Congressional Testimony

Assessing the Investment Climate in India and Improving Market Access in Financial Services in India

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Note: This testimony draws upon my ongoing Peterson Institute for International Economics project with C. Fred Bergsten, *Breaking Ground by Breaking Barriers: An Economic Partnership of the Largest Democracies*, supported by the US-India Business Council (USIBC) and the Smith Richardson Foundation (SRF).

Summary and Recommendations

Observation 1: **The Indian economy recently encountered serious turbulence and will require important reforms to stabilize it**. To some extent, India's problems reflect India's deep and ongoing financial integration with the world economy. For example, between 2010 and 2012, India received about $160 billion in foreign capital inflows. With the US Federal Reserve planning to reverse its unconventional monetary policy, and as the US economy has rebounded, some of this money is flowing back to the United States, causing currency declines and turmoil in several emerging markets, especially India. But India's problems also have deeper domestic origins, and require serious reforms to overcome them (elaborated in my recent *New York Times* article). Fiscal consolidation, based on eliminating wasteful subsidies and introducing new taxes, will be critical. But looming elections could complicate reform actions and perpetuate uncertainty and turbulence.

Observation 2: Economic uncertainty over the last year has triggered unprecedented liberalization of foreign direct investment (FDI) and other capital inflows. This seems paradoxical, at first blush, but is consistent with international experience that governments take action when a sense of crisis looms. In the last year, India has liberalized its FDI regime in several sectors—multi-brand retail, defense, petroleum and natural gas, stock exchanges, telecommunications, infrastructure—to a greater extent than in recent history. In order to attract foreign capital, the government also relaxed a number of constraints to foreign equity, portfolio, and debt inflows.

Prediction: **Further opening to foreign investors, especially providers of financial services, is likely.** A new pension-related bill has just cleared one of the two chambers of the Indian legislature. This bill paves the way for foreign investment—up to 26 percent—in the sector, with additional increases in the foreign limit linked to the draft insurance legislation. This insurance legislation, if passed, would allow for increased foreign ownership of insurance firms from 26 percent to 49 percent. The new governor of the central bank has signaled an openness to reforming the financial sector and to encouraging foreign participation in the Indian banking system.

Recommendation 1: The time may be ripe for pursuing a bilateral investment treaty (BIT). The recent spate of FDI liberalization—as well as competitive pressure from US-China investment

negotiations—could pave the way for India to pursue a BIT. Although negotiations will have to address some difficult issues, including investor-state disputes and visa issues, the domestic actions necessary to allow international negotiations are being taken.

Recommendation 2: A BIT is but a stepping stone for creating a broad and strategic framework for US-India trade. This framework would include embracing the principle of, and initiating preparatory work toward, a free trade agreement (FTA) in the medium term.

This framework is necessary for a number of reasons. First, the prize is big. India has had 30 years of close to 6.5 percent growth, and about 8.5 percent in the last decade. In 2012, it became the world's fourth largest economy after the United States, China, and Japan (PPP dollars). Its trade in goods and services is about a billion dollars. It will need investments in infrastructure, and imports of natural gas and services. The United States has comparative advantage as a supplier. Moreover, India-US trade is well below potential (about 50 percent), which a free trade agreement could rectify.

Second, the framework is required to address the broader regulatory challenges facing US business in telecommunications, preferential market access policies, intellectual property, tax uncertainty, and others. These challenges will be ongoing and some credible mechanism needs to be in place as a means for resolving them.

Third, more importantly, it is required to address the discrimination that each country is imposing on the other. India has signed (or is negotiating) free trade and economic partnership agreements with its largest trading partners that are all major competitors to the United States: Europe, Japan, Singapore, ASEAN and possibly ASEAN+6 (which includes China and South Korea), and Canada.

Soon, if not already, this discrimination may be the biggest challenge for US business in India. These regional trade agreements (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. Because India's barriers are high and the market is large and growing, the disadvantage to American companies can be substantial. The United States is inflicting similar discrimination on India by negotiating the Trans-Pacific Partnership (TPP) and Transatlantic Trade and Investment Partnership (TTIP).

Fourth, the broader framework will be necessary to revitalize the multilateral trading system by moving beyond a Doha Round to what Aaditya Mattoo (World Bank) and I have called a China Round of trade negotiations (Mattoo and Subramanian 2011). The US-India relationship has a key role to play in keeping China tethered to the multilateral system and, more broadly, ensuring its peaceful rise.

Finally, the broader framework will represent "going big." And going big is necessary because this is a relationship between two great democracies with deep commonalities; because this is a marathon not a sprint; because this is a multi- not uni-dimensional relationship; and because going big is the best way to address even the small. You can't solve problems relating to chicken (or even financial services) by only talking chicken or insurance.

I. Recent Macroeconomic Background, Challenges, and Reforms

India has experienced close to 6.5 percent growth for over 30 years since 1980. 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). 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 a decade of rapid growth, averaging close to 8.5 percent, India's GDP started to decelerate from late 2010, reaching a low of 4.4 percent in the first quarter of 2013 (figure 1).

