BOFIT Online
2005 • No. 2

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Is India emerging as a global economic powerhouse equal to China?

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Bank of Finland
BOFIT – Institute for Economies in Transition

Bank of Finland
BOFIT – Institute for Economies in Transition

PO Box 160
FIN-00101 Helsinki
Phone: +358 10 831 2268
Fax: +358 10 831 2294
bofit@bof.fi
www.bof.fi/bofit

BOFIT Online
Editor-in-Chief ***Jouko Rautava***

ISSN 1456-811X (online)
2.2.2005

Helsinki 2005

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Abstract

India has frequently been referred to as the country with the largest economic growth potential in the world after China. Many commentators seem to think its role in the world economy is already comparable to that of China. However, a closer look at merchandise trade, market share developments, and foreign investment figures reveals that India is still far behind China as far as international influence is concerned. An interesting exception is services trade, where India already plays an important global role due to recent fast growth of offshore outsourcing. Despite of the vitality of this sector, its weight in the Indian as well as in the global economy is relatively small. In general, India's economy and economic policy are still relatively inward looking and it seems unlikely that India will become a major driver of the world economy in the current decade. However, depending on India's economic policy and reforms, the situation in the next decade may already be quite different.

Keywords: India, China, economic growth, economic policy, foreign trade

* This paper has benefited from comments by Pavlos Karadeloglou and Filippo di Mauro. However, the usual disclaimers apply.

High expectations concerning India's economic growth and global role

After independence in 1947, India's economy grew slowly until the end of the 1970s (the 'Hindu rate of growth'). However, at the beginning of the 1980s the growth rate jumped to a new, higher level which – with the exception of a major macroeconomic and balance-of-payments crisis in 1991 – has been sustained ever since. During the last 20 years, India's real GDP has increased on average almost 6% per annum. In 2003, the growth of real output accelerated to over 8%. Moreover, the future of the Indian economy looks promising, as the annual growth rate is generally expected to remain around 6–7% in the coming years.[1]

India's economic growth performance has given rise to a lively debate on the possible causes lying behind it. A widely held view is that the moderate economic reforms of the mid-1980s and the more bold reforms after the 1991 crisis are the key determinants of the improved performance. However, this view has been challenged by the argument that the Indian economy had already moved onto a higher growth path before any meaningful market-oriented reforms were initiated in the mid-1980s.[2]

Recently, India has frequently been referred to as the country with the largest economic growth potential in the world after China. Using available demographic projections and basic models of capital accumulation and productivity growth, a widely cited report by Goldman Sachs argues that India – measured by the overall size of the economy in fixed US dollars – will already have overtaken all other major economies except the US, China and Japan before 2025.[3] In this projection, about two thirds (5.8% per annum) of the increase in India's US dollar GDP will come from real output growth, and one third from real appreciation of the rupee.[4] A key assumption of this projection is that India will carry out policies and develop institutions that support growth (prudent fiscal policy, liberalisation and opening up of the economy, investment in infrastructure, education, health care, etc.).

In addition to investment banks, some development economists are also quite optimistic regarding India's prospects. A recent study by Rodrik and Subramanian claims that the above-mentioned Goldman Sachs study may in fact underestimate India's true growth potential.[5] The authors argue that, given India's fundamentals (in particular a large pool of university-educated labour and well-established institutions), the Indian economy can be expected to grow on average about 7% a year (5.6% in per capita terms) during the next 20 years. Regarding reform policies, the authors do not see any particular need to change the current gradualist approach, which they consider in the Indian circumstances more of an asset than a liability. Interestingly, according to Rodrik and Subramanian, the Chinese economy has been running way ahead of its underlying institutional realities, and hence its growth is less sustainably based than India's.

Contrary to these positive views concerning India's growth prospects, there have, however, also been more cautious or even sceptical opinions expressed emphasising

[1] While in India statistics are usually compiled for a fiscal year starting in April, in this publication calendar years have been used.

[2] For the current debate, see Panagariya (2004), DeLong (2003), and Rodrik and Subramanian (2004a).

[3] Wilson and Purushothaman (2003), Dreaming with BRICs: The Path to 2050. A somewhat similar view is offered by the Morgan Stanley report 'China and India: New Tigers of Asia' (July 2004).

[4] In fact, projected growth in real output corresponds well to India's actual growth record in the last 20 years.

[5] Rodrik and Subramanian (2004b).

evident problems in the Indian economy and the economic policy-making environment. In the short to medium term, growth prospects are overshadowed by a poor fiscal position, as the general government fiscal deficit has fluctuated around 9–10% of GDP since 1998 and public debt is growing at an unsustainable pace.[6] In addition to increased uncertainty in the short run, excess public borrowing also affects long-term growth prospects by crowding out productive private investments. However, in spite of the huge deficits and excess borrowing by the government, lack of investment in infrastructure has led to serious problems in energy and water supply, transportation, and education and health care. As regards structural reforms, while India's political system based on democracy, federalism, and consensual decision making can be considered a major achievement, the current system is very inefficient and its ability to initiate essential reforms is considered relatively poor. This may hamper long-term economic prospects.[7]

In spite of the differing views concerning India's growth prospects, there is a common understanding that India needs to reform and modernise its economy in order to exploit its growth potential. Hence the current debate on the country's future concerns more the speed and sequencing of reforms than the need for reforms as such.

Given the increased interest of the wider public as well as economists in economic developments in India, this note explores India's role in the global economy and, by extension, its potential impacts on the euro area in the foreseeable future. For this purpose, China is used as a benchmark. In the next section, we describe the similarities and differences of the economies and economic policies of India and China since 1980. After that, we turn to analyse merchandise trade developments. Then, due to India's central role in offshore outsourcing of business services, special emphasis is given in the subsequent two sections to trade in services and outsourcing. After trade issues, a separate section deals with foreign investment in India and China. The paper concludes by noting that India still lags far behind China as far as foreign trade, investment and global influence are concerned. Moreover, we argue that the Indian economy is unlikely to become a major driver of the world economy in the current decade and its impact on the euro area will therefore also remain limited. However, depending on India's economic policy, the situation in the next decade may already be quite different.

