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Service-led growth and the balance of payments constraint in India: An unsustainable strategy

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Abstract: India has been an exemplary case of economic growth, lionized in the international press as one of the emerging market economies that will take over the world economy in the current century. The Indian services revolution is often cited as an example of an alternative development strategy under which the process of growth is services-led, as against the traditional manufacturing-led paradigm that has historically been the case. This paper suggests that the Indian development strategy actually looks eerily similar to the Central American and Mexican patterns of integration into the world economy, which are highly dependent on the exports of people, directly through migration, and indirectly through low wages in particular sectors ('maquilas' in the Americas, the call centers in India), even if the growth rates in India have been considerably higher than in those Latin American regions.

Key Words: Economic Development, Service Sector, India
JEL Codes: O11, O14, O53

[1] The opinions expressed are strictly those of the authors and do not coincide with the institutions to which they are affiliated.

Introduction

It is well known that the balance of payments is an important demand constraint to growth in an open economy. A country's imports cannot grow faster than the rate of growth of its exports permanently without incurring a balance of payments crisis, and imports depend on output growth, which means that the balance of payments becomes a recurrent problem if imports outpace exports.[2] Consequently, achieving a higher long-run rate of growth would require a country to reduce its balance of payments (BOP) constraint through an improved export performance and the production of import substitutes, which would lower the income elasticity of demand for imports.

A country therefore needs to direct policy efforts towards making its exports more attractive and competitive in external markets, and at developing import substitutes if demand is to be expanded without hitting the proverbial balance of payments constraint. While a country that does not have an international reserve and vehicle currency may temporarily grow beyond its BOP constraint, if capital inflows are available, eventually exports would need to grow sufficiently to cover, not just imports, but also the service of factor payments associated with the capital inflows. In other words, the BOP constraint is the fundamental limit to economic growth in peripheral countries.

Besides a reduced balance of payments constraint, in developing countries, a growth and development process that is both sustainable and inclusive also requires a transformation of the productive base of the economy, or the generation of high productivity activities, good quality

[2] Thirlwall (1979) famously argued that the growth rate consistent with balance of payments equilibrium depends on the ratio of the growth rate of exports to the income elasticity of demand for imports. This has been known as Thirlwall's Law, and a significant body of evidence was gathered in McCombie and Thirlwall (1994). The idea of the crucial importance of an external constraint to economic growth in peripheral countries harks back to Raúl Prebisch's work at the Economic Commission for Latin America (ECLA). See Prebisch (1959). Indian development pioneers like Prasanta Mahalanobis seemed more concerned with the capital requirements associated with what was called the Big Push. See Mahalanobis (1953).

employment, and greater domestic value-added. Even if a developing country manages to reduce its balance of payments constraint, concentrated improvements in productivity and employment, and disguised unemployment may remain at the industrial level. Thus, active policy efforts to generate quality employment on a wide scale, and improve productivity in different industrial and agricultural activities would be crucial. Since the classic work by Baumol there have been serious doubts about the possibilities for services to lead to significantly large increases in productivity, which should lead to serious questions about the Indian service-led development strategy.

Furthermore, as a reduction of the balance of payments constraint in India is the result of an improvement in the net exports of services, rather than an improvement in the external competitiveness of manufacturing exports, which seems to be incapable of eliminating the persistent trade and current account deficits, the country exhibits an increasing dependency on financial inflows and remittances. Dependency on service workers often associated to the information and telecommunication sectors, in the now infamous call centers, financial openness, and dependency on remittances from immigrants hardly seem like the constitutive elements of a development strategy worth emulating. Even if the economy can grow at relatively fast pace in the medium run, the sustainability of such strategy is highly questionable.

