DRIVING GROWTH FOR INDIA THROUGH MANUFACTURED EXPORTS was the subject of the speech delivered by Mr. M.S. Banga, Chairman, Hindustan Lever Limited, at the Annual general Meeting held on June 26, 2002

THE UNRECOGNISED DRIVER OF GDP GROWTH

It may come as a surprise to you that exports have been one of the largest drivers of India's economic growth, contributing over 25% of GDP growth in the last decade. Exports is now 10 % of India's GDP, and has grown by 11 % in dollar terms per annum over the last 10 years – more than twice the rate of the domestic sector. Going forward, the importance of exports will only increase.

Historically, India has focussed on exports largely to manage Balance of Payments, and in many ways it has been a residual sector in economic planning. In today's global economy, exports must become one of the cornerstones of India's economic planning and growth over the next decade.

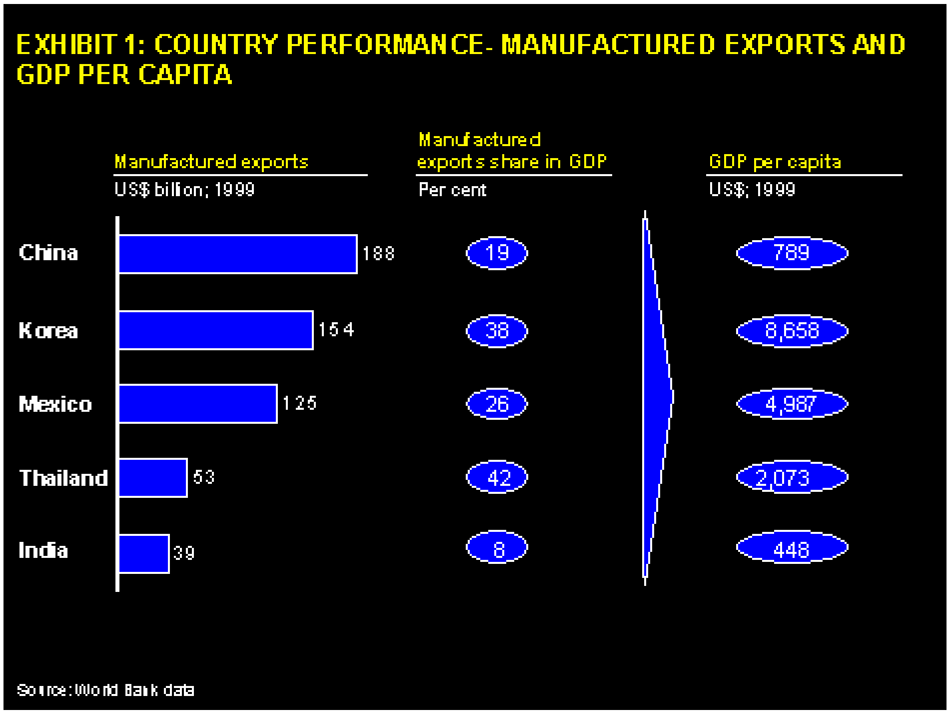
I believe India should aspire for an export growth of 20 % per annum over the next decade – nearly double the current target of 12 % in our 10th Plan. This will take exports to over US$ 100 billion in five years, and add 2 % to GDP growth every year. It will double the current employment growth rate in the organized private sector, creating 70 million new jobs over 10 years. This vision could fundamentally reshape India's economic growth with its multiplier effects.

Hindustan Lever has for many years been one of India's largest exporters with a strong focus on manufactured exports. In this speech, I have built upon this experience to outline India's potential in manufactured exports, identify the critical barriers that need to be addressed and propose some specific initiatives that Government and Industry can take to exploit this opportunity.

THE POTENTIAL FOR MANUFACTURED EXPORTS

India clearly has the potential to become a global sourcing centre for services. The continuing growth in the IT and IT-enabled services sectors amply demonstrates this. However, India cannot rely on services alone to drive exports. Manufacturing constitutes 72 % of global trade worth US$ 6 trillion. For exports to be a major platform for growth, it is imperative that we focus on and drive manufactured exports.

Other countries have accomplished this in the past. Korea, Mexico, Thailand and China are all examples, where the power of manufactured exports has been leveraged to drive economic growth and raise per capita incomes. India, with roughly similar intrinsic strengths, is a poor comparison in both absolute and relative terms -- our manufactured exports are less than a third of those of Mexico, Korea or China.



