Congressional Testimony

Deepening US-India trade relations

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Summary and Recommendations

1. India's economy has been growing rapidly, at about 6½ percent for over three decades since 1980, and close to 9 percent in the last decade. As a result, it has emerged as a major power with an economy (US$4.7 trillion) that in 2012 became the world's third largest (in purchasing power terms), surpassing Japan and now behind only China and the United States. Its trade in goods and services is close to a trillion dollars, and expected to double every seven years.

2.This dynamism has expanded opportunities for US business. US exports of goods to India have increased close to 700 percent in the last decade. Exports of services have doubled in the last four years. US foreign direct investment (FDI) has increased from US$200 million to US$6 billion. Moreover, trade and FDI flows between the two countries are balanced, minimizing the scope for macroeconomic and currency-related tensions.

3. However, India is currently encountering a bout of severe turbulence. On the economic front, growth has decelerated sharply, from 9 percent to 4.5 percent. And macroeconomic vulnerabilities--high fiscal deficits (9 percent of GDP), stubbornly elevated (double-digit) inflation, and a deteriorating external balance (over 4 percent of GDP)--have been mounting. Politically, India is heading toward its next general election, which has to take place before the spring of 2014, complicating and imparting uncertainty to economic policy-making.

4. In response to adverse developments, the government has undertaken, since late 2012, major domestic economic reforms. Reforms have also included an ambitious opening up of the economy to foreign direct investment and to foreign financial investors. Indeed, since the global financial crisis, few countries have opened up to foreign capital to the extent that India has. Significantly, and reflecting a domestic bipartisan consensus, there have been no major

macroeconomic reversals of opening to foreign trade and capital. These reforms have come against the backdrop of a longer-term trend of surging Indian trade and foreign direct investment, with enormous benefits for foreign and American business.

5. However, US business faces three major challenges in India. Two challenges common to all foreign business are: first, the weak and uncertain regulatory and tax environment that affects the civil nuclear industry, infrastructure, pharmaceuticals, and more broadly the operations of foreign multinationals in India. Second, although the broad macroeconomic picture is one of opening and surging trade and investment, protectionism in selected sectors has re-surfaced. India is seeking increasing recourse to localization—in banking, telecommunications, retail, and solar panels among others—which favors domestic providers of inputs and equipment over foreign providers. Thus, broad trade and macroeconomic policies toward foreigners are moving in the right direction but sectoral policies have experienced setbacks.

6. Third, American firms are increasingly facing implicit but substantial discrimination in India's large and growing market because of India signing (or on the verge of signing) free trade and economic partnership agreements with its largest trading partners that are all major competitors to the US: Europe, Japan, Singapore, ASEAN, and possibly ASEAN-plus 6. Soon, if not already, this discrimination may be the bigger challenge for US business than some recent sectoral measures. These RTAs are neither as comprehensive in their coverage across and within sectors as the FTAs negotiated by the United States, nor as expeditious in the time frame for implementation. But they provide more favorable access to non-American suppliers and because India's tariffs and barriers can be high, the discrimination can be substantial. Combined with the fact of India's large and growing market, US suppliers can really be disadvantaged.

7. The enormous potential for US-India trade and investment remains enormous not least because of India's unexploited growth opportunities. And this potential will be determined and realized, above all, by India's domestic reforms to re-vitalize investment and growth and to restore macroeconomic stability. Pro-growth trade and investment policies will also play an important role.

8.The US should adopt the following multi-pronged strategy for solving trade conflicts and maximizing the underlying potential. First, the US should address frictions especially where Indian policies are demonstrably protectionist (as in the case of many local content requirement policies) through multilateral (WTO) dispute settlement procedures. The US should not be reticent in this regard. India has an excellent record of compliance with WTO rulings against it. And one of India's most sweeping trade reforms occurred after a US-initiated WTO dispute panel found that India's broad quantitative restrictions on consumer goods violated WTO rules.

9. Second, US initiatives such as the Trans-Pacific Partnership (TPP) and the Trans-Atlantic Trade and Investment Partnership, by discriminating against India companies and exporters, will

exert natural pressure on India to open up either directly or by prodding participation in these and other trade liberalizing initiatives.

11.Third, there is merit in initiating deeper bilateral trade integration between India and the United States as a framework for giving recognition to the broader strategic imperative of closer cooperation between the two countries, for pursuing further liberalization in both countries and for reversing the discrimination that each is inflicting on the other. But this framework must also be used for re-vitalizing the multilateral trading system and the WTO by moving beyond the Doha Round and giving consideration to a broader "China Round." A re-vitalized multilateral system remains the best way of dealing with the rise of China and ensuring that it pursues transparent, rules-based, and non-discriminatory policies.

12. Finally, India's challenging regulatory environment is unlikely to see major improvements in the short to medium term. US business will have to learn to move outside its comfort zone to navigate an Indian market where rule of law and legal certainty cannot be taken for granted. If it does not, it risks losing out to firms from other countries in one of the world's largest and most dynamic markets. Unfortunately, to paraphrase the line from the great Italian novel, *The Leopard*, the more things stay the same in India, the more American business will have to change.

I. Recent macro-economic background

India has experienced about 6½ percent growth, for over thirty years since 1980, and nearly 9 percent over the last decade. As a result, India is now a 2 trillion dollar economy (measured at market exchange rates). In purchasing power terms, it became in 2012 the world's third largest economy (US$4.7 trillion), surpassing Japan and now behind only China and the United States. Its trade in goods and services is close to a trillion dollars, and expected to double every seven years.

But recently, India has experienced a bout of severe turbulence. After several years of rapid growth, averaging close to 9 percent, India's GDP growth decelerated from late 2010, reaching a low of 4.5 percent in the last quarter of 2012 (Figure 1). External factors, notably the euro-crisis-induced slowdown in the world economy and high oil prices explain part of the growth deceleration. But domestic factors—fiscal populism, weak governance, and policy uncertainty—have also played an important role.

Consumer price inflation has remained at or close to double digits for over three years. There are recent signs of a let-up especially in wholesale and core inflation but fundamental inflationary pressures remain a source of serious concern (Figure 2). Another worrisome trend is the deterioration in India's external balances. India's current account deficit that has remained less than 3 percent of GDP for many years, is now edging close to "flashing amber" territory of about 4.2 percent of GDP (Figure 3).

