India – huge potential but informal sector is still too large

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Economic situation Real growth (var. on prev. year) Real private consumption expendi- Inflation rate	**Pronounced cyclical weakness and low inflation** Economic growth has lost momentum of late, dropping to 5.0% year on year in the second quarter, the lowest in the past six years. This was due to both private consumption and investment activity. Moreover, India's economy is being dragged down by a (shadow) banking crisis. The Reserve Bank of India responded by lowering interest rates five times this year; further cuts cannot be ruled out. The inflation rate allows this as it is currently at 4.0% (September 2019), well within the target range of 4% +/-2 PP.
Growth financing Current account balance in % of External debt to GDP Currency reserves (imp. months)	**Moderate current account deficit with stable financing** India has a chronic current account deficit which, however, is not problematic as it is just 2.5% of GDP. It is covered primarily by foreign direct investment and loans. In a comparison of emerging economies, India's foreign debt is quite low at just under 20% and has hovered relatively consistently around this level for years. The country's currency reserves are very adequate and equivalent to around ten monthly imports – higher than those of many other emerging economies.
Growth resources Investment ratio Share of services Labour market participation	**Female labour force participation is much too low** At around 30%, the investment ratio is high. It is one important reason that India has been able to achieve significant productivity gains in the past years. The share of manufacturing has remained steady at around 15% for several years, while the share of the services sector has grown continuously to around 54%. With respect to labour force participation, India is wasting potential. It is below the international average and female labour force participation in particular is shockingly low.
Economic relations with Germany Germany's share of exports Germany's share of imports FDI inflows from Germany	**Imports and FDI from Germany are slightly losing ground** Germany is India's fifth most important export destination and the tenth most important source of imports. While the share of exports has fluctuated but largely remained steady in the past years, Germany's share of India's imports has trended downward. German FDI in India looks similar, having decreased since 2015. Improving investment conditions is on the Modi government's agenda. German FDI should be able to benefit in the long term.

The current value is among the ...

Legend:	lowest	low	medium	high	highest

20% of the past 10 years.

Investment climate – assessment by our local experts

India is the world's second most populous country and of interest to investors simply because of its gigantic domestic market. At the same time, Indian consumers still have a lot of catching up to do, which promises generally high demand for goods and services in the future. India's low labour costs should also play a role for investors. Investment conditions have improved noticeably ever since pro-reform Prime Minister Narendra Modi took office. However, high administrative hurdles, obscure bureaucracy and corruption and the shadow economy reduce the quality of India as a business location. Relevant improvements are on the agenda.

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Focus topic: The Indian labour market exhibits several peculiarities

Average labour costs in India are very low but it must be noted that significant differences exist between regions and depending on workers' skills. The Indian labour market paints a mixed picture with respect to the level of training. India achieves high scores in scientific-technical education but that does not resolve the problem of its skills shortage. Furthermore, the Indian economy – and hence its labour market – is burdened by a very high share of the informal sector.

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Investment climate – assessment by our local experts

India is generally of interest to foreign investors because of its enormous domestic market. With 1.4 billion inhabitants, the earth's second most populous country will in future be characterised by domestic consumers' high pent-up demand. Its real purchasing-power-adjusted per-capita income is the lowest of the 'BRIICS states'. However, it has more than tripled in the past 25 years and the only large emerging economy to have achieved a higher rate is China. It has been backed by rapid economic growth averaging 6.7% per annum during the same period. In addition to these fundamental aspects, it is particularly the labour costs and skills level that should please investors (see focus topic).

