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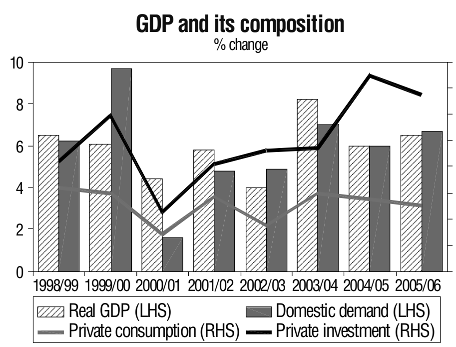
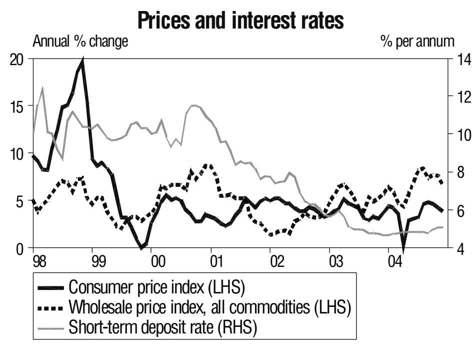
India — Another China in the making?

February 2005



Source: Ministry of Finance, Reserve Bank of India, IIF



Source: Reserve Bank of India

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For a country its size, India gets surprisingly little attention from markets. There are three reasons for this — its tiny stock of foreign currency bonds available for trading, its currency management practices that eliminate excessive exchange rate volatility and its relative macroeconomic stability compared to most other emerging markets.

But attention is increasing as are comparisons to China's huge economic presence. Popular theory holds that what China is doing to global supply chains for manufactured goods, India is doing for services. An equally popular notion is that today's supply-demand imbalance in natural resources (and related high commodity prices) is trifling compared to the true scarcity that will exist when India truly joins China in the development race. Exaggerations abound, but there are elements of truth to both notions. After reviewing recent trends in India's economy and comparing these to developments in China, we examine India's relevance to global commodity markets and to the offshoring phenomenon.

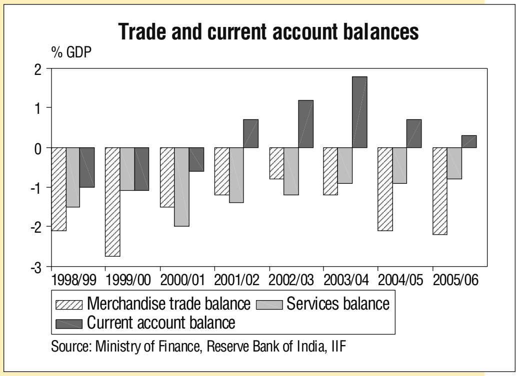
Recent trends in India's economy

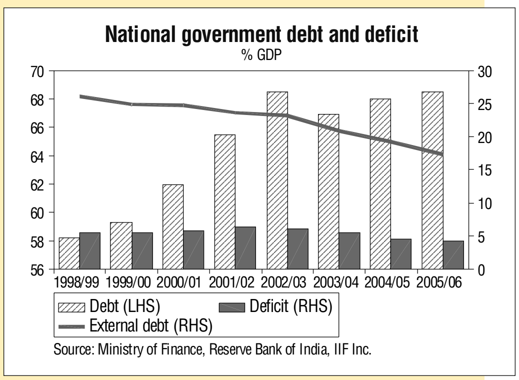
Recent growth has been strong, but medium-term trends have been less inspiring. India grew by 8.5% in the 2003 fiscal year ended March 2004, a 15-year high and well above the 4.7% average growth pace in the previous three years. Since then some momentum has been lost. A longer-term perspective shows real GDP growth oscillating in the 4-7% range since 1980, with a sharp downturn in 1991 followed by a recovery to 8% by 1996, giving way to slower and slower growth in the 1997-2002 period.