This paper suggests that the Indian development strategy actually looks eerily similar to the Central American and Mexican patterns of integration into the world economy, which are highly dependent on the exports of people, directly through migration, and indirectly through low wages in particular sectors (‘maquilas’ in the Americas, the call centers in India), even if the growth rates in India have been considerably higher than in those Latin American regions. The rest of the paper is divided in two sections. The next section discusses the limitations of the

Indian development strategy, emphasizing the sustainability issues related to the BOP. The following section compares the Indian development strategy with Latin America, and concludes that beyond questions of sustainability the limitations of the Indian strategy to raise living standards of the population as a whole should be seriously doubted. We conclude with a plea for change.

Cyber Coolies and the BOP constraint

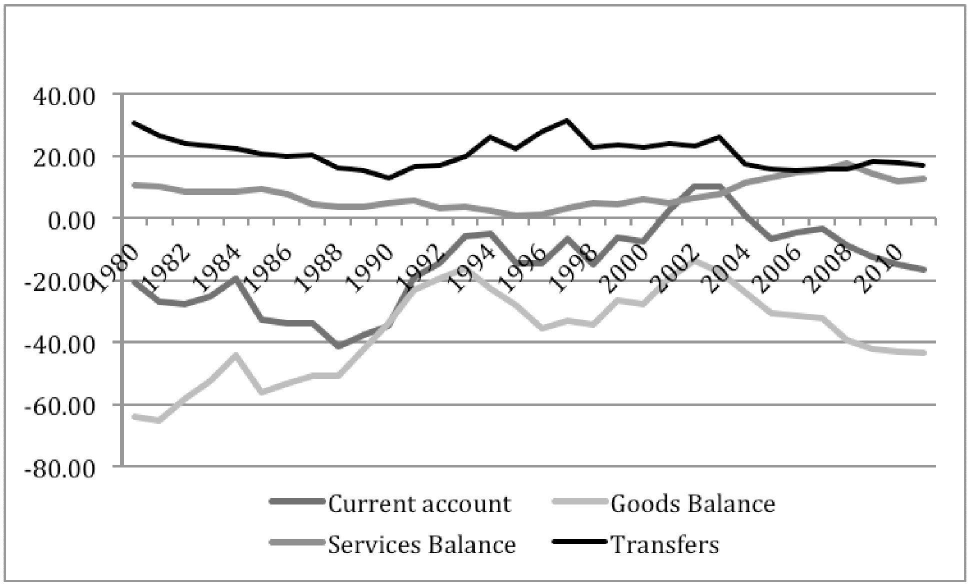
India has been an exemplary case of economic growth, lionized in the international press as one of the BRICS, the emerging market economies that will take over the world economy in the current century. The Indian services revolution is often cited as an example of an alternative development strategy under which the process of growth is services-led, as against the traditional manufacturing-led paradigm that has historically been the case (RBI Monthly Bulletin, 2009; World Bank, 2011). Until recently, barring a few economists that have emphasized the inequalities associated with the Indian development strategy (e.g. Bhaduri, 2008), there has been little concern about the potential fragility of India's current services-led growth and persistent trade and current account deficits in the media, policy and academic circles.[3]

Figure 1 shows the evolution of the current account, the exports of goods, the exports of services and the net flow of remittances, all as a share of exports of goods and services, from 1980 onwards. Two features are particularly striking in the Indian experience. Contrary to what most people think, in part influenced by the Chinese export-led growth strategy of the last three decades, India maintains a persistent deficit in goods, which exploded in the last decade and is

[3] A notable exception is Rakshit (2009), who has explicitly noted the limitations of the service-led strategy. His main concern is with the fact that in spite of high growth, labor absorption in services has been awfully small. While the point is important and well taken, our main concerns in this paper, as it will be seen, lie somewhere else. For more on the problems associated with the quantity and quality of jobs created by the liberalization process in India see Nabar-Bhaduri (2011).

only partially compensated by a surplus in trade in services (implying significant trade deficits, of around 30% of total exports, which are not shown in the figure), which increased mostly in the last decade. The other feature is that the current account deficit has also been more or less perennial, with a brief period of surplus in the middle of the first decade in this millennium. The current account deficits have not been bigger because the net inflows of remittances have remained fairly large throughout the whole period.

