India's services exports

Oh so capable

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- The rise in services exports, including a rapid increase in professional services, has raked in USD60bn more in revenues (between FY19 and FY23f)
- Even though the growth rates in IT services exports will likely moderate over the next two years, other developments like lower oil prices could lower the c/a deficit, providing a buffer to the rupee
- Beyond that, as tech penetration spreads, the continued rise in *net* services exports (by USD100bn between FY23 and FY30) could help fund a rising goods trade deficit

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Some meaningful shifts have happened in India's services economy. On a *net* basis, services exports are now raking in USD60bn/year more in revenues than in the pre-pandemic period. This has provided some much-needed relief on the BoP front.

We've always known about India's promising IT sector. But what's driving the recent exuberance? The rise in the revenues of the top IT companies has definitely played a role. But other IT services exports are rising even more rapidly. What could be driving this? One, mid-sized IT firms have been gaining market share. Two, over the last three years, professional and management consulting services exports have grown the fastest, at 29% CAGR, followed by computer services (16%), and research and development (13%).

The one sector that generates revenues under each of these headings, and we believe, has contributed to the fast growth in IT services, is the rise in Global Capability Centres (GCCs). What are GCCs? Put simply, they are delivery centres set up by large MNCs. They provide tech, engineering & IT support, as well as R&D. India is home to about 40% of global GCCs, and this ratio is only expanding as GCCs rise in scope. Starting off as providers of support functions, they have moved up the ladder, to R&D and business development.

After a terrific run, however, it is possible that the pace of increase in India's IT services exports moderates over the next year or two, in line with slowing global growth. But we do not see India's external finances as a major cause for concern. Led by the gains from already higher services exports, the moderation in oil prices, and the recent fall in consumer goods demand, we believe the current account deficit will fall from 2.5% of GDP in FY23 to 1.7% of GDP in FY24. This will provide a much needed cushion at a time when the Fed is likely to raise rates further.

Beyond the next two years, the outlook for services exports looks exciting as tech penetration spreads. NASSCOM has a target of USD500bn in IT services revenues by FY30. If this target comes to bear, *net* services exports could rise further, leading to an increase in *net* services exports by USD100bn between FY23 and FY30. This is important because as India's GDP growth rises, as do goods imports, a higher services surplus could help fund a rising goods deficit.

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Meaningful shifts

Some meaningful shifts have happened in India's services economy. And they can't be ignored.

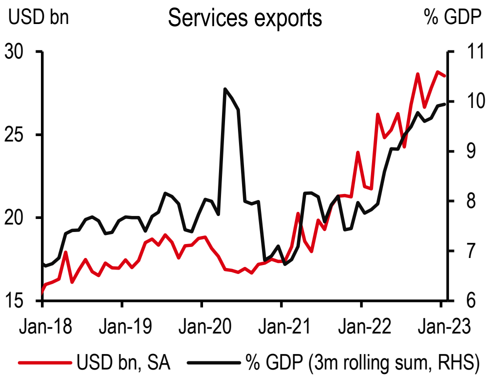
Services exports have risen at a staggering pace, from USD17bn/month in FY19 (the pre-pandemic period) to USD27bn/month in FY23 (see chart 1), marking a 12% CAGR increase.

On a *net* basis, services exports are now raking in USD60bn/year more in revenues than in the pre-pandemic period (with *net* exports rising from USD6.8bn/month in FY19 to USD12bn/month in FY23, marking a 15.3% CAGR). This has provided much-needed relief on the BoP front.

And the rise is impressive in *real* terms too (see chart 2). At 40% higher than pre-pandemic levels, real services exports have outpaced high-tech, medium-tech and low-tech goods exports by a considerable margin.