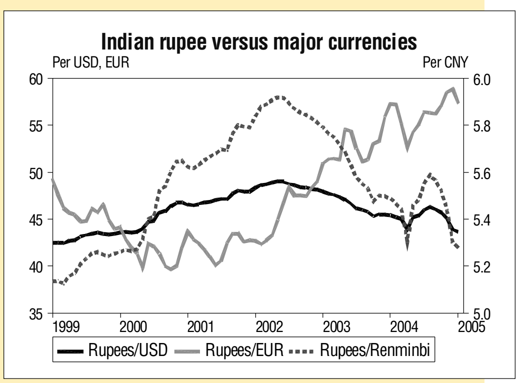
Unlike elsewhere in Asia, the current boom in India has not been driven by exports, which make up only 13% of its GDP, but by 7-10% annual growth in manufacturing and services and, in 2003/04, exceptional agricultural output that boosted incomes and spending. The near-term outlook calls for healthy trend growth of 6-7%, reflecting the reforms that have energized the industrial and service sectors, while the slippage from FY2003 is due to a collapse in agricultural output growth to around 1% in 2004/05 from nearly 10% growth the year before.

Inflation has become more of a concern recently given the large increases in oil and other commodity prices and has become a source of worry for policymakers. India is a net oil importer, and oil products make up about 30% of total imports. In addition, 8-10% growth rates in industrial production towards the end of 2004 have also pushed input prices up. Consumer prices have climbed to a growth rate of around 5% from 4% in the 2000-03 period. India's wholesale price index hit a 3½-year high of 8.7% in late summer and has fallen only slightly since then. These trends convinced the Reserve Bank of India to raise interest rates for the first time in four years in the fall of 2004. Short-term market rates have climbed about 100 basis points since mid-summer to a yield of 5.3% in November 2004.

Despite higher rates, services and private investment are projected to continue to grow strongly while consumption will grow around its trend rate. Healthy reserves and relatively low external debt have lessened India's external vulnerability. Nevertheless, the recent national election revealed a deep vein of dissatisfaction among India's rural and urban poor who feel they have been left behind by the country's recent advances.







Reconciling the demands for greater distribution of public resources and greater public control over the economy with the needs for deficit reduction, privatization and infrastructure investment will be a significant challenge for the current government.

In terms of international exposure, India's annual trade deficit is expected to be in the US$15 billion range this year and next, or just above 2% of GDP, up from US$6 billion in 2001-02. Most of the increase is due to high oil prices, which pushed the import bill to annual growth rates of more than 30% in the third quarter of 2004. Meanwhile exports are slowing. In October 2004, imports grew nearly 20%, while exports grew slightly less than 10%. The country has an overall current account surplus of about 0.7% of GDP, but it is shrinking alongside the expanding trade deficit. The current account surpluses seen since 2001 represent a dramatic shift from decades of current account deficits. Though India has experienced strong capital inflows in recent years, foreign direct investment inflows are small compared to China. In 2003, about US$4 billion in foreign direct investment flowed to India, representing less than 1% of GDP.

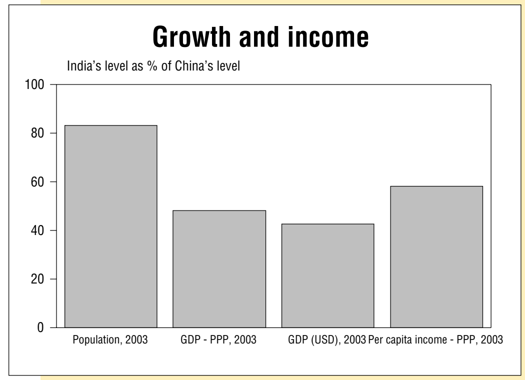
One of India's largest challenges is its persistent government deficit. This year's shortfall is expected to be in the US$30-35 billion range, or about 5.5% of GDP, similar to levels seen in the past few years and only slightly below the eight-year peak of 6.3% in FY2001. Adding India's states to the picture pushes the general government deficit to 9-10% of GDP, easily one of the worst among the major developing nations. Despite this, India's total government debt is a middle-of-the-pack 80% of GDP, while external debt is a reasonable 20% of GDP. One of the key methods planned to increase revenues is to devise ways to tax the expanding service sector. While the service sector now represents more than 50% of the economy, manufacturing still bears the brunt of corporate taxation. India has one of the lowest tax-to-GDP ratios among emerging Asian economies and is hampered by tax exemptions and avoidance.