India's inward versus China's outward orientation

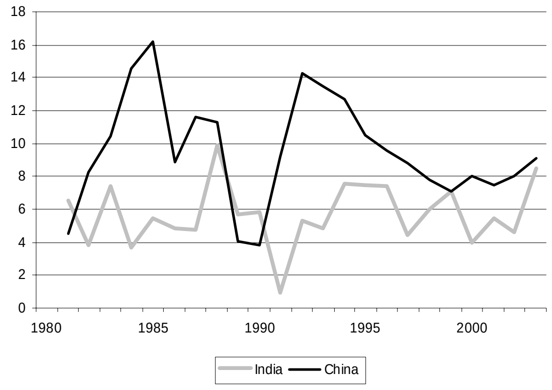
In order to assess India's growth record and prospects to become a major international economic player, China is an interesting example to which India's performance can be compared. Firstly, China's unbeatable growth performance since 1980 offers a natural benchmark for any growth comparisons in emerging Asia. Secondly, while the relative positions of India and China, measured by GDP per capita, have varied during decades and centuries, in 1980 their income levels were similar without any noticeable trend towards divergence.[8] Thus, broadly similar initial income levels will facilitate comparisons of post-1980 developments. Charts 1, 2 and 3 illustrate the GDP development of India and China since 1980.

[6] In 2003, the ratio of general government debt to GDP was about 85%. For more on the fiscal situation, see Pinto and Zahir (2004).

[7] Desai (2003).

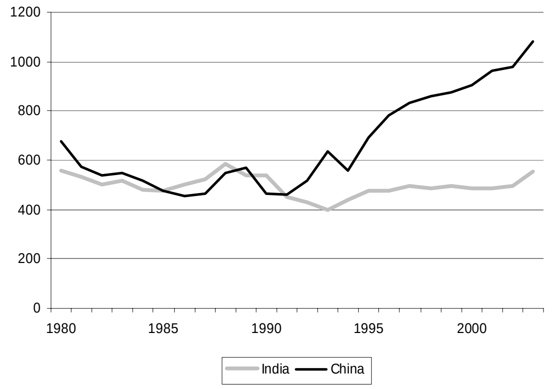
[8] In PPP terms India was actually richer than China until the beginning of the 1990s.

Chart 1. Annual growth in India's and China's real GDP, %



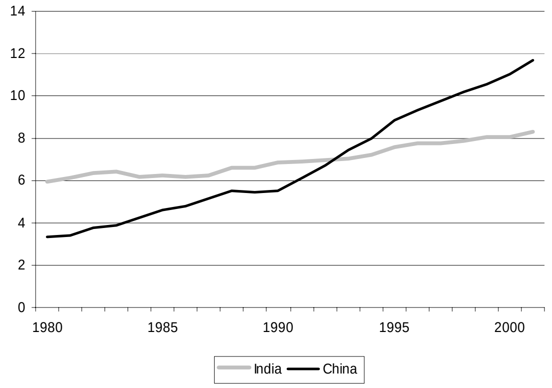
Source: IFS.

Chart 2. Indian and Chinese GDP per capita in constant 2003 dollars



Source: IFS.

Chart 3. Indian and Chinese GDP per capita (PPP) relative to the US, %



Source: UN Common Database.

India and China have many similarities related to geography, size of population and overall business environment (bureaucracy, corruption and other problems common to transition and emerging countries). They are both also dependent on imports of oil and many other commodities. However, there are also important differences that should be taken into account when assessing these two countries' growth prospects. These range from differences in the availability of English-speaking university graduates to entirely different political systems and, consequently, institutions. In the long run, demographic differences may also become important as the Chinese society is greying much faster than that of India. Table 1 offers some basic data on population, level of development and business environment.

Table 1. India and China, some basic development and business environment indicators

	India	China
People (2001-02)		
Population, million	1048	1281
Population density, people per sq.km	353	137
GDP per capita, USD (PPP)	2570	4390
Life expectancy at birth, years	63	71
Literacy rate, adult (% of people ages 15 and above)	61	91
Business environment (2003)		
Time to enforce a contract (days)	365	180
Time to resolve insolvency (years)	11	3
Time to start a business (days)	88	46

Source: World Development Indicators Database, World Bank.

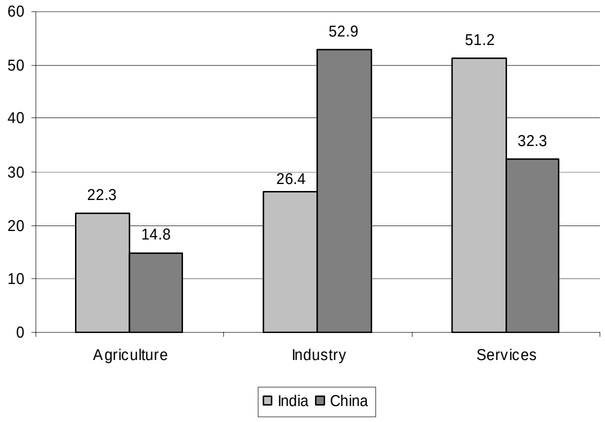
As regards economic policy, the approaches chosen by the two countries have been quite different: China has followed an outward-oriented strategy, while India's approach has clearly been more inward looking. Due to a severe macroeconomic and balance-of-payments crisis in 1991, the Indian authorities were forced to reconsider their policy stance, and since then India has gradually liberalised and opened up its economy. However, while it is becoming more difficult to characterise India's current approach concerning openness to international competition, its economy is still relatively closed by most measures. In addition to a relatively low ratio of exports to GDP (Chart 6), average trade-weighted import duty rates in India are much higher than in China or in other Asian countries. Moreover, non-tariff barriers are also high, and India has become one of the most active users of anti-dumping measures in the world.[9]

For over 20 years, India's economic growth has relied mainly on domestic demand and services output, while in China exports of goods and manufacturing industry have been the key drivers of the economy. Consequently, today the structure and dynamics of the Indian economy differ significantly from those of China, as evidenced by Chart 4. In addition to the higher share of services in Indian output, agriculture plays a more important role in India than in the Chinese economy.[10]

[9] On India’s openness, see Chauvin and Lemoine (2003), IMF (2003), and Wacziarg (2002).