Underlying the problem of inflation and external imbalances is the fiscal position. As a result of rising expenditures, mainly devoted to the social sectors and transfers, which have doubled in per capita terms over the last decade, the government's budget deficit has remained close to 10 percent of GDP (Figure 4).

A comparison of India's macroeconomic indicators with other emerging market countries (Figure 5 from the IMF) illustrates that India is uniquely vulnerable: it has much higher inflation and much larger fiscal deficits than many emerging markets. Compared to China, for example, India's inflation and fiscal deficits are nearly three times as great.

Late last year, in response to these adverse developments, and in order to head off a looming investment downgrade by the foreign credit ratings agencies, the government undertook bold actions. It enacted measures to reduce fuel subsidies on diesel and limit the subsidy on cooking gas. The reductions are ongoing and take the form of small but steady increases in the consumer price of diesel. It approved greater foreign direct investment (FDI) not just in multibrand retail (which will benefit Walmart in particular) but in aviation, broadcasting and power exchanges. And since the crisis, steady liberalization of the capital account has taken place to allow more access for foreigners to the Indian equity, corporate and government bond, debt, and foreign exchange markets.

Further, to avoid delay in implementation of large projects, a number of measures have been taken, including the setting up of a new Cabinet Committee on Investment (CCI) under the chairmanship of the Prime Minister. The Committee has been mandated to fast track large infrastructure projects. The authorities have recently accepted all the major recommendations of an Expert Committee that would bring about greater clarity in taxation, and are also seeking to avoid retroactive tax and other measures.

For some time now, preparations have been underway to implement a full-fledged value added tax (called the Goods and Services Tax, GST) at the federal and state levels. The expectation is that implementation of the GST will begin in 2014, and when fully implemented this tax is expected to yield about 2 percent of GDP in additional revenues which would improve the medium-term fiscal picture. Importantly, since 2010 the government has embarked on a large project of biometric identification (*Aadhaar*) with the aim of using this as a basis for direct cash transfers to eventually replace the transfers that take place indirectly, ineffectively, and leak-intensively, through various forms of subsidies for food, fuel, and power. This program offers the possibility that government subsidies which are a big drag on the budget could be replaced by measures that cost less and better reach the intended beneficiaries.

The most recent budget submitted to Parliament on February 28, seeks to reduce the budget deficit and limit expenditures which is especially important ahead of elections to Parliament that must take place before the spring of 2014. Politics in the next year will be dominated by the fact of impending elections. Put differently, the temptations to be fiscally populist will be great; and the ability to liberalize the economy to foreign business will also be constrained.

II. The Broader, Medium-Term Context

India’s current macroeconomic difficulties, and adoption of specific localization measures notwithstanding, should be seen against the backdrop of positive long term trends and future potential. Since India’s reforms were unleashed in 1991, India’s trade barriers have come down substantially. As Figure 6 shows, India’s average MFN tariffs declined from 100 percent in 1986 to less than 10 percent in 2009. The figure under-states progress on trade opening because India also maintained a broad range of severe quantitative restrictions on consumer goods which were eliminated in the late 1990s. Despite some recent reversals of a sectoral nature, there is no threat of India repudiating the fundamental strategy of embracing greater openness. And this view is shared across the political spectrum: Congress and BJP-led governments have both implemented market opening.

India has, until recently, been amongst the biggest users of anti-dumping actions. The country that has been the greatest target of Indian actions has been China. It is noteworthy that in the last 12-18 months, Brazil and Argentina have displaced India amongst those taking the greatest recourse to antidumping actions (Table 1).

Reflecting the combined impact of policy liberalization, technological change and India's internal dynamism, India's trade surged during the last decade (Figure 7). Exports of goods and non-factor services surged seven-fold in just over a decade from US$60 billion to US$ 420 billion. And imports also increased seven-fold from US$75 billion in 2000 to US$525 billion in 2011. As the chart shows, India recovered robustly from the impact of the global financial crisis. India's openness ratio (the ratio of trade to GDP) doubled over the course of a decade from about 25 to 50 percent. Indian global integration is thus well advanced.

Similarly, India's FDI has also increased but from a very low base of about US$3.5 billion in 2000 to US$43.5 billion just before the crisis. FDI has not completely recovered from the global financial crisis but recent measures should carry forward the momentum established earlier (Figure 8). India's FDI inflows remain well below those of China (which have averaged close to US$ 100 billion over the last decade), so India has to catch up for the nearly two decades of surging FDI that China has benefitted from.

This surging overall trade and investment has benefitted United States-India bilateral trade . India's exports to the US have increased by about 250 percent since 2000, from US$ 9 billion in 2000 to US$32 billion in 2011 (Figure 9a). The United States is India's largest export market. More dramatically, US exports of goods to India have increased by nearly 700 percent, from US$ 3 billion to US$ 23 billion (Figure 9b). However, China has overtaken the US as India's largest supplier of goods and services, and the US is not even amongst the top three sources of imports for India. It is important to note that US-India trade is broadly balanced unlike India-China and US-China trade, so that the scope for trade frictions from exchange rate and macroeconomic policy is minimized in the case of India-US trade.

Trade between India and the US in services is also surging. Between 2006 and 2010, US exports of services to India (cross-border delivery plus sales by US foreign affiliates) have more than doubled from about US$ 12 billion to nearly US$ 25 billion. This remarkable growth occurred during the global financial crisis. A similar trend characterizes India's exports of services to the US (Table 2).

In terms of FDI, two points are worth noting. First, the United States is not the largest investor (consistently) in India. According to OECD data (Figure 10), US FDI to India surged from about US$200 million to nearly US$6 billion in 2010. But the United States was surpassed by the United Kingdom for the most recent period and by Japan in earlier periods. So, the potential exists for large increases in US FDI to India.

Second, FDI like trade in goods and services is also increasingly becoming two-way. A study commissioned by Federation of Indian Chamber of Commerce and Industry (FICCI) showed that between 2004 and 2009, 90 Indian companies made 127 Greenfield investments worth US$ 5.5 billion in metals; software and IT Services; leisure and entertainment; industrial machinery; equipment and tools; and financial services. During the same period 239 Indian companies invested in excess of US$ 20 billion in merger and acquisitions in different states and across a wide range of sectors. As a result, tens of thousands of direct jobs (predominantly US citizens), supporting many more indirect ones, have been created.