At present, India is also scoring on economic policy. Prime Minister Narendra Modi, who has been in office since 2014, has proven to be a determined reformer. He has realised ambitious reforms with a cash changeover ('demonetisation'), the introduction of a uniform national VAT system (Goods and Service Tax, GST) and a reform of insolvency law. On balance, the Indian economy has become significantly more competitive since Modi took office, as reflected in the very noticeable improvements in the Ease of Doing Business Index, the Global Competitiveness Index and the Competitive Industrial Performance Index. Modi started his new tenure in 2019 on the back of a surprisingly good election outcome. That increases the potential for further reform steps. The fight against corruption and the shadow economy remain at the top of his agenda. India was able to improve just slightly on the Corruption Perceptions Index (CPI) in the past years and only South Africa ranks higher among the large emerging economies. But a CPI rank of 78 – along with Burkina Faso, Ghana and Lesotho – provides ample room for improvement for an economy as ambitious as India. Other projects for the new term include completing the labour law reform and the overdue land rights reform.

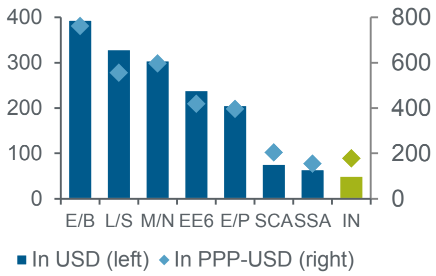
As a country with a structural current account deficit, India relies on capital inflows, not least on foreign direct investment (FDI). Although FDI is generally developing well, reflected by the fact that India ranked ninth in the world by FDI inflows in 2018, direct investors still face enormous challenges. This is mainly due to the high bureaucratic hurdles which make it complicated and tedious to start a business in India. In spite of the clear improvement on the Doing Business Index, the country still ranks below average in the sub-categories of 'Starting a Business', 'Registering Property' and 'Enforcing Contracts'. Therefore, without local partners, investors in India often struggle. However, FDI conditions are gradually improving, most recently through the liberalisation of FDI rules introduced in August 2019.

Conclusion: The vast domestic market with its enormous potential, low labour costs by international standards and the economic reform environment clearly speak in favour of India as an investment destination. Nonetheless, investors should prepare to face a number of bureaucratic obstacles. It is therefore advisable to partner with a local business.

Based on an interview conducted with Kunal Makkar (DEG New Delhi Office Director) on 16 September 2019.

Figure 1: Minimum wage by region and country group

Average mandatory monthly minimum wage, medians



E/B: Eastern Europe / Balkans (without Russia), M/N: Middle East / North Africa (without Turkey), L/S: Latin and South America (without Brazil), E/P: East Asia / Pacific (without China and Indonesia), EE6: Brazil, China, Indonesia, Russia, South Africa, Turkey, SCA: South and Central Asia (without India), IN: India, SSA: Sub-Saharan Africa (without South Africa)

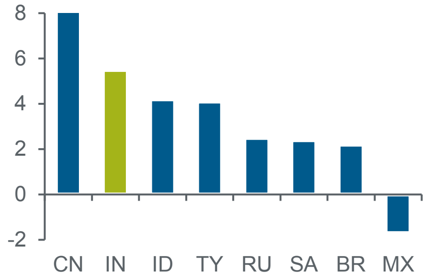
Source: International Labour Organization (ILO), own calculations

Focus topic: The Indian labour market exhibits several peculiarities

The local labour market is attractive for investors looking to do business in India, not least because of the low labour costs. The average minimum wage in India of around USD 50 per month is even slightly lower than that of Sub-Saharan Africa and thus surprisingly below the median of the other six large emerging economies ('EE6', approx. USD 240, Figure 1). However, it must be taken into account that India has a tangle of various minimum wages that in some cases differ significantly between the federal states and the central government, as well as in accordance with the worker's skills. Besides, there is a uniform national minimum wage – which, however, is not binding – of currently INR 176 per day (this is equal to USD 2.51 based on the current average INR-USD exchange rate for 2019, as at 28 October 2019). However, the new minimum wage act yet to be adopted will introduce a mandatory national floor; the various existing minimum wages will not be allowed to fall below this level.