[10] India’s agriculture is very vulnerable to weather conditions, as the monsoon rains can be very erratic and the irrigation system covers only one third of the cultivated area.

Chart 4. India's and China's structure of GDP in 2003, %



Source: OECD Main Economic Indicators.

Regarding future growth prospects, investment in infrastructure and production capital has been found to be an important factor in explaining differences in growth performance in developing countries. The GDP-share of investment has traditionally been higher in China than India, but this gap seems to have widened further since the 1980s (Chart 5). In general, given its development needs, India's investment ratio of about 23% of GDP must be considered low, while China's 35–45% is very high by any standards.

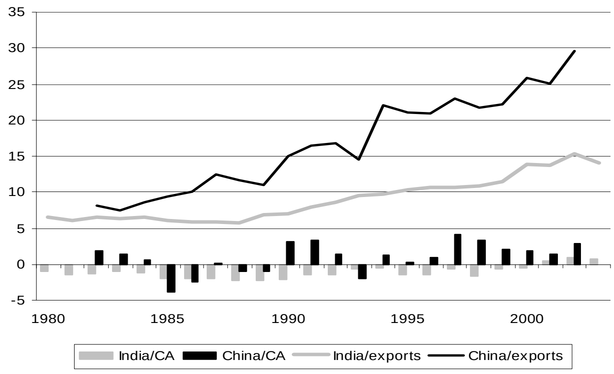
Policy differences concerning openness and integration to the world economy are reflected in trade figures (Chart 6). Thus, while Chinese exports of goods and services as a share of GDP have been steadily increasing since the beginning of the 1980s, in India the export share began to increase only around 1990. The rapid growth of Indian exports since the mid-1990s is largely due to the services sector, which currently accounts for about one third of India's total exports. Another noteworthy factor that has helped India to keep its current account in a reasonable balance is remittances by Indian citizens working abroad.[11] Contrary to many other emerging countries, India and China have avoided excessive current account deficits, and hence external indebtedness has not been a serious policy issue.

[11] In recent years, workers' remittances have amounted to 1.6–1.8% of GDP, while in the latter part of the 1990s they were still over 2% of GDP.

Chart 5. Fixed investment, % of GDP

Source: IFS.

Chart 6. Exports (goods and services) and the current account, % of GDP



Source: IFS.

During the last two decades, China has outperformed India by most economic indicators. Thus, in spite of similar initial income levels in 1980, China's current GDP per capita of more than 1000 dollars is roughly twice that of India. China has also been more successful in decreasing the level of poverty.[12] Moreover, China has become a major economic player in the world economy, while India's role in the world market is still relatively small and limited to a few industries, as evidenced by the sections that follow.

[12] Srinivasan, T., N. (2003).

Merchandise trade developments illustrate the differences between India and China

Since the beginning of 1980s, India's goods exports have constantly grown slower than China's, leading to significant differences in total trade volumes (Table 2). In 2003, India's merchandise exports expanded at about the same rate as world exports to USD 57 billion, while the value of Chinese exports of goods increased an astonishing 35% (partly due to a weakening of the dollar) totalling USD 438 billion. Thus, although the size of the Indian economy measured in dollars is already the third largest in Asia after Japan and China, the total value of exports of goods allows it only tenth place in the region.

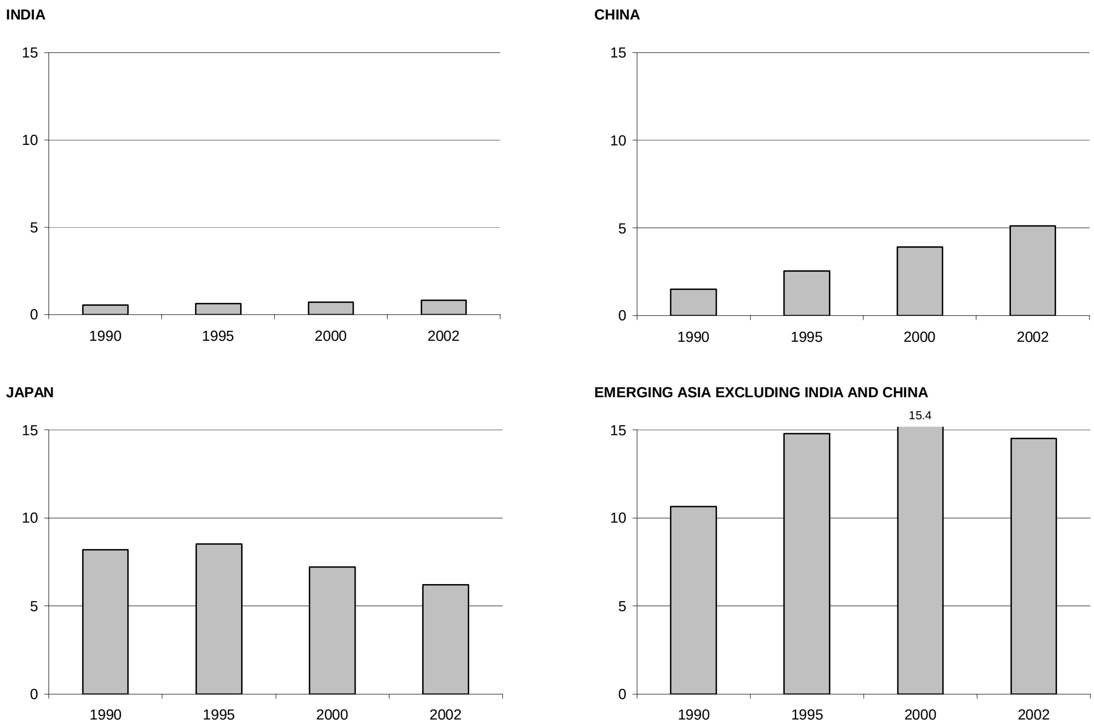
China's impressive export performance is also illustrated by its market share development (Chart 7). As regards merchandise exports, China has roughly doubled its market share to 5% since the mid-1990s. However, Chinese figures partly reflect its role as the assembly centre for the Asian electronics industry, and hence its market share gains in the world market have partly been counterweighted by market share losses by other Asian economies. In spite of healthy growth in recent years, India's share of the global merchandise trade is only about 1%.