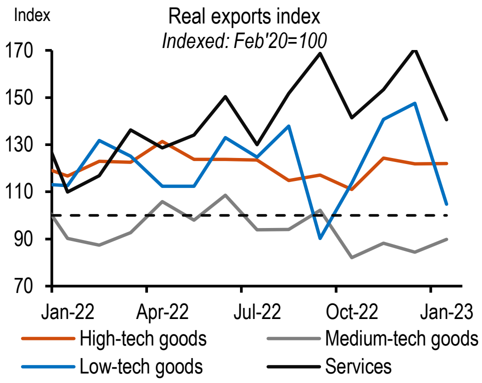
In fact, India's services continue to gain *global* market share, even as the share of goods seems to have flat lined (see chart 3).

Chart 1: Services exports have risen at a staggering pace…



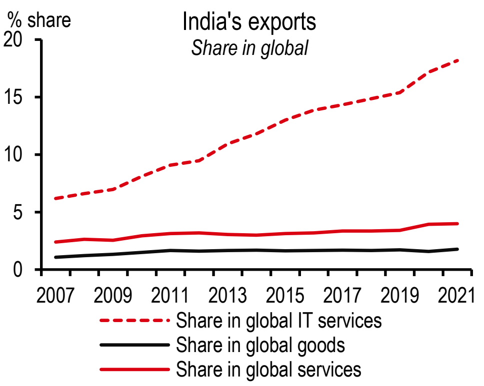
Source: CEIC, HSBC

Chart 2: … and the rise is impressive in real terms too



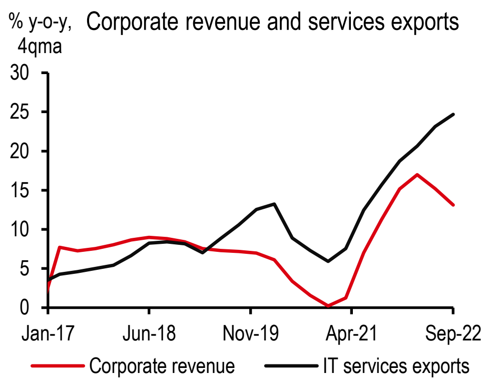
Source: CEIC, World bank, OECD, HSBC calculations

Chart 3: India's IT services continue to gain global market share, even as the share of goods seems to have flat lined



Source: ITC trademap, UNCTAD, CEIC, HSBC

Chart 4: "Other" IT services exports are rising faster than the revenues of the major IT firms



Source: Company reports, CEIC, HSBC. Note: We include the revenues of seven prominent IT services firms

Knowns and unknowns

We've always known about India's promising IT sector. But what's driving the recent exuberance?

The rise in revenues of the top IT companies has definitely played a role[1]. After all, it is well known that big shifts happened in the pandemic period that were particularly supportive of higher IT spend globally, even improving the medium-term trends. As explained by our IT analysts, there have been two inter-related developments. **One**, COVID-19 has accelerated front-end digital investments and multi-channel commerce for most industries, and, **two**, this has further re-enforced companies' transformation of their back-end tech-infrastructure to be more agile and adaptive. The cloud is core to this: every USD1 spent with cloud companies like AWS should lead to USD3 spend on IT services with Indian IT companies (see: *Indian IT: Living on a cloud*, 14 September 2021).

But there seems to be something going on beyond the gains made by the large IT firms. "Other" IT services exports are rising faster than the revenues of the IT majors (see chart 4). Until about five years ago, the revenues of the major IT firms made up about 55% of overall services exports, which has now fallen to about 45%. Over the last two years, the revenues of the IT majors have grown by 12.2% on an average, while overall IT services exports have grown by 20.2%.

What could these "other" IT services exports be driven by?

One important driver could be that the ***mid-sized*** **IT firms are growing well, gaining market share**. In fact, in FY22, they grew about 50% faster than the large IT firms.

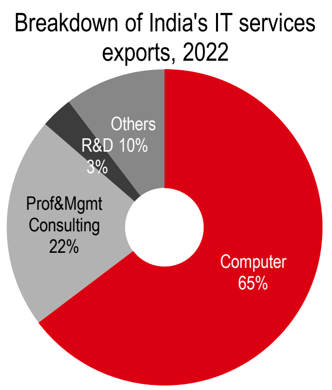
But some other developments are also worth noting.

