India – plenty of light, but also some shadows

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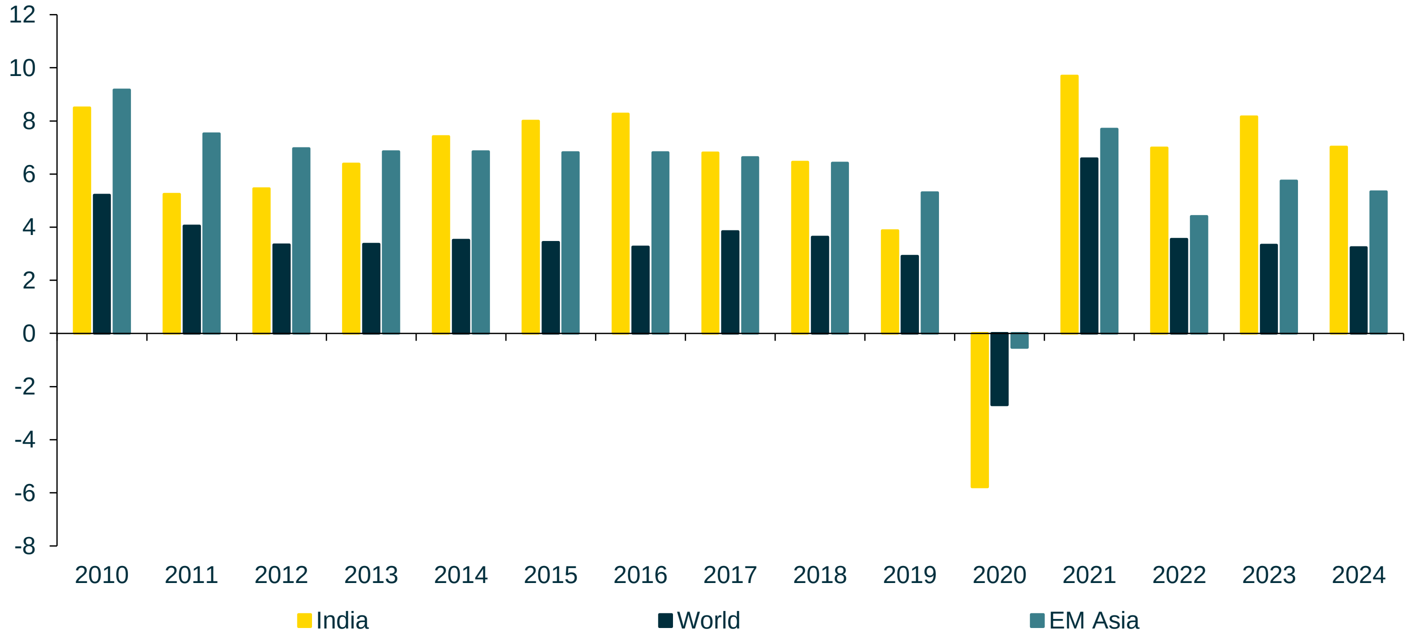
With a growth rate of around 7%, India was one of the stars of the global economy last year. This growth was driven by continued strong population growth and a number of reforms implemented in recent years. This impressive performance is expected to continue in the coming years. However, the country still has considerable structural weaknesses, including inadequate infrastructure and bureaucratic red tape. This is why India is still a poor country in terms of GDP per capita. It will probably still be of comparatively lesser importance as an export market for German products but offer some potential as a production location.

India: one of the growth stars of recent years...

In view of the Trump administration's aggressive tariff policy, many companies are looking for new export markets. Even the recent flare-up in the conflict with Pakistan is unlikely to change the fact that India often finds itself at the center of attention in this regard. After all, India's economy has regularly shown one of the highest growth rates worldwide in recent years. Not only did it exceed the global average, but in the last four years – i.e. after the temporary setback due to the coronavirus pandemic – it also significantly exceeded the average in Asia, even if the slower-growing developed economies of Japan and Korea are not taken into account (Chart 1). As a result, India's total economic output has more than doubled in the last 12 years.

Chart 1 - Growth star India

Real GDP, change on year in percent



Source: IMF world economic outlook, Commerzbank Research

Based on current exchange rates, India is now the world's fifth-largest economy, and the International Monetary Fund expects the country to overtake Japan and Germany by 2030, moving into third place. Based on purchasing power parities, India has long since achieved this position.