Table 2. Annual growth of Indian, Chinese, and world exports, %

	Average 1980–2002	Average 1980s	Average 1990s	Average 2000–2002	2003	First half of 2004
India, total exports	9.4	6.9	9.9	15.2	12.2	
- Goods	9.1	7.9	8.9	13.1	13.0	21.9
- Services	10.6	4.0	13.7	20.0	10.3	
China, total exports	15.1	11.1	16.9	18.6		
- Goods	15.1	11.3	16.6	19.0	34.6	35.6
- Services	15.4	9.5	19.8	14.9		
World, goods exports	5.8	5.4	6.6	4.6	15.3	

Source: IFS for 1980–2002. The figures for 2003 and 2004 are from the RBI and DRI and do not necessarily correspond exactly with previous figures.

Chart 7. Asian countries' market share of world exports of goods, %



Note: China's figures do not include Hong Kong.
Source: IMF Balance of Payments Statistics.

In addition to growth performance, the development of the structure of exports indicates that the Indian economy has not been as flexible and dynamic as the Chinese economy (Tables 3 and 4). Firstly, in India exports of food, metal ore and petroleum products still account for over one fifth of total exports, while in China the share of food and primary commodities has rapidly declined to less than 8% of total exports. Secondly, machinery, office machines and electronics account for less than 10% of Indian exports, compared to over 40% in China.

Textiles and clothing are extremely important export items for both India and China. As world trade quotas on textiles will be removed at the beginning of 2005, this will have a major positive impact on Chinese and Indian exports of textiles and clothing in the coming years. According to a recent study by the WTO, the Chinese clothing industry's share of US imports could increase from the current 16% to 50% after the elimination of the quotas. India will also benefit, as its share in US imports is expected to rise from today's 4% to 15% in the coming years. While the European market will face similar changes, the overall impact will be smaller, as the quotas have not been as binding in Europe as in the US.[13]

An interesting feature of India's foreign trade is the role of gems and jewellery, as the international jewellery industry makes intensive use of cheap Indian labour to process gems and produce jewellery. The massive scale of this activity is demonstrated by the trade figures – gems and jewellery accounted for 16% of Indian exports and 10% of imports in 2002.[14]

[13] The results are based on GTAP model simulations. See Nordås (2004).

[14] In table 3, trade in gems and jewellery is included in "Metals and mineral manufactures".

Table 3. The structure of India's foreign trade, %

Exports	1985	1990	1995	2000	2002
Food and commodities	41.3	27.7	24.7	20.4	21.7
Chemicals	3.6	7.4	8.1	10.5	11.2
Textiles, clothing, footwear	22.2	27.3	28.6	28.3	24.2
Metals and minerals manufactures	15.6	19.6	21.6	22.4	23.7
Machinery	4.7	5.3	5.1	5.2	5.5
Office machines and electronics	1.7	2.1	2.5	2.7	2.9
Other manufactures	10.8	10.6	9.4	10.4	10.8
Total	100.0	100.0	100.0	100.0	100.0

Imports	1985	1990	1995	2000	2002
Food and raw materials	16.0	12.7	11.7	10.1	10.7
Energy	26.5	27.3	23.7	34.7	32.0
Chemicals	14.6	12.9	15.4	9.0	9.2
Metals and mineral manufactures	17.0	16.9	14.2	14.5	14.4
Industrial machinery	13.9	9.3	11.8	5.8	6.2
Office machines and electronics	4.0	4.9	5.4	7.4	9.6
Transportation equipment	2.9	3.9	3.0	1.9	3.1
Other	5.1	12.3	14.9	16.6	14.7
Total	100.0	100.0	100.0	100.0	100.0

Source: UN Comtrade database.

Table 4. The structure of China's foreign trade, %

Exports	1985	1990	1995	2000	2003
Food and commodities	53.9	25.8	14.4	10.2	7.9
Chemicals	3.9	6.0	6.1	4.9	4.5
Textiles, clothing, footwear	21.0	30.4	30.0	24.9	21.0
Metals and minerals manufactures	2.0	7.5	10.3	8.5	7.5
Machinery	1.5	10.7	6.3	8.2	8.7
Office machines and electronics	0.7	6.8	14.8	24.9	34.2
Other manufactures	16.9	12.9	18.1	18.4	16.2
Total	100.0	100.0	100.0	100.0	100.0

Imports	1985	1990	1995	2000	2003
Food and raw materials	14.8	16.3	14.6	11.6	10.6
Energy	0.6	2.4	3.9	9.2	7.1
Chemicals	7.1	12.5	13.1	13.4	11.9
Metals and mineral manufactures	21.1	8.3	9.4	9.4	9.7
Industrial machinery	22.0	19.1	20.4	11.9	12.6
Office machines and electronics	5.6	10.1	15.4	26.2	29.9
Transportation equipment	10.9	11.2	4.0	2.8	4.2
Other	17.9	20.2	19.2	15.6	14.1
Total	100.0	100.0	100.0	100.0	100.0

Source: UN Comtrade database.