A quick breakdown suggests that IT services make up about 70% of overall services exports. Within IT services exports, computer services have a 65% share, followed by professional and management consulting services (22%), technical and trade related services (8%), and research and development (3%, see chart 5).

What's perhaps more important than the share is the growth trends across these sectors. Over the last three years, **professional and management consulting has grown the fastest, at 29% CAGR**, followed by computer services (16%), and research and development (13%) (see chart 6).

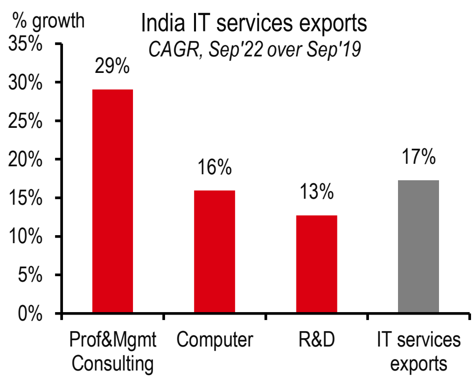
The one sector that generates revenues under each of these heads, and has, we believe, contributed to the fast growth in IT services, is **Global Capability Centres (GCCs)** and their rise.

Chart 5: Breakdown of IT services exports



Source: CEIC, HSBC

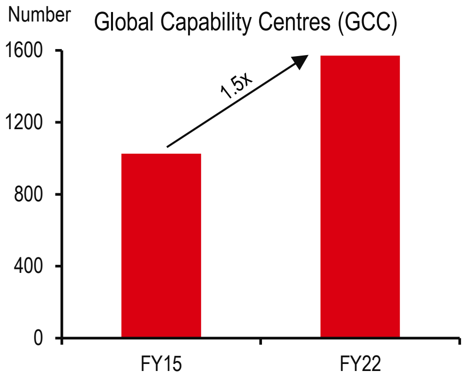
Chart 6: Over the last three years, professional and management consulting exports have grown the fastest



Source: CEIC, HSBC

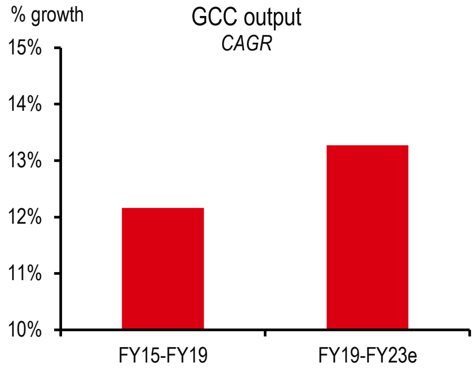
1 Here we include the revenues of seven prominent IT services firms

Chart 7: Many large MNCs have set up GCCs in India, and the number has been rising



Source: Nasscom, HSBC

Chart 8: GCC output has risen quickly in recent years



Source: Nasscom, CEIC, HSBC

Oh so capable

What are GCCs?

Put simply, they are delivery centres set up by large MNCs. They provide tech services, research and development, and engineering and IT support[2].

Many large MNCs have set up GCCs in India, and the number has been rising, from 1,026 in FY15 to 1,570 in FY22 (see chart 7). In fact, India is home to about 40% of global GCCs, and this ratio is only expanding.

Currently, their direct output, in terms of sales to parent organization and other industries, is about USD51bn, making up about 25% of overall IT services exports[3]. And the output of GCCs has risen 13.3% CAGR over FY19-23, from 12.2% in the four years prior (see chart 8). In the last two years (FY21-23), the output of GCCs has risen 19% CAGR, broadly in line with the growth in overall IT services exports.

More important than past growth are future prospects. GCCs are expanding both in scope and depth**.** After starting off as providers of support functions, they have moved up the ladder, to tech enablement, business operations, capability development, and even R&D and business development.

