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Exports of Services and Offshore Outsourcing: An Empirical Investigation in the Indian Context



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In commemoration of Jawaharlal Nehru Birth Centenary (1889 - 1989), Export-Import Bank of India instituted the International Economic Development Research Annual (IEDRA) Award in 1989. The objective of the award is to promote research in international economics, trade and development and related financing, by Indian nationals at universities and academic institutions in India and abroad. The study titled 'Exports of Services and Offshore Outsourcing: An Empirical Investigation in the Indian Context' is based on the IEDRA Award 2011 winning thesis by Dr. Brijesh Pazhayathodi, Assistant Adviser, Reserve Bank of India, Bangalore.

INTRODUCTION

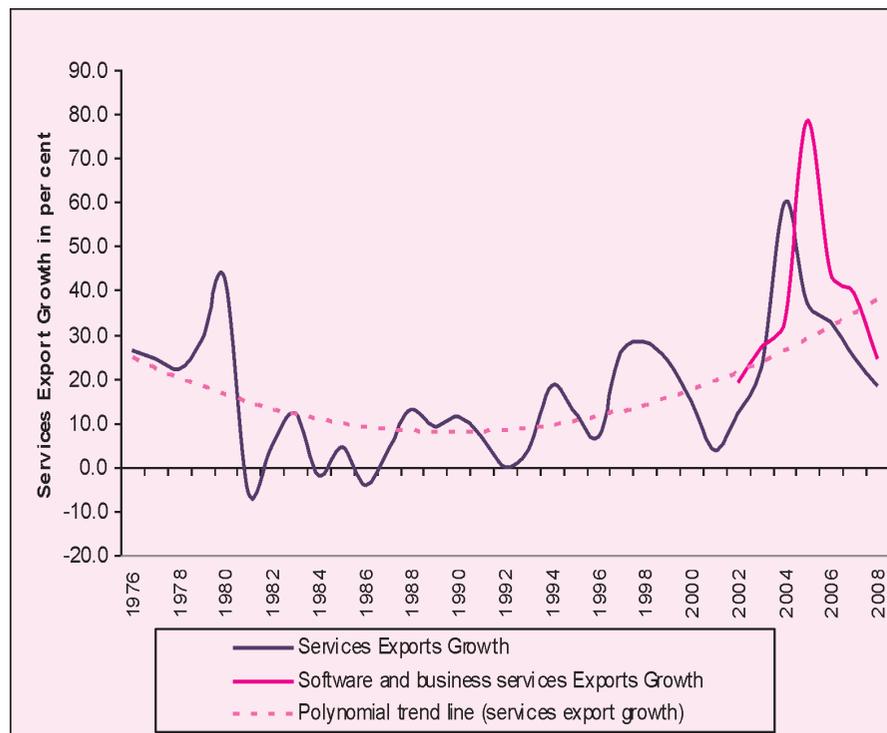
In the present world, offshore outsourcing of services is one of the most rapidly growing components of international trade in services. Understanding the characteristics of services would help to better understand the phenomenon of outsourcing. The categorization of transactions to facilitate the trade in services (and WTO negotiations) has been adopted by GATS on January 1, 1995. The relative importance of each mode of services transaction is determined by the regulatory environment prevalent among the trading countries regarding trade in goods and services, movement

of persons and technological capabilities of these countries.

In the last two decades, service sector has emerged as the largest and fastest-growing sector in the global economy as well as in the Indian economy. Increase in international outsourcing or exports of Information Technology Enabled Services/ Business Process Outsourcing (ITES/BPO) from India have stimulated services exports from India which is now around 2.7 per cent of the global exports.

Due to revolution in the sphere of information technology (IT), it has become possible to deliver

services across borders and at rather low costs as compared to the past. India's exports of ITES/BPO services have witnessed expansion in recent years, especially after the Y2K problem (year 2000 software switching over problem). The success in tackling the Y2K problem by India's software professionals led to outsourcing the non-core activities by the developed countries like the US and the EU to India. The availability of cheap supply of skilled labour has significantly contributed to the comparative advantage of India's ITES/BPO exports. Innovations in IT technology, investment in education by India for sustained

Figure 1: Growth in India's Services Exports

period of time such as in Indian Institute of Technology (IITs), Indian Institute of Management (IIMs) and engineering colleges, proficiency in English language, time zone difference, etc. have been the contributory factors to growth of services from India in general and growth of ITES/BPO services in particular. ITES/BPO sector has enhanced India's credibility as a business destination.

BPO is typically categorized into back office outsourcing (i.e., internal business functions such as human resources or finance and accounting) and front office outsourcing (i.e., customer-

related services such as business contact centre services). BPO that is contracted outside a company's country is called offshore outsourcing, while BPO that is contracted to a company's neighboring (or nearby) country is called nearshoring. Given the relationship between BPO and the IT industry, the former is also categorized as an information technology enabled service or ITES. Knowledge process outsourcing (KPO) and legal process outsourcing (LPO) are some of the sub-segments of business process outsourcing industry¹. In India's Balance of Payments (BOPs) statements, 'outsourcing' is classified under

the category 'software exports' and 'business services exports' within 'miscellaneous exports' which is a sub-category of services. The composition of India's services exports has changed dramatically in favour of 'miscellaneous' services which include 'outsourcing'. Miscellaneous services exports include software and other business services.

