India’s Service Sector: A Mid-Year Review of Performance and Outlook

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Although the service sector has been a driver of growth, many regulatory and policy bottlenecks remain. There is a need to move beyond the IT and business services-led paradigm and focus on developing services that are better integrated with the rest of the economy through backward and forward linkages. Complementary regulatory frameworks and domestic reforms also need to be put in place to support liberalisation in various services. In the context of FTA negotiations, India needs to pursue its interests in services by pushing for greater market access for its service providers. from partner countries.

S.1 Introduction

India’s service sector has emerged as the largest and the fastest growing sector of the economy. The sector accounted for 57 per cent of Gross Domestic Product (GDP) in 2013–14 without construction and for 64.8 per cent of GDP if one includes construction activity. In the global context, among the top 15 countries in terms of economic size, India ranked 10th in terms of its overall GDP and 12th in terms of its services GDP[2] in 2012. The sector consists of a wide range of activities from modern, technology-intensive services such as Information Technology (IT), telecommunication and audio visual services to others with high employment linkages such as tourism and distribution services and others with high linkages with industry such as transport and other infrastructure services.

Services have consistently registered the highest growth among all sectors of the economy and have helped drive India’s overall GDP growth for the past decade and more. The Compound Annual Growth Rate (CAGR) for services GDP at 8.5 per cent for the 2000–13 period has exceeded that for overall GDP at 7.1 per cent. Globally, India had the second fastest growing services sector, after China over the 2000–13 period. Services have also contributed significantly to India’s foreign investment flows and exports. India has had the fastest growth in services exports among all leading service exporters, with a CAGR of 20.2 per cent over the 2001–13 period. However, the sector’s share in employment has remained low at 28.1 per cent in 2012, when compared with its very high contribution in GDP.

This chapter provides an overview of the Indian service sector’s performance in the 2013–14 financial year and specifically in the first half of the current 2014–15 financial year and outlook for the remainder of financial year (FY) 2014–15. It also highlights some important domestic and international developments in this sector. The chapter concludes with a summary of various regulatory and institutional issues that need to be addressed in the service sector to improve the latter’s growth prospects in the near term.

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2. Most of the discussion in the introduction and subsequent section is based on the Economic Survey, 2013–14, unless mentioned otherwise.

S.2 Services Performance in 2013–14

The services sector has registered sub-normal growth in the last two years, reflecting the effects of the continued global and domestic slowdown. In FY 2013–14, the services sector grew at 6.8 per cent, marginally lower than in 2012–13 (Table S.1). This deceleration was due to slower growth in the subsectors of trade, hotels and restaurants and transport, storage and communications which slowed from 5.1 per cent in FY 2012–13 to three per cent in FY 2013–14. Construction also registered very slow growth at 1.6 per cent in 2013–14. The subsectors of financing, insurance, real estate and business services, however, registered high growth of 12.9 per cent with banking and insurance showing the highest growth at 11.8 per cent followed by the real estate, ownership of dwelling and business services subsectors at 10 per cent. The worst performing subsectors were railways at 0.3 per cent followed by hotels and restaurants at 0.5 per cent. Overall, the service sector exhibited mixed performance across its different sub-segments in FY 2013–14. Table S.1 shows the overall and sub-sectoral performance of India's service sector for the past few years.

India's share in world services exports has increased over the past two decades, from 0.6 per cent in 1990 to 3.3 per cent in 2013, higher than its share in world merchandise exports.

India's services exports have grown more rapidly than for the world through most of the past decade, but in FY 2013–14, services export growth decelerated from 5.4 per cent in FY 2012–13 to 4.8 per cent, lower than for the world. Software services exports, which constituted 46 per cent of total services exports registered slower growth in FY 2013–14 at 5.4 per cent as compared to 5.9 per cent in FY 2012–13 while travel services registered negative growth of 0.4 per cent. Financial services exports grew very strongly at 34.4 per cent in FY 2013–14.