As with exports, import figures also show that the Chinese economy has gone through a deeper transformation than India's. Food, raw materials, energy and basic metal manufactures account for two thirds of India's imports, while the respective figure for China is 40%. As regards investment goods, China's industrial machinery imports of USD 52 billion dwarf India's USD 4 billion imports in 2003. The high and increasing share of electronics, in particular electronic parts and components, in Chinese imports reflects China's growing role as the assembly centre for the Asian electronics industry, with considerable effects on trade flows in the region.

Due to its relatively modest domestic production capacity, India had to import about 70% of its crude oil consumption of about 113 million tonnes in 2003 (Table 5). Thus, oil imports account for about one third of the value of India's total imports, and hence changes in the world market price of oil have a major impact on India's terms of trade and external balance. In China, just one third of the country's total oil demand is covered by imported oil, and oil imports account for less than 10% of total imports.

Table 5. Oil production and consumption in India and China in 2003, million tonnes

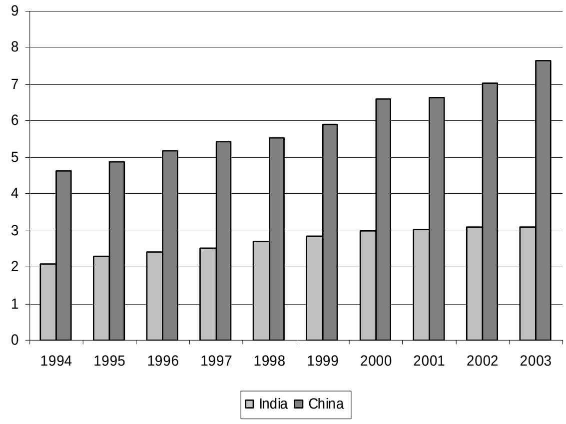
	India	China
Production	37	169
Consumption	113	275
Difference	-76	-106

Note: In addition to imports, the difference figure also takes into account changes in stocks and statistical discrepancies due to definition and measurement disparities in production and consumption data.
Source: BP 2004 Statistical Review of World Energy.

Media coverage related to the upsurge in international oil prices would make it seem as if India and China were almost equally important buyers in the global oil market. However, a closer look at oil market data indicates that such a perception is perhaps not correct (Chart 8). While the domestic output of oil in both countries is stable or increasing only slowly, China's oil demand and, as a consequence, imports have been growing much faster than India's demand and imports. Hence, since the late-1990s China has imported in volume terms more oil than India, and the difference in this respect is widening. The IEA estimates that China's demand for oil in the first half of 2004 increased about 20% year-on-year, against about 7% in India and 4% globally.[15]

[15] There are major problems with the Chinese and Indian oil statistics. In particular, the data on oil stocks is inadequate. This gives room for speculation on actual purchases of oil by India and China.

Chart 8. Development of India's and China's share of global oil demand, %



Source: BP 2004 Statistical Review of World Energy.

India has benefited from the boom in offshore outsourcing of services

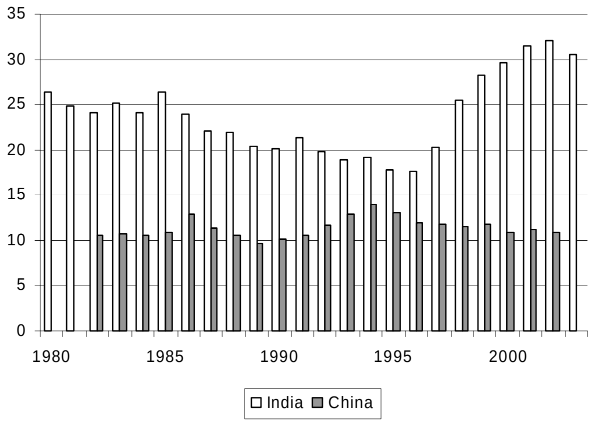
Contrary to merchandise exports, in services trading India plays a more prominent global role and in this field has been able to challenge China. This is largely due to recent developments in the offshore outsourcing of various software and business services.

Until the mid-1990s, China's exports of services increased faster than India's. However, due to a boom in the offshore outsourcing of various information technology, business process and call-centre work (IT/BPO)[16] from major industrial countries, India's service sector has experienced extraordinary growth during the last 10 years. As a consequence, the share of services in India's total exports of goods and services has increased to about one third. In China, the respective share has been relatively stable at around 10–14% (Chart 9).

In spite of the recent rapid growth in exports of outsourcing services from India, China is still a bigger exporter as far as exports of total services are concerned. In 2002, Chinese services exports totalled USD 40 billion (2.4% of the world market), against 25 billion (1.5%) from India. However, in business services, which are more directly linked to the outsourcing business, India has managed to outperform China, as evidenced by Chart 10. As with goods exports, the market share gains of India and China in services trading have been counterweighted by significant market share losses by other Asian countries.

