Economics

IN: Reviving manufacturing

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- **The government is keen to expand manufacturing, focusing on export industries**
- **Favourable demographics, low wages and the currency are India's key strengths**
- **Reforms to lower structural impediments are underway**
- **Job creation and growth are the goals**

The government is keen to expand manufacturing and raise its contribution to GDP. Here we discuss three questions: What does this entail? How will government succeed? Why the need?

What does manufacturing entail?

The service sector's share in GDP rose to 56% in FY14 from 52% in the early 2000s (Chart 1). Agricultural, meanwhile, shrank to 17% of GDP from 21%. By contrast, manufacturing's share has stagnated at 15-16% for nearly three decades. This has hampered growth, even though the sector grew 15% YoY during 2003-2008.

Around the same time, Asian peers concentrated their efforts on expanding manufacturing, boosting growth and keeping external imbalances in check. India's manufacturing value-added (MVA) as a percentage of GDP stood at 13% in 2013, compared to 24% for Indonesia and 30% in China and South Korea (Chart 2). India is now trying to recoup the missed opportunity.

Chart 1: Sector-wise contribution to India's GDP

as % of GDP

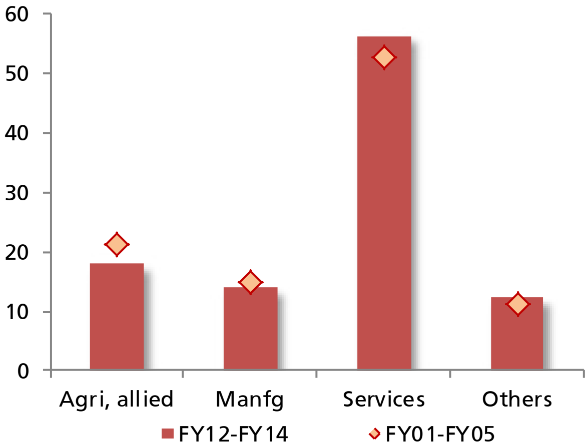
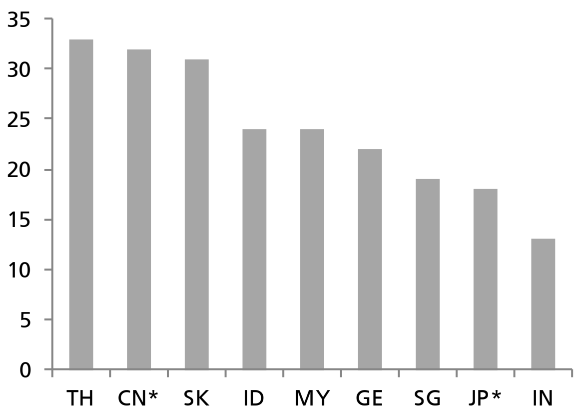


Chart 2: Value-added manufacturing (2013)

as % of GDP



*2012, World Bank

Radhika Rao • (65) 6878-5282 • radhikarao@dbs.com

Focus on exports

India's focus is on export-oriented manufacturing, as in other Asian countries like China, Korea and Taiwan. Initially, this would allow a shift away from traditional exports (agriculture, gems and jewellery, petroleum etc.) into more labour-intensive manufactured goods.

At the heart, focus is on a shift to export-oriented manufacturing

At present, the export mix is already fairly represented by manufactured goods – chemical products (13% of total exports), engineering goods (19%), textiles (9%) and electronic products (2.5%). A concerted effort could conceivably raise the share of manufactured exports to 70% or more in the coming years.

But a word of caution is in order. If the shift towards manufacturing is geared toward import substitution rather than export promotion, gains could fall sharply. India's past trysts with this strategy have hurt growth and competitiveness, and disincentivised the private sector. Protectionism typically leads to poor resource allocation and rent-seeking activities that the country can ill-afford at this juncture.

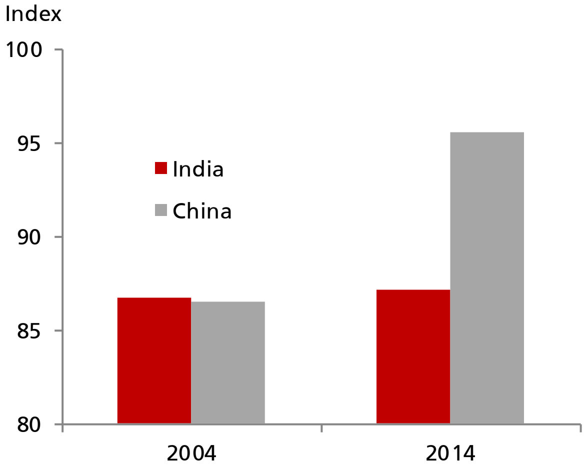
India's strengths

India has several advantages as a manufacturing base. According to recent research conducted by the Boston Consulting Group, India is gaining cost competitiveness vis-a-vis China (Chart 3) [1]. Ten years ago, both countries stood at about 86 relative to US costs (a lower number signifies lower costs vis-a-vis the US) . Today, India's index has remained relatively unchanged at 87 while China's has jumped to 97. Given the shifting costs, global companies should find India an increasingly attractive alternative to China as an offshore manufacturing base.

