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MAY 2024

InFocus

Macro comment

What Modi's re-election means for India's economy

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Narendra Modi's Bharatiya Janata Party (BJP) has a significant lead in the opinion polls for India's general election. A third term in power is likely to be confirmed on 4 June and so it is important to assess the economic implications of another five years of a Modi premiership. In this edition of *InFocus*, Economist Sam Jochim delves further into these topics.

Executive summary

One of Modi's key ambitions for his third five-year term as Prime Minister is to grow the manufacturing sector as a share of gross value added (GVA). His 'Make in India' initiative forms a key part of the strategy to achieve this, aiming to attract foreign direct investment into 14 key sectors. However, the policy's success has been debatable. While it is likely that there is a fresh push in Modi's prospective third term, headwinds remain and there are clear areas for policy improvement such as reducing import tariffs.

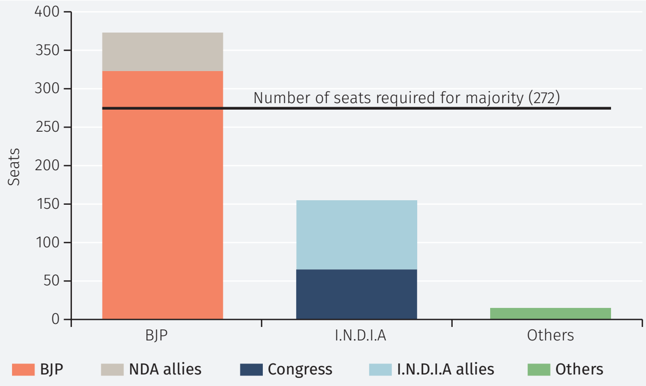
Infrastructure development will form another key area of focus for Modi. In his first ten years as Prime Minister, he focussed on building roads and electrifying railways. These infrastructure targets were ambitious and often they were not achieved, but in attempting to reach them, there was often a significant acceleration in progress. In his third term it is likely that the focus shifts to producing more electric vehicles and developing infrastructure which will help India in its efforts to achieve net-zero by 2070.

Despite his popularity among Indian voters, Modi faces challenges in his prospective third term. Unemployment is the most prominent concern among Indian voters. Youth unemployment is high by historical standards and female labour force participation is low. Reforms to India's outdated labour laws could help tackle these issues.

Election appears a formality

Voting in India's general election began on 19 April and is split into seven phases, lasting 44 days and ending on 1 June. The election is expected to be the largest in the world, with 968 million people eligible to vote, and there is little doubt about the outcome. The National Democratic Alliance (NDA), led by Modi's BJP, is projected to win 373 seats – well above the 272 needed to secure a majority in the Lok Sabha (lower house of Parliament). The opposition coalition, the Indian National Developmental Inclusive Alliance (I.N.D.I.A), led by Mallikarjun Kharge's Congress Party, is expected to win just 155 seats (see Figure 1).

1. Opinion poll seat projection for India's 2024 general election



Source: ABP-CVoter. Data as at 16 April 2024

Although a majority in the Lok Sabha is seemingly a formality for the BJP-led NDA, passing legislation in India requires approval at both levels of Parliament. The NDA are four seats short of a majority in the Rajya Sabha (upper house of Parliament) and this could act as a constraint on the speed with which legislation is passed, though it is unlikely to prevent Modi from pushing through his agenda.[1]

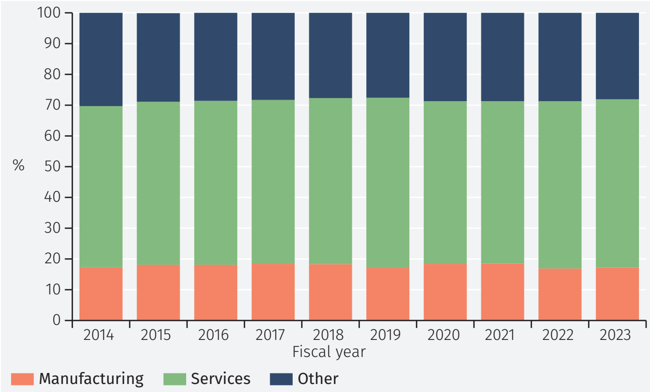
Modi's key ambitions: manufacturing and trade

One of Modi's key ambitions for his third five-year term as Prime Minister is to grow the manufacturing sector as a share of GVA. Since Modi took office in 2014, the manufacturing sector has accounted for just under 20% of GVA (see Figure 2). This is despite the BJP's '*Make in India*' initiative which aims to "*transform India into a global design and manufacturing hub*".[2]