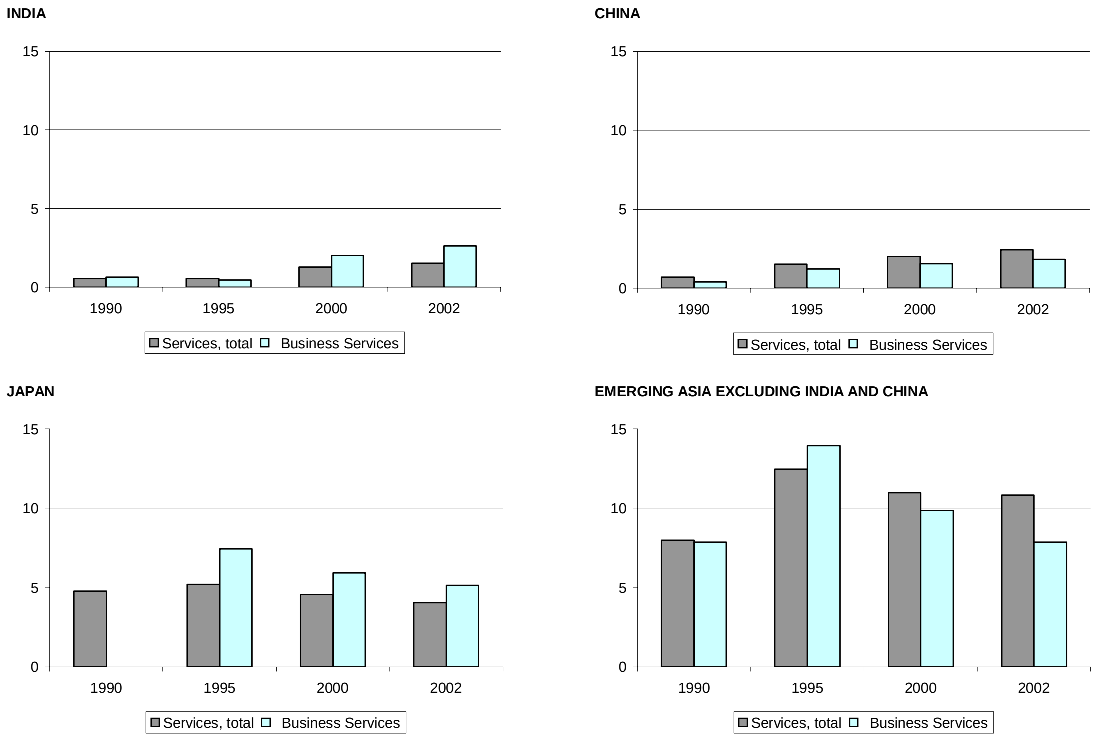
[16] Due to the increasing number of services provided by the offshore outsourcing industry, the terminology is yet to be established and abbreviations like ITES (information technology enabled services), BPO (business process outsourcing), and IT/BPO are frequently used to illustrate typical offshore outsourcing activities.

Chart 9. The share of services in total exports, %



Source: IFS. The 2003 figure for India is from the RBI's balance of payments statistics, and hence it is not necessarily comparable to previous figures.

Chart 10. Asian countries' market share of world services exports, %[17]



Note: China's figures do not include Hong Kong.
Source: IMF Balance of Payments Statistics.

[17] 'Business services' refer to services other than travel and transportation, ie trade in IT/BPO services is included in this category.

Macroeconomic effects of India's outsourcing business may have been exaggerated

India's success in the outsourcing business has raised a lot of interest among politicians, business people and trade unions. However, the picture concerning India's economic potential and impact on the global economy is confusing, as people tend to overemphasise either possibilities or threats related to services outsourcing.

The rise in offshore outsourcing of various services is mainly due to technological developments that enable efficient transfer of data and information over long distances. India's success in the field is explained by several additional factors. Firstly, India has a large pool of skilled, English-speaking and relatively low-cost labour. Secondly, contrary to most other sectors in the country, the IT/BPO industry has enjoyed a liberal regulatory environment that has promoted competition and inflow of foreign direct investment (FDI). Moreover, India's geographical location allows it to exploit time zone differences, which is a significant advantage in certain back-office activities.

Large-scale offshore outsourcing of software and business services is a relatively new phenomenon, as only in 1996 did India's exports of IT/BPO services exceed the USD 1 billion mark. However, since then growth in the sector has been impressive, and in 2003 exports exceeded USD 12 billion. The software and business process outsourcing industry already accounts for about 40% of total services exports from India. Moreover, compared to China, where local enterprises in this sector are still relatively small, in India the largest domestic companies (Tata, Infosys, Wipro) have already expanded their activities into other countries – including China. Thus the biggest Indian companies are already true global players.

The prospects of the Indian software and business process services sector are promising, although the market is continuously changing and new competitors are emerging in Asia and elsewhere.[18] However, while the offshore outsourcing of IT/BPO work will remain an important issue at enterprise level everywhere, the macroeconomic impacts of this industry on the Indian economy or at the global level are perhaps smaller than one would expect given the media coverage of the issue.

According to the Indian IT industry association NASSCOM, the IT/BPO sector in India employs less than one million people, which is a negligible number compared to the total workforce. Total sales of the IT/BPO industry in relation to GDP have increased during the last half decade from about 1% to close to 4%, and hence the share of value added (ie the GDP share) produced by the sector must be even less. The IT/BPO sector may have important spillover effects on other sectors of the economy, and it certainly serves as a good example of pro-market reforms. However, factors other than services exports will continue to dominate the overall economic development of India in the coming years.