India not another China — yet

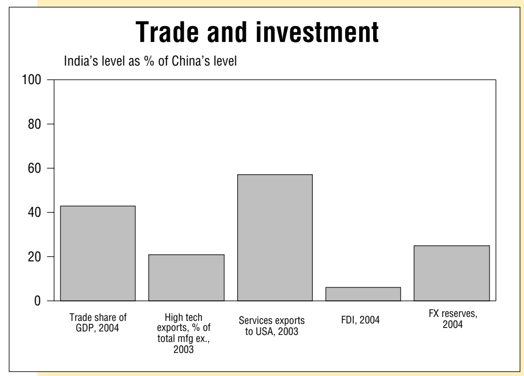
India's population, at just over one billion, is 83% of China's total. In purchasing power parity terms, China is the world's second-largest economy and India is the world's fourth. Both economies exhibit high, but geographically uneven, growth rates, with some large cities developing rapidly while outlying rural regions remain quite poor even by developing world standards.

Beyond population and total purchasing power parity (PPP)-adjusted GDP, the similarities between India and China begin to run dry. Their economic structures are different: industry contributes 53% of China's output compared to 26% in India. In contrast, India's weighting in services and agriculture (52% and 22% in 2003) are higher than China's (32% and 15%, respectively).

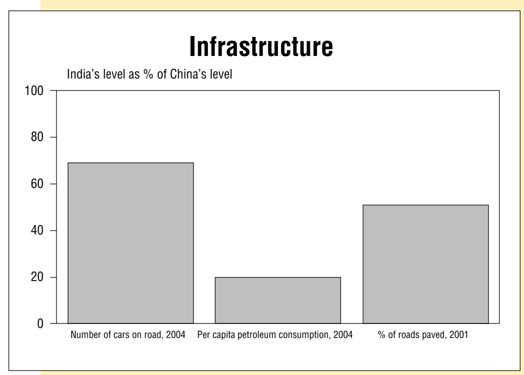
India is further behind on the development path, with lower per-capita income levels and a less advanced infrastructure. India's per capita income is only 58% of China's in PPP terms and only 48% in U.S. dollar terms. Private consumption per capita is only 70% of Chinese levels. In terms of infrastructure, 91% of China's roads are paved compared to 46% of India's; India's rate of fixed and mobile phone subscribers per 1000 people is just 16% of China's; India lags China and other regional competitors in power, transport and other key infrastructure required to support industrial development. In terms of human capital, India has a lead in technical education, but it may be fleeting given that China's literacy rate is 84.5% compared to 56.4% in India. What's more, China's national savings rate of 40% compares to 18% for India and gives China a huge advantage in available domestic capital for human and physical infrastructure development over and above its tenfold advantage in FDI flows.



India's general model of development is also different. China is officially a command economy but contains pockets of some of the most intense competition in the world, while India is officially a market economy but is held back by extensive government regulation. China is highly open to international trade and investment; India is much less so and has, instead, used a model that features import tariffs and emphasizes growth from domestic sources. As a result, China's share of world trade has trebled to 6% in the last 10 years, while India's has remained constant at about 2%. Put another way, net trade is worth 74% of GDP in China but only 32% in India. While this means that India is not as dependent on external demand for growth, its domestically oriented model has not been as successful as China's and India's growth rate has lagged.



Fortunately, these differences mean that India and China are not really in competition in world markets yet. India attracted only 7% of the foreign direct investment that China did in 2003, yet China is not considered to be siphoning foreign direct investment that might have otherwise gone to India. While both list the United States as their top export market (destination for 20% of exports for India and 30% for China), their top exports are different. More than 90% of China's exports are manufactured products, while 20% of India's exports are textiles and another 11% are agricultural products. In addition, trade between India and China is growing rapidly — bilateral trade grew to $7.2 billion last year and will likely hit $10 billion in 2005, and China is now India's second most important export market.