One of the key pillars of this initiative is the Production-Linked Incentives (PLI) scheme, which was introduced in 2020. The scheme proposes financial incentives with the goal of boosting domestic manufacturing across 14 key sectors.[3] Its introduction was aligned with the release of an updated foreign direct investment (FDI) policy that aims to improve the ease with which foreign companies can invest in India.[4]

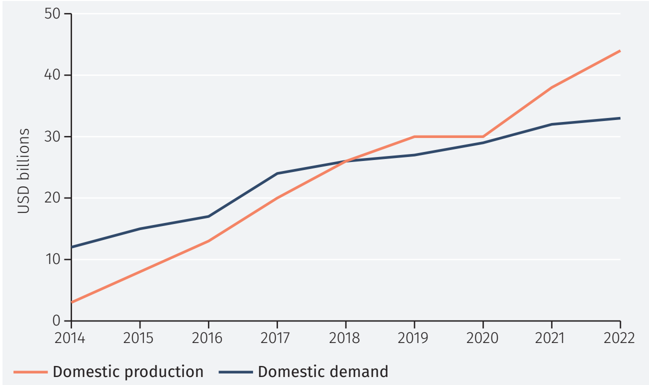
[1] The maximum number of members in the Rajya Sabha is 245, however, five seats are currently vacant meaning the upper house consists of 240 members. The NDA holds 117 seats, meaning it is four seats short of a majority. Each Rajya Sabha member serves a six-year term, with elections held every two years and a third of the membership replaced biennially. For further details, see: https://sansad.in/rs/about/introduction
[2] https://www.makeinindia.com/index.php/about
[3] https://www.investindia.gov.in/production-linked-incentives-schemes-india
[4] https://static.investindia.gov.in/2020-10/FDI-PolicyCircular-2020.pdf

2. Share of gross value added (constant FY 2011 prices, %) [5]



Sources: MOSPI and EFGAM calculations. Data as at 01 May 2024.

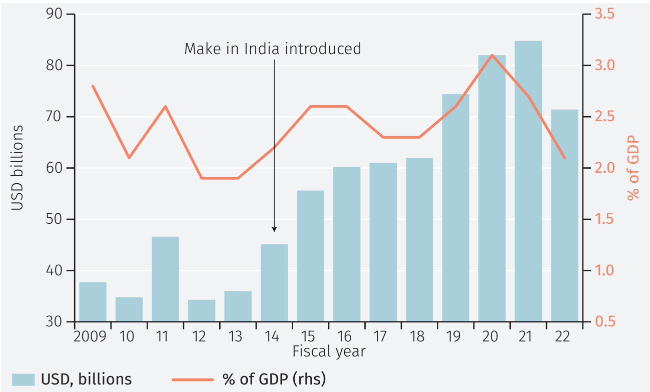
4. Domestic production and demand of mobile phones



Source: ICEA. Data as at 07 May 2024.

However, the success of these policies is debatable. Although FDI has risen in USD terms since the 'Make in India' initiative was introduced in 2014, it has not risen as a percentage of GDP (see Figure 3). Furthermore, most of the flows have not been into sectors that PLIs focus on. In fact, the PLI sectors accounted for 31% of FDI from fiscal year (FY) 2000 to FY 2013 but their share of FDI dropped to 26% when measured from FY 2000 to FY 2022.[6] The sectors the Indian government wants to grow may not necessarily be viewed as good investments by foreign investors.

3. Total FDI inflows to India

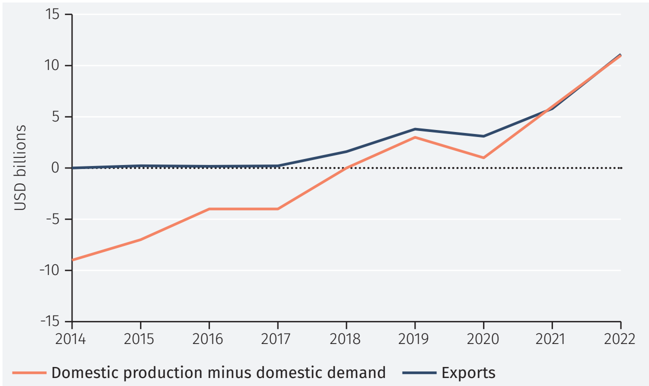


Sources: DPIIT, World Bank, LSEG Data & Analytics and EFGAM calculations. Data as at 03 May 2024.

However, there are some sectors for which policy success is clearly visible. Smartphone manufacturing stands out as the most obvious one. Domestic production of smartphones has increased dramatically from USD 3 billion in FY 2014 to USD44 billion in FY 2022 (see Figure 4).