The recent turbulence also reflects India's deep and ongoing financial integration with the world economy. For example, between 2010 and 2012, India received about $160 billion in foreign capital inflows. With the US Federal Reserve planning to reverse its unconventional monetary policy and as the US economy has rebounded, some of this money is flowing back to the United States, causing currency declines and turmoil in several emerging markets, especially India. The rupee declined by about 20 percent against the dollar within a short period of time and has now recovered some ground (figure 2). Looming elections will remain a source of uncertainty.

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 letup especially in wholesale and core inflation but fundamental inflationary pressures remain a source of serious concern (figure 3). Another worrisome trend is the deterioration in India's external balances. India's current account deficit, which has remained less than 3 percent of GDP for many years, is now about 4.5 percent of GDP (figure 4). This current account deficit and the need to finance it has been the proximate cause of the recent troubles, including the decline in the rupee.

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 5).

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 reform 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 but in aviation, broadcasting, and power exchanges.

In response to the recent troubles, a number of measures have been taken to encourage foreign capital inflows into the Indian market. The qualified foreign investor (QFI) scheme has been expanded to cover a wider range of permissible investments, including mutual funds, equity, and corporate bonds. Limits on inflows into Indian government and corporate securities have been increased to US$81 billion today, up from $66 billion at end-2012, while the withholding tax on these investments has been lowered to 5 percent. The limit on foreign debt borrowing (External Commercial Borrowings, or ECBs) has been raised to $40 billion today, up from $20 billion in May 2011. Within this limit, priority is accorded to ECBs for infrastructure financing. There are virtually no limits on foreign portfolio investments in the Indian equity market. In response to exchange market turbulence, some restrictions have been placed on the ability of Indians (but not foreigners) to invest or send remittances abroad.

Economic stability can be restored through major reforms to cut inefficient spending and raise taxes, thereby pruning the deficit and taming inflation. On the spending side, the subsidies for fuel, power, and fertilizers need to be cut. On the tax side, India's version of the value-added tax (the Goods and Services Tax, or GST) needs to be implemented expeditiously. The GST will place the Indian finances on a sounder medium-term footing, make them more transparent, and also go some way toward creating a common market in India. These steps need not come at the expense of the poor. For example, India is implementing an ambitious biometric identification scheme that will allow targeted cash transfers to replace inefficient welfare programs.

India can still become a manufacturing powerhouse, if it makes major upgrades to its roads, ports, and power systems, and reforms its labor laws and business regulations. But the country is in pre-election mode until early next year. Elections increase pressures to spend. So India's weakness and turbulence may persist for some time yet.

II. Trade and Investment Background

US exports of goods to India increased about 700 percent in the last decade. Exports of services have doubled in the last four years. US FDI has increased from US$200 million to $6 billion.

Reflecting the combined impact of policy liberalization, technological change, and India's internal dynamism, India's trade surged during the last decade (figure 6). Exports of goods and non-factor services surged sevenfold in just over a decade from US$60 billion to $420 billion. And imports also increased sevenfold from $75 billion in 2000 to $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 under way.

Similarly, India's FDI has also increased, but from a very low base of about US$3.5 billion in 2000 to $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 7). India's FDI inflows remain well below those of China (which have averaged close to $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 trade and investment has benefitted the United States and India. India's exports to the United States have increased by about 250 percent since 2000, from US$9 billion in 2000 to $32 billion in 2011 (figure 8a). The United States is India's largest export market. More dramatically, US exports of goods to India have increased by nearly 700 percent, from $3 billion to $23 billion (figure 8b). However, China has overtaken the United States as India's largest supplier of goods and services, and the United States 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 United States 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 $12 billion to nearly $25 billion. This remarkable growth occurred during the global financial crisis. A similar trend characterizes India's exports of services to the United States (table 1).

In terms of FDI, two points are worth noting. First, the United States is not the largest investor (consistently) in India. According to Organization for Economic Cooperation and Development (OECD) data (figure 9), US FDI to India surged from about US$200 million to nearly $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 $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 for US citizens), supporting many more indirect ones, have been created.

III. Recent and Prospective Liberalization of Financial Services

India has undertaken a series of reforms in the financial sector aimed at making it more competitive but also more resilient to shocks. For example, India is one of the 14 countries (out of 27 that are Basel Committee members) that have issued final Basel III capital rules.

Two outstanding pieces of draft legislation relate to pensions and insurance. Recently, the draft pensions bill was passed by India's lower house of parliament. This bill paves the way for foreign investment—up to 26 percent—in the sector, with additional increases in the foreign limit linked to the draft insurance legislation.

More uncertain is the fate of the draft insurance legislation that would allow for increased foreign ownership of insurance firms from 26 percent to 49 percent. At the moment, there does not seem to be political consensus to ratify this bill which may have to await the conclusion of the elections, currently scheduled for early next year.