... due to strong population growth...

Economic development is undoubtedly favoured by the still-rising population. Although the population is no longer growing quite as rapidly as in the first ten years of this millennium, when the number of inhabitants rose by more than 1.5% each year, India's population continues to grow very strongly, with an annual increase of almost 1%.

According to World Bank estimates, India's population will continue to grow from the current 1.4 billion to 1.7 billion by 2050. This is in contrast to most Western economies and China, where the population is expected to decline. The working-age population in India will also increase from around 960 million at present to around 1.1 billion by 2050.

... various reforms by the government...

Economic growth has also been driven by a series of reforms implemented by the Modi government over the past few years. The most important of these is certainly the nationwide Goods and Services Tax (GST) system introduced on July 1, 2017. It replaced numerous indirect taxes at the federal and state level, thus significantly simplifying the tax system for companies. In addition, the GST – like the German VAT, for example – only taxes the added value generated by the selling company, which makes the division of labor between different companies more profitable than in the previous tax system. Furthermore, this tax reform has significantly simplified trade between the different states, thus significantly advancing India on the way to a single domestic market.

The Insolvency and Bankruptcy Code (IBC) was introduced as early as 2016. This has also replaced many different regulations and thus consolidated and simplified the country's insolvency and bankruptcy laws. The process of insolvency proceedings was streamlined, standardized, and its length was limited. Some key objectives of the IBC include ensure a time-bound resolution process, promote entrepreneurship and credit availability from banks, maximize the value of assets of insolvent entities, and promote a fair balance for all stakeholders i.e. for creditors and debtors. For example, the IBC mandates that the Corporate Insolvency Resolution Process (CIRP) be completed within 180 days with an option to extend it by a maximum of 90 days. An amendment in 2019 extended it further to 330 days. There could be further amendments but at least it shows the government was willing to act and lay down a marker. Furthermore, a moratorium period is declared once the insolvency commences. It remains in force until the end of the CIRP. The moratorium also ensures that the CIRP has full control and is the only mechanism through which claims are settled.

As a result, the ratio of non-performing gross assets in the banking system's total assets fell from 11% in 2017 to a 12-year low of 2.6% in the third quarter of 2024. The IBC also aimed to introduce greater discipline among borrowers and better risk management for a healthier and stronger banking sector. Between 2019 and 2020, 10 public banks were merged into four units to improve efficiency and scalability.

In addition, restrictions on foreign direct investment (FDI) were relaxed. For example, the government now allows 100 percent foreign ownership in a number of sectors, including healthcare, infrastructure, and construction, unlike in the past. In the pharmaceutical sector, foreigners can invest up to 100% in new projects ("greenfield projects") and for existing companies ("brownfield projects"), the cap is now 74%. In the renewable energy sector, including solar, wind, hydro, and bioenergy, 100% FDI is permitted for both greenfield and brownfield projects.

The government introduced the Production Linked Incentive (PLI) scheme in 2020. It aims to boost domestic manufacturing, reduce import dependency, enhance exports, and generate employment across various sectors. The PLI scheme covers 14 sectors, including electronics and IT hardware, pharmaceuticals and medical devices, automobiles and auto components, renewable energy, and white goods.

The next important reform to monitor is the new labour law, which was passed at the federal level between 2019 and 2020. It is intended to replace the 29 laws that are in force so far with four comprehensive codes. The codes cover wages, industrial relations, social security, and occupational safety, health, and working conditions. It will drastically simplify and modernize the outdated labour laws that are 70 years old. The new regulations are intended to reduce undeclared work, ease the burden on employers, cut red tape, and attract more foreign direct investment. The new regulations contain additional rights for employees, but also, for example, a certain relaxation of protection against dismissal for companies with 100 to 300 employees. An important goal here is – as with sales tax – to standardize the rules in the individual states. However, these regulations have not yet been applied because the states have not yet passed the corresponding regulations. It is currently planned that the regulations will gradually come into force from spring 2026, depending on the size of the company.