This has been accompanied by a rise in India's exports of mobile phones (see Figure 5). Having accounted for around 0.3% in FY 2014, mobile phones now account for around 3.8% of India's total exports.[7]

5. Mobile phones: Domestic production less demand and exports



Sources: ICEA and EFGAM calculations. Data as at 07 May 2024.

Yet headwinds remain and there are clear areas for policy improvement in Modi's next five-year term as Prime Minister. Although India's smartphone industry has grown significantly since the introduction of 'Make in India', import tariffs supposed to encourage local sourcing of parts are likely to have increased production cost inefficiencies and reduced productivity.[8]

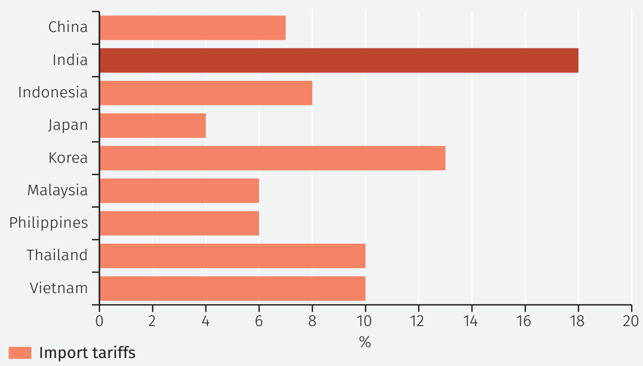
Tariffs reduce competitiveness in global markets. It is notable, for example, that Vietnam and India accounted for roughly the same share of world mobile phone exports in 2010 but

[5] Fiscal year 2023 shows second advanced estimate data.
[6] EFGAM estimates based on data from India's Ministry of Commerce and Industry and Department for Promotion of Industry and Internal Trade. Data as at 19 December 2023.
[7] Estimates based on data from India's Department of Commerce.
[8] Khandelwal, A. and Topalova, P. B. (2011) 'Trade Liberalization and Firm Productivity: The Case of India', *The Review of Economics and Statistics*, 93(3), pp. 995-1009. Available at: https://ssrn.com/abstract=1949292

Vietnam's share was over four times greater than India's in 2022.[9] Over the same period, India's average tariff on mobile phone parts rose by around a third while Vietnam's was unchanged and ended 2022 at almost half the level of India's.[10]

It is positive, therefore, that India reduced its import duty on mobile phone components from 15% to 10% at the beginning of 2024.[11] But India's high import tariffs are not exclusive to mobile phone parts and it generally has higher tariffs than many other East Asian economies (see Figure 6).

6. Most favoured nation simple average import duty in 2022



Note: Most Favoured Nation (MFN) import duties are what countries promise to impose on imports from other members of the WTO, unless the country is part of a preferential trade agreement (such as a free trade area or customs union). Source: World Trade Organisation. Data as at 08 May 2024.

The signing of a free trade agreement (FTA) in March 2024 with Iceland, Lichtenstein, Norway and Switzerland represents a step in the right direction.[12] Furthermore, negotiations on FTAs with both the European Union and the UK are currently ongoing.[13]

Modi's aim for India's manufacturing sector to account for 25% of GVA by 2025 means it is likely that more PLIs are announced over the next year under a fresh push of the 'Make in India' initiative. The time scale is extremely ambitious but progress in reducing protectionist policies in Modi's third term would reduce production cost inefficiencies and help set India on the right path.

Modi's key ambitions: infrastructure and clean energy

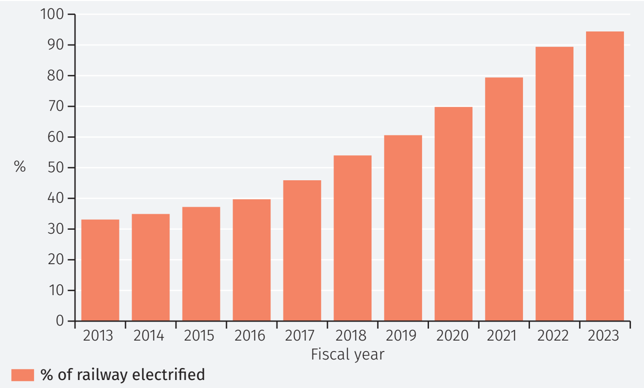
In the BJP's 2019 election manifesto, the party pledged to construct 60,000 km of national highways by 2024 and electrify all railway tracks by 2022.[14] Modi's party has failed to meet these goals.

At the end of 2023 there were 146,145 km of national highways in India, 49,600 km above the level in 2019, and 94% of railways had been electrified by the start of FY 2024.[15,16] Despite not achieving the targets, the progress compared to the period before Modi was first elected in 2014 is significant (see Figures 7 and 8).

