India as a Manufacturing Hub*

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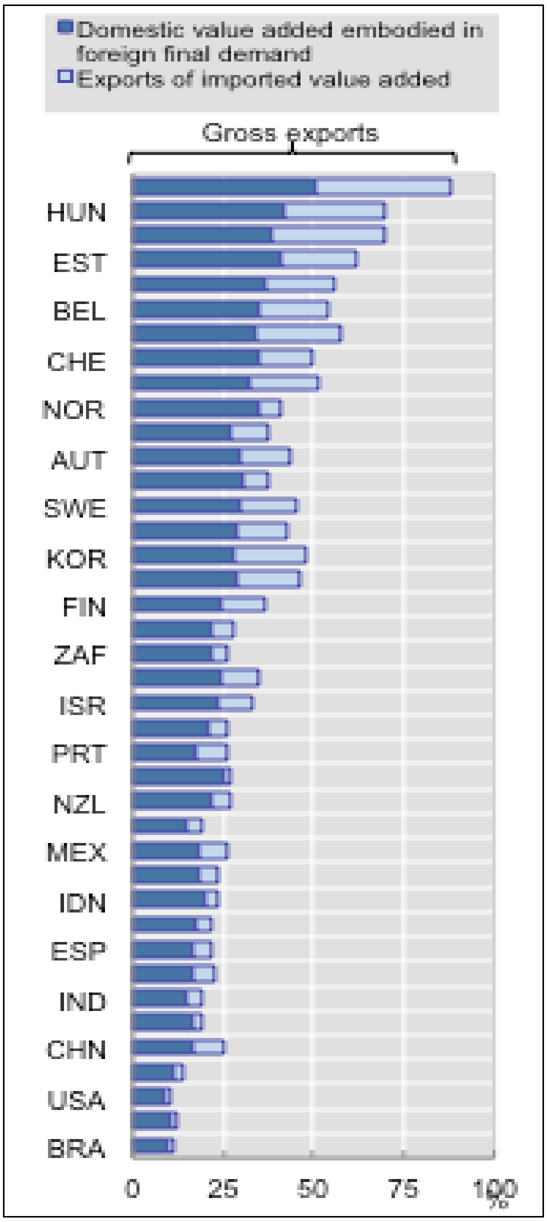
The BJP-led NDA government has declared that among its early policy decisions would be measures to revive India's languishing manufacturing sector, by making the country a global manufacturing hub. This policy thrust has supporters outside the government as well. Financial Times columnist Martin Wolf argues that vital reforms the new government should undertake "would be in employment regulation, education and infrastructure, with a view to making India a base for labour-intensive manufacturing. With Chinese wages rising, this is a plausible ambition." So for growth to occur, India must use the opportunity that wage competitiveness offers to displace China as a global, low-cost manufacturing hub, by inducing flexibility in labour markets, improving skills and strengthening infrastructure.

There is of course good reason to focus on manufacturing. Assessed merely in terms of rates of growth, the success of India's post-Independence industrialisation effort is partial at best. The most obvious indicators of that are the inadequate diversification of India's production structure away from agriculture to manufacturing, and the rather premature and rapid diversification into services that has occurred in recent decades. In 1960, industry contributed 37 per cent of GDP in Brazil, 45 per cent in China, 19 per cent in India, 19 per cent in Indonesia, around 25 per cent in South Korea, 19 per cent in Malaysia and 19 per cent in Thailand. By 1985, the figures were 45 per cent in Brazil, 43 per cent in China, 26 per cent in India, 36 per cent in Indonesia, 39 per cent in South Korea, 39 per cent in Malaysia, and 32 per cent in Thailand. And in 2010, the figures were: 28 per cent in Brazil, 47 per cent in China, 27 per cent in India, 47 per cent in Indonesia, 39 per cent in South Korea, 44 per cent in Malaysia and 45 per cent in Thailand. India has clearly lagged.