However, the medium-term prospects (after the next elections) for more reform of the financial services sector appear promising. Even on the insurance bill, the differences between the two main parties are more tactical, relating to extraneous political issues, than substantive. Both broadly share the objectives and content of the draft legislation.

Perhaps, more importantly, the new governor of the central bank has signaled an interest in broader reform of the financial sector. In 2009, Dr. Raghuram Rajan (2009) authored a report which laid out a road map for reforming the Indian financial system. For example, in relation to the banking system, which is still dominated by state-owned banks, he said:

> India has a number of foreign owned banks, many of whom have been with us a long time and helped fuel our growth. They have been in the forefront of innovation, both in terms of improving productivity, as well as in terms of creating new products. We would like them to participate more in our growth, but in exchange we would like more regulatory and supervisory control over local operations so that we are not blindsided by international developments. The RBI will encourage qualifying foreign banks to move to

> a wholly owned subsidiary structure, where they will enjoy near national treatment on a reciprocal basis. We are in the process of sorting out a few remaining issues so this move can be made.

He also indicated an interest to internationalize the rupee, to remain open to capital flows, and to liberalize restrictions on investment and position-taking in India's financial markets.

IV. Bilateral Investment Treaty (BIT)

The rationale for a BIT between the United States and India was succinctly laid out in a letter sent to President Obama in December 2011 by a number of senators, including Senator Mark Warner. Matthew Stokes and Niraj Patel (2012) of the Center for Strategic and International Studies (CSIS) discuss in detail the case for a BIT between the United States and India, including the rationale, content, and likely political impediments. India has signed at least 80 such agreements, including with European nations, ASEAN, and Japan, which arguably leads to discrimination against US investors.

For India, two additional and recent developments might increase the incentives for India to embark on BIT negotiations with the United States.

First, in the last year, India has liberalized its FDI regime—to multi-brand retail, defense, petroleum and natural gas, stock exchanges, telecommunications, infrastructure—arguably to a greater extent than in recent history. In multibrand retail, some of the more onerous sourcing and other requirements were also relaxed.

This recent spate of FDI liberalization paves the way for India to pursue a BIT. Although India still has a number of sectors in which FDI is partially restricted (for example, defense production, civil aviation, banking, insurance, broadcasting, stock exchanges, depositories), the climate for liberalization has become more propitious.

Second, it will not go unnoticed in India that the United States and China have made progress in their BIT negotiations. There will therefore be competitive pressure on India to engage similarly with the United States.

Clearly, negotiations will have to address some difficult issues, including pre-establishment rights, investor-state disputes, and visa issues, but the domestic actions necessary to allow international negotiations are being taken; and moreover, the external competitive pressure to take these actions has increased.

V. Investment Climate: States Versus Center

In recent years, there has been a considerable shift in economic and political power to the states. Indeed, most issues that critically concern investors—land, infrastructure, human capital, law and order—are largely the domain of states. So, even if there is an improvement in governance in the federal government, what happens in the states will increasingly determine India's economic fortunes.

It is not that leadership in the states is better on average than at the center, but in a decentralized India, a few visibly successful experiments can have powerful repercussions for the economy. Capital and labor can and will flow from the laggard states to the performing ones because India is broadly an economic union. The laggards will have fewer excuses for non-performance if the experience of a neighboring state is better. In the past, the southern states were the pacesetters. This is no longer the case today. There are encouraging improvements in states across India—in the north (Delhi, Haryana, and Himachal Pradesh), west (Gujarat), east (Bihar and Chattisgarh), and Central India (Madhya Pradesh).

This competitive dynamic is one cause for hope. The other is that the Indian voter is increasingly rewarding good governance. Until recently, India's political system was characterized by anti-incumbency, with identity politics trumping good governance and economic performance. As a result, politicians had little incentive to deliver essential services and enact lasting reforms. Recently, though, Indian voters have reelected many incumbents who improved economic outcomes while throwing out poor performers, as exemplified by the ousting of the Communist party in West Bengal. These trends portend reasonable rates of economic growth in India even if the scorching rates of the past decade prove elusive.

These trends reinforce the need for outsiders to deal increasingly with state governments, especially the better governed ones. At this stage, these contacts will have to involve dealings between these state governments and the private sector and private investors. India’s constitutional structure will not allow state governments to take on direct international obligations. One possibility in the future is for state governments to push the federal government to take on international obligations on their behalf. For example, India could join the World Trade Organization’s Government Procurement agreement, in which the list of covered entities could be state government and their agencies. But in relation to the financial sector, this might be more difficult because many or most of the laws and regulations in this sector come under the domain of the federal government.

Decentralization is not without risks. The governance of the economically best performing states is based on leaders who, while democratically elected, have few checks and balances. Decentralization has also arguably not gone far enough because the states have been very reluctant to extend its advantages to local governments, which has had a pernicious effect on urbanization. Cities in India need more autonomy and their leaders need to be held more accountable.