THE GLOBAL OPPORTUNITY FOR SOURCING

A substantial part of manufactured exports comes from global companies outsourcing manufacturing activities from low-cost locations. Economic cycles, market and competitive pressures and falling costs of interaction and transaction will continue to fragment industry value chains, and enable outsourcing of manufacturing activities to lower-cost economies. A study done by Bear, Sterns & Co. estimates that outsourcing of manufacturing across a broad category of industries could grow to 50% of the total, by 2010.

As mentioned earlier, several countries have successfully used outsourcing to build their economies. Taiwan is the world's leading source for semi-conductor manufacturing. China today produces 30 % of all air conditioners, 24 % of all washing machines and 16 % of all refrigerators sold in the US. Indeed, as much as 60% of the US$ 250 billion FDI into China was to build capacity for outsourcing.

And yet, the potential for outsourcing manufacturing remains largely untapped, with many sectors still concentrating their manufacturing in the developed world. In Auto Components, the global market is US$ 750 billion with most of its manufacturing in high-cost countries. The Indian auto components industry is a mere US$ 3 billion, with exports of US$ 375 million. Given Indian engineering and design skills as well as lower costs, there is a big opportunity to increase sourcing of auto components for global companies.

Similarly, in Apparel, although a fair amount of manufacturing has already moved out of the developed world, the US still produces US$ 47 billion of apparel, Italy US$ 27 billion and Germany US$ 21 billion. Indian exports in comparison are approximately US$ 5 billion. This could be another window of opportunity for us. Even if some countries limit our exports through quotas, we can emulate China and grow our share in non-quota countries.

In the FMCG sector, the top 20 companies generate sales of over US$ 450 billion. As consumption is largely driven by the developed economies, most of the manufacturing is still located in high-cost regions. HLL is targeting outsourcing opportunities in several categories.

There could be similar opportunities in many other sectors.

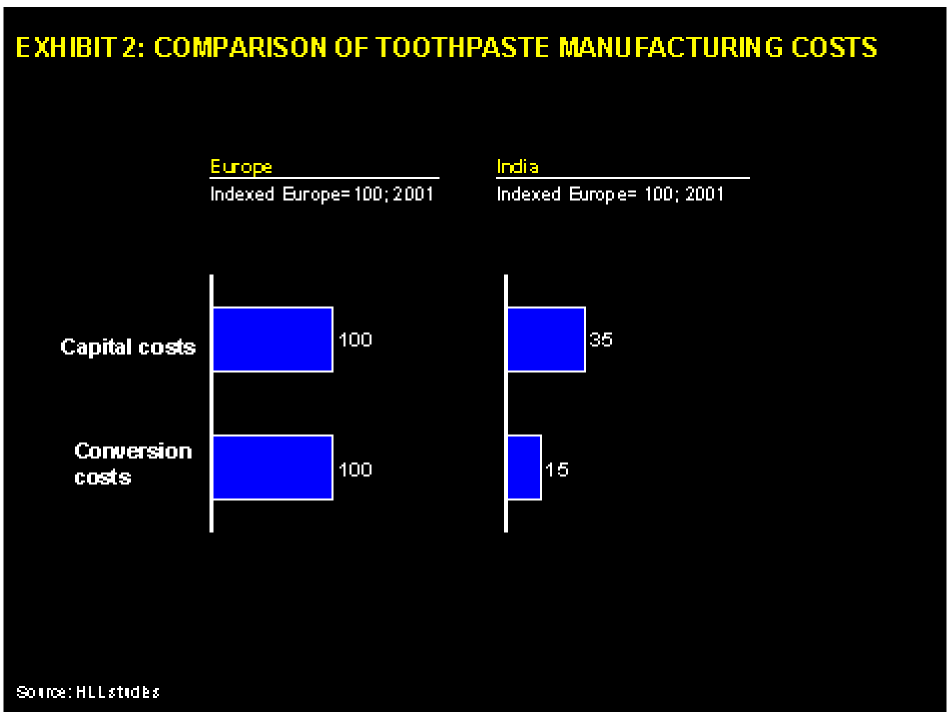
Driving exports by sourcing for global companies has many advantages. It attracts FDI into India. It also avoids the large marketing investments required to gain foreign consumer and market access with its associated risks. It is built on long-term relationships and therefore has much more stability and sustainability.

Sourcing thus offers a powerful and sustainable driver for India's economic growth. We have to focus on realising its potential as early as possible.