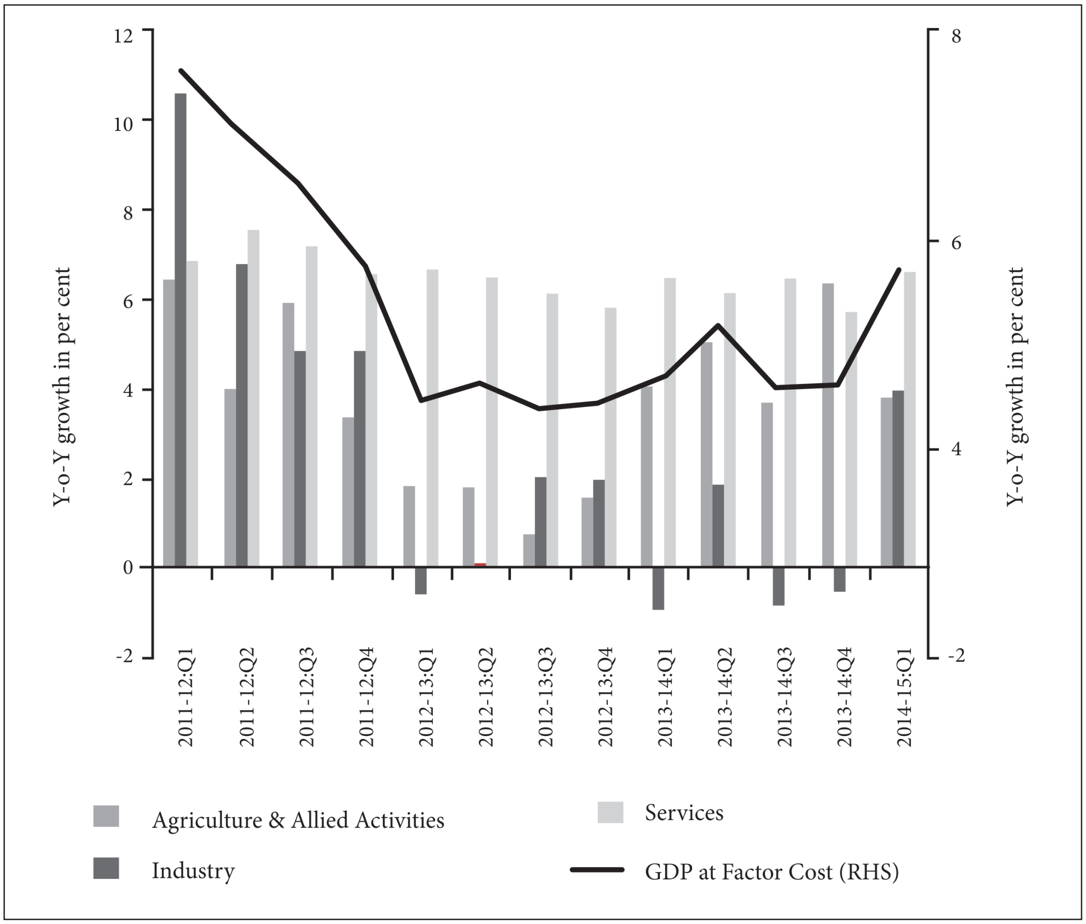
The services sector attracted a significant share of Foreign Direct Investment (FDI), accounting for 45 per cent of cumulative FDI equity inflows for the April 2000–March 2014 period. As per the Department of Industrial Policy and Promotion (DIPP), cumulative FDI inflows in services amounted to US $ 40,197 million between April 2000 and June 2014. The leading recipient sectors were financial and non-financial services, construction, telecommunications, computer hardware and software and hotels and tourism. Other services receiving FDI included trading, information and broadcasting, consulting, hospital and diagnostic, education, air transport, ports and retail services. Together, these services accounted for 54.7 per cent of total FDI inflows for the 2000–01 to 2013–14 period. However, FDI inflows to these leading sectors declined sharply by 37.6 per cent to US$ 6.4 billion compared to an overall growth of 6.1 per cent in total FDI inflows in 2013–14.

Services inflation is not captured in the Wholesale Price Index (WPI) and is partially captured in the Consumer Price Index (CPI) through items like medical care, education, recreation, transport, communication and housing. Preliminary price indices which have been developed for certain services indicate a fall in telecom and banking services inflation in recent years, mild inflation for postal services and a sharp increase in inflation for railway services.

S.3 Services Performance and Outlook in 2014–15

Following the deceleration in services growth in the last two years, there are signs of a growth revival in this sector in FY 2014–15. Alongside overall GDP which grew by 5.7 per cent in Q1 of FY 2014–15, services grew by 6.6 per cent, up from 5.8 per cent in Q4 of FY 2013–14 and higher than the growth registered by industry and agriculture in the first quarter of FY 2014–15. Figure S.1 shows the quarterly GDP growth performance of the three broad sectors of the economy between 2011 until the first quarter of FY 2014–15 while Table S.2 shows the quarterly sub-sectoral performance within individual sectors for FY 2013–14 and the first quarter of FY 2014–15.