... and a price stability-oriented monetary policy

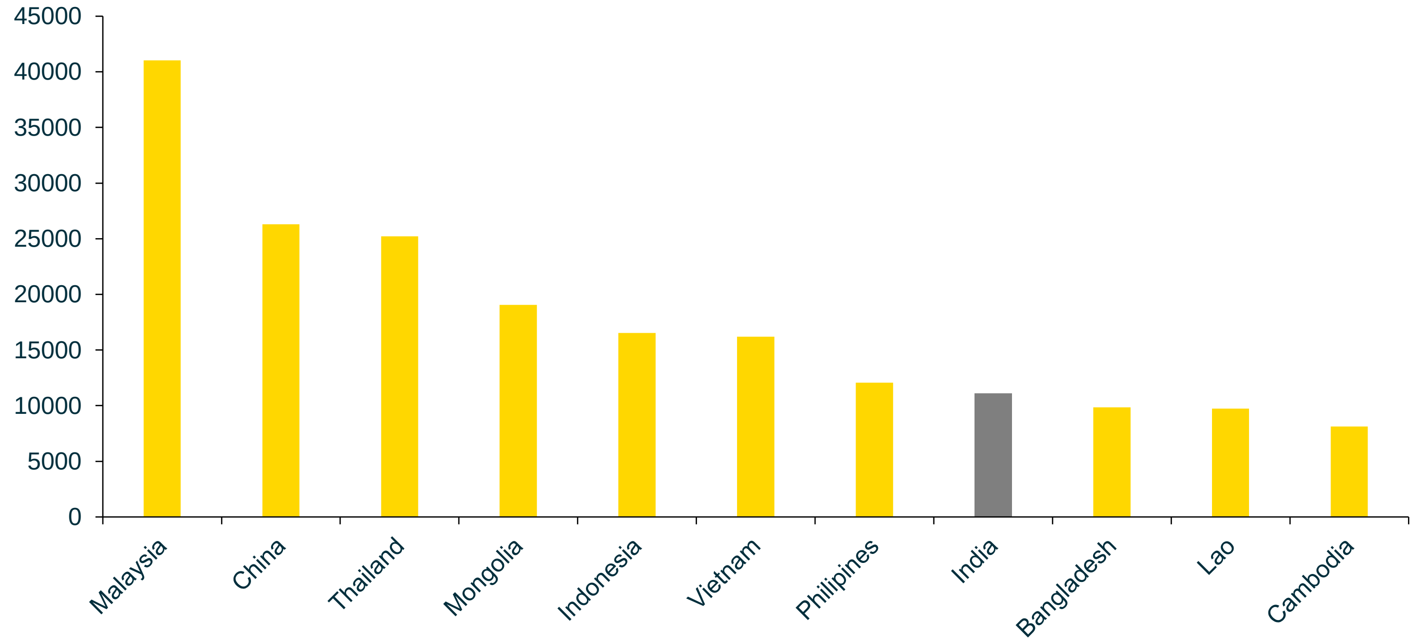
Financing conditions have also improved in recent years. Since 2016, the Reserve Bank of India (RBI) has been pursuing an inflation target with a bandwidth of 2–6% and a median of 4%. It has managed to push down the inflation rate, which averaged almost 10% between 2009 and 2013, to just over 5% last year. This has contributed to the decline in the yield on 10-year long-term bonds from around 8.5% at the beginning of the 2000s to around 6.5% at present.

But: GDP per capita is still very low...

However, India's economy still has many structural weaknesses. This is indicated by the fact that its fifth place among the largest economies is due solely to its large population. Last year, for example, its GDP per capita, using purchasing power parities, was just over USD 11,000. This is just 42% of China's GDP per capita, and among the larger countries in Southeast Asia, India is in the lower half, with India lagging further behind Vietnam and just ahead of Bangladesh (Chart 2). if we use market exchange rates, India would fall even further back to second-last place in this group, just ahead of Bangladesh.

