Made in India

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The next big manufacturing export story

A CII-McKinsey Report

Executive Summary

In the past, India did not tap into its manufacturing exports potential to the fullest. Going forward, however, 'Made in India' could become the next big manufacturing exports story. The global trend to manufacture and source products in low-cost countries (LCCs)* is likely to gather strength over the next ten years, particularly in the skill-intensive industries where India has a significant competitive advantage. If India were to take advantage of this trend, manufacturing exports from India could increase from US$40 billion in 2002** to approximately US$300 billion by 2015, leading to a share of approximately 3.5 per cent in world manufacturing trade. Along with robust domestic demand growth, this is likely to create 25-30 million new jobs in manufacturing and add 1 per cent to India's annual GDP growth rate. Achieving this acceleration in manufacturing exports will require that Indian players adopt a global mindset, carefully select product segments and rapidly build cost excellence and marketing capability; that MNCs proactively develop India as one of their top three sourcing hubs; and that the government implement key reforms in taxation, infrastructure, clusters (SEZs), labour and skill development to help unlock India's manufacturing potential.

MANUFACTURING OFFSHORING TO LCCs WILL INCREASE WITH SKILL-INTENSIVE INDUSTRIES DRIVING THE SECOND WAVE

Manufacturing offshoring to LCCs is a well-established trend, with US$1,300-US$1,400 billion worth of manufacturing goods exported from LCCs in 2002. Furthermore, while world trade grew at 6 per cent in 2002, LCC exports increased by nearly 13 per cent. Labour-intensive industries (toys, apparel and footwear) and select skill-intensive industries (computer hardware and consumer electronics) constituted the first wave of this offshoring.

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* This includes countries with wage rates less than a third of the US: India, China, Thailand, Poland, Mexico, Turkey, Brazil, Indonesia, Russia, the Philippines, South Africa, Malaysia and Taiwan.

** 2002 is used throughout the report to refer to the period April 2002-March 2003.

Going forward, the offshoring wave will encompass skill-intensive industries such as auto components, specialty chemicals and industrial electronics. As a result, offshoring to LCCs is expected to increase from the current US$1,300-US$1,400 billion to US$4,000-US$4,500 billion by 2015. The skill-intensive industries will drive most of this increase. In the US, for example, the share of skill-intensive industries could rise from 55 to 70 per cent of total offshoring to LCCs.

Four factors will drive this growth: continued margin pressure on players in home markets; the emergence of a strong supplier base in LCCs; explosive demand growth in LCCs; and the dismantling of regulatory barriers by the World Trade Organisation (WTO).

INDIA HAS THE POTENTIAL TO CAPTURE APPROXIMATELY US$300 BILLION IN MANUFACTURING EXPORTS BY 2015

In 2002, China's manufacturing exports were US$300 billion, Taiwan's US$145 billion, Mexico's US$140 billion, Malaysia's US$78 billion and Thailand's US$55 billion. India lagged far behind, with US$40 billion in manufacturing exports.

Despite its modest start, India can – and should – aspire to become one of the three largest exporters of manufactured goods among LCCs by 2015. This will require growing manufacturing exports from US$40 billion in 2002 to approximately US$300 billion by 2015, and consequently increasing India's share of world manufacturing trade from the current 0.8 per cent to 3.5 per cent by 2015.

The aspiration, though ambitious, is attainable. India has several advantages in skill-intensive industries, such as auto components and pharmaceuticals, where the next set of offshoring opportunities will arise. Apart from low wage rates, these advantages include engineering skills (process, product and capital engineering), established raw material bases, a mature supply base and a growing domestic demand.

In-depth assessment shows that out of this approximately US$300 billion of total manufacturing exports, US$70-US$90 billion could be captured from just four sectors – apparel, auto components, specialty chemicals and electrical and electronic products. India's exports in these sectors were US$10 billion in 2002.

In apparel, global trade could grow from US$200 billion in 2002 to over US$300 billion by 2015. Of this, India can grow its exports from US$6 billion in 2002 to US$25-US$30 billion by 2015, i.e., it can become the second-largest LCC exporter with 8-10 per cent of world trade. This is ambitious but attainable. To illustrate, China's share of world trade is already at 20 per cent and China could capture 40-50 per cent of world trade in the future.

In auto components, LCC offshoring is poised to take off and could reach US$375 billion by 2015. India should aspire to capture US$20-US$25 billion of this (by 2015), as compared to exports of just over US$1 billion in 2003 – implying a required growth rate of almost 30 per cent a year. Such growth has been seen in competing LCCs like Thailand and China over the last three-five years. What is more, their aspiration is to achieve similar or higher growth levels going forward.