III. Challenges for American Business

However, it remains true that the Indian economy remains less open than several other emerging market economies and that pockets of protectionism have emerged recently. US business faces three major challenges in India, two of which are faced by all foreign business and one that is increasingly unique to the US. The two challenges common to all foreign business are: first, the weak and uncertain regulatory and tax environment and second increasing recourse to localization which favors domestic providers of inputs and equipment over foreign providers. The third uniquely American challenge is the discrimination faced by US business.

1.Regulatory and tax environment

India's uncertain policy environment has taken a toll of investment and growth. The sectors/policies of interest to foreign business that have been particularly affected include:

Civil nuclear supply: under the current nuclear liability regime, supplier liability is potentially unlimited which dampens enthusiasm for suppliers such as General Electric.

Power: inadequate cost recovery and pricing policies, state sector domination, and limited coal supplies affect the profitability of the power sector and the attractiveness for private sector participation;

Retail: despite the ambitious liberalization, regulatory obligations are limiting the enthusiasm of foreign retail brands;

Taxes: the retroactive taxation underlying last year's budget has been addressed but issues related to transfer pricing and taxation continue to affect investor sentiment;

Land acquisition: Despite the passage of a new bill, investor concerns remain regarding procedures and compensation.

2.Protectionism through localization

India has undertaken measures in a number of sectors that would require local sourcing of inputs, parts and components not just in relation to government purchases (which are not inconsistent with India's WTO obligations because India is not a member of the Government Procurement Agreement) but also for the private sector. The sectors covered include power, banking, telecommunications, retail, and energy. (In addition, in a number of professional services--legal, accounting and architecture--foreign providers are virtually excluded from the marketplace).

Why the sudden and enthusiastic embrace of localization by India? There seem to be two reasons. First, at a time of slowing growth and given the longer trend of the weak performance of the manufacturing and employment, localization is a second- or third-best policy response aimed at addressing what India considers are vital priorities: building a large manufacturing base that is cutting edge in terms of technology and that creates robust employment opportunities in the formal sector. It is second or third best because the broader and more direct reform agenda—improving regulation, eliminating legal obstacles to employment generation—is politically difficult to implement.

A second reason is China. Impressed by China's ability to induce foreign business to indigenize and transfer technology, and believing that India has China's bargaining power, India is attempting to imitate the Chinese experience.

3.Discrimination against American suppliers

US firms and businesses are not being targeted for direct discrimination. Rather this discrimination is happening indirectly but substantially because of India signing (or being on the verge of signing) free trade and partnership agreements with nearly all the major competitors to the US.

A major development of India's trade policy over the last decade has been the aggressive pursuit of regional trade agreements, especially but not confined to Asia. In addition to comprehensive economic partnership agreements with Singapore and Japan, India is either negotiating or has negotiated some form of RTAs with a number of countries and regional groupings.

These include: Agreement on South Asia Free Trade Area (SAFTA) with Afghanistan, Bangladesh, Bhutan, and Maldives; India-Thailand FTA, which will include ASEAN-plus tariff concessions; India-ASEAN Comprehensive Economic Cooperation Agreement (CECA); Regional Comprehensive Economic Partnership (RCEP) Agreement among ASEAN + 6 Japan, Korea, and New Zealand, Australia, China, India); India - EU Broad Based Trade and Investment Agreement (BTIA); Global System of Trade Preferences (GSTP).

Now these RTAs are neither as comprehensive in their coverage across and within sectors as the FTAs negotiated by the United States, nor expeditious in the time frame for implementation. But they signal India's interest in seeking access to markets abroad. Equally more important, the strong "Look East" nature of the policy is a reaction to China's strong and growing economic presence in East Asia.

All these agreements provide more favorable access to non-American suppliers and because India's MFN tariffs and barriers can be high in some sectors, the discrimination can be substantial. And add to that the fact of India's large and growing market, and US suppliers can really be disadvantaged.

Of course, it must be added that the United States is reciprocating this discrimination (also indirectly) against Indian business when it negotiates the TPP and the Trans-Atlantic agreements.

IV.The Way Forward

The starting point for forging a cooperative partnership is the recognition that despite frictions, the underlying potential is enormous. In my recent book *Eclipse: Living in the Shadow of China's Economic Dominance,* I project that the Indian economy will average a medium-term growth of about 8-8.5 percent, and that its trade in goods and services, currently close to a trillion dollars, will roughly double every seven years, so that by 2018, it will reach close to 2 trillion dollars.

Moreover, from a US perspective there are several encouraging trends: US FDI to India is still far below potential; India will have enormous energy needs, including for natural gas which the US will be able to supply; the potential of infrastructure investment of about a trillion dollars could be exploited by US companies; and India's demand for services will increase enormously, which, as my Peterson Institute colleague Brad Jensen has shown, will disproportionately benefit the US which has a comparative advantage in supplying services.

Against this background, the US should adopt the following multi-pronged strategy for minimizing frictions and maximizing the underlying potential.

Use multilateralism for addressing frictions

First, the US should address frictions and conflict through dialogue and where Indian policy is egregiously protectionist address it through multilateral dispute settlement procedures. In this regard, the recent case initiated by the US against India on solar panels is a good illustration of such a policy. Perhaps, the US should consider initiating more such disputes for policies in other sectors. This approach is desirable for a number of reasons. India takes its WTO obligations very seriously and has had a very good track record of implementing WTO dispute settlement rulings. As Table 3 illustrates, when India is a respondent, disputes are either settled to the satisfaction of all parties or India appears to comply with the rulings against it.

In fact, it is not widely recognized that arguably the most important and sweeping reform of Indian trade policy occurred because of a WTO dispute panel—initiated by the United States-- that ruled against India's quantitative restrictions on consumer goods. These restrictions were severe in intensity and very broad in scope.

For the US, the virtue of using WTO dispute settlement is to reassure the world of its faith in rule-based multilateral institutions; it is also diplomatically and politically less confrontational than unilateral and bilateral actions.