VI. The Way Forward: A New Strategic Framework

Trade and economic relations between India and the United States need a broad strategic framework. This framework would include as critical elements embracing the principle of, and initiating preparatory work toward, a free trade agreement in the medium term. This is so for a number of reasons.

First, the prize is big. 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* (Subramanian 2011), I project that the Indian economy has the potential to post medium-term growth of about 8 percent. Once India navigates the current turbulence, this 4.7 trillion dollar economy will double every seven to 10 years; the trillion dollar trade could also double every seven years so that by 2018, it could reach close to 2 trillion dollars.

Moreover, currently US-India trade is well below potential. They are mutual under-traders. Prachi Mishra (of the International Monetary Fund) and Devesh Roy (International Food Policy Research Institute) calculate that, all things equal, US exports to India should be 50 percent greater than current levels (Prachi and Roy forthcoming 2013). India's exports to the United States should be about 25 percent greater too. Emiko Fukase and Will Martin (World Bank) estimate that a comprehensive US-India FTA would almost double US exports of goods and services to India; and increase Indian exports to the United States by 15 percent (Fukase and Martin forthcoming 2013). While both countries would gain, the United States would gain substantially.

India will need about a trillion dollars' worth of investments in infrastructure. Its demand for energy, including for natural gas, will be enormous, as will its demand for services, including financial services. My Peterson Institute colleague Brad Jensen (forthcoming 2013) has shown that the United States could disproportionately benefit from these developments because it has a comparative advantage in supplying services.

Second, the framework is required to address the broader regulatory challenges facing US business in telecommunications, preferential market access policies, intellectual property, tax uncertainty, and others. These problems will inevitably be of a recurring nature. To resolve them without excessive frictions, the two countries will need an ongoing mechanism of dialogue backed up by more formal arrangements, including possibly a free trade agreement.

Third, the framework is required to address the discrimination faced by US business in Indian markets and vice versa. A BIT cannot be this mechanism because of its relatively narrow scope. And for that reason it offers limited scope for trading mutually advantageous concessions. The BIT, desirable as it may be, will need to be complemented in the medium term by a broader strategic framework.

Soon, if not already, this discrimination may be the biggest challenge for US business in India. 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 United States.

A major development of India's trade policy over the last decade has been the aggressive pursuit of regional trade agreements, especially with, 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); agreements among ASEAN + 6, the latter comprising 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 most-favored nation (MFN) tariffs and barriers can be high in some sectors, and 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.

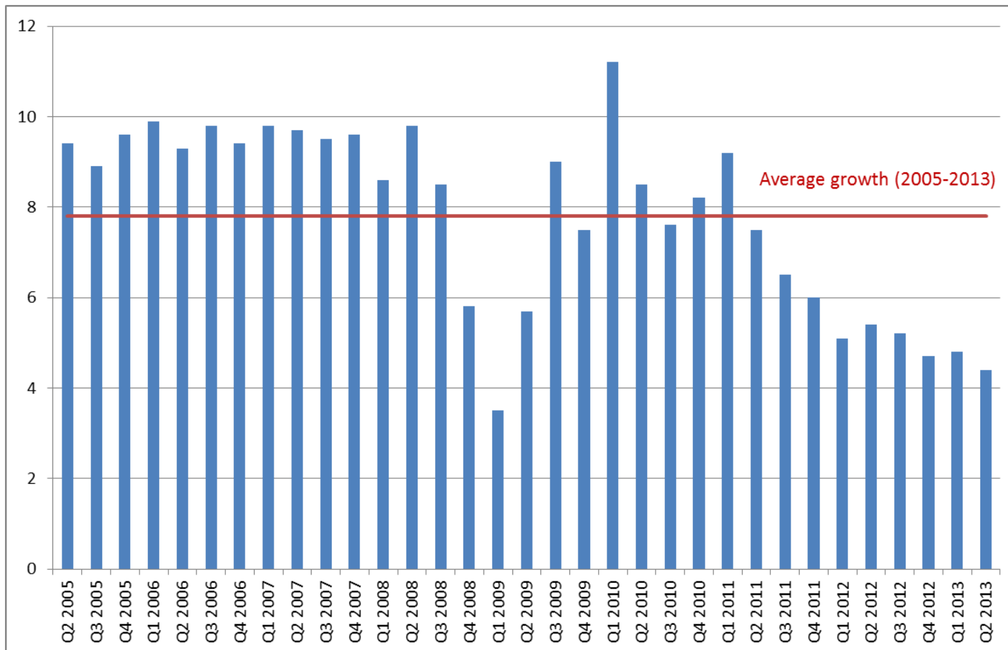
Of course, it must be added that the United States is reciprocating this discrimination (also indirectly) against Indian business when it negotiates the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP).