The strategy of exploiting global value chains to accelerate manufacturing growth is by no means new. By the late 1960s the argument had gained ground that the truly international firm seeking the lowest-cost production locations for segments of increasingly fragmented manufacturing processes had arrived. Liberalisation of trade and investment rules to attract the relevant segment to individual developing countries, which increasingly serve as locations for world market production, was seen as a way to benefit from the emerging new international division of labour.

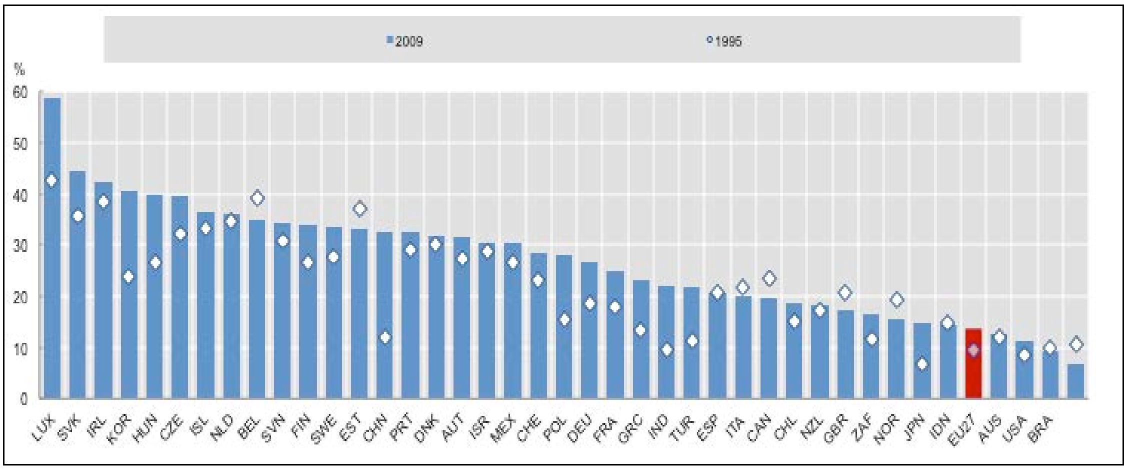
Chart 1: Decomposition of gross exports as a percentage of GDP



The experience since then seems to have validated that argument. Value chains have become a dominant feature of the world economy. According to the [OECD and UNCTAD](), global value chains (GVCs) have increased interdependence between countries, with 30 to 60 per cent of G20 countries' exports consisting of imported inputs or inputs for others. The production of goods and services is increasingly carried out wherever the required skills, materials and infrastructure are available at competitive cost. So it seems to make sense for India to use the opportunity that growing wage competitiveness offers to displace China as a global, low-cost manufacturing hub.

However, that is a strong case for caution here. Integrating into a value chain may result in a significant increase in the gross value of manufacturing production, but little in terms of increased value addition in domestic manufacturing. The latter is obviously important. The GDP of a country is the sum total of value added, and diversifying into manufacturing requires a rising volume of value addition in domestic manufacturing. The evidence does suggest that: (i) income derived from trade flows within GVCs, measured as the domestic value added embodied in foreign final demand (that is, "exports of value added"), has increased by 106% between 1995 and 2009 (in real terms); and (ii) that the share of emerging economies in world exports of value added has increased from 21% in 1995 to 34% in 2009. So while a high share of imported value added in a country's exports is indicative of a high degree of integration in to GVC chains, as is true of China, South Korea and Germany, these countries are also important exporters of domestic value added (Chart 1).