THE STUDY

The major objectives of this empirical study are to examine the general perception that developed countries are the only predominant countries that outsource (or contract out/import) services; to study whether India has a comparative advantage in services exports especially in ITES/BPO exports; to examine whether outsourcing has led to unemployment in the US and the UK; to examine the extent to which software and business services exports provide support to India's balance of payments; to measure the impact of economic growth in developed countries, such as, US and UK and exchange rate on India's ITES/BPO exports; and to identify the determinants of ITES/BPO exports with the help of firm level data. The study used annual data mainly from IMF, BoP statistics and CMIE

¹http://www.business.reachinformation.com/Business_process_outsourcing.aspx; accessed on December 10, 2010.

which covers a 9 year period from 2000-01 to 2008-09 for empirical testing.

The study noted that the backbone behind the growth of BPO industry in India is the development of IT. IT is an 'enabling' technology and mastering its use generates externalities throughout the economy. The diffusion of IT or software results in increasing returns to scale, and hence, ITES growth is believed to be important for enhancing national productivity and competitiveness, spurring exports and economic growth. The application of IT makes administrative and management processes of infrastructure efficient, transparent and unbiased. India's ITES/BPO sector could be instrumental in bringing about financial, cultural, gender and digital inclusion. There has been a rapid growth in direct employment in India's ITES/BPO sector and indirect employment through support activities, such as, transportation, security and catering. The industry has also played a key role in regional development in IT-BPO intensive states. The rise of ITES/BPO exports could also stimulate R&D activities in India. Moreover, due to the rising importance of services sector and recent pick

up in service exports from India, FDI inflows into India are also shifting increasingly away from manufacturing sector, towards services sector. Hence, the direct economic impact from the growth of the Indian ITES/BPO industry is growing rapidly. It provides significant support to India's Balance of Payments position and helps in accretion of foreign exchange reserves. In fact, it has multi-fold impact on the economy.

ANALYSIS AND CONCLUSION

The research work found out that even though industrialized countries outsource more than developing countries in absolute terms, in terms of size of economy (GDP), it is the developing countries which import more than developed countries. The general perception that global trade in ITES/BPO services is dominated by lopsided one-way outsourcing by developed countries from developing countries is not supported by the available data. India has advantage in exporting services which includes outsourcing of services when compared with export of goods. It has also been found out that in the case of India, the relative comparative advantage in goods

exports is gradually decreasing while that of services exports is increasing. India also has a clear revealed advantage in export of computer and information services over developed countries like the US.

The study after analyzing the employment data in the US and the UK also noted that offshoring from developing countries, such as India does not appear to have any disproportionately large effect on skilled tasks or jobs in the US or the UK. The developed countries like the US and the UK which are big exporters and importers of services gain from trade in services. Short-term job losses in these countries, if any, due to outsourcing are well compensated by cost reduction and productivity gain made by these countries. The net result of outsourcing is that, both developing countries and developed countries ultimately end up in a win-win situation.

The study also reflected that Indian software and services exports have strong association with the US business cycle stressing the need for diversification of markets. It also shows a relatively high level of confidence of investors in the IT sector as compared with other indices such as oil and gas, metal, consumer durables, etc.

Advertising intensity of firms, growth in major markets, viz., the US and the UK has a positive impact on exports of India's ITES/BPO firms. Thus, there exists a cointegrating relationship between India's software exports and US and UK economic growth and Rupee/US dollar exchange rate.

It is generally perceived that India's exports of ITES/BPO services have significantly contributed to current account receipts and thus provided support to India's balance of payments position. The contribution of software services and business services to the growth of foreign exchange reserve has been consistently rising over the years while that of merchandise trade and other services is coming down. ITES/BPO services have also increased capital inflows by attracting FDI. However, it may be noted that growth of this item is quite sensitive to the growth of world economy and hence, these flows may exhibit sharper volatility as compared to the other components of BOPs. However, unlike private transfers, outsourcing leads to number of positive externalities (with multiplier effect) including addition to domestic production capacities, growth of new firms in the country, new employment opportunities within the country

(both direct and indirect employment), brand building (e.g., as seems to be the case with the growth of ITES/BPO sector in India) etc.

The study emphasised that since world trade in services including ITES/BPO is growing at a much faster rate than trade in goods, it will provide opportunity to India to raise its share of services in world trade. India's revealed comparative advantage is in export of services, more specifically on computer and information services exports. ITES/BPO exports are giving significant support to India's Balance of Payments position and therefore, it is very important for Indian economy. It has helped in diversification of current account receipts, which earlier was heavily depending on private transfers. It also contributes to capital account by attracting foreign investment in ITES/BPO sector. Foreign exchange earnings from ITES/BPO exports have significantly contributed to rising foreign exchange reserves position of India. However, there is a strong association between India's ITES/BPO exports and the US GDP. Further, the upswing and downswing in exports of ITES/BPO sector are moderate as compared with other export items of current account receipts.

The study also suggested certain policy measures including need for taking precautions to prevent sudden changes in exchange rate; active negotiation in WTO against any barrier measures like legislative changes, change in visa rules etc undertaken by developed countries; adequate attention to increase the quantity and quality of education, especially technical education in India; rapid improvement in infrastructure facilities to face the rising competition; substantial improvement of general business environment in India; and effective utilisation of India's advantage in ITES/BPO sector to improve domestic governance and inclusive development.

The contents of the publication are based on information available with Export-Import Bank of India and on primary and desk research through published information of various agencies. Due care has been taken to ensure that the information provided in the publication is correct. However, Export-Import Bank of India accepts no responsibility for the authenticity, accuracy or completeness of such information

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