Figure S.1: Overall and Sectoral Quarterly GDP Growth, 2011–12 Q1 to 2014–15: Q1 (% y–o–y)



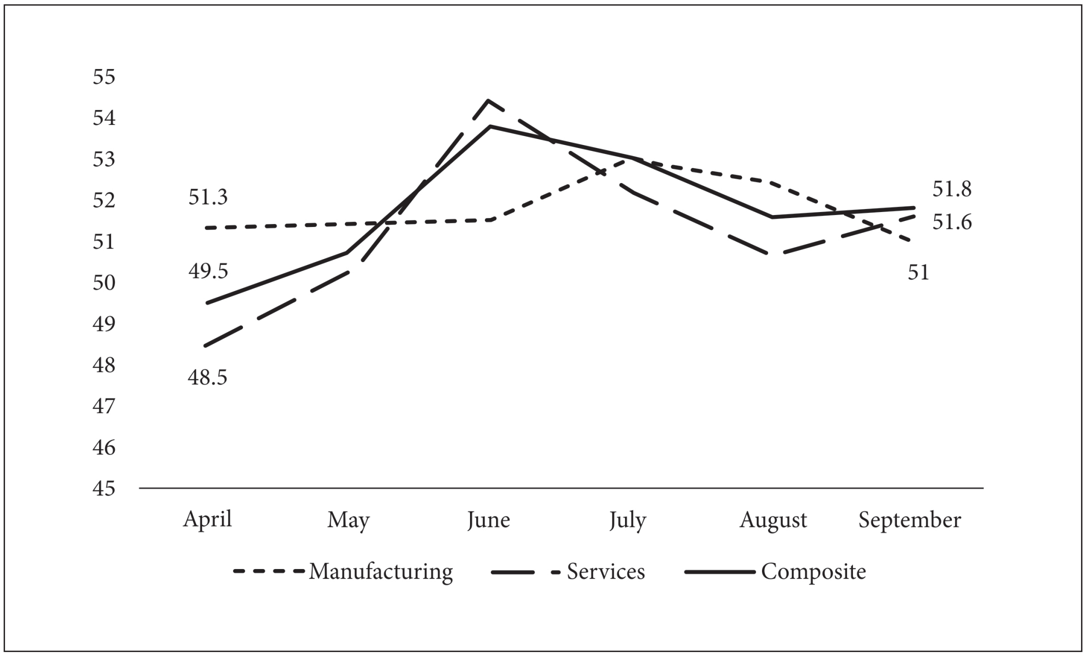
Source: RBI, Monetary Policy Report, September 2014, http://rbi.org.in/scripts/PublicationsView.aspx?id=16048#I2 (accessed October 8, 2014).

As shown in Table S.2, within the service sector, growth has varied across subsectors. Segments such as community, social and personal services and finance, insurance, real estate and business services have shown good performance with growth rates of 9.1 per cent and 10.4 per cent, respectively in Q1 of FY 2014–15 while segments such as trade, hotels and restaurants and construction have registered lower growth rates.

Among the services sectors, some key indicators indicate improved activity. For instance, the net tonne kilometres and passenger kilometres grew at 3.3 per cent and 5.5 per cent, respectively in the first quarter of FY 2014–15. Other transport segments such as civil aviation, cargo handled by civil aviation and cargo handled at major ports registered growth rates of 7.5 per cent, 6.2 per cent and 4.3 per cent, respectively. These are indicative of improved economic activity this financial year, given the linkage between segments like transport and passenger services with overall industrial activity.

Various indices and estimates from the first half of FY 2014–15, similarly, indicate an expansion in India's services business and outlook for the service sector. The Markit-HSBC Services Purchasing Managers Index (PMI) which is calculated on the basis of responses received from 350 purchasing managers of private companies across various services (hotels and restaurants, transport and storage, financial intermediation, renting and business activities, post and telecommunication and other services), where a value above 50 indicates expansion in activity, has shown ups and downs in the first six months of this financial year. The index rose to 50.2 in May from 48.5 in April 2014, for the first time signalling expansion in the service sector in nearly a year, following a rebound in new business orders. The index touched a 17 month high in June 2014 at 54.4 points but fell in August to 50.6 before rising to 51.6 in September 2014, unlike the manufacturing PMI which continued to show a decline. Overall, there is an indication of expansion in services activity, also corroborated by the first quarter expansion reflected in the national accounts figures released by the Central Statistical Organisation. Figure S.2 shows the HSBC PMI for the first two quarters of 2014–15.