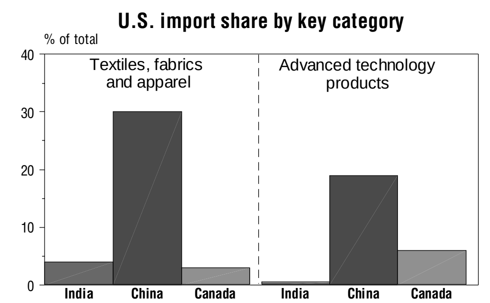


The degree of competition is likely to intensify rapidly. The January 2005 end to the 10-year-old WTO agreement that parcelled out textile export quotas among members has launched a large shift in clothing manufacturing to China and India and away from higher-cost countries such as Mexico and the Caribbean. India will benefit from the lifting of quotas immediately, while China will have to wait two years before accessing the same markets due to its late entry into the WTO.

Textiles and garments are major export items for India, accounting for $US14 billion in 2003 compared with $10 billion in software. India holds a 3.7% world market share in textile exports compared to its 0.5% market share in software. The end to quotas is expected to give India another two percentage points by 2010. Only China can match India's scale advantages in textiles, but studies have shown that India has both a labour and capital cost advantage over any other country including China. However, Chinese textile and garment firms have so far handily dominated their Indian competitors. Europe provides a good case study. In the textile sector where quotas were lifted in 2001, China's market share has risen from 24% to 45%. In contrast, India's global market share has been nearly stagnant. Constrained by the quotas, more stringent labour laws and poor industry integration it's share has moved from 2.9% in 1995 to just 3.7% in 2002.

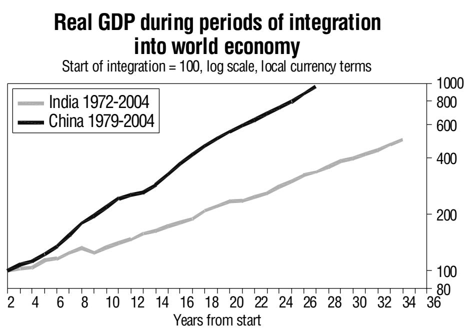
The popular conception is that the reverse is true in the information technology field, where China is said to be a decade or more behind India. India's advantages in language, technical education, managerial talent and product quality have allowed it to expand beyond manufacturing low-cost hardware; in fact, India has ceded this ground to others in favour of developing its software, programming and high-tech services and consulting sectors. India's surplus in software services trade doubled in the three years from 2000-01 to 2003-04 during which data are available, while India's surplus in miscellaneous services has moved from a deficit in 1996-97 to a surplus of US$5 billion. Despite these rapid gains, India's service sector still lags China's in terms of total services exports to the United States, where India's 2003 level was just 57% of China's level. And, despite China's reputation as an assembler of cheap labour-intensive goods, one-quarter of China's exports to the United States in 2003 were classified as "high-tech"; the comparable figure for India was about 5%. The high-tech advantage may be tilted in India's favour, but only at the highest level of high-tech value-added.

Source: IMF, RBC Financial Group



Source: U.S. Department of Commerce

The net effect is that China has a good head start on India in terms of the kind of development that boosts per capita incomes, that is to say, growth concentrated in high value-added sectors that can exploit a productivity advantage in world markets. India may never catch up, but that does not mean it cannot still grow rapidly in the next decade. Both countries face similar challenges related to the uneven distribution of recent income growth. If China's growth falters, India's relatively weak trade integration with China means that India would emerge basically unscathed and, in fact, benefit by way of lower world energy and commodity prices.



Source: IMF, RBC Financial Group

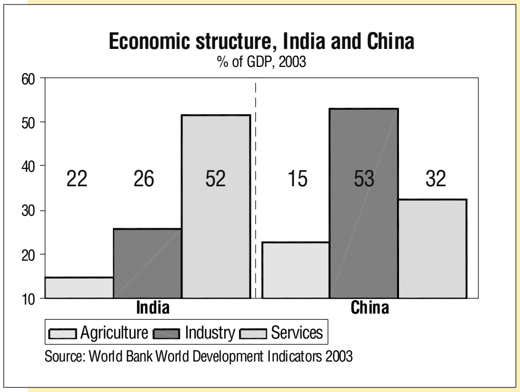
True battleground may lie in energy, commodities