Figure 1 External Balances (% Exports)



Source: World Economic Outlook, IMF

The arguments dismissing the potential risks entailed in these persistent current account and trade deficits have adopted a rather myopic approach, asserting that higher current account deficits facilitate the attainment of higher rates of economic growth. There are three lines of reasoning along which these arguments have generally proceeded. One line has argued that earnings from the invisibles component of the current account (mainly remittances and the exports of services) have helped to sustain these deficits and that those can be counted to continue in the foreseeable future (see, for example, RBI Monthly Bulletin, September 2009). A second line of argumentation has suggested that the surge in trade deficits since the mid-2000s reflect the requirements of rapid economic growth, since it is non-oil, rather than oil imports that have pushed up these deficits (e.g. Patnaik, 2003; Sohrabji, 2010). The third line of reasoning has focused on the ability of capital inflows to close the gap opened by the current account deficit, and has argued that the greater freedom on capital flows in India in the post-liberalization period has aided the private sector to smooth out its consumption path (e.g. Barua, 2005; Khundrakpam and Ranjan 2008).

It has also been argued that Foreign Direct Investment (FDI) inflows will help to make India's balance of payments sustainable by increasing the competitiveness of Indian industry, stimulating exports and enhancing foreign exchange reserves. Indeed, Khundrakpam and Ranjan (2008) boldly conclude that by enabling private players to further smooth out their consumption or by running higher current account deficits, further liberalization of capital flows in India will facilitate the attainment of yet higher rates of economic growth! Nevertheless, some Indian economists have emphasized that the current growth trajectory has inherent elements of instability, is not capable of generating a sustainable path of development and entails significant financial fragility risks. More recently, in the wake of the recent global economic recession, the slow economic recovery in the United States and the onset of the economic recession in Europe in the backdrop of the euro crisis, some alarm bells about the unsustainability of these external deficits have even begun to sound in Indian policy circles (e.g. Strategic Plan, Indian Ministry of Commerce, 2010; The Economic Times, 25 January 2011). In our view, the main risks associated with the current Indian development strategy come from the dependency on service exports, on the one hand, and the increasing liberalization of the financial account and the increasing need of capital inflows, on the other, that the persistent current account deficits entail.

Banga (2006) and Rakshit (2009) emphasize that the rapid growth of services, and not just the exports of services, has been accompanied by a decline in the share of agriculture and manufacturing in GDP, and that the declining share of manufacturing has occurred before India has reached a mature stage of industrialization. They further emphasize the failure of this rapid growth of services to generate adequate employment opportunities. Rakshit (2009) shows that from a growth rate of 4.89 per cent between 1983-84 and 1987-88, employment growth in the services sector has consistently fallen over time, and was about 1.6 per cent during the period 1999-2000 to 2004-05.[4] Rakshit's findings reflect the fact that the main drivers of this services-led growth are the software, business, finance and communications sectors that have relatively low employment elasticites. Further, he argues that there still remain the questions of meeting the needs of food, clothing, investment and industrial products that must constitute a large part of consumption before a sufficiently high standard of living can be attained. This raises strong doubts over the sustainability of the current growth path in a poor and large country like India.[5]

There is, also, a well known problem associated with a service-led development strategy related to Baumol's disease, which suggests that productivity in the service sector tends to grow at a snail pace if at all. Baumol and Bowen (1965, p. 500), argued that: "the output per man-hour of the violinist playing a Schubert quartet in a standard concert hall is relatively fixed, and it is fairly difficult to reduce the number of actors necessary for a performance of Henry IV, Part I."

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[4] Nabar-Bhaduri (2011) similarly shows that the export-led strategy in India has limitations since the sectors that have been able to catch up with the developed world have relatively low employment elasticity.