In similar vein, the development of the Indian service industry is likely to be a smaller threat to the industrial countries than one would expect from the media coverage. The US accounts for about 70–80% (about USD 9 billion) of India's exports of IT/BPO services. However, while this is some 6–7% of total US imports of 'business services',

[18] Investment banks and research companies (eg AT Kearney, Deloitte, Forrester, Gartner, and McKinsey Global Institute) provide analysis and forecasts on the IT/BPO business. As regards India, the source most often cited is the Indian IT industry association NASSCOM.

imports from India are unlikely to pose a major threat to the US economy and employment. In the euro area, India's role is evidently much smaller than in the US.[19]

In fact, there are good reasons to believe that outsourcing is not a zero-sum game, but brings more benefits than costs to all participants, as suggested by the basic theory of international trade. From this perspective it is possible that the euro area countries have suffered in relative terms from the uneven competitive situation created by offshore outsourcing developments since the mid-1990s. Thus, for example, compared to enterprises in the US and the UK, enterprises in the euro area – largely due to their exotic language demands – have found it more difficult to cut their costs through offshore outsourcing.[20]

In order to give a rough idea how the relative positions of industrial countries in the global services market have changed, Table 6 reports market share development in the US, the UK and the three largest euro area countries. As regards the US and the UK, there is no evidence that they have lost their share of the global market for services. In fact, they both seem to have significantly increased their market share in the 'business services' category. Given their good external competitiveness, it is perhaps difficult to argue that countries like India could be a major threat to their domestic markets either. As regards the euro area, the situation seems to be somewhat different, as Germany has managed to retain its market share, while France and Italy lost ground particularly during the 1990s. Thus, although serious problems related to statistics on services trading make any conclusions very tentative, there seems to be some indication that at least some euro area countries have not been able to make use of the new business opportunities brought about by recent advances in IT technology.

[19] Although there are significant problems concerning services statistics and related employment data, recent research on the IT/BPO services industry indicates that the scale of offshore outsourcing is still relatively small compared to domestic supply of the same services. Moreover, job losses related to offshore outsourcing of various services are relatively small compared to other factors affecting labour markets in industrial countries. Many of these issues are covered by the articles of Brainard and Litan (2004), Cronin, Catchpowle and Hall (2004), Kirkegaard (2004) and Liikanen (2004), which can be found in CESifo Forum, volume 5, No. 2, 2004. Drezner (2004) offers an extensive review of the debate on outsourcing in the US.

[20] A recent study by UNCTAD and Roland Berger Strategy Consultants (2004) analyses the service offshore strategies of the top 500 European companies.

Table 6. Industrial countries' market shares of world services exports, %

		1990	1995	2000	2002
United States	Total Services	17.0	17.2	19.5	17.8
	Business Services	15.6	15.1	19.4	19.4
United Kingdom	Total Services	6.5	5.8	7.7	7.7
	Business Services	7.8	6.9	11.2	11.5
France	Total Services	8.8	7.8	5.3	5.3
	Business Services	11.8	9.4	4.6	4.7
Germany	Total Services	7.7	6.5	5.7	6.5
	Business Services	8.0	7.3	6.7	7.5
Italy	Total Services	5.8	5.2	3.7	3.7
	Business Services	6.7	4.2	2.9	3.2

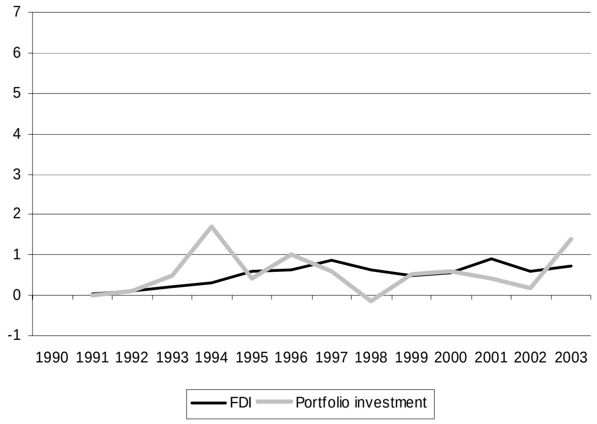
Note: Figures correspond to those in Chart 7 for the Asian countries. 'Business services' refer to services other than travel and transportation; trade in IT/BPO services is included in this category. Source: IMF Balance of Payments Statistics.

FDI developments underline India's weak integration into the global economy

Investment flows into India illustrate well the consequences of the country's inward-looking policies. Due to strict regulations effectively limiting foreign ownership, direct and portfolio investment in the Indian economy has been very limited (Charts 11 and 12). The major exceptions in this respect seem to be some services (business services, telecommunications, and hotels and restaurants) and the car industry, which have gradually been liberalised and opened up for foreign companies. Due to enhanced competition, imported capital and know-how, the growth performance of these sectors has been impressive. The prominent role of foreign capital is demonstrated by the fact that multinational companies account for almost half of India's exports of business process outsourcing services, although domestic enterprises dominate software exports. In a similar manner, due to stiff competition brought about by a dozen foreign car manufacturers, India's car industry is today one of the most dynamic in the world.[21]

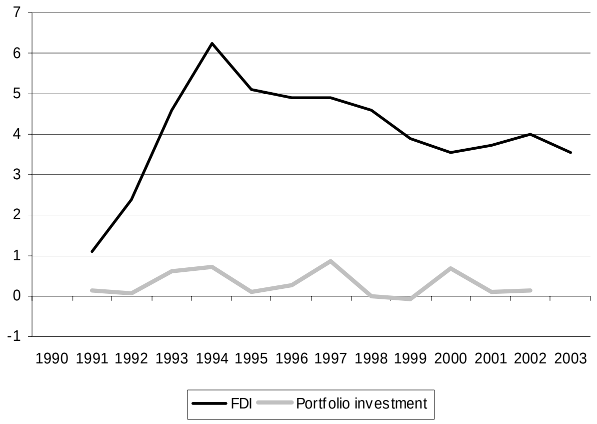
[21] For more on the role of FDI in India’s IT/BPO and car industry, see World Bank (2004) and Farrell and Zainulbhai (2004).

Chart 11. India's FDI and portfolio inflows, % of GDP



Source: Balance of Payments Statistics, IMF.