Figure S.2: HSBC Purchasing Manager Index, April to September 2014–15



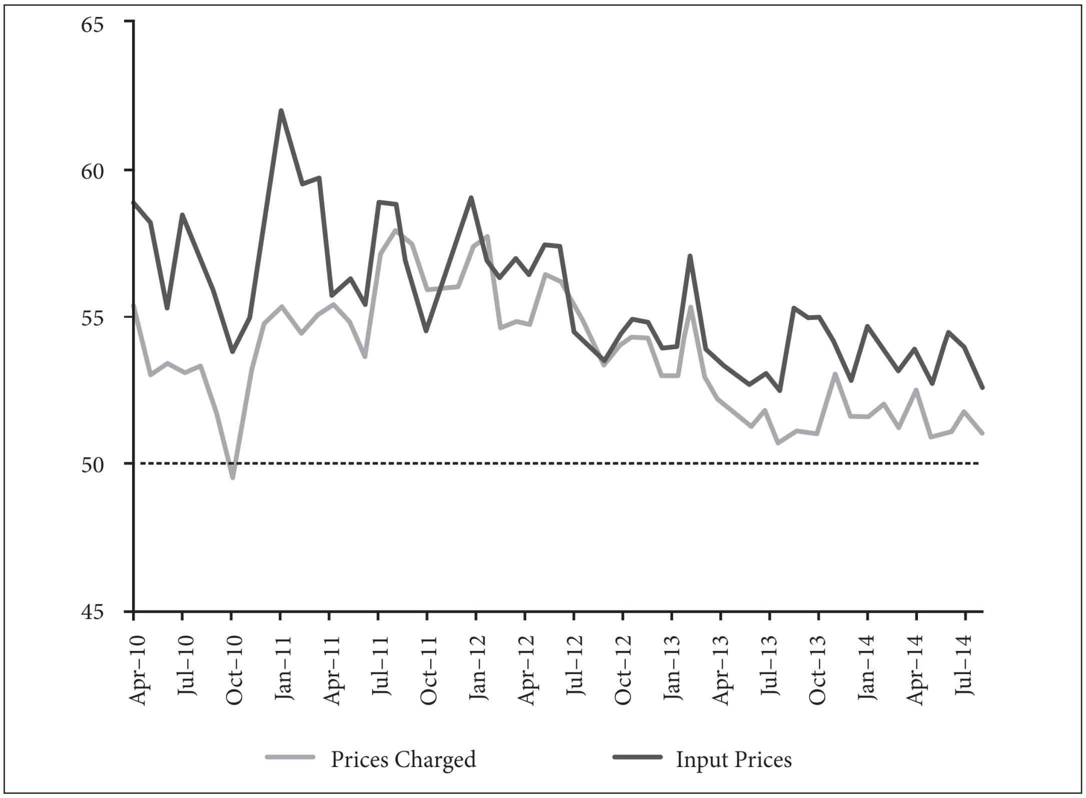
Source: http://www.thehindubusinessline.com/economy/india-services-growth-quickened-in-sept-hsbc-pmi/article6477810.ece (accessed October 8, 2014).

The September survey found that business activity rose in half of the six subsectors that are covered, the strongest expansion taking place in post and telecommunications. The survey noted a solid overall pick up in the pace of services activity since August 2014. This expansion has been linked to an increase in new work intakes as opposed to manufacturing where there has been a deceleration in the growth of new orders. There is also evidence of job creation in the service sector in September with employment rising across the private sector for the first time since June this year.[3]

Overall, business sentiment among Indian services companies was strong in September, in anticipation of improved demand.[4]

The September 2014 survey also showed that inflationary pressures for inputs eased in the service sector and had moderated from their recent peak in 2011. They were the lowest since November 2009. Output prices of service firms rose moderately in recent months. Figure S.3 shows the output and input price movements in services as captured by the PMI for services. It highlights the moderation in both input and output prices for services over the past year.