Almost 50% of the 1,570 GCCs in India provide Engineering R&D support. These account for over 40% of the total GCC headcount and have been growing at a 12% CAGR. An example here is the GCC set up by AstraZeneca, which has rebranded itself as a Global Innovation and Technology Centre (GITC), driving increased innovation.

The next few years…

After a terrific run, it is possible that the pace of increase in India's IT services exports moderates a shade over the next year or so, in line with slowing global growth. Traditionally, weak growth years and macro uncertainties are associated with lower discretionary project spend and shorter tech budgeting cycles. HSBC's IT analysts expect growth in the revenues of the top IT companies to slow to 7-8% CAGR over FY24 and FY25, from about 12% in the two years prior (see *IT Services: 2022 flashback and 2023 outlook*, 8 December 2022).

2 Companies like HSBC, AMEX, H&M and 3M from diverse sectors have set up GCCs in India.
3 In terms of employment, GCCs have a headcount of about 1.5mn, employing about 30% of IT services professionals.

But we see no major cause for concern about India's external finances over this period. Led by the gains from higher services exports over the last few years, the moderation in oil prices over the last few months, and the tapering off of import-intensive pent-up consumption demand, we forecast **the current account deficit will fall** from 2.5% of GDP in FY23 to 1.7% of GDP in FY24 (see table 1):

- **We assume Brent oil prices average USD10/b lower** in FY24 compared to the levels in FY23. This should lower the current account deficit by 0.3% of GDP.
- **The core trade deficit** (excluding oil and gold) **is likely to narrow** from 3.2% of GDP in FY23 to 2.2% in FY24, as falling import-intensive consumption demand more than offsets the drag from weak goods exports (see chart 9).
- Meanwhile, we forecast **the services balance will remain unchanged** at 4.2% of GDP in FY24, after rising sharply in the years prior (from 3% of GDP in FY19 to 4.2% in FY23f), as global growth slows.
- Weakness in global growth and lower oil prices are likely to **lower the remittances and the invisibles balance** (see chart 10), but will likely be offset by gains from lower oil prices and the lower core deficit discussed above**.**

A lower c/a deficit is particularly important at a time when Fed rate hikes are likely to continue for longer. Our US economist expects three more 25bp Fed rate hikes over the March, May and June FOMC meetings. Last year, when the c/a deficit soared to 4.4% of GDP in September at a time when the Fed was raising rates, the rupee came under weakening pressure.

A narrower c/a deficit over the next year will likely provide some domestic buffer to the rupee in uncertain times, even taking the pressure off the RBI to hike one-to-one with the Fed.

We expect a 25bp repo rate hike in the quarter ending June 2023, taking the repo rate to 6.75%, with risks of a further rate increase if the rupee comes under pressure.

… and gains beyond

The medium-term outlook for IT services looks more exciting than before as tech penetration spreads across industries and the width of possibilities from GCCs expands. As per our IT analysts, the medium-term growth outlook for IT services has improved – even if growth over FY24 and FY25 slows to 7-8% CAGR, it will likely remain higher than the 5-7% pre-COVID-19.

NASSCOM has a target of USD500bn in IT services revenues by FY30. We estimate that after a temporary softening in overall services exports growth in the next two years, this would require a rise back up by about 9% CAGR between FY26 and FY30.

More interestingly, this means that on a net basis, exports which have risen from USD6.8bn/month in FY19 to USD12bn/month in FY23, could further rise to USD20bn/month by FY30 (see chart 11).

As discussed above, between FY19 and FY23, this provided additional revenues of USD60bn. **If Nasscom's targets come to bear, *net* services exports could rise by USD100bn between FY23 and FY30**.

This is significant because as India's GDP growth and investment rate rises, leading to more goods imports, the worsening of the goods trade deficit can be offset to a large extent by a rising services surplus (see chart 12), helping to keep external finances sustainable.