Fourth, the broader framework will be necessary to revitalize the multilateral trading system by moving beyond a Doha Round to what Aaditya Mattoo (World Bank) and I have called a China Round of trade negotiations. The US-India relationship has a key role to play in keeping China tethered to the multilateral system. The United States and India, individually and collectively, have a vital interest and key role in ensuring China's peaceful rise as argued by Ashley Tellis (Carnegie Endowment for International Peace) and C. Raja Mohan (Observer Research Foundation). See Raja Mohan (forthcoming 2013) and Tellis (forthcoming 2013).

Finally, the broader framework will represent "going big." And going big is necessary because this is a relationship between two great democracies with deep commonalities; because this is a marathon not a sprint; because this is a multi- not uni-dimensional relationship; and because going big is the best way to address even the small. To put it more colloquially, "you can't solve problems relating to chicken (or even financial services) by only talking chicken (or insurance)."

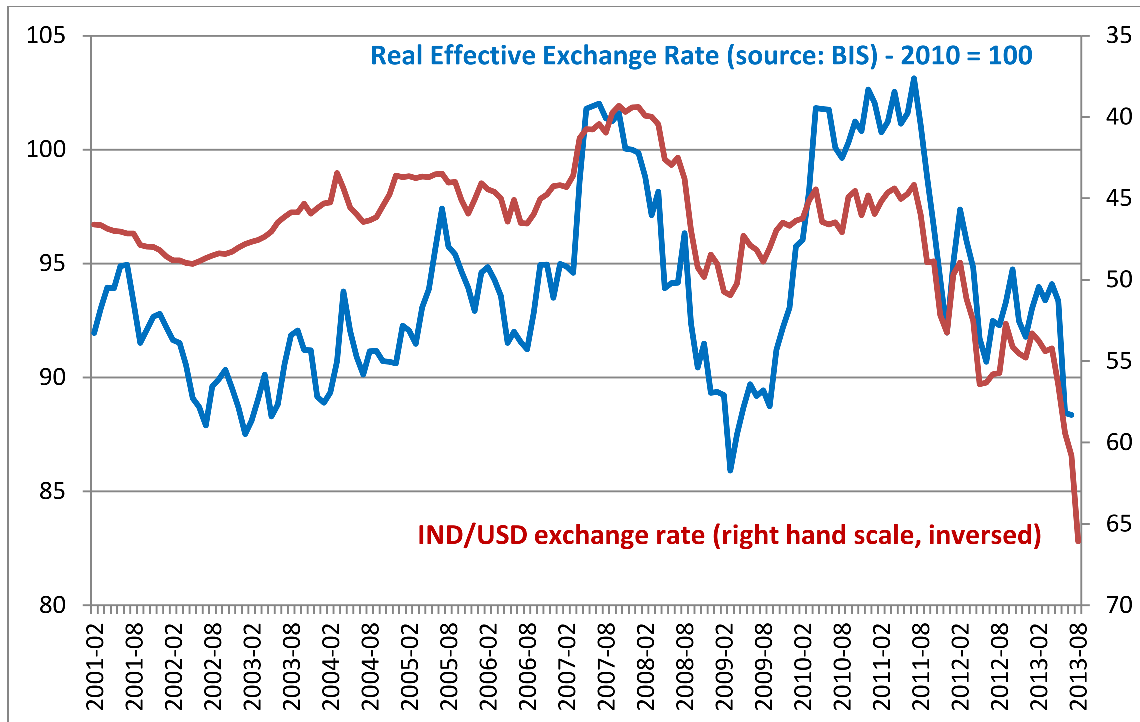
My colleague C. Fred Bergsten and I will soon be finalizing a book, *Breaking Ground by Breaking Barriers: An Economic Partnership of the Largest Democracies*, which will elaborate fully on such a broad framework, its rationale, content, the impediments to achieving it, and how they might be overcome.

Figure1 India: quarterly GDP growth, 2005–13 (percent)