Figure 2: Wage growth in emerging economies

Average real wage growth (2008–2017), in per cent year on year

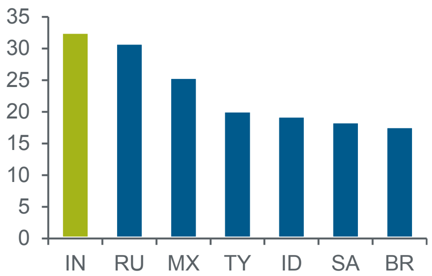


CN: China, IN: India, ID: Indonesia, TY: Turkey, RU: Russia, SA: South Africa, BR: Brazil, MX: Mexico

Source: ILO

Figure 3: Tertiary-level STEM degrees*

In per cent of all tertiary degrees (most recent available figure)

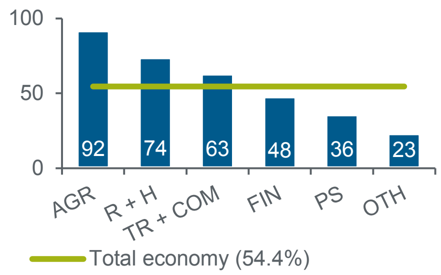


* Science, technology, engineering and mathematics

Source: World Bank

Figure 4: Share of informal sector

In per cent of gross value added in the respective sectors



AGR: Agriculture, R + H: Retail and Hospitality, TR + COM: Transport and Communications, FIN: Financial Sector, PS: Producing Sector, OTH: Other Areas (including government)

Source: Federation of Indian Chambers of Commerce and Industry, Konrad Adenauer Foundation, 'Informal Economy in India: Setting the framework for formalisation', 2017.

Essentially, there are two economic reasons for the low average wage level. First, India has relatively high population growth. Although it has been decreasing from just under 2% in the 1990s and around 1.5% in the 2000s, at a good 1% it is still much higher than in other emerging economies such as China, Brazil or Russia. That means around 6 million new potential workers enter the labour market each year. Second, India's labour market is characterised by a large informal component (see below). As a result, job vacancies in the formal labour market are limited, which leads to lower wages. But India is catching up. It has the second-highest real wage growth of the large emerging economies (Figure 2). If this trend continues, it will also reflect in rising minimum wages in future.

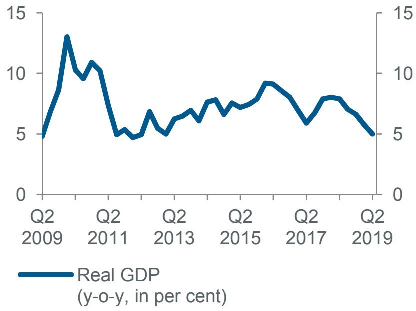
As an investment location, India also benefits from well-trained specialists – at least in part. India's educational system is regarded as inadequate overall. The literacy rate of around 70% (2011) is by far the lowest of all large emerging economies (and hence also lower than the average of the lower middle income countries). India also lags behind other emerging economies in the rate of tertiary level enrolments and graduations. However, the share of graduates from scientific-technical programmes (natural sciences, technology, engineering, mathematics) at least is particularly high (Figure 3). That makes India an interesting location for the relevant industries (IT, mechanical engineering, automotive sector). Nonetheless, India has a skills shortage in these areas as well. The government is seeking to address this shortage in the long term with its 'Skill India' programme.

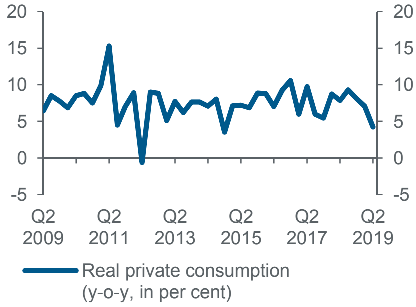
A major problem for India's labour market is the high share of the informal sector in the economy. According to different estimates, 50 to 60% of India's economic output is generated in the non-organised sector. The share of the informal sector is particularly high in agriculture and services industries, while formal business activities predominate in the producing sector and the public service (Figure 4). This is mainly due to the high administrative hurdles involved in formally registering a business or company and formally hiring workers. It is costly and, above all, very time-consuming. The significance of the informal sector is particularly obvious in the labour market. According to the ILO, around half the roughly 400 million employees work as unpaid 'family workers' or are self-employed with irregular incomes that depend very strongly on local markets and demand for services, e.g. from private households. Another 30% of employees are casual workers, that is, poorly trained people from poor backgrounds who are forced to earn their living on a daily basis. Only around 20% are actually in regular employment relationships. That makes it very difficult for jobseekers to find work in the formal labour market as there is intense competition. Conversely, for employers offering jobs in the organised sector it means that they can generally choose from a very high number of job applicants.