Exert indirect pressure

Second, US initiatives such as the Trans-Pacific Partnership (TPP) and the Trans-Atlantic Trade and Investment Partnership will exert natural pressure on India to open up: either directly or by participation in these and other trade liberalizing initiatives. Just as Indian RTAs exclude US suppliers, TPP and TATIP do the same against Indian suppliers.

Create a new strategic framework

There is merit in creating such a new framework for a number of reasons:

- to give recognition to the broader strategic imperative of closer cooperation between the two countries that share common democratic values;
- to pursue further liberalization in both countries and to roll-back the discrimination that each is inflicting on the other via their respective regional trade agreements;
- to revitalize multilateralism and the WTO by moving beyond the Doha Round to what Aaditya Mattoo and I call a "China Round" of multilateral negotiations. This offers the best way of organizing global economic relations and for dealing with the rise of China and ensuring that it follows open, rules-based and non-discriminatory policies.

That is why the Peterson Institute for International Economics has undertaken an ambitious project (led by C. Fred Bergsten and me and supported by the US-India Business Council, the Smith Richardson Foundation, and the Erranda Foundation) to help create such a strategic framework. We hope to have the results before the end of 2013.

V. Concluding Thought

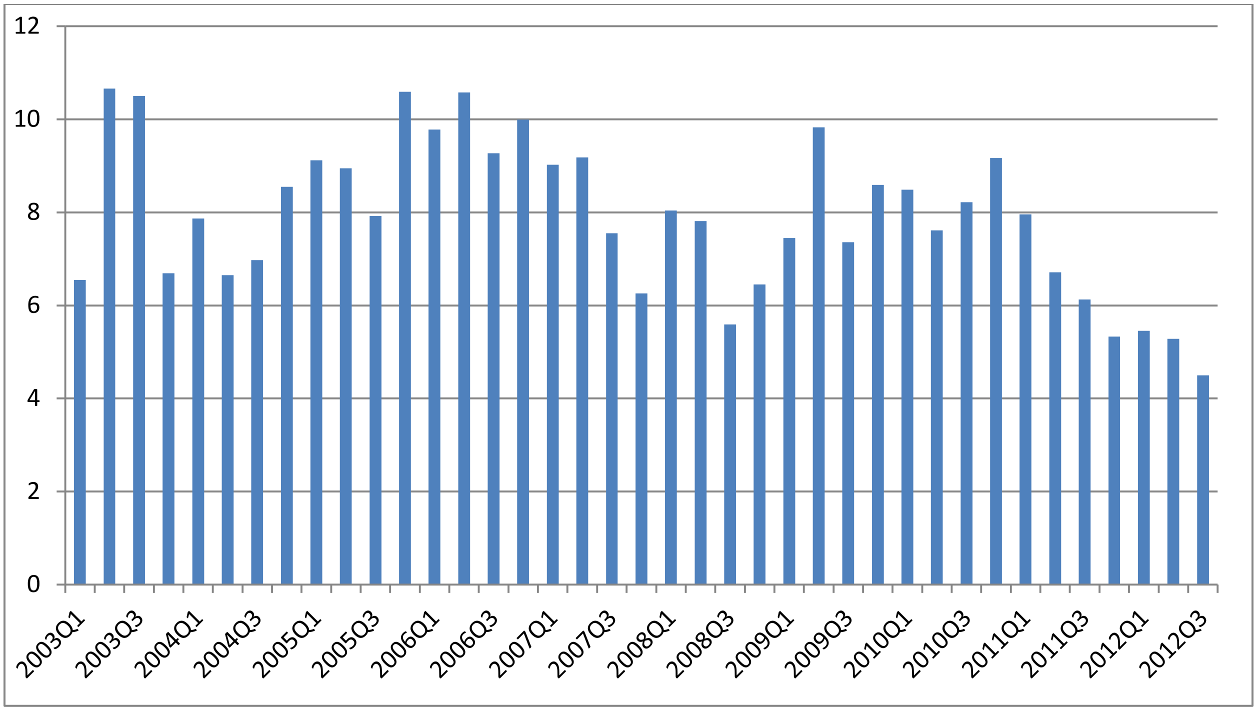
Note that the strategy outlined above will address two of the three major challenges faced by US business (protectionism and discrimination) described earlier. But it would not seriously address the first challenge, namely India's weak and uncertain regulatory regime. Clearly, one of the major impediments to boosting India's economic prospects and opportunities for domestic and foreign investors is its regulatory regime, including weak governance, corruption, uncertain tax and investment climate. Improving this regime is a first-order priority for India from a purely domestic perspective but it would also benefit foreign business.

But there is little prospect that India will at any time in the near future establish a regime—for example, on nuclear liability, on land acquisition, on power pricing, on taxation of MNCs and so on--that in terms of rule of law and legal certainty will match the standards found in most advanced countries; nor will it be able to provide the investment-friendly climate that is associated with effective top-down systems such as China.

This creates a dilemma for American business. If it relies on, and waits until, India's regime changes, there is a serious risk that the wait will allow companies from other countries to gain a competitive edge over US business in one of the world's largest and most dynamic markets.