7. National highway length constructed

Source: Ministry of Road Transport & Highways. Data as at 09 May 2024.

8. Share of Indian railway electrified



Sources: Central Organisation for Railway Electrification and EFGAM calculations. Data as at 09 May 2024.

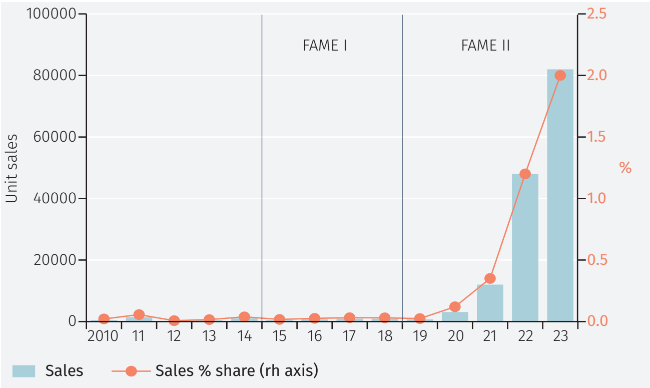
Infrastructure development will remain a key area of focus for Modi in his next five-year term. However, it is not a sustainable policy to keep building roads at the same pace, as the marginal benefit of each additional road diminishes, and there will be no railway left to electrify. The focus is therefore likely to shift.

The BJP aims to expand its network of trains. While most new trains will be electric, India is also producing 35 hydrogen powered trains as part of its 'Hydrogen for Heritage' initiative, with the first one expected to enter service later in 2024.[17]

[9] https://icea.org.in/blog/wp-content/uploads/2024/01/Tariff-Report-3.0-2_compressed.pdf
[10] Based on most favoured nation simple average duty data from the World Trade Organisation. Data as at 08 May 2024.
[11] https://taxinformation.cbic.gov.in/view-pdf/1010004/ENG/Notifications
[12] https://www.admin.ch/gov/en/start/documentation/media-releases.msg-id-100351.html
[13] https://tinyurl.com/26snrx7k and https://tinyurl.com/2v5jr2db
[14] https://www.bjp.org/files/2019-10/BJP-Election-english-2019.pdf
[15] https://tinyurl.com/9rpwk6uw
[16] https://core.indianrailways.gov.in/index.jsp
[17] https://pib.gov.in/PressReleasePage.aspx?PRID=1896102

And instead of building more roads, India will focus on building more electric vehicles (EVs). Electric cars have a 2% market share in India, less than one fifth of the market share of electric two/three-wheelers, highlighting the potential for growth (see Figure 9).[18] Modi's government approved a new EV policy in March that reduces import costs for foreign EV producers setting up manufacturing in India.[19] Furthermore, it is likely that a third 'Faster Adoption and Manufacturing of Hybrid and Electric Vehicles' (FAME) scheme, which subsidises production and consumption of EVs, is announced in Modi's first third-term budget in July, following the expiry of FAME II in March 2024.[20]

9. Electric car sales and sales share in India



Sources: International Energy Agency, Ministry of Heavy Industries and EFGAM calculations. Data as at 13 May 2024.

The infrastructure drive in India forms part of a larger focus on reducing CO_2 emissions, with the country having announced a target of achieving net-zero by 2070.[21] While this is a long-term objective, short-term targets such as increasing the non-fossil fuel energy production capacity to 500 gigawatts (GW) by 2030 are more tangible.

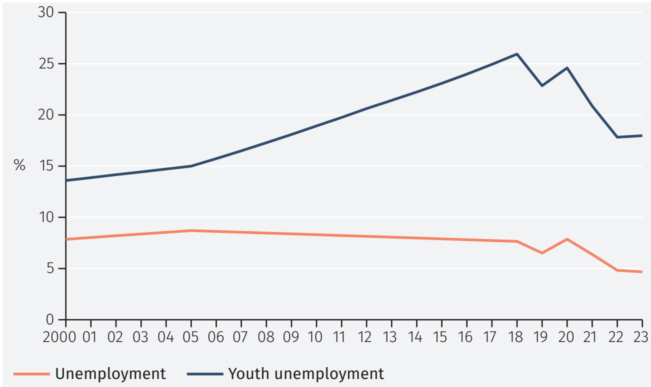
At the end of 2023, India had 188.2 GW of non-fossil fuel energy capacity, a 13.7 GW increase compared to the previous year.[22] However, to reach the 500 GW target by 2030, capacity will have to increase by 44.5 GW a year. This is an extremely ambitious target. Indeed, many of Modi's targets are ambitious and often they are not achieved.