[5] Adopting a detailed input-output analysis to study the linkages of the service sector with the rest of the economy, Hansda (2005) finds that while services have become an important input content in the industrial sector, the growth of the industrial sector is an equally important pace setter for overall services growth. Thus, for services-led growth to be sustainable, a growing industrial sector is a necessary condition.

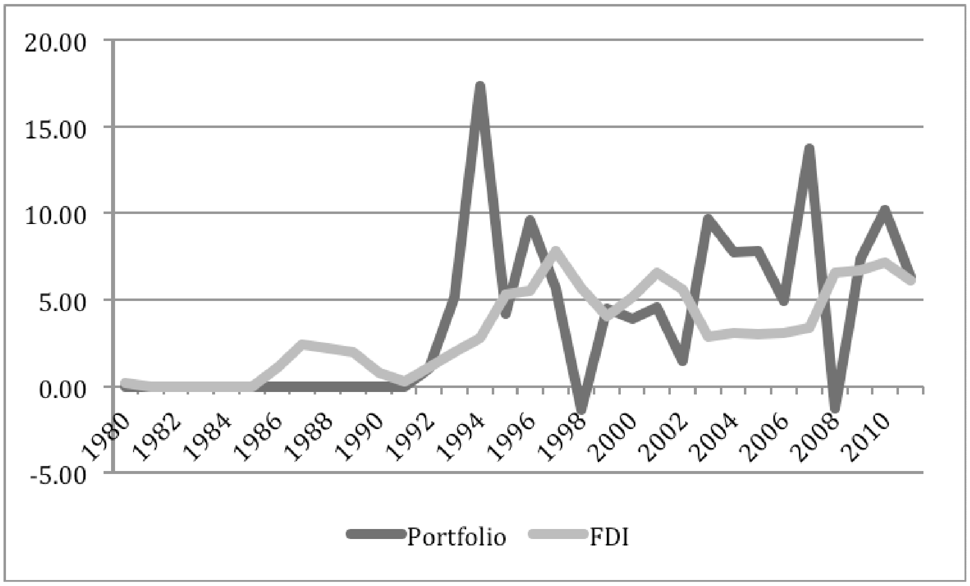
That should not be confused, obviously, with lack of productivity in the services sector as a whole, but it should be noted that the quality of the services often improves as a result of higher productivity in manufacturing.[6] For example, the improvements in the phonographic, cinematographic, the electronic, and the telecommunications industries implies that more people have access to Schubert's quartets and Shakespeare's' plays at lower costs. In the same way, that Prebisch had suggested that countries that specialized in the production and export of primary commodities could not benefit from the increases in productivity, which were not translated into higher wages, but were transmitted to the consumers in world markets by lower prices of commodities, one can argue that a service-led strategy will not be translated into higher wages in the call centers in India, but in lower prices for those services in the developed countries. In that sense, even if service exports continue to grow sufficiently fast to compensate the growing trade deficits in goods, and the persistent current account deficit, it might represent a limited development strategy.[7]

Also, the sustainability of the Indian strategy depends crucially on the financial liberalization process that started after liberalization in 1991. Figure 2 shows net Foreign Direct Investment and Portfolio flows as a share of total exports, and it is clear that they have increased significantly after liberalization. Also, it is evident that portfolio flows have been more volatile, than FDI flows, with net outflows after the Asian crisis and more recently after the so-called Great Recession.

[6] Kaldor's first law suggests that output as a whole is related to the rate of growth in the manufacturing sector. In that sense, both the primary sector and the tertiary sector depend on manufacturing for the increase in the rate of productivity growth (Kaldor, 1966).

[7] Mazumdar (2008) notes that since liberalization, investment growth has been driven by the private corporate sector, with a contraction of public investment in key sectors, which also creates a long-run constraint to economic development.