Chart 2 - India's GDP per capita still very low

GDP per capita, in PPP US Dollar, 2024



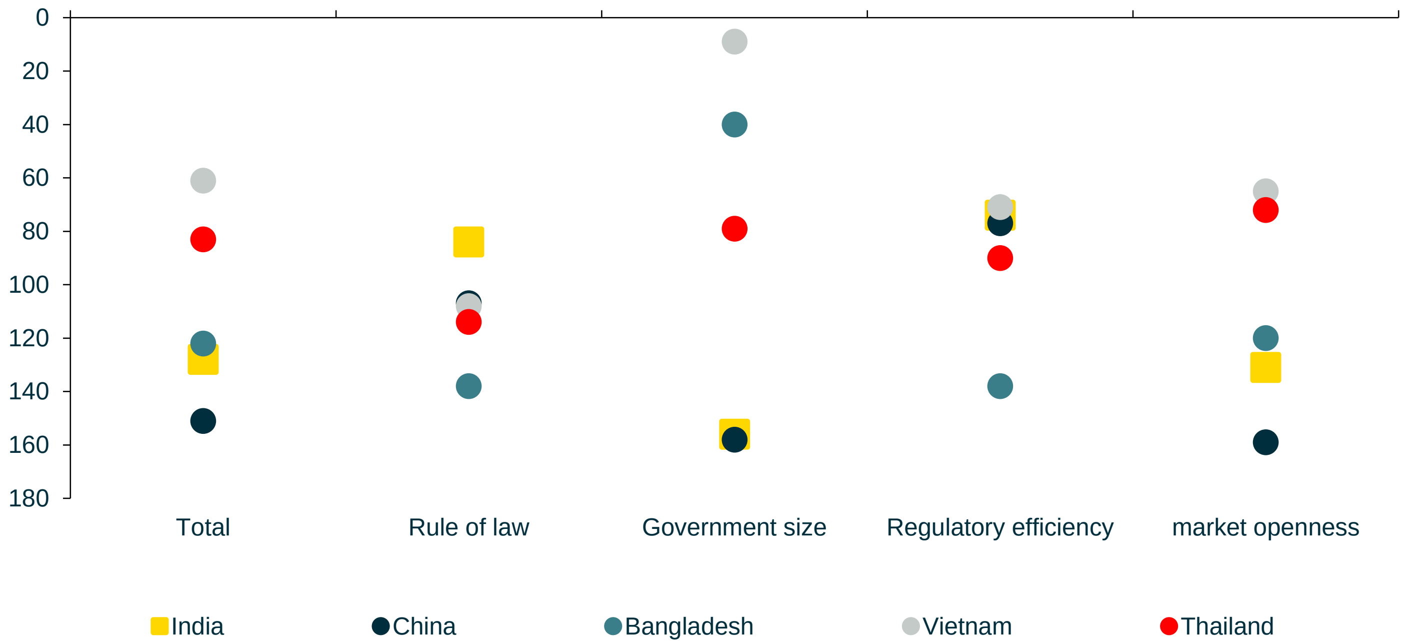
Source: IMF world economic outlook

... also because the state is delaying structural change...

One reason for the low economic output per capita is the state's still frequent interventions in the economy. For example, India is ranked only 128th among 176 countries surveyed in the Index of Economic Freedom calculated by the Heritage Foundation (Chart 3). India does not perform well in any of the four sub-groups considered in this index. The areas of “size of government” and “openness of markets” appear to be particularly problematic.

Chart 3 - India's economy suffering on several weak spots

Rankings in the Index of Economic Freedom and its subcomponents among 176 countries