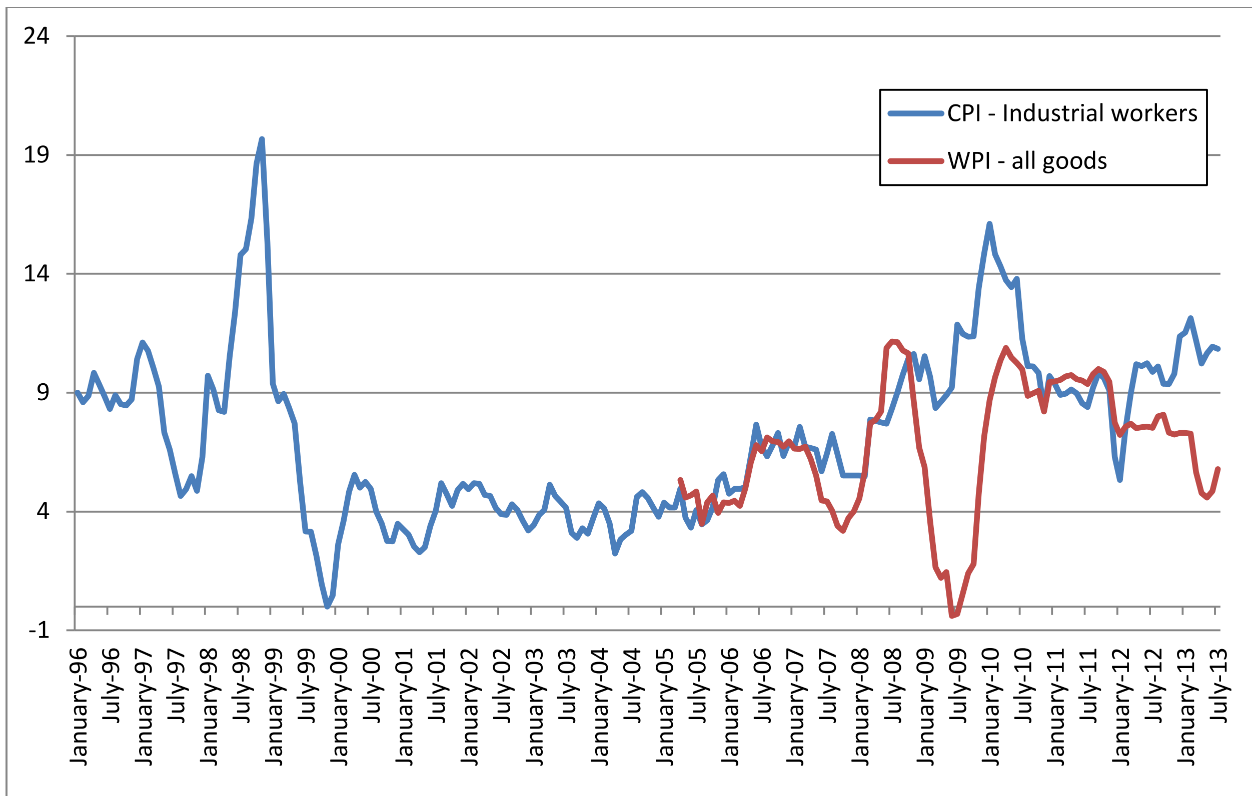
Source: Reserve Bank of India.

Figure 2 India: exchange rate developments, 2001-August 2013



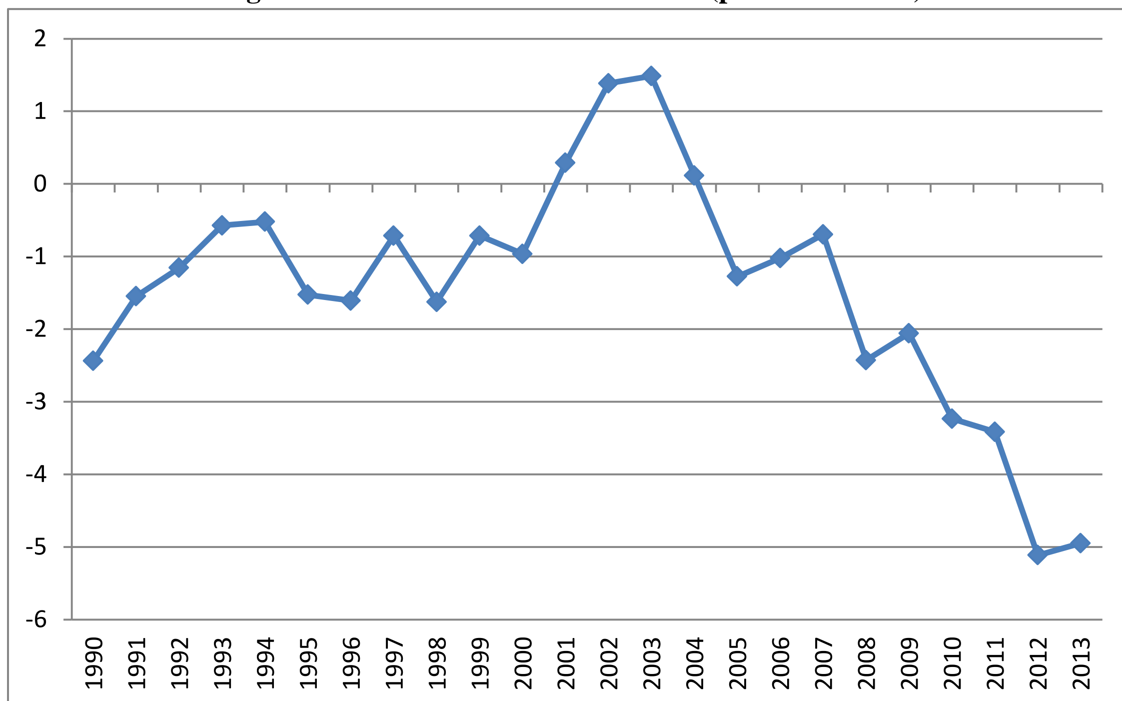
Source: Bank for International Settlements.

