<u>Paper Name</u> – Indian Economy - II

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<u>Services Led Growth</u>

- Article presents an analysis of Indian economy. It is noted that the economy has undergone major macroeconomic and structural reforms post 1991 (BoP crisis). The changes have been there in trade, FDI, industrial policies, institutional and regulatory measure. As a result of reforms, the growth picked up from compound annual growth rate of 5.8% during 1990s to 7.3% during 2000s. Two decades saw India to be one of the fastest growing economies.

- It is crucial to note that the services sector played a significant role in enabling this economic performance. Post 1991, as it has grown very rapidly. The 2 sub sectors which particularly important in this were – Information Technology (IT) and Business Process Outsourcing (BPO).

- **<u>Author begins by listing the growth trends in India's Services Sector</u>.** Services sector growth rate increased – 7% (1988 – 89) and 9.2% (2002 – 09). Growth rates in agriculture and industry (2.2%) were lower than service sector growth (7.7%). Within services sector – the driving sub – sectors were communication, banking and insurance, construction, trade and distribution services. All these sectors grew at 7% CAGR. The sub – sectors with slow growth are railways and public administration services; both of which grew at less than 4%. Average share of industry in GDP decreased from 22% (1990 – 94) to 20% (2005 – 09) and average share of agriculture decreased from 30% (1990 – 94) to 18% (2005 – 09) but the share of services increased during this period – services share in GDP was about 48% in 1990 but increased to 64% in 2009.

- **<u>The article, discusses the contribution of services sector to employment, since it is a crucial aspect for developing, labour abundant nations</u>.** Services sector output has increased but its contribution to employment has not increased. From 1991 to 2001, share of services in GDP increased 10% but the employment share increased from 20.8% to 24.8% implying a low employment elasticity. While output share increased from 50% to 60% from 1993 to 2007; but the employment share increased only from 21.2% (1993 – 94) to 25.4% (2007 – 08).

- Most employment is concentrated in trade and distribution, construction, hotel and restaurant, community and personal service segments. The sub – sectors – communication and financial services were growing very rapidly but the employment didn't grow very much even in these sectors implying that the growth has been mainly due to the productivity gains and technological improvements.

- Indian data on output and employment in services is not very precise because of the process of data collection, dis-aggregation and coverage. Price indices data doesn't have services' data and WPI doesn't include services.

- **<u>The data for the trade in India's services sector exports and imports have shown significant growth –</u>**

	Exports	Imports
1980	$2.9 billion	$2.9 billion
2000	$16.7 billion	$19.2 billion
2010	$116.3 billion	$108.6 billion

- In 2010, trade surplus ($7.7 billion) helped to overcome the trade deficit partially in goods. Average annual growth rate of India's services export increasing from 19.5% (1995 – 99) to 25.2% (2000 – 09). Services in India's exports have increased from 18.5% in 1995 to 34.9% in 2010.

- India has outperformed many other developing countries in terms of services export. The average annual growth rate of services exports in India is 17.3%; whereas in China it is 15.8% and the world average is only 5.6%. This shows India's increased competitiveness.

- India's share in world service exports from less than 1% in 1980s to 3.1% in 2010 and imports from 0.7% to 3.1% during the same time period; which again shows that India is more competitive in services than goods (worldwide).

- The structure of India's exports has changed overtime. Earlier there were traditional services (transport, travel) and now, new services (business services, computer and information services) are there. Contribution of the traditional and new sub – sectors of India's services to total exports from India are depicted below –

	Traditional Services	**New Services**
1995	over 50%	0%
2000	30%	28%
2010	12%	51.5%

- **However, it should be noted that overtime, diversification of services sector exports has been there** with new and emerging sub – sectors like financial services, insurance, communication, construction coming up and this has made the services sector broad based. Also, in the meantime the sub – sectors IT and BPO have grown very rapidly.

- India has a comparative advantage in skilled and labour intensive services, along with cross border labour mobility being there. Both these factors played a significant role in India's successful service export industry. In USA out of all professional visas given 68% were for Indian computer professionals and 63% were for specialty occupation.

- India has been among top 5 source countries for temporary skilled workers to US (professionals in health care, architecture, engineering and education). India is an important supplier to Middle East for semi – skilled and low skilled workers.

- **At this juncture, one needs to understand that there are certain constraints for India's service export namely,**
  External barriers: immigration and labour market regulation, protectionist bills in US to ban outsourcing of government contracts to developing economies, linking fee for specialty occupation visas.
  Domestic barriers: infrastructure, financial, regulatory, technical, standard – related constraints.

Next, the article discusses the trends in India's IT – BPO Services

1. IT and BPO services exports have increased from $754 million (1995 – 96) to $9.6 billion (2002 – 03) and finally to $59 billion (2010). In 2010, the industry turnover was 6.4% of GDP.

2. Within industry, IT accounted for $33.5 billion of exports which is almost 50% of the total services exports and BPO accounted for $14.2 billion of exports and engineering and software products for another 19%.

3. India's IT – BPO exports to USA were 61% and to UK were 18% in 2010. After 2010, new markets have emerged in Asia Pacific and Middle East.