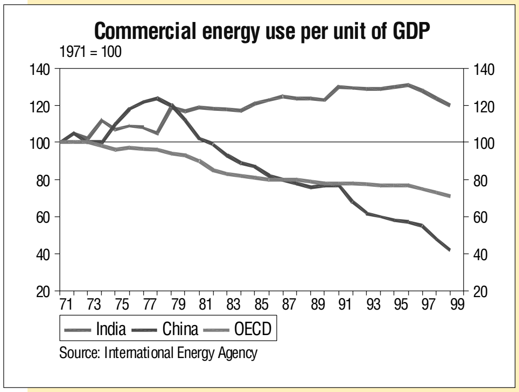
So far, India and China are pursuing different, even complementary, trade and development strategies. While there seems to be no limit to the ability to transfer manufacturing to China, the bulk of China's dominance occurs at the low-value end of the spectrum. There are limits to the extent services can be offshored to India, but services represent a higher step in the value-added chain. Exports may, therefore, not be the arena where the two countries' interests collide.

That collision is more likely to play out in the demand for raw materials as both countries compete for what are limited supplies even in the long-run. But this does not mean that we are expecting India to lead a spike in demand for raw materials in 2005 on the same scale as China's demand surprise of 2004. For one thing, India's growth rate is slower. Since 2000, India's average real GDP growth rate has been 5.7% compared to 8.4% for China. In 2005, India is expected to grow by 6.5%, two percentage points slower than China.

More importantly, the characteristics of India's growth are different. We already know that India's economic structure is different — industry is less important to its economy. Unlike China, India is not the key beneficiary of a worldwide structural shift in manufacturing production facilities. It was not Chinese consumer demand that caused raw materials shortages, it was China's investment spending boom as factories and infrastructure were created to serve consumer demand in developed countries. India's growth, in contrast, is both driven (and constrained) by domestically generated demand. Manufacturing contributed only 16% of GDP in 2002, a figure generally unchanged since the late 1970s. In China, manufacturing accounts for half of GDP. In India in 2004, gross domestic investment measured 24% of GDP compared to 47% for China. India's services sector requires less capital investment and, hence, fewer raw material inputs.

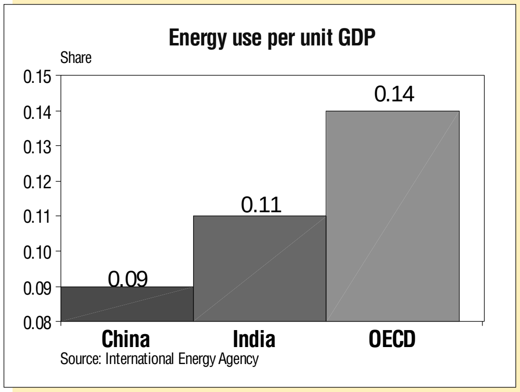
Another reason not to expect India to be a key driver of commodity prices in 2005 is that the levels of India's demand are much lower than China's in many cases and, therefore, even stronger demand growth rates on the part of India translate into smaller strains on overall world commodity production. For example, while China accounts for 20% of world copper consumption, India accounts for just 2%. China consumed 21% of the world's aluminum in 2004 compared to 2.8% for India. Both India and China produce iron ore, but India sends more than 80% of its iron ore exports to China. At these ratios, a doubling of demand from India (highly unlikely) is the same as a smaller 10-20% demand increase in China. There is also uncertainty about the extent of China's slowdown — January's commodity market sell-off highlights fears that the slowdown will be worse than expected, but recently released data show that China's economy grew by 9.5% in last year's fourth quarter, well above expectations. India is still not yet the swing player in global commodity markets that China is at this time.