Figure S.3: PMI Services (seasonally adjusted) for Input and Output Prices, April 2010 to July 2014

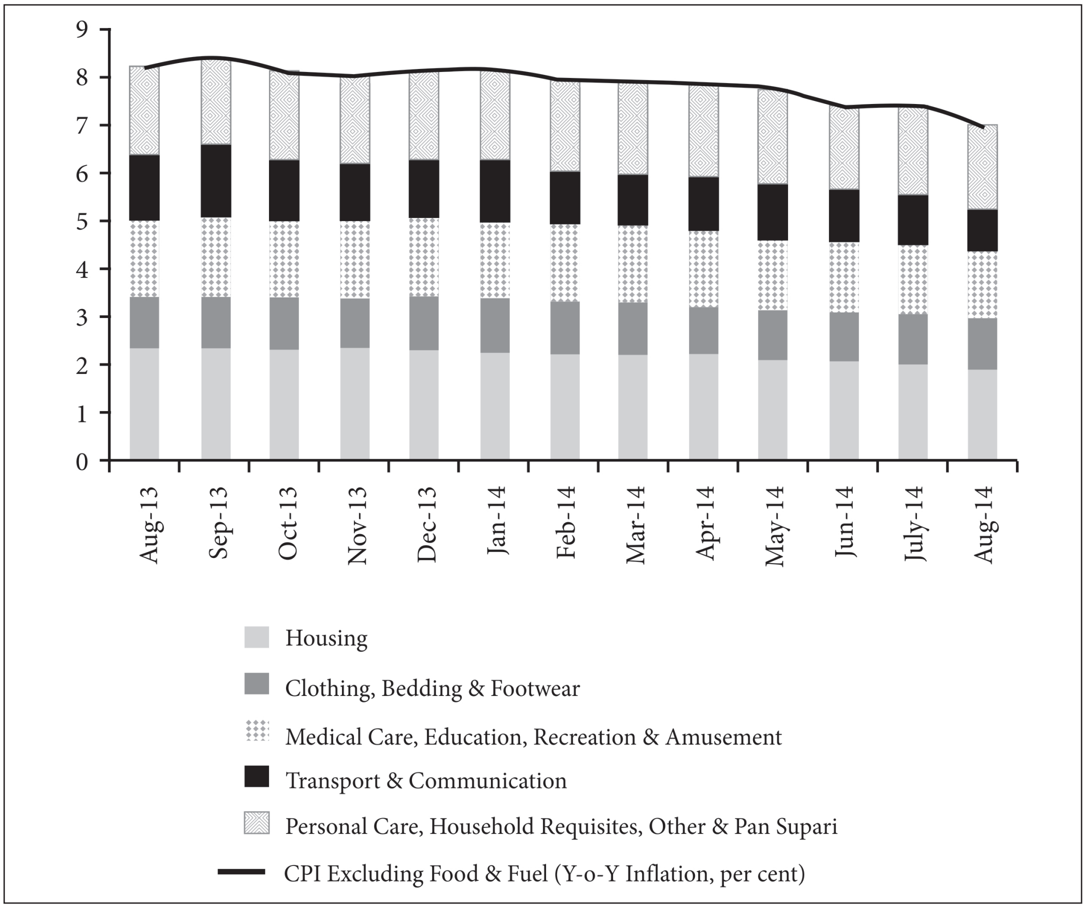


Source: HSBC India Services PMI.

3. http://pib.nic.in/newsite/PrintRelease.aspx?relid=109185.
4. http://www.business-standard.com/article/news-cm/moderate-expansion-of-private-sector-activity-in-september-2014-hsbc-india-services-pmi-114100700246_1.html.

Figure S.4 shows the contribution of various service sector activities to the CPI. It highlights the moderation in services inflation and decline in inflation for certain components such as transport and communication and medical care, education and recreation and amusement services between August 2013 and 2014.