Figure 2 Financial Flows (% Exports)



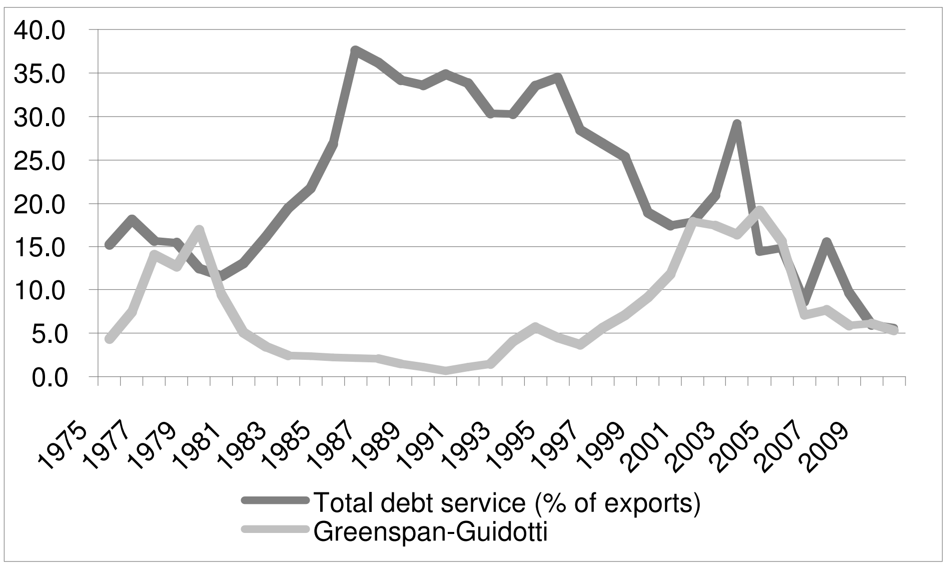
Source: World Economic Outlook, IMF

Chandrasekhar and Ghosh (2010) argue that increases in Foreign Direct Investment inflows need not be accompanied by an increase in exports. The domestic, rather than the external market, is the major focus of foreign investors. Despite the rapid increase in FDI inflows in the 2000s, the export intensity of Foreign Direct Investment Companies (FDICs) in India has remained relatively stable. Chandrasekhar and Ghosh (2010) further show that with liberalization of FDI norms, there has also been an increase in net foreign exchange outflows in India, particularly during the period between 2002-03 and 2006-07. They attribute this to the two effects typically entailed by a greater liberalization of FDI norms. First, a more liberal regime is likely to increase the imports of FDICs on account of considerations such as transfer pricing, easier access to product innovations in external markets; etc. Indeed, the ratio of imports to exports of FDICs in India has risen rapidly in the 2000s, and stood at 158.5% in 2007-08 (Chandrasekhar and Ghosh, 2009). Second, with increased foreign shareholding in joint ventures and/or the acquisition of domestic firms, royalty and technical fee payments; and the repatriation of profits and/or dividends to the parent company are likely to increase.

Besides liberalizing FDI norms since the 1990s, the post-liberalization period has also witnessed policy efforts to liberalize portfolio inflows (Figure 2). In fact, portfolio inflows have exceeded FDI inflows in many years. As discussed earlier, it has been argued that these inflows are helping to sustain India's external imbalances, and, thus, the latter should not be considered to be worrisome or unsustainable. Some circles have even called for a further liberalization of capital inflows. However, these arguments neglect the potential financial fragility that such unrestricted inflows can entail. As Nayyar (2002) argues, when short-term inflows such as portfolio investment become a major means of financing trade and current account deficits, the resulting appreciation of the real effective exchange rate further widens these deficits. A vicious circle emerges, with these larger deficits requiring even greater portfolio investment inflows, which further increase net external liabilities. Moreover, the very persistence of large trade deficits may, over time, reduce investor confidence, and generate adverse expectations, ultimately resulting in a reversal of inflows and speculative attacks on the domestic currency. Thus, persistent trade deficits could potentially lead to a financial crisis and debt servicing problems in the long-run.