Near-term crude oil demand

China's 15% petroleum consumption growth in 2004 turned out to be triple projections from a year earlier. India's oil consumption rose a much lesser 3%, in line with projections. Markets are now aware of China's impact on oil demand projections. But is there a risk of a similar forecasting error for India? Not in the near-term. One reason is because, as indicated above, India's development strategy does not yet lend itself to sudden foreign-induced surges in activity. Another reason is that India's level of consumption is relatively small for such a populous country — 15% of China's consumption and 2% of that of the United States. In terms of barrels of oil, China's consumption represented about 8% of global demand in 2004, while India's represented just 1.2%. India's intensity of energy use per unit of GDP is 20% lower than China and 35% below OECD levels and is likely to fall as the economy evolves. More importantly, China's growth in consumption accounted for 33% of total world demand growth compared to less than 2% for India. Even if India's demand were to suddenly grow at Chinese rates of 15% in 2005 (again, unlikely given the macro outlook), this translates into an additional demand of 180,000 barrels of oil, 0.2% of total 2004 demand.



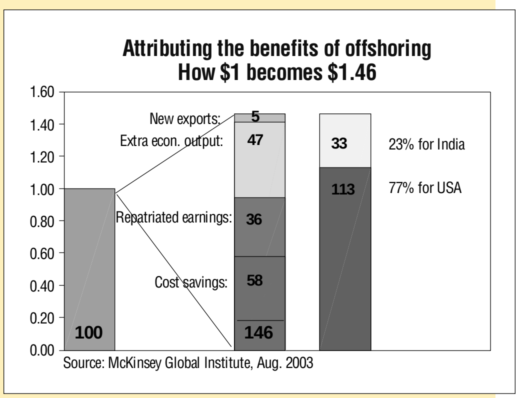
Resource competition not far away

However, the five-year outlook is much different. India is growing and developing rapidly. The major drivers of Indian raw material demand in the next five to 10 years include population growth, urbanization, rising living standards, transport and industrial demand, and strong infrastructure spending. India's population growth in the past five years has averaged 1.5% compared with 0.7% in China. The growth of India's working-age population has been stronger, at 2.2%. India's population is younger, too.

More than one-half of Indians are under the age of 25 and only 63% of India's population is working-age compared to 70% in China. Therefore, India's productive population will grow rapidly. On a per capita basis, India's intensity of energy use is only 55% of China's level. Although India's climate is warmer, per capita energy use is still expected to converge towards China's level over time. India's use of energy per unit of GDP has increased 20% in the past three decades, compared to a declining trend in China and in the OECD average. The International Energy Agency expects India's commercial demand for energy to increase by more than 2.5 times by 2020. Most importantly for markets, 75% of India's oil is imported today, a figure that will rise to 92% by 2020.

Along with growth in productive population comes a desire for higher living standards. Here, China and India are similar in trend, but again India lags China and may, therefore, add more to demand in the medium-term. India's per capita disposable income level is 70% of China's. India lags much further in many other measures of consumer ownership. Above and beyond India's lower level of per capita car ownership (83%) and number of cars on the road (63%), India has just 23% of China's television sets, 31% of its personal computers, 20% of its telephone lines and 10% of its mobile phone subscribers. As these huge populations seek ever-higher living standards, rising demand for cars, cell phones and other modern household conveniences points to a bullish medium-term trend for raw material demand.

Finally, India's big plans to upgrade its infrastructure will also help support commodity prices in the medium-term. It is widely acknowledged that a major barrier to investment in India is its disastrous infrastructure. Only 30% of India's rural households have access to electrical power; the plan is to connect all households by 2012. Officials want to increase access to clean water, too. Just homebuilding and upgrades alone suggest strong demand for plumbing and electrical equipment. India's government is also in the midst of a massive 500 billion Rupee road-building project that will add 8,000 kilometres to India's transportation infrastructure. In terms of both consumer and investment activity, China and India are poised to compete for access to energy and commodity inputs.



The outsourcing debate in perspective

Outsourcing has long been a source of productivity growth, but the recent U.S. labour market downturn recast the practice in a very negative light, particularly its offshore component. However, while manufacturing jobs have been under threat of displacement to countries with cheaper labour costs for some time, service sector jobs have not. More than four of five jobs are in the service sector, making the threat appear many times larger than for manufacturing. Because of its burgeoning IT services industry, India has emerged as a key target of those resisting the movement of services jobs overseas.