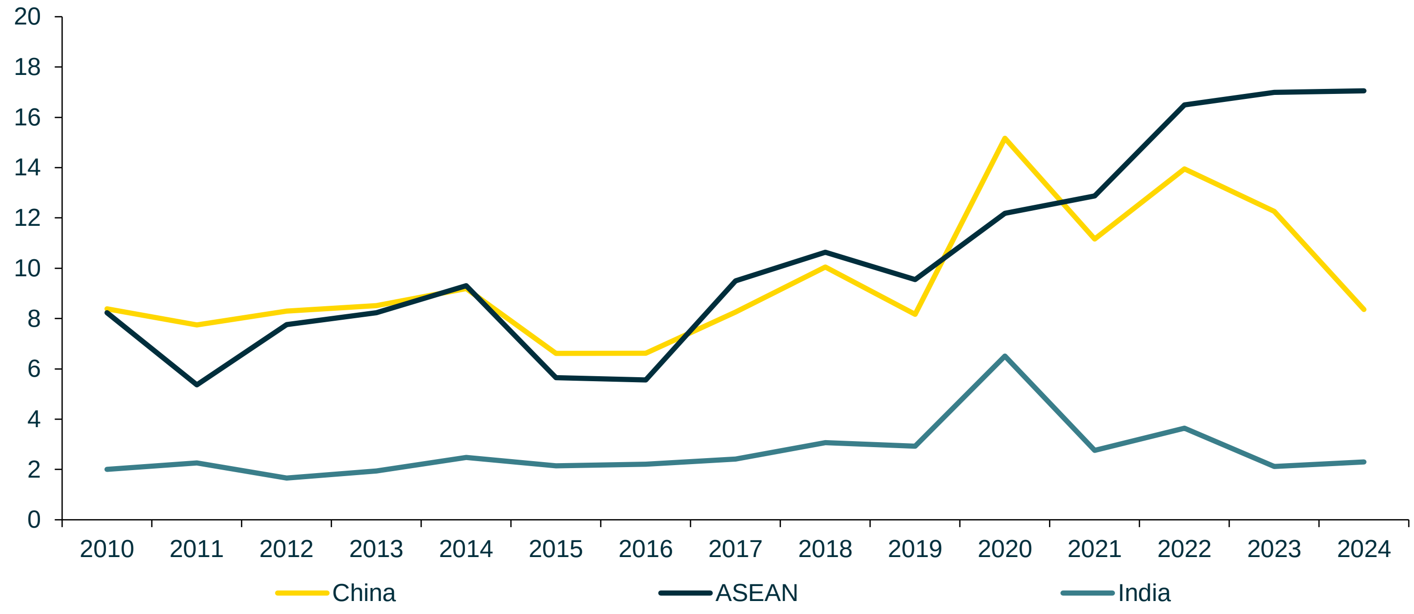
Source: Heritage Foundation, Commerzbank Research

In many areas, the state is slowing structural change. One example is agriculture, which still accounts for one-sixth of India's economic output and is heavily subsidized by the state. This preserves inefficient structures. In fact, the share of employment in agriculture has actually increased over the past six years. During the same period, the share of employment in manufacturing and the service sector has declined.

At the same time, the economy is still largely protected from external competition. For example, the regulations for foreign direct investment are still relatively restrictive despite the loosening of restrictions in recent years. This has contributed to the fact that less FDIs has flowed into India in recent years, while investment in the ASEAN countries, for example, has increased significantly (Chart 4).

Chart 4 - India captures a small percent of global inbound FDI

% share of global inbound FDI



Source: UNCTAD, OECD, Commerzbank Research

The comparatively high tariffs that India imposes to protect its industries and companies also have a structure-preserving effect. Added to this are numerous non-tariff trade restrictions. This restrictive foreign trade policy not only conserves structural weaknesses, but could also lead to a trade conflict with the US in the short term. However, there is also a chance that pressure from Washington will force the Indian government to adopt a more liberal foreign trade policy. This could put a strain on the economy in the short term but probably have a positive impact on India's economic development in the long term. The US placed a reciprocal tariff rate of 26% on imports from India. It is lower than the 29% rate for Pakistan, 37% for Bangladesh, and 46% for Vietnam. India could benefit in the short-term but the larger gains will come if the higher tariffs force India to liberalize further. India is already in discussions with the US on a possible trade deal to reduce the rate and could be among the first few countries to reach a deal.

... infrastructure remains in poor condition in some areas...

After the considerable investments of recent years, infrastructure such as roads, highways and bridges has improved, in some cities more than in others. However, there are still considerable problems. The rail network, for example, is outdated, overburdened and insufficiently supplied with electricity. This hinders freight traffic, makes it more expensive and slows down India's efforts to improve manufacturing production and exports. The energy infrastructure, public health system, education system, water supply and sewage disposal also urgently need to be expanded.

... and tax transparency and predictability remain an issue

There are reports of a hefty USD1.4 billion tax demand by the government on the local subsidiary of a major German car manufacturer. The allegations are that the subsidiary misclassified imports as auto parts, which carry a lower tariff of 5-15%, instead of nearly completed cars, known as completely knocked down (CKD) units, which have a higher tariff of 30-35%. The government alleged the practice has been in place since 2012.