Note that we are not suggesting that, in spite of persistent trade and current account deficits, India is close to a BOP crisis. In fact, when one looks at basic indicators of the ability to finance its external position the economy seems to be doing fairly well. Total debt services as a share of exports remains at low levels, slightly above 5%, and the so-called Guidotti- Greenspan rule that says that countries should hold in reserves 100% of the short-term debt is also clearly maintained (see Figure 3). Total debt service as a share of exports increases with periods of international crisis, like the debt crisis in the early 1980s, the Asian crisis in the late 1990s, and the Great Recession in the late 2000s, but never reaches dangerous levels. The Guidotti-Greenspan line in the graph shows the inverse of short-term debt obligations to international reserves, and was clearly, with the exception of the period in the late 1980s and early 1990s, at safe levels.

Figure 3 Debt-Export and Reserves-Debt Ratios



Source: World Bank Development Indicators

Yet, the fact that no BOP crisis seems to be imminent does not imply that the development strategy is sustainable in the long-run. Particularly problematic, from our perspective, is that while the Indian model of development is seen as an example to other emerging economies, its dependence on remittances and exports from a low wage services sector, which is not very dynamic from the technological point of view, is not very different from the Latin American development strategy, one that has been considered considerably less innovative and much more prone to external crises than the Asian experience.

India in the Latin American Mirror

India's services-led growth has been unable to address the problem of absorbing surplus labor into high-productivity jobs. The main drivers of services-led growth have been in sectors such as business, finance communications and software, in which technological progress takes place essentially in the industrial sector that produces the equipment used, rather than in the delivery of the service, which, in turn, are not produced in India. In addition, the ability of the business, finance, communications and software services sectors to incorporate workers has been insufficient given the size of the India labor force. That is why India's failure to significantly accelerate the growth of its manufacturing and agricultural sectors in the post-liberalization period is problematic. As a result, of the service-led development strategy open and disguised unemployment therefore remain an acute problem in the Indian economy. Around 78% of the labor force continues to be rural, with the agricultural sector accounting for around 60% of total employment, despite a very low productivity. In industry and services, the urban formal sector employs only around 7% of the workforce. The remaining employment in industry and services is in the urban informal sector, with wages and work conditions much poorer compared to the organized sector, and closer to those in the rural areas (Anant *et al.*, 2006).

Besides the unemployment problem, there is another factor that casts doubts on whether this current growth path is sustainable. This is the constraint imposed by external demand – there is no guarantee that the current strong export performance of India's services can be indefinitely sustained, and generate sufficient foreign exchange earnings to finance rising trade deficits indefinitely. To make things worse, it is highly unlikely that the benefits of service exports would be accrued by workers in the domestic sector, which would imply higher wages and expansion of formal domestic markets. In fact, the competitive advantage of the Indian call centers is their low wages by international standards, and the fact that as an ex-colony of Britain, English is a fairly common second language.

The growth in services is, in part, associated with the expansion of services exports, which, in turn, are related to the offshoring process in the developed world. India has an edge because it provides English-speaking workers at a highly competitive price, which explains why it has become the preferred choice for offshoring. The English speaking advantage, the relatively high levels of education of the labor force, and the relatively low wages by international standards are often used to explain the competitive advantage of the Indian economy in the services sector. The main problem with the service-led development strategy is that the technological improvements in the software and telecommunications industries that have allowed for the expansion of the service sector India, have not remained in India in the form of higher wages, and have not helped significantly in the increase of the domestic market. Trivedi (2003) has characterized call centers as "brutally exploitative" and its employees as "cyber coolies of our global age, working not on sugar plantations but on flickering screens, and lashed into submission through vigilant and punitive monitoring, each slip in accent or lapse in pretence meaning a cut in wages." In this sense, call centers are not very different from 'maquilas' in Mexico and Central America, which also cannot be seen as models of development, being also brutally exploitative, and depending basically on low wages, without transferring significant amounts of the gains of technological change to the workers in the developing countries.