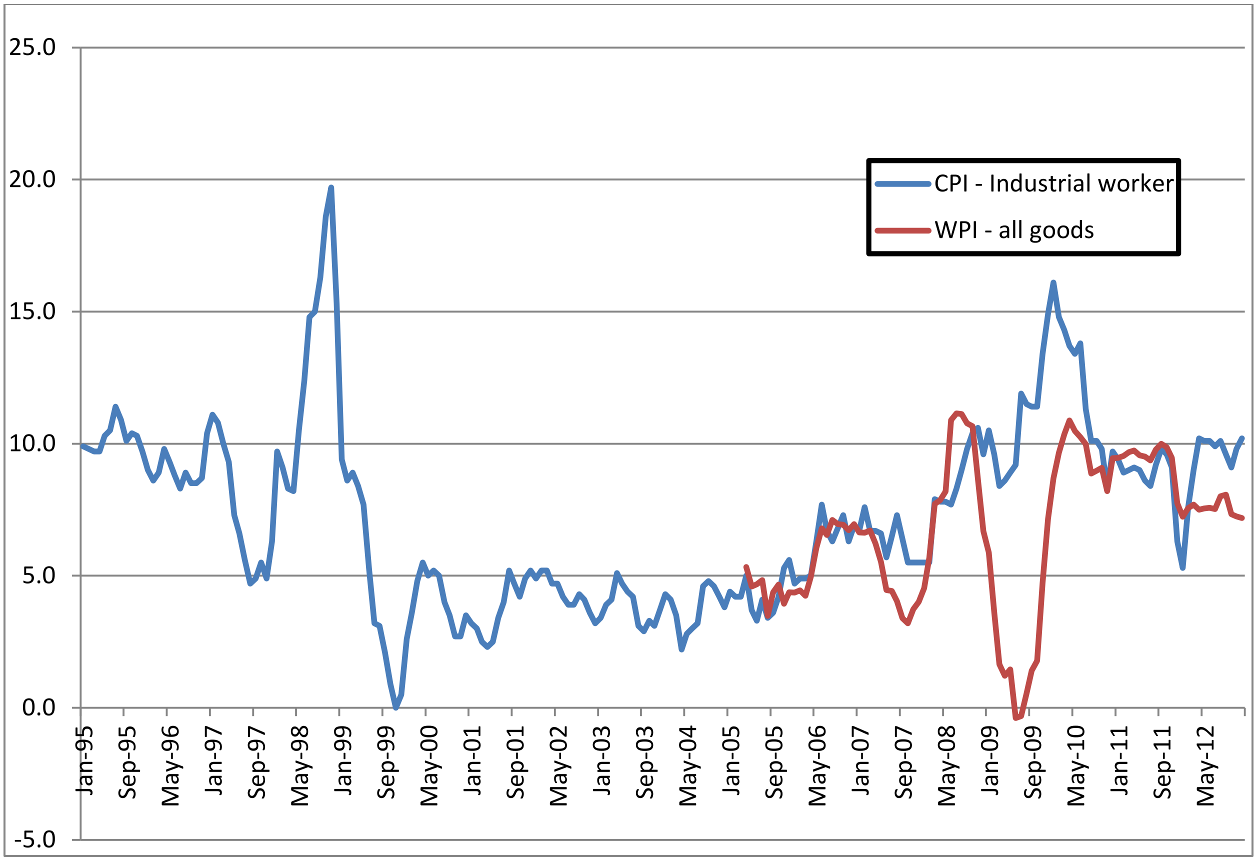
Indeed, in a number of sectors such as infrastructure, this may already be happening. Figure 10 illustrates, for example, that US FDI to India appears to be well-below potential. For American business, with its visceral need for rule of law, the challenge will be to adapt itself to negotiate messy foreign economic environments such as India's or else risk losing business to more pragmatically nimble counterparts in other countries. India will need to change but if it does not so too will American business. And, unfortunately, to paraphrase the line from the great Italian novel, *The Leopard*, the more things stay the same in India, the more American business will have to change.

Figure1. India: Quarterly GDP Growth, 2003-2012 (in percent)



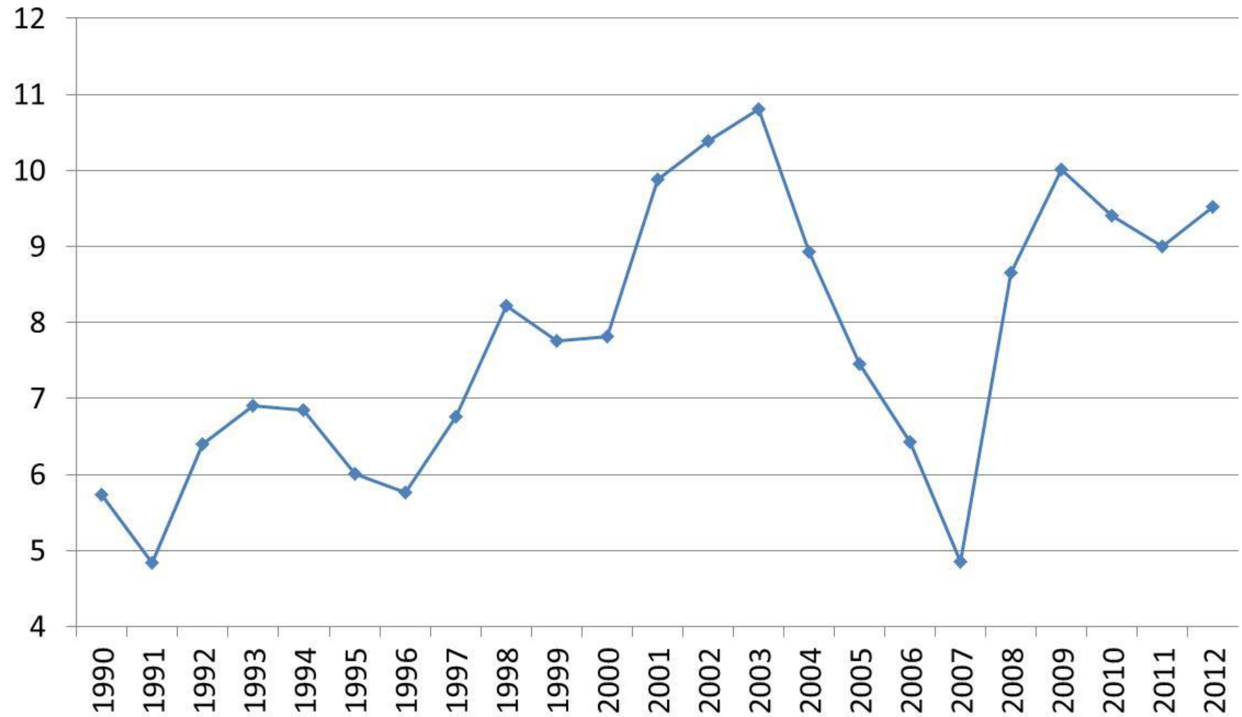
Source: Reserve Bank of India

Figure 2. India: Inflation, 1995-2012 (in percent)