Secondly, India's enjoys favourable demographics, as the working age population (15-64 years) make up close to two-thirds of the overall population (Chart 4). This should ensure a steady supply of labor, provided the required vocational and tertiary training is provided. Technical, information technology and engineering capabilities have already been pointed as strengths by existing business houses, accompanied by the renewed push for R&D.

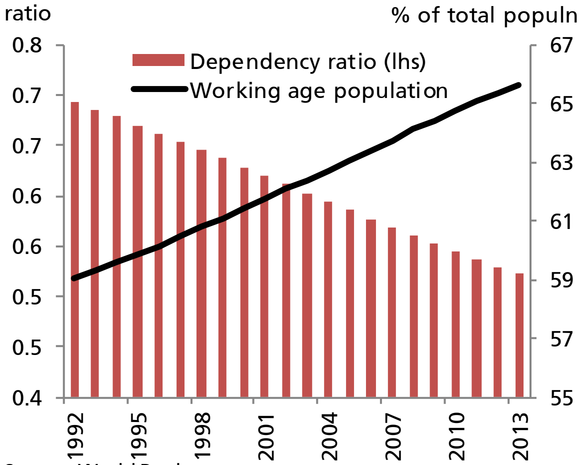
Next, a weak currency should complement the push for an export-oriented manufacturing sector. Against the US dollar, the rupee is down 55% since the start of 2008.

Chart 3: Cost-competitiveness index (vs the US)



Source: Boston Consulting Group

Chart 4: India favourable demographics



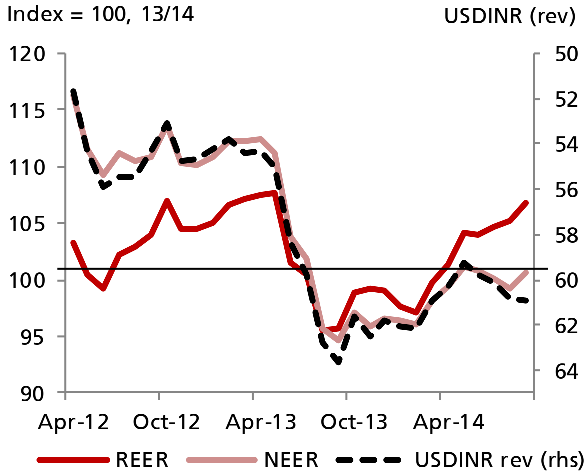
Source: World Bank

Authorities are likely to lean against rupee appreciation winds

We do not mean to imply that the rupee would be held down in order to boost competitiveness. But the authorities would likely lean against any appreciation winds, given the significant inflation differentials (Chart 5) and need to build FX buffers.

Official preference will likely be to keep volatility low and pursue moderate depreciation to offset inflation differentials with the rest of the world.

Chart 5: USDINR vs Real effective exch rate movts



Finally, the government has adopted a single-minded focus on improving governance and creating a conducive environment to attract domestic and foreign businesses. The central bank is also keen to develop and deepen financial markets, which would improve financing options available to the private sector.

How will the government get there?

The government launched the flagship 'Make in India' initiative last month. Key aspects include establishing a single point of contact for investors and an investor facilitation cell to assist prospective foreign parties.

Key reforms include (see also Table 1):

i) Land acquisition/ ecosystem: A re look of the 2013 Act is required to shorten time involved in acquiring land and to rationalise rehabilitation costs. Land acquisition problems accounted for one-quarter of the stalled projects as of June 2014. Most were in the manufacturing sector, according to the CMIE.

In addition, a 2011 National Manufacturing Policy had recommended the opening of National Investment and Manufacturing Zones (NIMZs) along the lines of industrial parks in other countries [2]. Such a provision would require the centre/ state government to acquire land on behalf of businesses, along with an enabling system by way of infrastructure and logistical support.

ii) Infrastructure: Addressing infrastructural deficiencies is key to increased manufacturing. Support is required across the board, from coal supplies, power availability, improving railway/ road/ ports connectivity.

iii) Labour reforms: Specific measures for the labour sector were released last month (see Table 1). A comprehensive review of restrictive labour laws is required. These laws influence everything from hiring to firing and become more restrictive as employee-strength grows in industrial units. This harms competitiveness and discourages firms from scaling-up operations.

Long-standing structural impediments are now easing, albiet gradually

Sorting this out will necessitate a review of the Industrial Disputes Act, in order to simplify and reduce the number of laws governing employment and labor practices. Active participation and empowerment of the state governments is equally important, as they are responsible for enforcing regulations on the ground. States of Rajasthan, Madhya Pradesh and Haryana have moved in this direction.

iv) Long-standing macroeconomic constraints are gradually easing. Disinflation is underway and current account and fiscal balances set to meet targets. A credible central bank and a decisive mandate for the government have helped restore market stability and confidence.