In electrical and electronic products, world trade already exceeds US$1 trillion and countries such as China, Taiwan, Malaysia and Thailand all have a significant lead. LCC offshoring is expected to increase from US$345 billion in 2001 to at least US$600 billion by 2015. Of this, India should aspire to capture US$15-US$18 billion, as compared to exports of US$1.2 billion in 2002. This will require India to become a top three-five player with a 1-1.5 per cent market share of world trade as compared to the over 5 per cent market share of countries like Taiwan and China.

In specialty chemicals, offshoring to LCCs is low (less than US$30 billion in 2002) but could increase to US$110-US$120 billion by 2015. India's chemical, engineering and cost-innovation skills could by then make India one of the top two LCC exporters with a potential US$12-US$15 billion in exports. Several Indian companies are already leading the charge in areas such as pharmaceutical intermediates and India is one of the top two LCC exporters in segments like dyes and intermediates, Active Pharmaceutical Ingredients (APIs) and agrochemicals for crop protection.

India can achieve these goals if Indian companies, the central and state governments and MNCs move to capture the opportunity.

INDIAN COMPANIES WILL NEED TO SIGNIFICANTLY STEP UP THEIR PERFORMANCE

The vast majority of Indian manufacturing companies today are largely domestic market-focused and sub-scale, and pursue mostly undifferentiated business models. A few companies, however, are taking the initiative to grow globally and have achieved a measure of success. For India to fully capture the potential from manufacturing exports, the export focus needs to get broad-based across sectors and across companies within a sector.

In order to be successful, Indian companies will need to adopt a global mindset to build scale and achieve cost excellence; acquire market access rapidly, including using inorganic routes such as acquisitions where required; strengthen design and innovation skills; build a global or regional operating footprint; and master the ability to manage a world-class talent pool and organisation. These actions will form the foundation for ambitious global growth and will need to be supported by a judicious choice of market segments and business models.

In apparel, the dismantling of quotas in January 2005 will create a unique opportunity for India because MNC buyers want to build an alternative large-scale sourcing base to China. India has the potential to become the second-largest exporter among LCCs. To achieve this, apparel companies need to choose between 'operational excellence' and 'design and innovation'. Operational excellence-led companies will compete on the basis of lower costs and will be distinctive in their economies of scale (4,000- to 5,000-machine factories), sourcing of fabric and labour productivity. Best practices in operations and quality enhancement measures will ensure their success. Players competing through design and innovation will be characterised by innovative fabric R&D, close relationships with supplier mills, relationships with retailers' design departments, a good understanding of fashion trends, and an ability to offer a range of readymade designs to customers.

In auto components, leading Indian companies are already seeing a significant acceleration in demand. More Indian companies can capture this opportunity if they specialise in components where they can build world-class competitiveness (e.g., components that require skilled manpower in the process design, equipment design and production stages); rapidly build sales and marketing capability in developed markets; and create an environment of relentless, continuous improvement in India.

In electrical and electronic products, Indian companies can choose to focus on: (a) manufacturing only; (b) design and manufacturing; (c) design, manufacturing and branding. Given the trend towards outsourcing of design and India's strengths in both design and manufacturing, it is suggested that Indian companies focus on the second model – design and manufacturing. Success for Indian companies in this sector will require an aggressive mindset focused on establishing cost- or capabilities-based leadership; selecting the right product segment based on its attractiveness and fit with India's strengths and the company's access to relevant technology; and locking in customers and technology through innovative approaches.

In the specialty chemicals segment, winning Indian companies can adopt one of two business models: 'low-cost producers' (offering products at the lowest cost and to exact specifications driven by scale, process and capital-engineering skills, privileged access to feedstock and chemical knowledge) or 'application developers' (providing products customised for specific end-use applications). In this segment only those companies that continuously climb the experience curve through process innovation, capital engineering and selected backward integration in advantaged feedstock are expected to win the game eventually. A few Indian companies have already started ascending this curve.

THE GOVERNMENT NEEDS TO REMOVE FOUR BARRIERS TO EXPORT-LED GROWTH

Providing a significant boost to manufacturing-led exports should be recognised as one of the nation's most important economic priorities. To achieve this aspiration, the government will need to act decisively. It will need to:

- **Stimulate domestic demand by reducing indirect taxes and import duties:** China's success in manufacturing is built on a strong domestic market, achieved through the systematic lowering of indirect taxes from 32 to 15 per cent of retail price in 1994. In India, too, the government should replace all indirect taxes on goods such as excise, state and central sales tax, octroi and entry tax with a single nationwide Value Added Tax (VAT) (with suitable distribution of collections between the centre and states). It should also reduce tax levels from their current 25-30 per cent to 15 per cent of the retail price (similar to China) and duties on all imports to a single rate of 10 per cent by 2007.
- **Debottleneck ports and accelerate power reforms:** Well-functioning ports and low cost, uninterrupted power are critical to India's export competitiveness. India's ports today are already at saturation point with container capacities of 43 million tonnes being fully utilised. The container

capacity requirements for exports alone are expected to reach 120-150 million tonnes by 2015. The government needs to take the lead in making public investment in additional capacities (over and above currently planned expansions), continuing with planned privatisation of operations and further reducing customs clearance times to one or two days (as has China) from the current one or two weeks. For power, state governments need to implement the Electricity Act 2003 by defining access charges for third-party supply of industrial power and by pushing for privatisation of distribution.