INDIA'S COST ADVANTAGE

In the context of sourcing, India's cost advantages vis-à-vis the developed world are well known. The magnitude of the difference may, however, come as a surprise.

I would like to demonstrate this through our own estimate of the potential savings from sourcing toothpaste for Europe from India.



There are other categories as well, where we have a similar edge. In the sourcing of tea-bags, for instance, our conversion costs are 25% of the US.

Our advantage in capital costs comes from a variety of sources. Superior Indian skills in engineering design and manufacturing have helped us substitute imported capital goods at a fraction of the international cost. In-house project management gives considerable benefit as does higher asset utilisation.

In addition to the labour cost advantage, conversion costs are lower as we have taken several initiatives to improve capital productivity. We have also leveraged our domestic business to derive scale benefits and institute best practices to reduce costs and wastages.

These cost differentials, even net of freight, open up a significant opportunity for sourcing some FMCG categories out of India for Europe and the US. This holds true for other sectors too, where India can very effectively become a major manufacturing base for the developed world, if we remove some cost and other barriers.

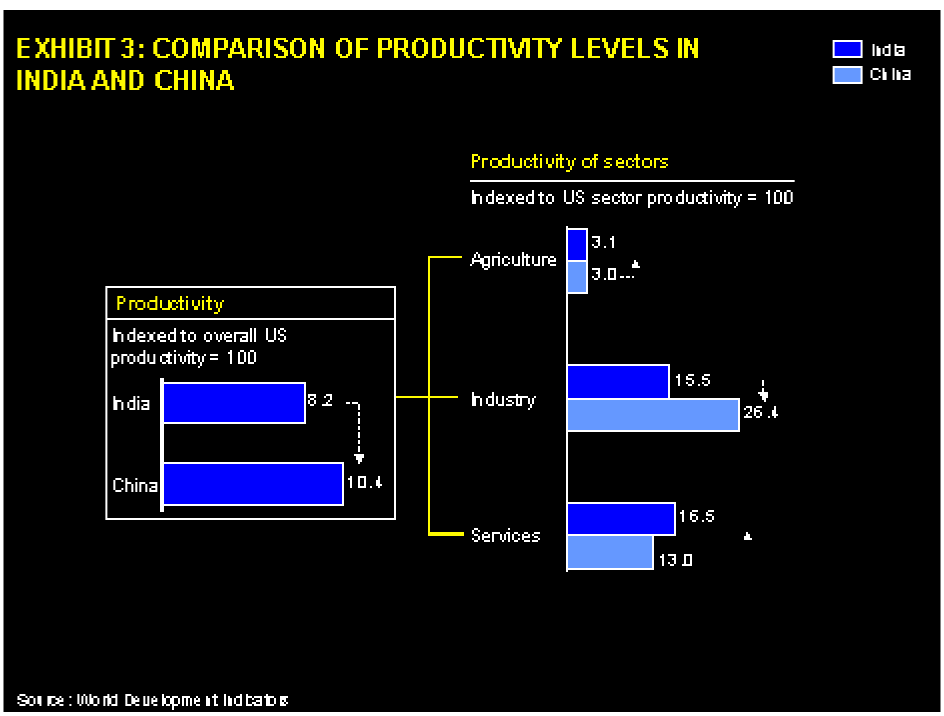
BARRIERS TO THE GROWTH OF SOURCING

While we compare favourably vis-à-vis developed countries, India is uncompetitive when compared to other low-cost nations such as China. This is with respect to some of the key factors critical to sourcing business out of the developed world: Cost, Image and Process competitiveness.

Cost Competitiveness

The decision to relocate a manufacturing operation is primarily based upon a substantial and sustainable cost differential. Producing a shirt in China today costs 20 % less than what it does in India. Labour costs account for half of this differential, with infrastructure costs and taxes making up the rest.

Labour productivity in India is low. World Development Indicators show that India's labour productivity in manufacturing is 70 % lower than China, and over 80% lower than the US. Interestingly, this differential is seen only in manufacturing with India's labour productivity in both the agriculture and services sectors being higher than that of China. However, it is heartening that there are pockets of excellence with world-class productivity in Indian industry, showing that this can be achieved.



Labour reform will be a very important enabler and it is critical that we move with resolve and speed. There are some other steps too that we can take to enhance productivity.

