undergoing big changes globally, making it possible for India to find an enhanced place in the world share, if the country rises to the occasion. Export supply chains are getting rejigged. There is global appetite to invest in new-age firms.

And both the drivers are interconnected. Technological innovations by tech firms are leading to higher services exports.

Both also need the 'physical' economy to rise in tandem

But to realise full potential, both of these growth drivers require the 'physical' economy to rise in tandem, particularly India's infrastructure and manufacturing sectors. Both exporting and new-age firms are users of India's hard infrastructure (roads, ports, rails and power). And both will also depend heavily on the goods produced by the manufacturing sector.

High quality infrastructure, access to finance and lower regulatory burden will be key

The ecosystem that keeps small manufacturing firms from growing needs to be changed. And this requires effort across the board – access to high quality infrastructure, access to finance, and lower regulatory burden (labour laws, inspections, etc.):

1. **High quality infrastructure** – Government capex can have a crowding in impact on the private sector, if done prudently. The resilience of central government capex in 2021 y-t-d is a good start. The government's INR6tr asset monetisation plan can provide a further push, by making more funds available to do new capex. Execution will be key.
2. **Access to finance** – Strengthening the Insolvency and Bankruptcy Code, as a means to deal with frequently rising bad loans that make banks risk averse, is critical. Industrial credit has grown 1.7% in the last five years, much lower than nominal GDP growth of 10.3%.

   The high funding costs this triggers hurts the growth of firms, especially the smaller and more labour intensive ones, which don't have much access to capital markets.

   Eventually, privatising/disinvesting public sector banks, even if gradually, given the political economy challenges, will be key. The budget of 2021 did well here in chalking out some plans[17].

17 The budget speech mentioned that disinvestment targets of several PSUs, including the IDBI Bank, will be completed in 2021-22. In a first of its kind, the budget also proposed to take up the privatisation of two Public Sector Banks and one General Insurance company in the year 2021-22.

3. **Lower regulatory burden** – Eventually, the regulatory burden of running businesses in India needs to be lowered. Some improvements have been made[18]. Many remain to be made.

All said, the momentum around the new growth drivers is building. Consistent effort to augment the 'physical' economy, can have a big growth pay-off.

18 In the World Bank Ease of Doing Business Index, India ranked 63rd in 2019, compared with 142nd in 2014.

Disclosure appendix

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