Chart 12. China's FDI and portfolio inflows, % of GDP



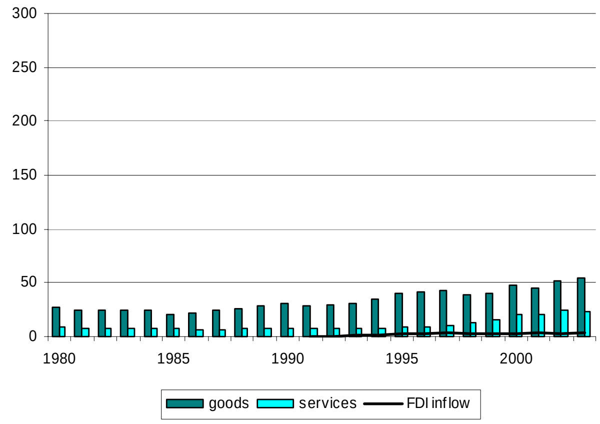
Source: Balance of Payments Statistics, IMF.

Contrary to India, the Chinese economy has been open to foreign direct investment, which has had a major impact on China's economic growth since the early 1990s. Today, multinational companies account for about half of country's exports.[22] However, as a consequence of very strict requirements concerning the participation of foreigners in equity trading and the fact that the state still holds majority stakes in nearly all listed companies, the role of portfolio investment remains negligible in China as well.[23]

[22] For an interesting account concerning the impact of FDIs on competition and prices in China, see Farrell, Gao and Orr (2004).

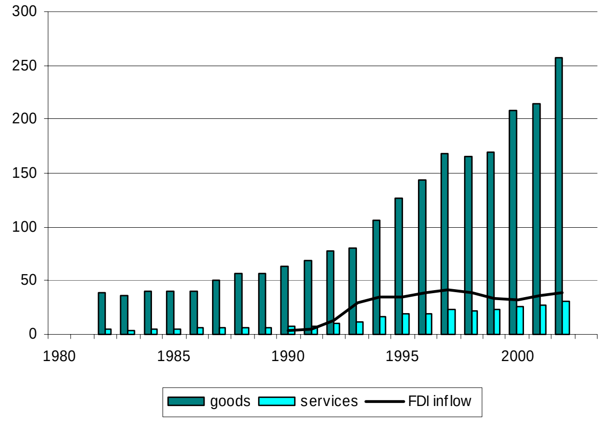
[23] BOFIT Weekly 3/2004 and Andy G. Ji (2004), Chinese stock market struggle to find its place in the SEO reform, BOFIT China Review 1-2/2004.

Chart 13. India: Exports and FDI inflow, per capita in 2003 dollars



Source: IFS.

Chart 14. China: Exports and FDI inflow, per capita in 2003 dollars



Source: IFS.

In order to summarise the diverse developments in India and China during recent decades, per capita figures on trade and FDI offer a complementary view of the involvement of these countries in the global economy. Charts 13 and 14 illustrate how much each Chinese and Indian citizen, on average, earned in export revenues and attracted foreign direct investment measured in constant US dollars in 1980–2003. The big picture emerging from these and earlier charts is clear. China's stronger overall economic performance is associated with rapidly increasing per capita trade and significant FDI inflows. In India, for its part, it is still difficult to identify any significant changes in these respects.

Conclusions

In 1991, India was hit by a severe macroeconomic and balance of payments crisis that forced the authorities to reconsider the country's economic policy based on protectionism, heavy regulatory and control systems and state ownership of numerous sectors of the economy. Accordingly, India started to liberalise and open up its economy, though this has happened very gradually. However, the change in policy stance together with India's good growth performance – particularly its phenomenal emergence as a global hub for offshore outsourcing of IT/BPO services – have given rise to great optimism concerning India's economic future. Many commentators seem to think its role in the world economy is already comparable to that of China.

However, in spite of India's growing importance in the global economy, comparisons with China seem premature. A closer look at merchandise trading volumes, market shares, and foreign investment figures reveals that India is far behind China as far as international influence is concerned. An interesting exception is the services industry, where India already plays an important global role. Despite the vitality of this sector, however, its weight in the Indian as well as in the global economy is relatively small. Moreover, other emerging countries including China have shown rising interest in the services offshore outsourcing business, which in the course of time may threaten India's current dominance in the field. Consequently, it is unlikely that India can count too much on the IT/BPO sector as far as its growth prospects and international role are concerned.

Looking to the future, three possible scenarios emerge that could be used to outline the prospects for the Indian economy. In the first scenario the Indian economy manages to sustain its current growth momentum and steadily increases its influence in the world economy. However, simple computations indicate that its relatively low starting level mean that India's international role would change only slowly in the near future. Thus, for example, if Indian exports continue to grow by 15% annually, this would mean that its total imports in constant US dollars in 2010 would be less than half of what China exports today.

The second scenario assumes radical changes in India's reform policies and openness that would improve long-term growth prospects through increased FDI inflows. In spite of positive long-term effects, reforms would take time and would perhaps even imply some costs in terms of short-term economic growth. Consequently, it is very likely that, under this scenario too, India would fail to significantly increase its global role before 2010.

The third scenario is a crisis scenario. Particularly due to its extremely poor fiscal position, India is vulnerable to possible negative shocks to its economy (eg oil prices, interest rates). A negative macroeconomic shock together with a possible fiscal crisis would by definition be detrimental to short-term growth. However, as evidence from India and elsewhere suggest, there might be a connection between scenarios two and three in that bold reforms are perhaps possible only after a major crisis.

Thus, while India's current situation resembles in certain respects that of China about ten years ago, it seems unlikely that India will be able to repeat the Chinese example and become a major player in the world economy by 2010. Consequently, India's impact on the euro area, too, will remain limited during the next five years or so. However, if India manages to sustain current growth momentum, the situation may already look quite different by the first half of the next decade.

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