4. IT and BPO have provided employment as well – to 2.3 million directly and 8.2 million indirectly. These services are provided in many verticals – banking and financial services industry (BFSI), telecom, manufacturing, retail, healthcare, travel and tourism. Also, these services have moved up the value chain as well – a growing number of offshore R & D were located in India and there was a shift towards higher end services like business analytics, equity research, market research.

5. Service exports are classified as onsite i.e. temporary movement of software professionals to other markets and offsite i.e. through data or voice or information

flow over the phone or internet. The ratio of offsite – onsite is 85:15 implying India is most popular offsite destination mainly because of skill availability, favorable business destination and low cost labour.

- **FDI in India's Services Sector** – Author notes that the average share of FDI flows in India towards service sector increased from 10.5% in 1990 – 94 to 28.3% in 1995 – 99. In 2009, services accounted for almost 75% of FDI inflows. The Compound Annual Growth Rate (CAGR) of FDI increased from 36% between 1992 – 93 and 2001 – 02 to 36.7% between 2006 and 2009.

- Changing share of the services sub – sectors in India with respect to FDI inflows –
    a) Telecommunication, Real Estate, Construction – have always been important implying the growth and liberalization dynamics on the domestic front in India which have helped these sub – sectors grew rapidly.
    b) Share of computer services has declined mainly due to the recent global economic slowdown and saturation.
    c) Share of business, financial, consulting and misc. services has increased over time in FDI inflows.

- FDI outflows – Services accounted for over 50% of total FDI outflows during 1999 – 2008. The main sub sectors – communication, software, business services. In software and health services. Indian firms are increasingly emerging as exporters of capital.

- **In order to understand the services sector comprehensively, it is crucial to analyze or reflect on the liberalization of services in India. The author highlights the following points in this regard –**

1. Recent structural and institutional reforms in India have involved opening up of the key services like – telecommunication, banking and insurance – to attract much needed foreign capital and technology and to encourage competition and efficiency.

2. A number of services have been put on automatic FDI approval route (subject to certain conditions and regulatory requirements). For example, construction, housing, townships, hospitals, diagnostics, wholesale cash and carry trade, computer related services.

3. Government monopoly has been eliminated and independent regulators have been established especially in long distance telephone and internet. FDI is permitted in most segments (telecommunication, internet, etc.) with a ceiling of 74% foreign equity participation and even 100% in call centers and BPOs.

4. **Telecom** Regulatory Authority of India (TRAI) has been established as independent regulatory authority. **Insurance Services** have been opened up to foreign equity with a ceiling of 26% on automatic basis. An independent regulator – Insurance Regulatory Development Authority (IRDA) has been set up. **Banking services** have also been opened up – foreign equity participation up to 74% in private banks and up to 20% in public sector banks. Although restrictions apply with respect to voting rights, licensing requirements, approval from authorities, etc.

5. Problematic FDI – **Retail** is the only FDI that's partially open because of the strong opposition from the lobby and concerns about displacement of small retailers. **Legal services** in services sector, remain closed to FDI. Higher education is another such area which is much debated – foreign education providers are not allowed to set up campus and give degrees.

6. It is crucial to note that the debate about liberalization in services sector is basically an equity – efficiency debate or trade – off. In order to exploit the gains of liberalization we need to have domestic regulations, reforms, development of regulatory framework, regulatory capacity. The evidence for this can be presented as follows. Indian economy has had efficiency gains. World Bank study 2004 analyses the degree of correlation between – liberalization in insurance, business services, IT and IT banking enabled services, communication – and, higher growth rates have been seen with broader gains in efficiency.

7. **Productivity** – there are productivity gains also. McKinsey estimates that productivity has increased in telecom and software services. Also, there has been increased productivity for other sectors due to technological externalities, knowledge spillovers, improved management practices, technology diffusion. Export opportunities have also increased along with increased efficiency and competitiveness.

- **<u>Lastly, the article highlights a few significant points regarding India's Multilateral and Regional Engagements in Services –</u>**

1. India has been actively involved in WTO service negotiations. India's role is proactive in General Agreement on Trade in Services (GATS) under <u>mode – 4;</u> temporary cross border movement of service providers and under <u>mode – 1;</u> cross border supply of services.
2. In 2004, India along with other developing countries made a submission to provide Service Provider Visa (SPV) under GATS for intra – company transferees, contractual service suppliers or independent professionals.

3. Doha Round – there was pressure on India to have more binding and more liberal commitments on the commercial presence (GATS mode 3). India has received request from developed nations to the multilaterally bind in liberalization where its level of

liberalization fall short in sub sectors like banking, insurance, telecommunication. Also, requests have been there to open up in services sub sectors like retail, higher education, legal, accountancy services.

4. India has made a number of bi – lateral and regional agreements by entering into broad – ranging trade negotiations which cover services, investment, labour mobility. Some of these include –
    a) India Singapore Comprehensive Economic Cooperative Agreement (CECA), 2005.
    b) India Korea Comprehensive Economic Partnership Agreement (CEPA), 2009.
    c) Several Agreements with EU and Australia.

- <u>The article concludes that India's main interest and competitive advantage lies in services.</u>