Good port infrastructure is critical to global trade. In India, greater delays due to customs and handling leads to 30 % higher working capital requirement. In addition, trans-shipment and poor turnarounds impose an additional cost of 1.5 % on Indian exports versus other low-cost locations. In an era of dynamic markets, these create a powerful customer servicing barrier to sourcing from India.

Cascading taxes at all levels add to the cost differential. Outside of the SEZs/EOUs, there is no facility to refund taxes like CST, octroi and entry taxes. HLL's own data shows that this results in an additional cost of 7 % for a product like shampoo. Such structural disadvantages in cost render us globally uncompetitive.

Image Competitiveness

India today has certain intrinsic advantages over other low-cost economies in Asia. These include our commitment to democracy, an established judicial system, a large domestic market as well as the third largest pool of science and technology trained people in the world.

However, customers today do not view India as a sourcing centre of choice, in terms of quality, reliability and customer service. It is critical to change this perception by creating visible examples of India's potential leadership in two or three sectors. Japan used its leadership in the electronics and auto industries to establish itself at the cutting edge of quality and innovation. Korea has done this with consumer electronics.

The other big barrier is the adoption of internationally acceptable safety, health and environmental standards. Industry must begin a programme of voluntary compliance, well ahead of statutory impositions, especially as these truly make economic sense. Our own experience in HLL is that greater investments in safety and health lead to greater productivity. Similarly, environment friendly processes have resulted in lower costs. In the last five years, we have cut down HLL's water consumption by 65% and specific energy consumption by half.

Process Competitiveness

Despite the ongoing reform process, India ranks as one of the most restrictive and opaque economies to do business with. In the Country Business Ranking done by the Economist Intelligence Unit, India was ranked 46 among 60 countries on several business enabling factors, while Korea, Mexico, Thailand and China ranked higher. Also, both Industry and Government score poorly on process efficiency. Even getting an approval to convert an operating unit to a 100 % EOU takes over three months, with several departments being involved in the process. These factors make an enormous difference to the attractiveness of an outsourcing location. We must substantially reduce complexity and delay in our processes.

MAKING INDIA COMPETITIVE

It is important to acknowledge that a number of major Governmental initiatives in the recent past are all in the right direction. The creation of Special Economic Zones (SEZs) to facilitate global trade, the beginning of privatisation of Mumbai port and the Golden Quadrilateral Project adding 1500 km every year to our National Highway network will all add significantly to our international competitiveness.

However, more needs to be done – and quickly. I would like to suggest five immediate initiatives that Government and Industry can take to significantly improve the cost, image and process competitiveness of India, in order to make it a preferred destination for manufacturing outsourcing.

1. Identify, nurture and promote 2 or 3 'Star' sourcing sectors

India needs to create visible successes in a few sectors to build its image. Within our country's portfolio, I believe that Pharmaceuticals, FMCG and Processed Marine products are three industries with potential to be these 'Stars'. They combine high consumer visibility with stringent quality requirements in the countries of consumption, while leveraging on our strengths. Success in these could demonstrate Indian Industry's ability to deliver appropriate quality and customer service at a globally competitive cost.

In Pharmaceuticals, we have many success stories of Indian companies combining two very unique Indian characteristics: a large pool of talented chemists and good entrepreneurial ability. A sizeable export business of US $ 350 million has already been built in Active Ingredients for generic drugs and formulations. However, the global generics market is about US$ 30 to 35 billion in size, and there is tremendous headroom for upscaling exports by making pharma a 'Star' sourcing sector.

In the US$ 60 billion Processed Marine products market too, we have the potential to become a big player. We have considerable unexploited natural marine wealth and are also well below the 'maximum sustainable yield' levels in fishing. An emerging cost advantage vis-à-vis economies like Korea and Thailand which dominated global sourcing in the past, also gives us important leverage.

Similarly, our own experience in FMCG sourcing gives me the confidence that it too can be a 'Star' sector.

There is a rationale for the choice of these sectors. The US FDA requirements are stringent for pharma. Consumer involvement in food items is high. FMCG items are items of mass consumption. If we are able to successfully create a niche for ourselves in these sectors, it will give the 'Made in India' brand for manufactured exports a big boost, which we can then extend to other sectors.

I believe we need to establish an **Apex Sourcing Body** to nurture the 'Star' sourcing sectors. A good role model is NASSCOM, which has played a crucial role in positioning India as a global IT services sourcing base. Manufactured goods sourcing too will gain from a similar organisation, whose focus will be on building the India Inc. brand through some key activities - attracting lighthouse global companies to establish manufacturing bases in India; continuously highlighting legal and regulatory changes required by the sector; and finally, being a knowledge repository for information and research on the sourcing potential of India.