- **Encourage the development of several manufacturing clusters:** Clusters in the form of special economic zones (SEZs) with special economic systems and policies are a key feature of China's success in manufacturing. In India, a lot more needs to be done before its SEZs can be considered world class. It is suggested that the government permit sales to the Domestic Tariff Area (DTA) by charging import duties on inputs and excise/sales taxes on output. This will level the playing field for companies inside and outside the SEZ. In addition, permitting greater flexibility in the use of contract labour, simplifying administrative procedures and extending SEZ-like benefits to existing clusters or implementing the concept of 'virtual SEZs' will help.
- **Accelerate labour reforms and facilitate skill development:** Many countries have created labour flexibility and attracted labour-intensive industries (e.g., Thailand and Malaysia). Even a communist country such as China is much more flexible in its labour laws than India. To make Indian manufacturers globally competitive, the government should allow the use of contract labour for all activities (not just those of a temporary nature), repeal Section 5B of the Industrial Disputes Act (which mandates that companies with more than 100 workers obtain state government approval to rationalise their workforces) initially for all new investments and recruitment, and minimise the number of onerous inspections. To meet the industry's need for larger numbers of technically qualified people (1.5 million trained technicians required every year till 2015 – as compared to the current ITI output of 700,000 – in order to meet the incremental requirement of 20 million skilled technicians by 2015), the government should set up a private-public sector partnership to revamp the ITIs and encourage private sector investment in vocational training.

MNCs CAN DEVELOP INDIA AS A SOURCING AND MANUFACTURING HUB FOR SKILL-INTENSIVE INDUSTRIES

Historically, MNCs have not treated India as a global sourcing and manufacturing hub. Yet, there are several recent examples of MNCs beginning to see signs of success (e.g., Siemens and ABB in electrical and electronic products, Toyota and Cummins in auto components and engineering). For MNCs, India could become either a dominant sourcing and manufacturing base in its own right (in auto components, custom-based and non-electronic products), or an alternative sourcing hub to China to avoid the risks inherent in single-country sourcing (e.g., in apparel).

For early-mover MNCs, this is the opportunity to shape sourcing from India. The current constraints in infrastructure, policy and domestic demand leave India at a disadvantage compared to other LCCs like China. This implies that such MNCs will have to make an additional effort to overcome these constraints, develop suppliers and institute internal processes. But this effort is also likely to give them first-mover benefits in terms of proprietary relationships with the best suppliers, access to the best talent and support from the government because of their position as lighthouse investors. Consequently, they will reap the benefits of sourcing from India, i.e., cost savings, access to an enormous skill-base (of engineers, chemists, etc.) and innovation. Further, as government reforms unfold and the domestic market expands, MNCs will have the opportunity to participate in creating a market in what promises to emerge as one of the largest economies in the world.

THIS MANUFACTURING TRANSFORMATION COULD CREATE 25-30 MILLION JOBS FOR INDIA BY 2015

Manufacturing exports cannot grow from US$40 billion in 2002 to approximately US$300 billion in 2015 unless domestic manufacturing gross output grows from US$320 billion to US$1,100 billion. The combined effect will help expand India's overall manufacturing sector gross output from US$360 billion to approximately US$1,400 billion by 2015.

This will lead to a sustainable increase of 1 per cent per annum in GDP growth rate. In addition, it will create 25-30 million jobs in manufacturing by 2015 and possibly two or three times this number in the allied sectors (e.g., construction, education and entertainment) due to the multiplier effect. Manufacturing share as a percentage of GDP will grow from 16 to 21 per cent.

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The US$300 billion in manufacturing exports alluded to in this report is an aspiration, not a forecast. This aspiration, though ambitious, is attainable. It will all depend on how Indian companies transform their mindsets and operations; how MNCs proactively build aggressive, India-sourcing strategies based on India's competitive advantages; and how the government breaks down the barriers that currently impede export-led growth. The economic benefits that could be gained from attaining these goals are extremely exciting – just as the thought of allowing the status quo to remain is dreadfully depressing. ■