The same is likely to be true of Modi's non-fossil fuel energy production capacity target. It is unlikely that this goal is achieved. However, it is likely that there is a significant progress towards it, supported by policy initiatives such as the promotion of solar energy production through the Solar Park Scheme.[23]

Challenges and risks: Youth unemployment, female participation and labour market reforms

Modi faces challenges in his prospective third term. One of them is lowering youth unemployment. While the unemployment rate is relatively low compared to history, youth unemployment is relatively high (see Figure 10).

10. Unemployment and youth unemployment rate



Source: International Labour Organisation. Data as at 14 May 2024.

Attempting to draw manufacturing firms to India has failed to generate a significant amount of employment opportunities for younger workers, sometimes leading to social unrest.[24] One reason for this may be India's rigid labour laws.

For example, firms with more than 300 employees must request permission from the government to lay off staff.[25] This naturally reduces firms' incentives to hire them in the first place. It also has the potential to reduce production efficiency for large firms and represents a labour market rigidity that reduces attractiveness for foreign companies to invest in India.

Additionally, laws dating back to 1948 prevent women from working night shifts or in industries considered dangerous by the government.[26] It is unsurprising therefore that male labour force participation was 57.8% at the end of 2023, compared to just 19.9% for females.[27] While some states have been loosening restrictions, progress has been slow and national reforms would likely boost labour force participation.

Unemployment is the most prominent concern for voters in India.[28] While the recent introduction of the National Education Policy has the long-term potential to make India's labour supply more productive and more attractive to companies,

[18] https://iea.blob.core.windows.net/assets/aa21aa97-eea2-45b4-8686-ae19d8939161/GlobalEVOutlook2024.pdf
[19] https://pib.gov.in/PressReleaseIframePage.aspx?PRID=2014858
[20] https://fame2.heavyindustries.gov.in/
[21] https://pib.gov.in/PressReleaseIframePage.aspx?PRID=1945472
[22] EFGAM calculations based on data from India's Central Electricity Authority. Data as at 13 May 2024. https://tinyurl.com/v8cfrees
[23] https://cdnbbsr.s3waas.gov.in/s3716e1b8c6cd17b771da77391355749f3/uploads/2023/10/202310051100247622.pdf
[24] https://tinyurl.com/mu3d9rea
[25] https://labour.gov.in/sites/default/files/ir_as_passed_by_lok_sabha.pdf
[26] https://labour.gov.in/sites/default/files/factories_act_1948.pdf
[27] https://www.mospi.gov.in/sites/default/files/publication_reports/Quarterly_Bulletin_PLFS_October-December_2023.pdf
[28] https://www.lokniti.org/media/PDF-upload/1713766591_47430800_download_report.pdf

shorter-term rewards could be reaped from reforms to outdated labour laws.[29] This would boost the attractiveness of India as a destination for foreign firms to establish production bases, helping to generate new jobs, and increasing female labour force participation.

Conclusion

Narendra Modi's re-election for a third term as India's Prime Minister is highly likely to be confirmed on 4 June. Future policy will continue to focus on boosting the manufacturing sector, with new PLIs possible as part of the 'Make in India' initiative. Infrastructure investment with a focus on clean energy is also likely to be a key pillar of the BJP's policies for the next five years.

One of the themes of Modi's first two terms in office has been the setting of ambitious targets that are often not achieved. While this may continue, it is important to note that ambitious targets have often brought with them a significant acceleration in progress towards the government's goals. In addition, there are simple reforms such as reducing protectionist policies and updating outdated labour laws that could increase the effectiveness of existing policies while helping tackle challenges related to youth unemployment and female participation.

From 2014 to 2023, the MSCI India equity index in USD had a compound annual growth rate of 10.1% compared to 3.0% for the MSCI emerging market equity index in USD.[30] India's market is one we are optimistic about in the long term, supported by projections of real GDP growth of around 6% per annum for the next five years.[31] In our view, Modi's re-election is likely to be positive for markets, signalling continuity in policies supportive of Indian companies involved in manufacturing and infrastructure development. While it should be acknowledged that there is room for policy improvement, India remains on the right path for a prosperous future.

[29] See EFGAM *InFocus*, 'India: A light in a dimming global economy' (September 2023) https://tinyurl.com/3eze57ry
[30] EFGAM calculations on data from LSEG Data & Analytics. Data as at 01 January 2024. Note that past performance is not indicative of future results.
[31] See also EFGAM *InFocus* 'India: A light in a dimming global economy' (September 2023) https://tinyurl.com/3eze57ry

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