Given the scope of the operation of this institution, it needs to have the authority and funding that comes from Government backing. I would therefore recommend the creation of a quasi-government body with strong linkages to both the Commerce and Finance ministries, and independently managed by professionals deputed from Industry.

The Government is committed to removing fiscal incentives for exports over a period of time and the withdrawal of Sec. 80HHC benefits alone could save the Government Rs. 800 crore per annum. Some of this could be used to support the Apex Sourcing Body as well as other initiatives to build the 'Made in India' brand.

2. Create 'Virtual SEZs'

The current Special Economic Zone (SEZ) legislation aims to create world-class infrastructure within a specified region. While this is a welcome initiative, we must do more.

First, to enjoy the benefits of this legislation, a company needs to be physically located within the SEZ. This would require an existing exporter to spend valuable resources in relocating manufacturing facilities (and potentially suppliers) to an SEZ. An added complexity is that many industries need to be located near the source of raw materials (e.g., steel) or skilled labour pools (e.g., diamonds) and it does not make economic or business sense to move such industries.

Another issue is speed. Even if we start building an SEZ today, it will take two to three years to begin functioning with the full infrastructure in place. There is clearly a need for some interim action.

The solution lies in creating a network of what I call 'Virtual SEZs' (VSEZs). A VSEZ is similar in concept to the current EOUs. Any unit that exports more than 50 % of its production in a block of three years, wherever it is located, will be a deemed VSEZ. Consequently, these VSEZs would enjoy all the benefits available to an SEZ, including fiscal advantages, freedom from administrative procedures, labour management, and so on. The only advantage they would miss out on, of course, would be the infrastructure and shared service benefits that an SEZ offers. The administration of these VSEZs could be similar to that of EOUs – through EOU/SEZ Commissioners -- to preserve the autonomous operating system.

This approach would enable companies to quickly pilot outsourcing for global companies from their existing domestic units without making major investments. Once these pilots are successful, they could establish larger capacities in SEZs.

To begin with, the VSEZ facility could be extended to those companies with an export of Rs. 100 crore per annum. I believe that this would be an innovative way to kickstart sourcing without waiting till the SEZs are fully established.

3. Privatise 2 major ports to create world-class infrastructure

The experience in privatising three terminals in Chennai and Mumbai ports has been very encouraging. In Chennai, P&O data shows that within three weeks of privatisation, berthing delays came down from 200 hours to virtually zero and the number of containers handled went up 4.5 times – and all this was achieved through merely adopting better port management practices and greater process discipline. This privatisation has also brought in investment of Rs. 1400 crore.

I would urge the Government to take advantage of the current momentum around divestment and fully privatise two ports, Mumbai on the West coast and Chennai on the East. This will not only enhance efficiencies and bring down costs, but also earn Rs. 2000 crore, in addition to the annual revenue streams. This will establish world-class processes and systems in at least two ports in India and serve as a model to rapidly privatise other ports as well.

4. Drive industry productivity and process excellence through TPM

Indian industry must develop an obsessive commitment to productivity. Traditional methods of activity analysis and process upgradation will certainly bring some gains. But a step change in productivity will come from introducing and entrenching process excellence in every shop floor.

HLL's own experience in using ***Total Productive Maintenance (TPM)*** as a tool to deliver this has been very successful. The essence of TPM is business process improvement through working teams, cutting across organisational layers. These teams are empowered, and supported by suitable training and other inputs. They handle the entire process of problem identification, suggestions for improvement and implementation of the solution in a collaborative fashion. A TPM factory is unbelievably superior to a non-TPM one – I have seen this for myself. On an average, we have doubled productivity through TPM and, in some cases, taken it up to three times the original levels. We have now adopted TPM in our offices and sales processes as well.

While TPM as a concept is not new to India, we now need to adopt it with intensity and scale – with a religious fervour - across all industry sectors. How can we do this? First, we need to make TPM training a part of our ITI and Engineering education. This move will give more than 200,000 TPM-trained personnel annually to industry. Second, for more focussed inputs, we need a network of TPM institutes. Third, we need a JIPM (Japanese Institute of Plant Management) certification programme for exporters along the lines of SEI-CMM for IT services companies, which will add considerably to the image of our sourcing.