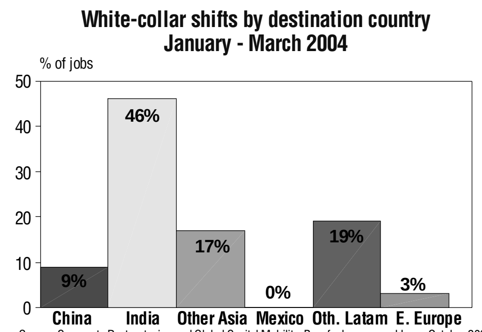
It is important to maintain perspective in this debate, both from the point of view of North American and India. The total number of North American jobs 'lost' to outsourcing is expected to eventually total several million during the next few years. However, this will be a drop in the total 150 million-strong Canada-U.S. employment bucket. The hardest-hit sectors at the moment have been financial services and information technology. Overall, though, offshore outsourcing is expected to affect only 0.2% of employed Americans, while so far Canada has been a net beneficiary of U.S. 'offshoring', gaining call and customer service centres.

On balance outsourcing is actually a job creator as firms save money and become more profitable and jobs are reallocated to high value-added sectors. An August 2003 McKinsey Global Institute study estimated that every dollar 'outsourced' to India created $1.46 in new wealth for the U.S. economy. There are also natural barriers to services outsourcing because many services require geographic proximity to the customer. It is estimated that currently nearly 90% of U.S. jobs fit this description, although this overly optimistic percentage will drop over time as people become more comfortable with alternative methods of services provision. Many services are also sensitive to language, culture and privacy concerns, while reputational risk is also a factor: a defective product can be returned, but a negative customer service experience cannot be easily erased.

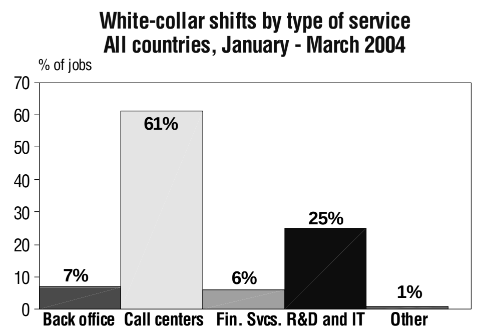
Despite these barriers, service sector outsourcing will grow in importance and India will be a main beneficiary. India has a huge advantage over many developing countries due to its advanced English-language technical educational system. There is quite simply no developing, low-wage country better positioned to offer a virtually seamless provision of English-language services. India's advantages offer it the unique ability to climb high up the value-added chain to approach developed country offshore service centres like Canada or Ireland. India also has a tremendous time-zone advantage in the provision of back-office services since they can be completed overnight while North America sleeps. These advantages have seen the United States become the destination for 65% of India's IT services exports.

However, the importance of IT services production to India is often exaggerated. As a percentage of GDP India itself is a bigger outsourcer of business services than the United States, with imports of business services worth nearly 2.5% of GDP for India compared to less than 0.5% of GDP for the United States. IT services represent only about 2% of India's economy. The McKinsey study noted that of the $1.46 in value created by U.S. offshoring to India, only 33 cents, or 23%, accrued to India, with the remainder accruing to the United States. India's IT services sector has been largely exempted from tax and is, therefore, not an important revenue source for the government.

The IT services sector has grown rapidly because it sidesteps India's traditional weakness in infrastructure, shipping its output electronically rather than by road. At the same time, however, low infrastructure dependence means that IT services provide relatively fewer spillovers to other companies or to the region. In general, outsourced services can often be smaller scale and are conducted under the radar by many North American firms. Unlike manufacturing plants, service operations are highly mobile. While they do pay wages at the top end of the scale, there is a natural constraint as rapid wage growth reduces the attractiveness of the industry as a whole. Finally, expanding EU membership suggests that India may see increased challenges from Turkey and Eastern Europe, which have the ability to work in the same time zone as Europe. That said, services outsourcing will likely be the most important catalyst for growth in India's standard of living during the next decade.



Source: Corporate Restructuring and Global Capital Mobility, Bronfenbrenner and Luce, October 2004



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