Figure S.4: Sub-groups' Contribution to CPI, excluding Food and Fuel Inflation, August 2013 to August 2014

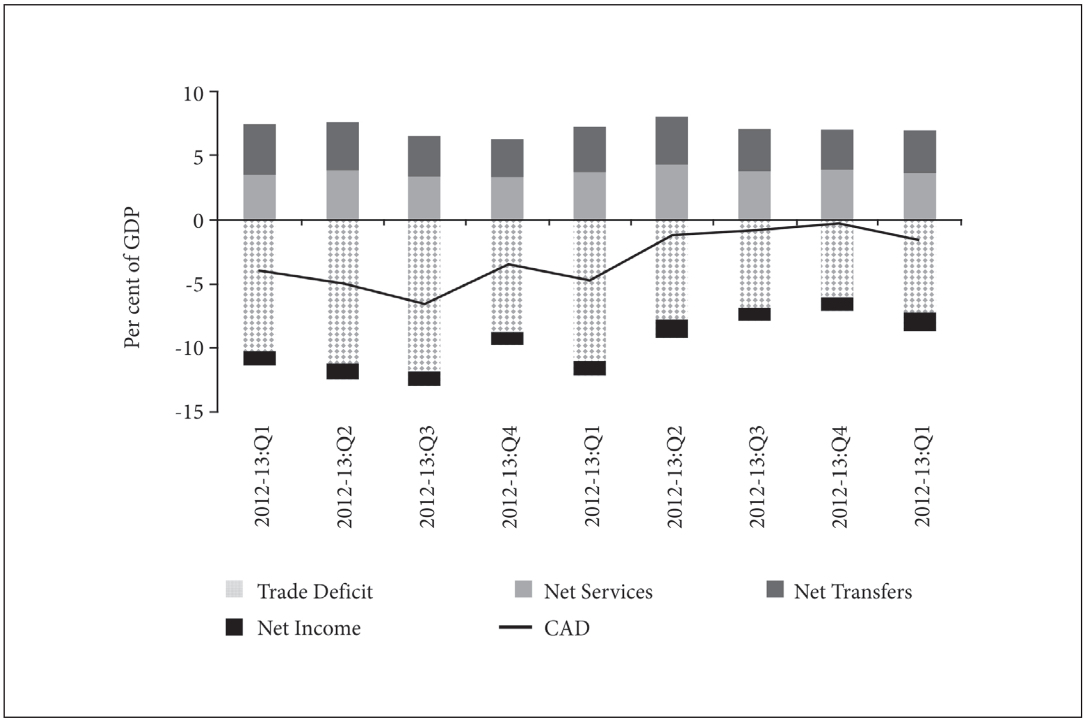


Source: RBI, Monetary Policy Report, September 2014, http://rbi.org.in/scripts/PublicationsView.aspx?id=16048#I2 (accessed October 8, 2014).

On the trade front, the trade balance in services was in surplus for July 2014 at an estimated US $6,522 million (₹39,170.22 crore), with services receipts of US$ 13,344 million (₹ 80,142.2 crore) and payments of US$ 6,822 million (₹ 40,971.98 crores).[5] There has been a small improvement in net exports of services in the first quarter, which together with a slight decline in the merchandise trade deficit has contributed to an improvement in the current account deficit (including petroleum oil & lubricants and gold) in Q1 of 2014–15 which shrank to 1.7 per cent of GDP compared to 4.8 per cent of GDP in the corresponding first quarter of 2013–14. Figure S.5 shows the quarterly trends and composition of the current account deficit since 2012–13 until the first quarter of the current financial year.

5. RBI Press Release, September 15, 2014.

Figure S.5: Composition of the Current Account Deficit, 2012–13:Q1 to 2014–15:Q1



Source: RBI, Monetary Policy Report, September 2014, http://rbi.org.in/scripts/PublicationsView.aspx?id=16048#I2 (accessed October 8, 2014).

The IT and Business Process Outsourcing sector, which is the main contributor to India's services exports grew at an estimated 10.3 per cent in FY 2013–14 in revenue terms, rising from US$ 95.2 billion in FY 2012–13 to US$ 105 billion in 2013–14 (estimated), according to National Association of Software and Services Companies (NASSCOM). Within overall revenues, export revenues increased by an estimated 13 per cent in 2013–14 while domestic revenues declined by one per cent.

S.4 Service Sector Projections for 2014–15

All indicators point to an expansion in business activity in services in FY 2014–15. There are signs of a growth revival in the aviation sector with the entry of new players such as Air Asia and Tata-SIA. Signs of revival in major economies such as the United States of America (US) and in global trade are expected to spur growth in the tourism and shipping segments of the service sector. There is also some optimism about increased investment and growth in services such as railways, insurance, telecommunication and aviation where foreign direct investment (FDI) liberalisation and regulatory reforms have been proposed. However, fiscal restraint by the Central government could dampen the growth of segments like community, social and personal services. Most other segments are expected to show a slow turnaround or moderate growth in the second half of FY 2014–15.