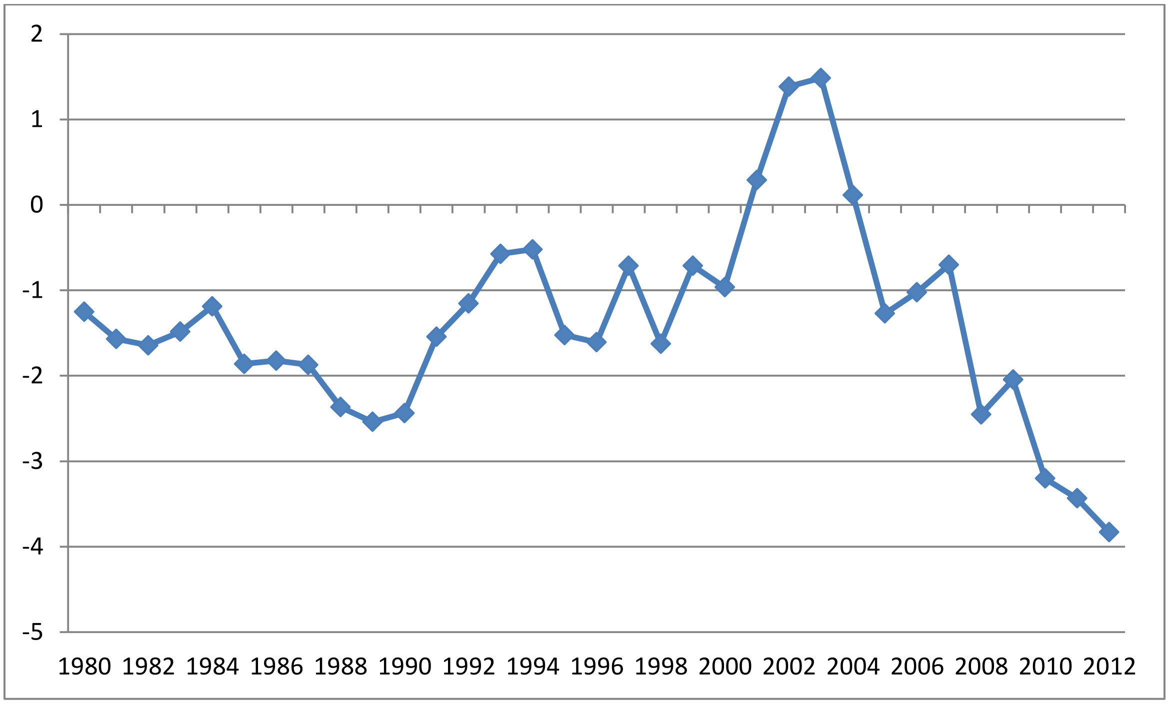
Source: IMF, International Financial Statistics

Figure 3: India: Government Budgetary Position (Net lending in percent of GDP)



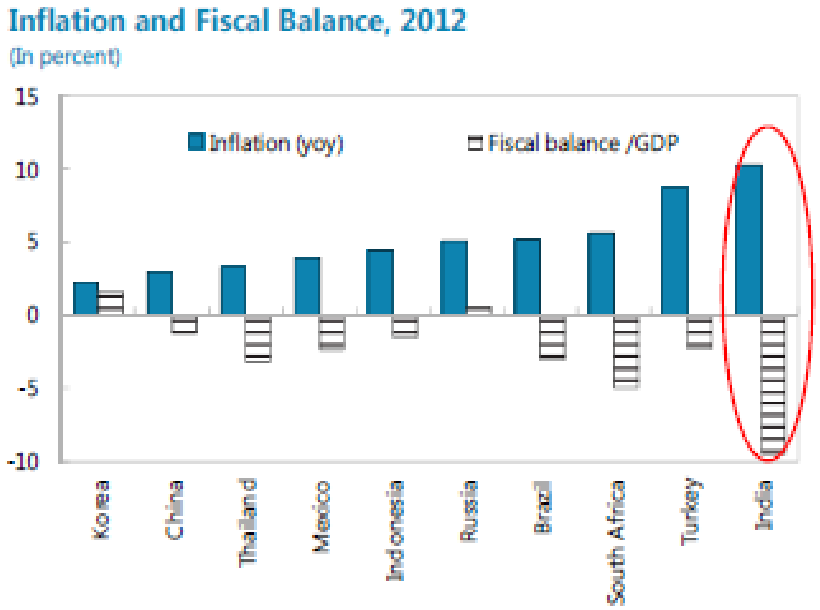
Source: IMF, World Economic Outlook

Figure 4. India: Current Account Balance (in % of GDP)



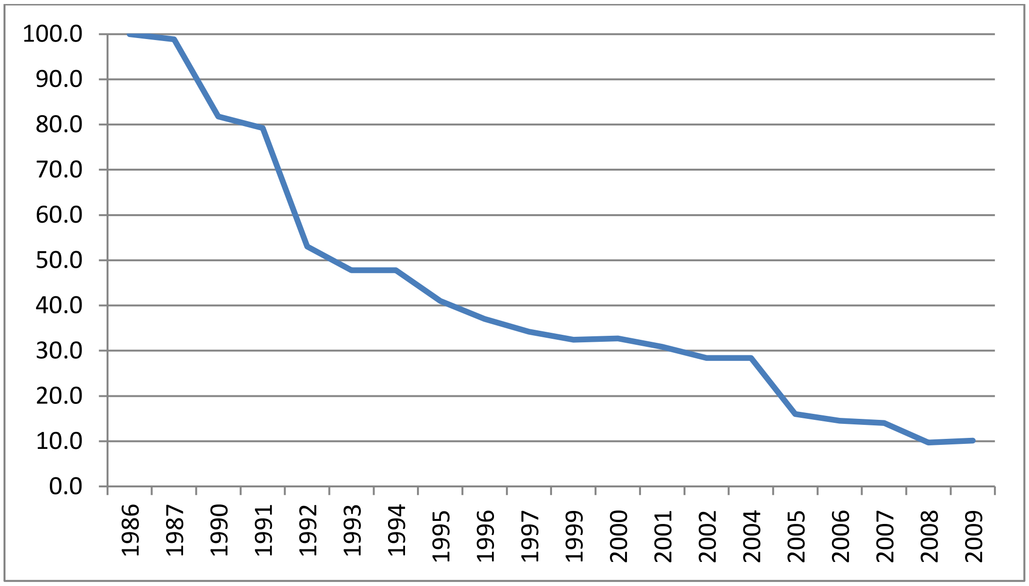
Source: IMF, World Economic Outlook

Figure 5. India's Macroeconomic Imbalances Compared to Selected Emerging Market Coluntries