Chart 2: Foreign value added content of exports (%age of total exports)

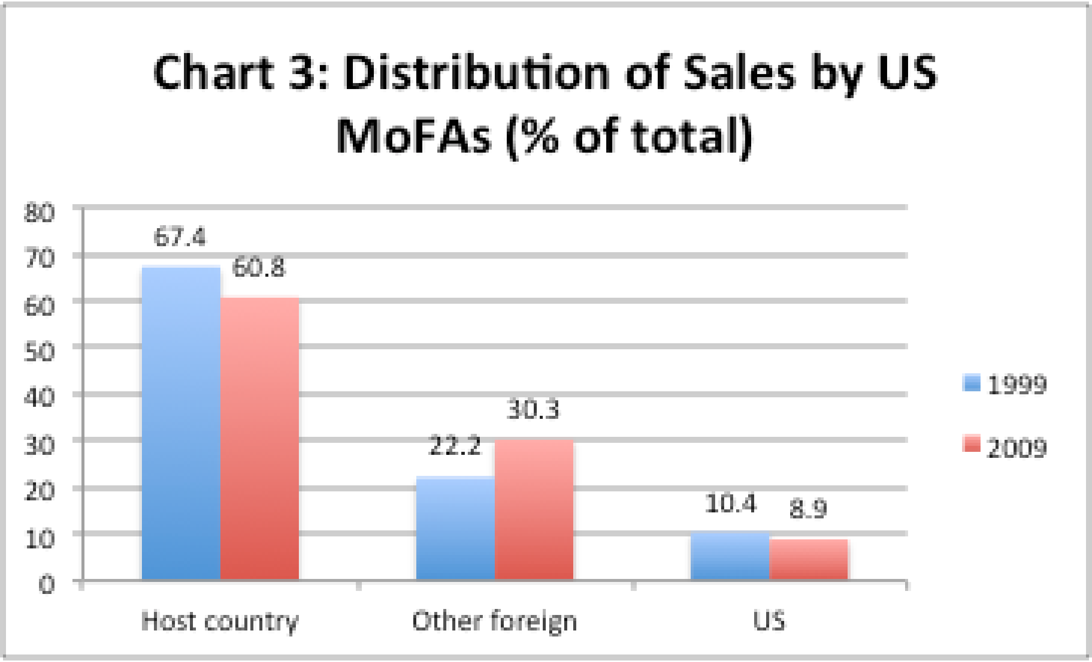


Yet the tendency is to measure the degree of integration of a country into global value chains using changes in the foreign value added content in exports as a percentage of total exports (Chart 2). While this may be high in the case of successful industrialisers like South Korea and China, an increase in the value of that indicator may be accompanied by little increase in domestic value addition. Nothing illustrated this more than the notorious IPhone example. The US deficit with China in the trade in IPhones and components is $1.65 billion, because IPhones are assembled as final products in factories in China and then exported to other countries including the US. But most of the components are imported into China, so that the US trade deficit with China in this area measured in value added terms is just $65 million. Little value addition takes place in the world's biggest IPhone assembler.

Moreover, even gross exports may not be high where integration into the global value chain is substantial. The evidence shows that foreign direct investment (FDI) has been a major driver of growth of GVCs, with a high correlation between FDI stocks in countries and their GVC participation. But not always do these MNCs produce for export. US MNCs have been expanding aggressively abroad, with the value added of their foreign affiliates grow at an average annual rate of 7.0 percent between 1999 and 2009, whereas the value added of parents in the US grew at an average annual rate of just 1.7 percent.

But the goal of the U.S. MNCs was to sell to local customers rather than to reduce their labor costs for goods and services destined for sale in the United States, Western Europe, and other high-income countries. Sales by foreign affiliates in 2009 totalled $4,857.0 billion. Sales to host-country customers accounted for 60.8 percent, sales to customers in foreign countries other than the host country accounted for 30.3 percent, and sales to U.S. customers accounted for 8.9 percent.

The increase in value added of foreign affiliates over 1999–2009 was most pronounced in China. These large increases in value added and mainly reflected expanded production to serve the large and growing local market. Roughly two-thirds of the total output of these affiliates was sold to local customers in both 1999 and 2009. The share of these affiliates' total output that was sold to U.S. customers actually declined to 10.2 percent in 2009 from 16.3 percent in 1999 (Chart 3).



Thus MNC relocation can be associated with very low value addition in the exporting hub. China's example suggests that this is likely to be truer in large countries where MNC interest in the domestic market is understandably strong.

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