The IT-ITeS services sub-sector is projected to grow by 12 per cent in revenue terms in FY 2014–15, with export revenue growth and domestic revenue growth projected at 13–15 per cent and 9–12 per cent, respectively. Increased discretionary spending and demand from the US and Europe is expected to spur India's exports of IT and IT-enabled services. However, although India will retain its competitive advantage in the near future and continues to be 30 per cent cheaper than the nearest low-cost country, its IT-ITeS sector will increasingly face challenges due to protectionism, increased competition, exchange rate volatility and wage inflation which could dampen its growth prospects.

S.5 Recent Policy Developments in Services

There have been several important policy developments in the first half of FY 2014–15 that are pertinent to the service sector. In the latest Union Budget, the composite cap in the insurance sector is proposed to be increased from 26 per cent to 49 per cent for companies with full Indian management and control, subject to Foreign Investment Promotion Board (FIPB) approval. The objective is to address the shortage of capital in the insurance industry by bringing in new players into the segment. The increased FDI ceiling is expected to bring in players across the life, general and health insurance segments and also brokers from overseas markets. There is a pending Bill on Insurance Amendment which is to be considered in Parliament before the increased FDI can be brought into effect through legislation. Several other proposals have been tabled for the financial services sector, such as a framework for licensing small banks, setting up six new debt recovery tribunals for public sector banks, allowing banks to raise long term funds for lending to the infrastructure sector with minimum regulatory pre-emption and implementation of the suggestions of the Financial Sector Legislative Reforms Commission with the enactment of the Indian Financial Code and measures to develop the debt, securities and derivatives markets. The Union budget has also eased various conditions for investment in the construction sector to encourage the development of smart cities. There is also a proposal to allow FDI in the Indian Railways so as to enable the creation of world class rail infrastructure. In railway operations, FDI has been proposed in PPP projects for suburban corridors, high speed train systems and dedicated freight lines.

India has also been actively negotiating broad-based comprehensive economic cooperation and partnership agreements that encompass services and investment, with various trading partners, including the EU, Canada, Australia and New Zealand. These agreements, once concluded are expected to boost India's services exports to these countries and also help attract investments in services and other sectors from these countries.

An important recent development in this context has been the signing of a Free Trade Agreement (FTA) in services and investments between India and the 10 member Association of Southeast Asian Nations (ASEAN) in September 2014, building upon the earlier FTA in goods that was signed in 2011.

The member countries are expected to get the agreement ratified by their Parliaments, following which the FTA will be formally adopted in the next India-ASEAN Summit next year. India's key interests in this agreement relate to the movement of natural persons (intra-corporate transferees, business visitors and contractual service suppliers). The expanded India-ASEAN FTA is expected to facilitate the mobility of professionals between India and the ASEAN countries and also create opportunities for investments. India hopes to leverage its strengths in the areas of finance, education, health, IT and telecommunications through this pact and balance its merchandise trade deficit with the ASEAN countries.

Another important FTA India is currently negotiating is the Regional Comprehensive Economic Partnership Agreement (RCEP), which includes the ASEAN members plus China, Australia, Japan, Korea and New Zealand. The RCEP is expected to provide Indian service providers with enhanced market access opportunities to the wider Asia-Pacific market and to bring about much needed regulatory harmonization with these countries. There is, however, concern among Indian industry regarding the competitive threat this FTA would pose due to China's membership in this mega trading bloc.

S.6 Outlook

Although the service sector has been a driver of growth in the Indian economy, many regulatory and policy bottlenecks which impede growth in this sector remain.

Various challenges need to be addressed in the near term, some of which have been outlined in the latest Economic Survey. These include establishing a nodal agency or department for services to enable a coordinated institutional approach to removing unnecessary and outdated regulations in the sector; introducing targeted policies to tap opportunities and conduct promotional activities in services; speeding up disinvestment in some service sector Public Sector Units (PSUs) to facilitate the growth of these services; revamping port services and building world class port facilities; and addressing tax and benefit schemes to encourage services exports.

Beyond these institutional measures, in order to realise the long term growth prospects of this sector, there is a need to move beyond the IT and business services-led paradigm. We need to focus on developing a services sector that is more integrally connected with the rest of the economy through backward and forward linkages with industry, growth of employment-intensive services, enhanced productivity and broad-basing of service sector output and trade.