Ongoing tax disputes will raise concerns for multinational companies (MNCs) over the transparency and predictability of India's tax enforcement practices. In the Federal Budget in February this year, the Finance Minister proposed changes to cut burdensome regulations, including simplifying international transactions and expanding Safe Harbour Rules (SHRs). The latter is aimed to provide greater tax certainty and reduce litigation for MNCs engaged in cross-border transactions. This is a positive step but the implementation will take time and face challenges.

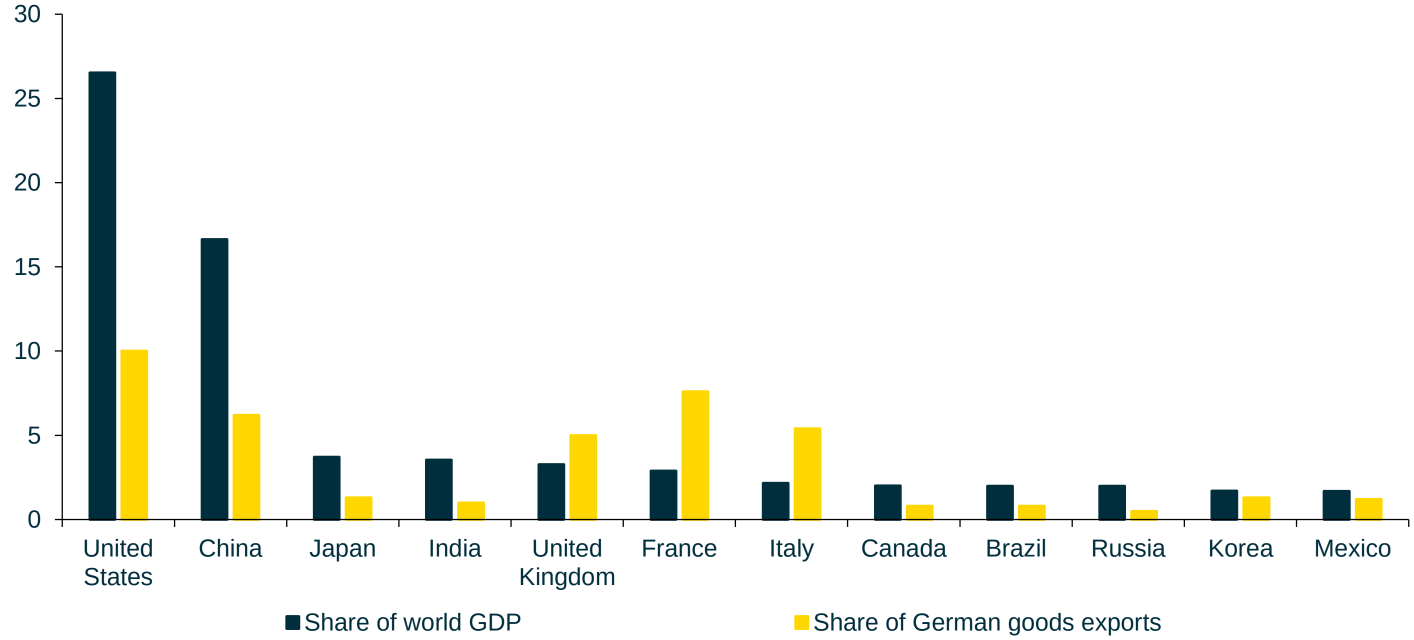
Conclusion: light and shade

The picture remains mixed: there is no question that the Indian economy will continue to grow strongly in the coming years. However, the growth rates are likely to be somewhat lower than in previous years due to the continuing structural weaknesses and a certain reform fatigue in politics, as evidenced by the slow implementation of the new labor legislation. This means that it will take a long time before per capita GDP catches up with that of the other larger Asian countries. Foreign companies in India therefore need to be patient in order to benefit from the country's undoubtedly high potential.

For German companies, India is likely to be of more interest as a production location than as an export market for the time being. India's share of German exports last year was just 1%, significantly lower than that of other major economies (Chart 5). This is likely to change only slowly.

Chart 5 - India's share of German exports is still low

Share of global gross domestic product (in US dollars) and of German goods exports, both in percent



Source: Destatis, IMF World Economic Outlook, Commerzbank Research

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