Figure 3 India: inflation, 1996–2013 (percent)



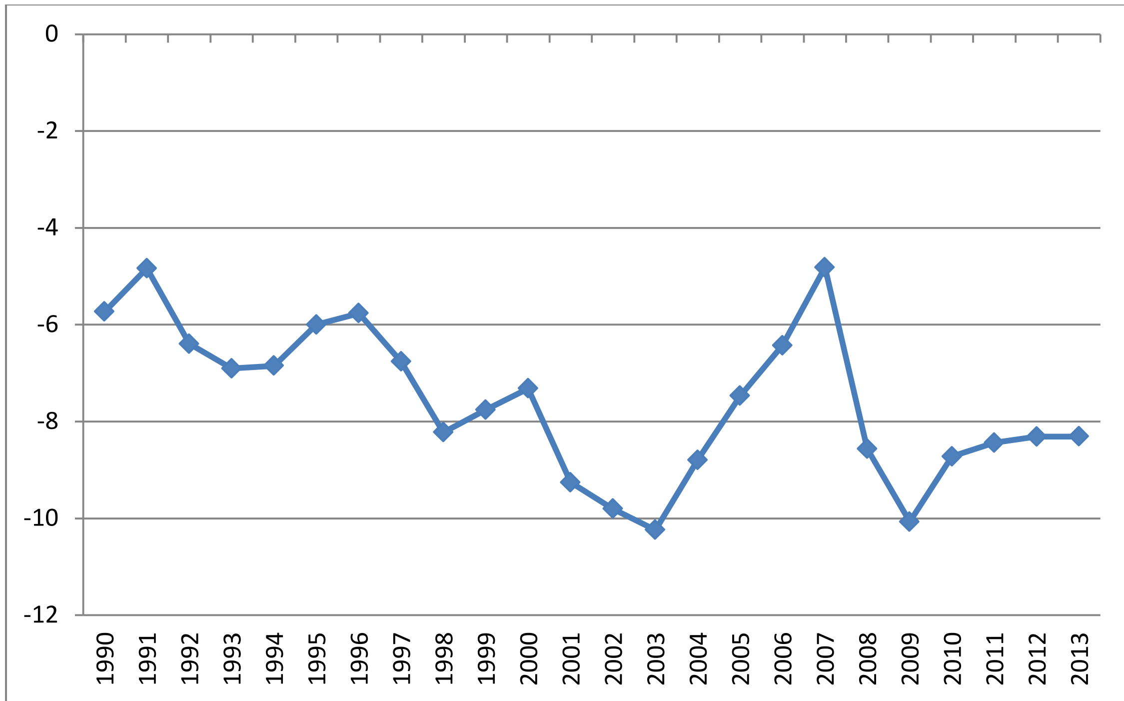
CPI = Consumer Price Index
WPI = Wholesale Price Index
Source: IMF, *International Financial Statistics*.

Figure 4 India: current account deficit (percent of GDP)