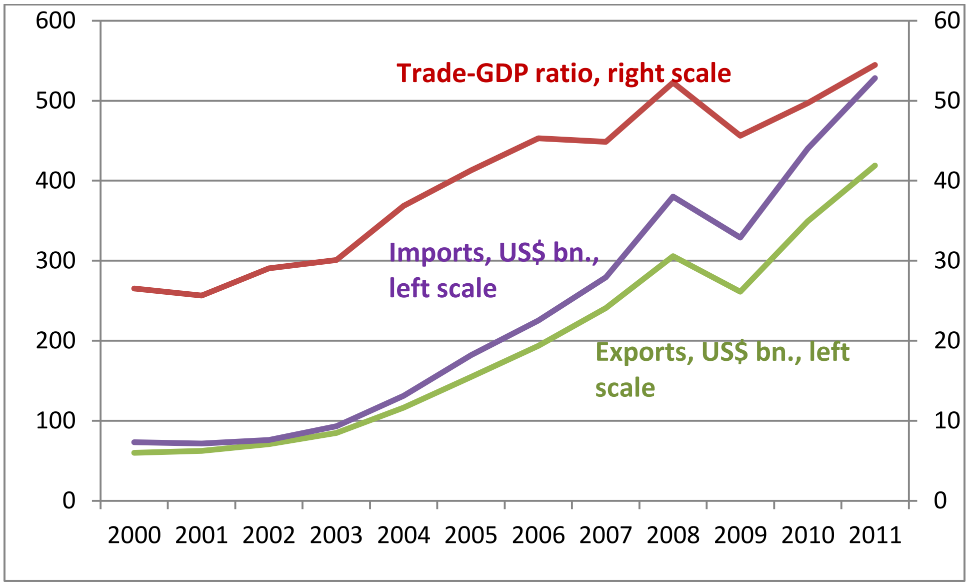
Source: IMF's Article IV Consultation, Staff Report, December 2012

Figure 6. India: Average MFN Tariffs, 1986-2009 (in percent



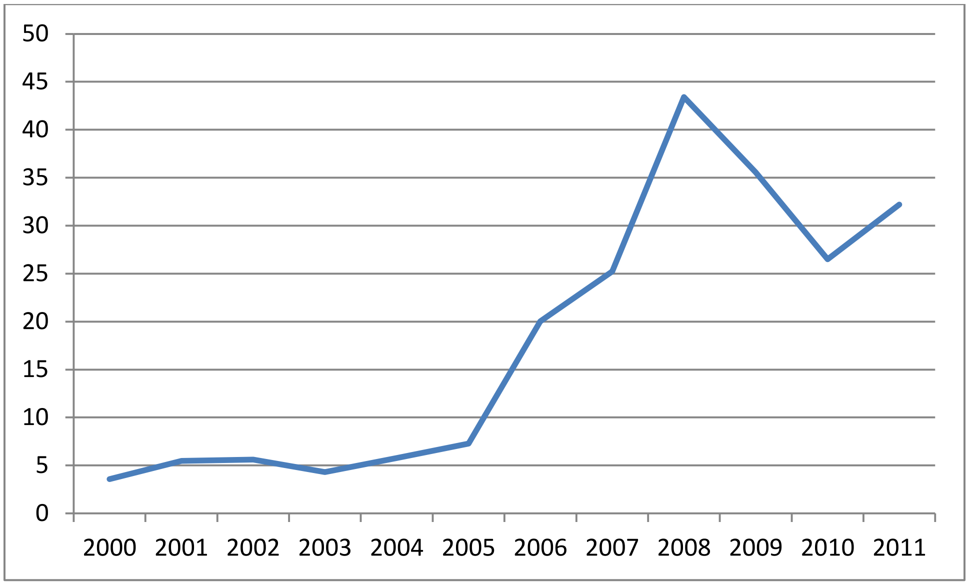
Source: World Bank, World Development Indicators

Figure 7. India: Trade in Goods and Services, Trade Openness Ratio, 2000-2011



Source: World Bank, World Development Indicators

Figure 8. India: Foreign Direct Investment, Net Inflows
(US$ billions)