Conclusion: India's labour market is not for the faint-hearted. The strongest argument, from the point of view of investors, is the low average cost of labour but the high administrative effort involved is a formidable barrier.

Charts

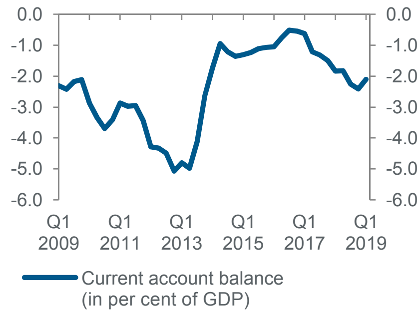
Economic situation

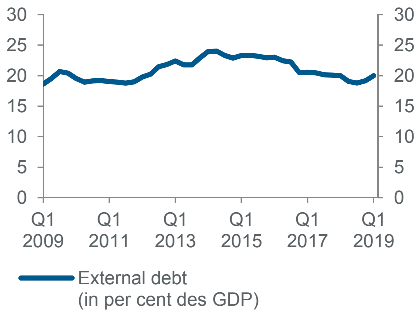




Source: Datastream; IMF, World Bank; own calculations

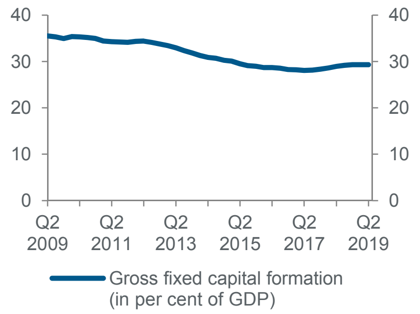
Growth financing

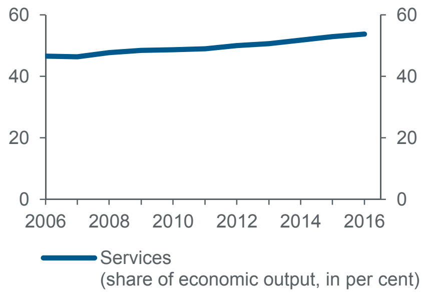


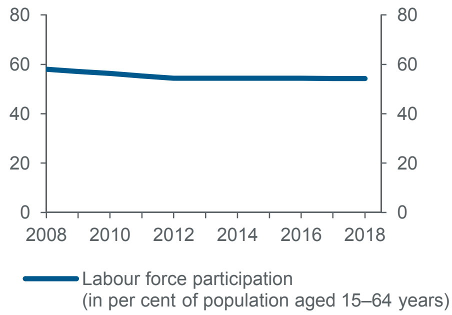


Source: Datastream; IMF, World Bank; own calculations

Growth resources

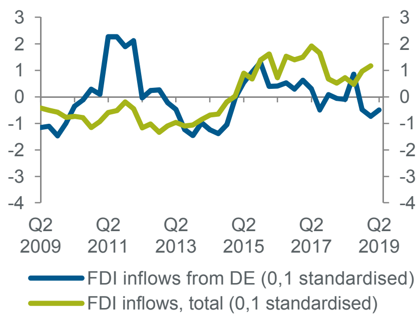






Source: Datastream; World Bank

Economic relations with Germany



Source: Deutsche Bundesbank; Datastream; IMF; UNCTAD; own calculations