Slow growth and a poor investment environment in recent years have led to an increase in stressed assets in the banking system. As recovery proceeds and stalled projects come online, the scale of distressed assets should begin to recede. Borrowing costs remains high, however, and not much respite is likely on that front until early- to mid-2015.

Why the push for manufacturing?

Two main goals - job creation and growth

The push for manufacturing has two aims: to create jobs and lift growth.

A robust manufacturing sector should boost employment significantly. As Chart 6 highlights, a disproportionate share of labour works in agriculture, which contributes only 15% to GDP. Services, which account for 60% of GDP, only employ one-quarter of the labour force.

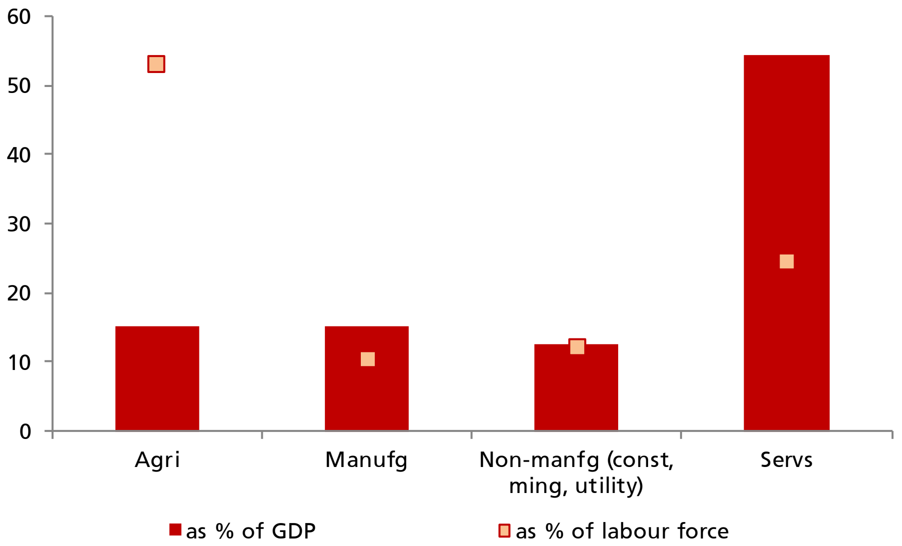
The manufacturing sector is more balanced, accounting for 15% of GDP and 11% of the employed labour force. Given this sector's significant labour-absorptive capacity, an increase in the share to 25% of GDP would help take-in an additional 100mn (one-fifth of the total labour force). This is beneficial from the angle of the economy's large working-age population.

Secondly, better employment prospects and a more even distribution of the work force points to higher income generation. This would help lift per capita GDP, which languishes at a weak USD 1570 in 2013-14, far behind China's USD 7300.

Finally, a revival of the domestic manufacturing sector would provide an important boost to India's potential growth and keep external imbalances in check. While the full impact would only appear over time, incremental efforts could raise manufacturing growth 3.0% this year (vs -0.7% last year). A stronger 5.0% jump in FY15 would help lift GDP growth to 6.5% in FY16 and above 7% in FY17-18.

Chart 6: Sectoral contribution to growth, labour force

% of GDP, percent of labour force



Notes:

[1] Boston Consulting Group manufacturing competitiveness index,

[2] Department of Industrial Policy and Promotion, National Manufacturing Policy, November 2011.

Sources:

Data for all charts and tables are from CEIC Data, Bloomberg, Planning Commission and DBS Group Research (forecasts are transformations).

Appendix 1

Table 1: Key initiatives towards the manufacturing sector

Make in India	Single point of contact of investors under the 'Invest India' initiative. Investor facilitation cell to be launched to assist prospective foreign parties through the entire investment cycle 25 sectors including electronics, IT, pharmaceuticals, automobiles, tourism etc. identified as key thrust areas Overhaul of the regulatory framework is in the works, with emphasis on skill development, infrastructure and easing FDI policies; Time-bound clearances plus 8-member team to answer investors' queries and provide feedback on further changes
Infrastructure	Coal mines to be allocated through auctions and encourage commercial mining Oil and gas sector exploration to be boosted by higher gas prices, deregulation Work on the Western Dedicated freight corridor underway Railway prices raised to improve profitaility and smart cities initiative announced Japan and China to contribute circa 10% of infra funding
Labour reforms	Shramev jayate program launched with procedural steps to ease labour law compliance Amendment of three important laws lined up by end-year Rajasthan, Madhya Pradesh and Haryana have taken lead in initiating reforms
Land acquisition/ environmental clearances	Environmental clearances for infra and industrial projects have been automated; 2006 Environmental Impact Assessment (EIA) Notification has been relaxed to exempt many categories of projects from environmental clearances; time bound nods likely shortly
Financing	New financing instruments like Investment Trusts, refinancing options through banks for infra projects

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