Source: World Bank, World Development Indicators

Figure 9a. India: Top 5 Export Markets in 2011 (US$ bn.) 1/

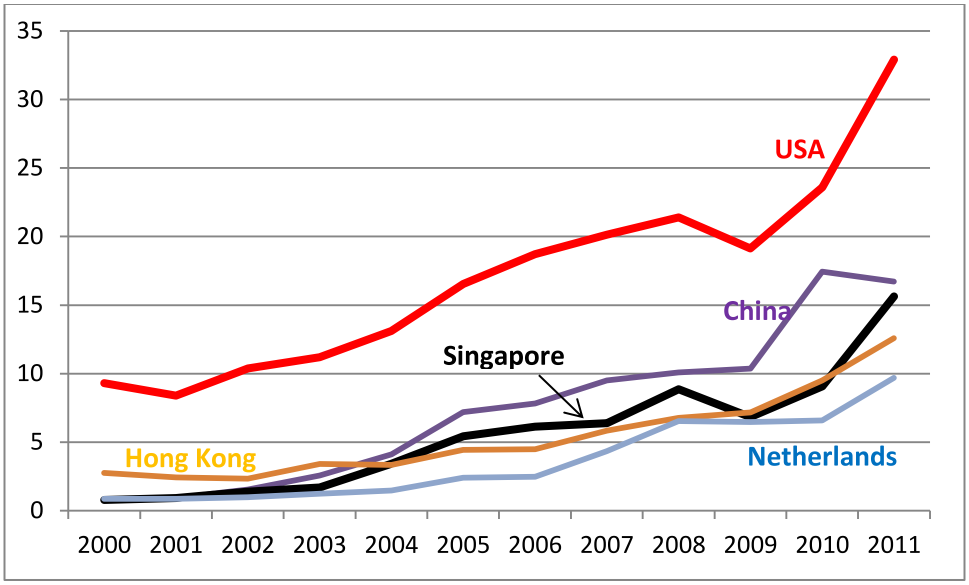
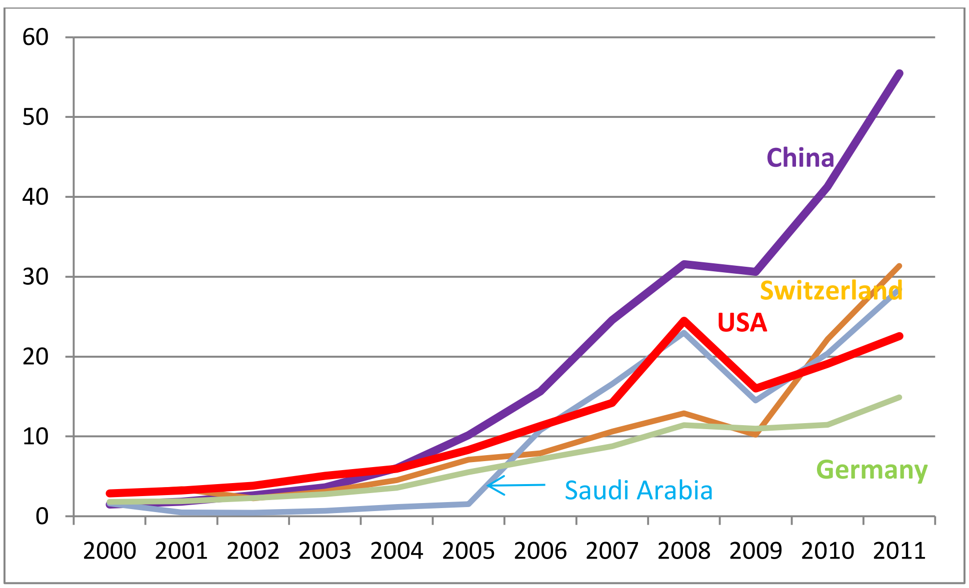
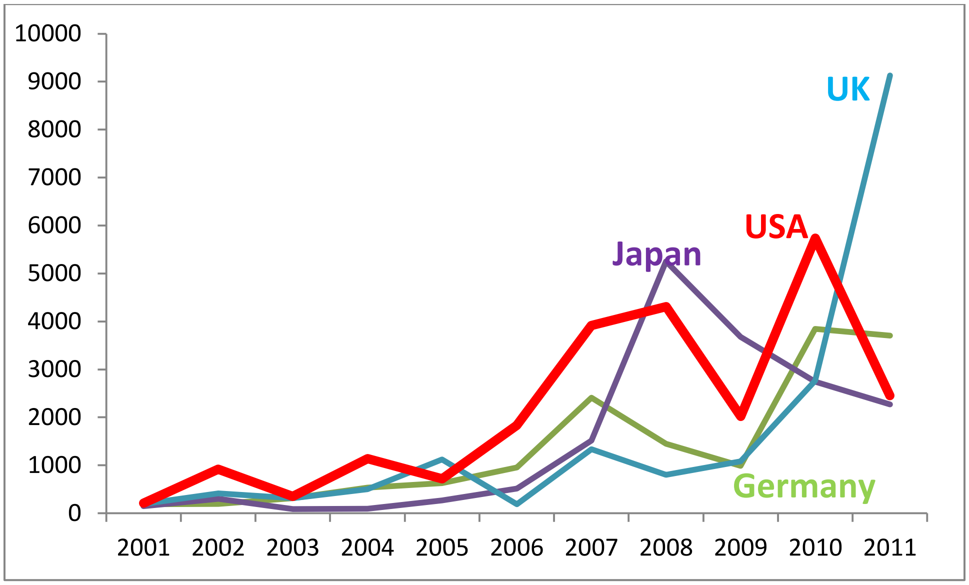


Figure 9b. India:Top 5 Sources of Imports in 2011 (US$ bn.) 1/



Source: OECD STAN Bilateral Database
1/ Excludes India's trade with the United Arab Emirates

Figure 10. Top OECD Foreign Direct Investors in India, 2001-2011, (millions of US dollars)



Source: OECD

Table 1.Top Ten Anti-dumping users, 1995-June, 2012

Country	1995	2001	2002	2003	2005	2007	2008	2009	2010	2011	2011	2012	1995-
											Jan. -June		2012*
India	6	79	81	46	28	47	55	31	41	19	10	7	663
United States	14	77	35	37	12	28	16	20	3	15	9	7	465
European Union	33	28	20	7	24	9	19	15	15	17	8	7	444
Argentina	27	28	14	1	12	8	19	28	14	7	4	10	301
Brazil	5	17	8	4	6	13	23	9	37	16	11	26	258
Australia	5	24	16	8	7	2	6	9	7	18	2	6	241
South Africa	16	6	4	8	23	5	3	3	0	4	1	0	216
China	0	14	30	22	24	4	14	17	8	5	0	4	195
Canada	11	25	5	15	1	1	3	6	2	2	0	10	165
Turkey	0	15	18	11	12	6	23	6	2	2	1	6	154
All countries	157	372	315	234	201	165	213	209	172	155	68	114	4125

Source: Economic Survey of India, 2013

Table 2. India-US Trade in Services, 2006-2010

Year	2006	2007	2008	2009	2010	% Change, 2010-2006
US Exports to India						
Cross-border	6533	8747	10189	9890	10317	58%
Foreign sales by US firms	5455	7305	9755	13064	14238	161%
TOTAL	**11988**	**16052**	**19944**	**22954**	**24555**	**105%**
India's Exports to US						
Cross-border	7437	9825	12465	12447	14155	90%
Foreign sales by Indian firms	3633	5159	6540	7070	7314	101%
TOTAL	**11070**	**14984**	**19005**	**19517**	**21469**	**94%**

Source: Ministry of Commerce, Bureau of Economic Analysis

Table 3. India as Respondent: Compliance in World Trade Organization Disputes

	All disputes	Disputes in process 1/	Disputes settled	Compliance 2/
Initiated by US	6	2	4	4
Initiated by other countries	16	8	8	8
Total	**22**	**10**	**12**	**12**

1/ Defined to include parties in consultation, panels composed, or authority for panel lapsed

2/ Defined to include panel reports adopted, implementation of adoption reported, or disputes settled or terminated, and to exclude requests for compensation or retaliation

Source: Compiled from WTO website (http://wto.org/english/tratop_e/dispu_e/dispu_current_status_e.htm)

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