Further, the dependence on remittances and export of business and communications services means that, as much as certain Latin American countries, in particular Mexico and Central American countries, India depends on exporting people (Pérez Caldentey and Vernengo, 2010). In the case of India the immigrants tend to be highly educated, and the low wage workers are not in the 'maquila' sector, but in the services sector. As in the case of Latin America, in India the inability to incorporate surplus workers in the more dynamic sectors of the economy, or to raise the levels of employment and productivity in its agricultural and manufacturing sectors, implies that disguised unemployment remains high. Reflected in the Latin American mirror the Indian strategy seems less impressive.

There is therefore a strong need to direct more active policy efforts towards generating good quality employment and accelerating the growth and competitiveness of the industrial sector if India's growth and development process is to be made more sustainable, inclusive and humane. These must include direct employment generation programs (e.g. infrastructural projects and rural development programs), and policy efforts to accelerate the growth and expansion of the Indian industry. To facilitate the expansion of industry, policy efforts must be directed at improving the technological capabilities and production efficiency of different industries. These could take the form of more active research and development (R&D) programs through public-private partnerships, credit policies that will make it easier for industrial entrepreneurs to replace outdated or inefficient capital equipment, the establishment of more development financial institutions and subsidies to firms for investing in R&D. In addition to generating more employment opportunities through an accelerated rate of industrial growth, such policies are also likely to make India's merchandise exports more competitive in the long-run, and improve its trade balances. Public investment and government procurement policies should be directed to the increase of well paid, high productivity jobs that reduce the needs for imports, and reduce the dependence on low-wage exports, remittances, and volatile capital flows as a way to finance persistent trade and current account deficits. There is no reason why India should only concentrate in the exports of people, or remain dependent on capital inflows with an open capital account, in order to obtain the funds for funding the external deficits. Public policy is essential for creating the conditions for a lower import coefficient. Sustained public investments could help to absorb surplus workers and may be directed to increase domestically produced manufactured goods, and, by allowing for the positive effects of scale economies, improve the international competitiveness of Indian manufactured products. More active employment and industrial policies are therefore indispensable to correct the adverse structural dynamics in the Indian economy.

Furthermore, as emphasized by Mazumdar (2008), there is also a need for policy measures to change income distribution patterns in a way that will widen the market for domestically produced manufactured goods, and raise public investments in agriculture and infrastructure. Higher wages would allow more consumption, which should be directed towards domestic goods. India’s slow transition to a more urban society, with an increasing role for manufacturing jobs, would also, by leading to the migration of workers from the rural areas with low wages in low productivity jobs to manufacturing jobs in the urban areas, create a more significant role for domestic markets. Meanwhile redistributive policies to raise the living standards of rural workers, and their consumption of domestic goods should be stimulated. The growth of the domestic market in order to raise the living standards of its population without hitting the external constraint should be the goal of India’s development strategy, and not to integrate into global markets on the basis of exports of people, implying the exploitation of its workers, for the benefit of global consumers. One should add that not only global consumers benefit from the services of the low paid Indian workers, but also local elites that imitate the consumption patterns of developed countries – the so-called demonstration effect – which also contribute to the persistent trade and current account deficits.

The idea that integration with global markets, sometimes referred to as globalization, is a goal in and of itself has been a typical obsession of Latin American elites, since the dawn of the Iberian colonization, with terrible results for the people of the region, even if the consumption patterns of the elites do emulate those from the advanced countries (Camara and Vernengo, 2002-3). Octavio Paz, the Mexican writer and ambassador to India, was fascinated by the similarities that he found between India and his native country, despite the incredible cultural differences. The current development strategy in India, as much as that of Latin America, prioritizes the integration into world markets, at the cost of the well being of its population. The development strategy in India makes Octavio Paz's (1995, p. 15) conclusion more understandable: "The strangeness of India brought to mind that other strangeness: my own country."

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