The benefits of such widespread adoption of TPM will be measurably large and the culture that it inculcates will be invaluable as we gear ourselves up to international levels of quality and productivity. Government and Industry should be demonstrably committed to this and should make concerted efforts to disseminate the concept and impart training for its implementation.

5. Moving to an enabling Fiscal and Regulatory Regime

Our approach to the regulatory regime for exports in the past has been one of control, stemming from the need to conserve foreign exchange, rather than to actively enable exports as a growth driver. There are two areas where the regime puts us at a distinct disadvantage, which we need to urgently address:

- Comprehensive VAT for exports: Outside of EOU/SEZs, there are no schemes for zero-rating of all indirect taxes for exports. Consequently, they add to the cost burden of the Indian exporter and make him uncompetitive. The proposed introduction of State VAT will be a good step, but we will need to move rapidly to a Comprehensive VAT covering all indirect taxes on both goods and services, to be globally competitive. 140 out of 147 countries in the WTO already have Comprehensive VAT.

I would strongly urge the Government to introduce Comprehensive VAT for the exports sector immediately. This would also provide useful learnings for implementation subsequently in the domestic sector.

- Simplify Transfer Pricing rules: The current transfer pricing rules are restrictive rather than enabling for exports. We must recognise that price fixation in international markets is subject to many variables, all of which may not be common across firms, industries or, indeed, across time. In view of this, we must make our transfer pricing rules less straitjacketed and formulaic. A simple solution is to increase the margin for variance from 5 to 15 %, and simplify the administrative and documentation procedures.

In addition, I would recommend that, in order to learn, we first implement the simplified regime for imports, and then roll the scheme out to cover exports.

PUTTING EXPORTS ON THE STATES' AGENDA

Apart from the Centre, the States also have to play an active and collaborative role in encouraging exports. One way to incentivise States to do this, is to give export performance due weightage in finance allocation metrics. This will help get on-the-ground support for various initiatives, which will make a big difference to exporters.

HLL'S VISION FOR MANUFACTURED EXPORTS

I would like to turn now to HLL's own experience. Historically, HLL, like many other companies, entered exports because of a statutory mandate. It is interesting that while the original imperative for exports is no longer relevant, the skills and competencies that we have built up over time now enable us to take advantage of the global sourcing opportunity in manufactured goods.

HLL enjoys international recognition within Unilever and outside, thanks to its performance in both the domestic and export markets. This has been a major factor in allowing us to tap the global sourcing opportunity. Our engineering design, set-up and project management skills have enabled us to set up capital facilities at one-fourth to one-third of costs in developed countries. Our factories' commitment to quality, reliability and productivity, which has been greatly enhanced by the adoption of TPM has helped us to deliver 'world class quality at world scale costs'. High-quality management talent has not only helped to get business in, but has also sustained it through excellent product & process innovation. Our customer service is supported by excellent IT-based systems and processes. Domestic scale has helped us gain significant cost advantages. These factors are relevant not only for us, to build on as we go forward, but also for Industry as a whole, because we have essentially leveraged on many characteristics that are unique to India, to emerge as one of India's largest exporters of manufactured goods.

Going forward, we have reformulated our approach to exports, to make sourcing an integral part of our strategy to maximise shareholder value. Sourcing already accounts for about half of our total exports of Rs.1500 crore. I believe, however, that this holds significantly greater promise. In Home and Personal Care, our innovation and research & development capabilities are noteworthy. We have one of the largest R&D facilities in the private sector, encompassing several Global Technology Centres. In Tea, our knowledge of plantations, buying and grading of teas, manufacturing and supply-chain gives us an edge in sourcing tea-bags and instant teas for the developed world.

HLL's vision is to build a billion-dollar sourcing business out of India.

CONCLUSION

Sourcing of manufactured exports for the developed world has the potential to change India's economic future. It could virtually double the export growth rate to 20% per annum, thereby adding US$ 4.5 to 5 billion annually to exports growth. This target is certainly within our reach, given the size of the sourcing opportunity and the experience of other countries, and in the context of our own existing and potential capability.

The benefits of this are huge - it would add 2% per annum to our GDP growth and double the employment generation in the private organized sector, creating 70 million jobs over 10 years.

We have a tremendous opportunity, which we cannot afford to miss. We must move quickly to pre-empt other countries in the race for global sourcing. Government and Industry must work together to dramatically improve India's Cost, Image and Process competitiveness.

The time is right for us to move Exports to the top of the economic agenda and make it a national priority.