Pending bills concerning FDI liberalisation in areas such as retail, education, insurance services need to be passed to provide increased transparency and clarity on the investment scenario for services. Complementary regulatory frameworks and domestic reforms also need to be put in place to support liberalisation in various services.

In the context of FTA negotiations, India needs to pursue its interests in services by pushing for greater market access for its service providers through visa facilitation, mutual recognition of qualifications and harmonization of regulatory standards while also putting in place the requisite domestic business environment to encourage investments into the service sector from its partner countries.

Table S.1: Share and Growth of India's Services Sector, at Factor Cost, 2000–01 to 2013–14, (% y–o–y)

	2000–01		2011–12@		2012–13*		2013–14**	
	Share	*Growth*	*Share*	*Growth*	*Share*	*Growth*	*Share*	*Growth*
Trade, hotels and restaurants	14.5	5.2	17.4	1.2	17.2	4.5	24.0	3.0
Trade	13.2	5.0	15.9	1.0	15.8	4.8	–	–
Hotels and restaurants	1.3	7.0	1.5	3.8	1.4	0.5	–	–
Transport, storage and communication	7.6	9.2	7.3	9.4	7.5	6.0	–	–
Railways	1.1	4.1	0.7	7.5	0.8	0.3	–	–
Transport by other means	5.0	7.7	5.4	8.6	5.6	6.6	–	–
Storage	0.1	6.1	0.1	2.9	0.1	8,6	–	–
Communication	1.5	25.0	1.1	11.2	1.1	6.5	–	–
Financing, insurance, real estate and business services	14.1	3.5	16.5	11.3	17.2	10.9	18.5	12.9
Banking and insurance	5.4	-2.4	5.7	12.9	5.9	11.8	–	–
Real estate, ownership of dwelling and business services	8.7	7.5	10.7	9.9	11.4	10.0	–	–
Community, social and personal services	14.7	4.6	13.8	4.9	14.3	5.3	14.5	5.6
Public administration and defence	6.5	1.9	5.9	4.2	6.0	3.4	–	–
Other services	8.2	7.0	7.8	5.4	8.2	6.8	–	–
Construction	6.0	6.1	8.2	10.8	8.1	1.1	7.8	1.6
Total services	51.0	5.1	54.9	6.6	56.3	7.0	57.0	6.8
Total services (including construction)	57.0	5.2	63.1	7.1	64.4	6.2	64.8	6.2
Total GDP	100.0	4.1	100.0	6.7	100.0	4.5	100.0	4.7

Source: Economic Survey, 2013-14, Chapter 10, Table 10.2, p. 176.
Note: Shares are in current prices and growth in constant prices.
* refers to first revised estimates, @ to second revised estimates,
** to provisional estimate.

Table S.2: Quarterly Real GDP Growth by Sectors, FY 2013–14 and FY 2014–15:Q1 (% y–o–y)

Sector	2013–14		2013–14				2014–15
	Share	*Growth*	*Q 1*	*Q2*	*Q3*	*Q 4*	*Q 1*
I. Agriculture, forestry & fishing	13.9	4.7	4.0	5.0	3.7	6.3	3.8
II. Industry	18.7	-0.1	-0.9	1.8	-0.9	-0.5	4.0
(i) Mining & quarrying	1.9	-1.4	-3.9	0.0	-1.2	-0.5	2.1
(ii) Manufacturing	14.9	-0.7	-1.2	1.3	-1.5	-1.4	3.5
(iii) Electricity, gas & water supply	1.9	5.9	3.8	7.8	5.0	7.2	10.2
III. Services	67.4	6.2	6.5	6.1	6.4	5.8	6.6
(i) Construction	7.4	1.6	1.1	4.4	0.6	0.7	4.8
(ii) Trade, hotels, transport & communication	26.4	3.0	1.6	3.6	2.9	3.9	2.8
(iii) Financing, insurance, real estate and business services	20.6	12.9	12.9	12.1	14.1	12.4	10.4
(iv) Community, social & personal services	12.9	5.6	10.6	3.6	5.7	3.3	9.1
IV. GDP at factor cost	100.0	4.7	4.7	5.2	4.6	4.6	5.7

Source: RBI, Monetary Policy Report, September 2014, http://rbi.org.in/scripts/PublicationsView.aspx?id=16048#I2 (accessed October 8, 2014).