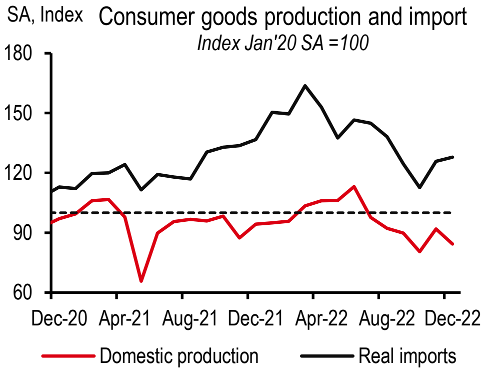
In conclusion, India's IT sector has risen impressively to meet global tech needs. This is likely to provide an additional cushion to external finances in the short run (when the Fed hikes rates for longer) and also the medium term (helping fund a likely rising goods trade deficit).

Table 1: India's current account balance

USD bn, unless specified	FY22	FY23f	FY24f
Current account balance	**-39**	**-84**	**-63**
% of GDP	*-1.2*	*-2.5*	*-1.7*
Goods	**-189**	**-277**	**-260**
Exports	429	442	451
Oil Exports	63	75	74
Non-oil Exports	366	367	377
Imports	619	719	711
Oil Imports	162	211	211
Gold Imports	46	34	42
Non-oil non-gold Imports	411	474	458
Services	**108**	**142**	**153**
Exports	255	321	340
Imports	147	179	187
Income & Transfers	**43**	**50**	**45**

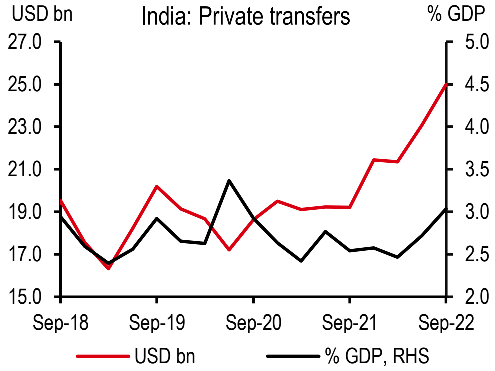
Source: CEIC, HSBC estimates

Chart 9: The import of consumer goods has fallen



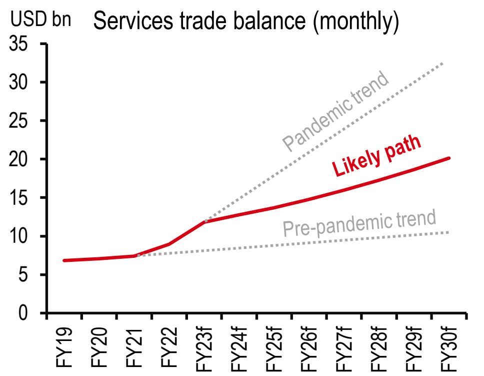
Source: CEIC, HSBC

Chart 10: Remittances have risen quickly, but could moderate in line with global growth and oil prices



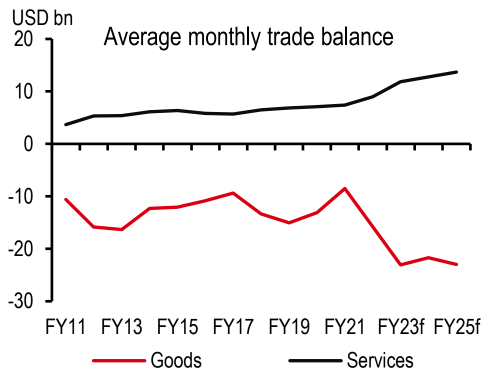
Source: CEIC, HSBC

Chart 11: On a net basis, exports could further rise to USD20bn/month by FY30



Source: Nasscom, HSBC calculations

Chart 12: The worsening of the goods trade deficit can be partly offset by rising services surplus



Source: CEIC, HSBC estimates

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1 This report is dated as at 09 March 2023.

2 All market data included in this report are dated as at close 08 March 2023, unless a different date and/or a specific time of day is indicated in the report.

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