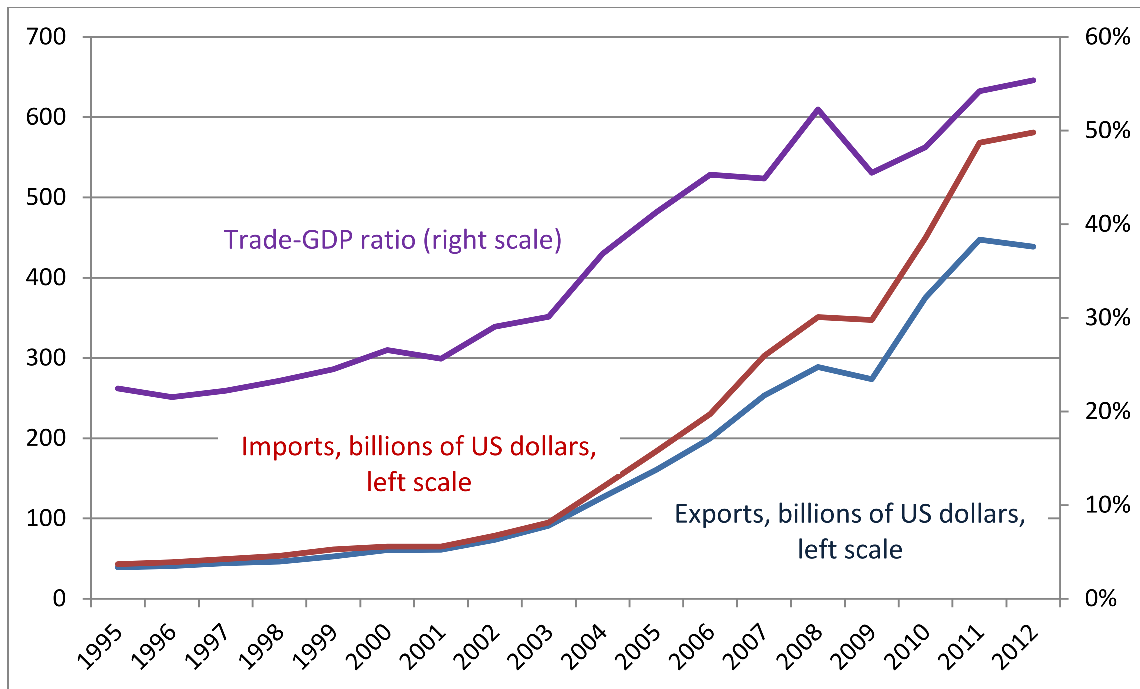
Source: IMF, *World Economic Outlook.*

Figure 5 India: government budgetary position (net lending in percent of GDP)



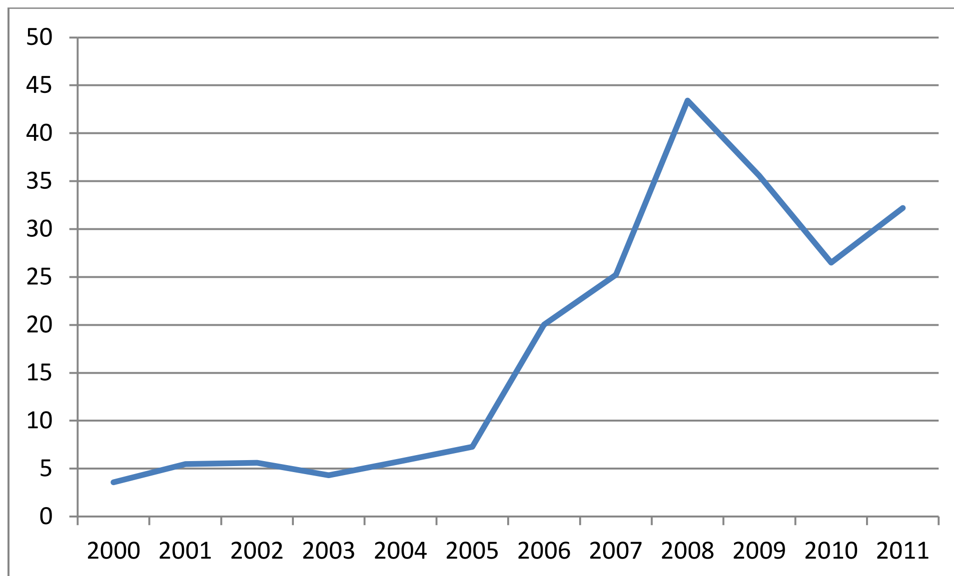
Source: IMF, *World Economic Outlook.*

Figure 6 India: trade in goods and services, trade openness ratio, 2000–11



Source: World Bank, *World Development Indicators.*

Figure 7 India: Foreign Direct Investment, net inflows
(billions of US dollars)



Source: World Bank, *World Development Indicators.*

Figure 8a India: top five export markets in 2011 (billions of US dollars)

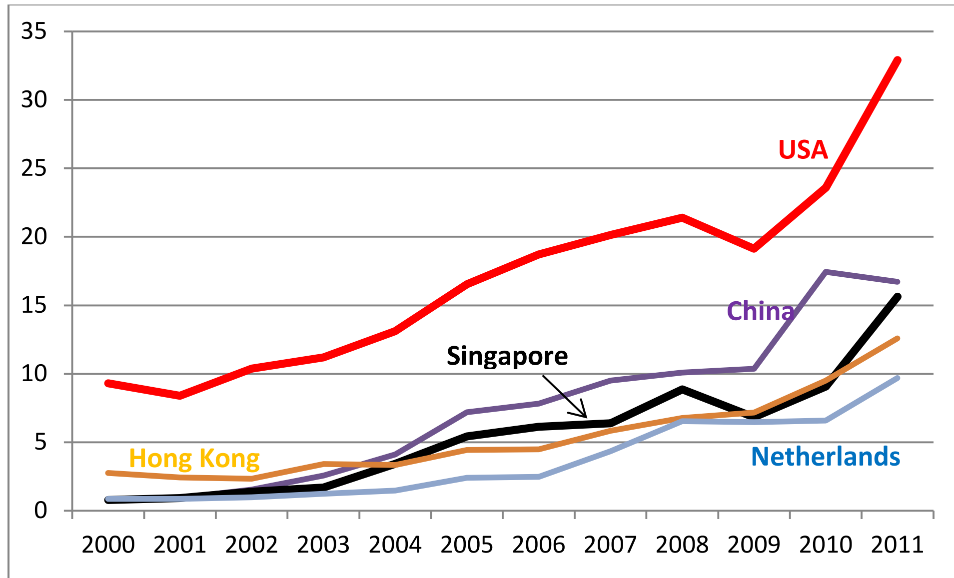
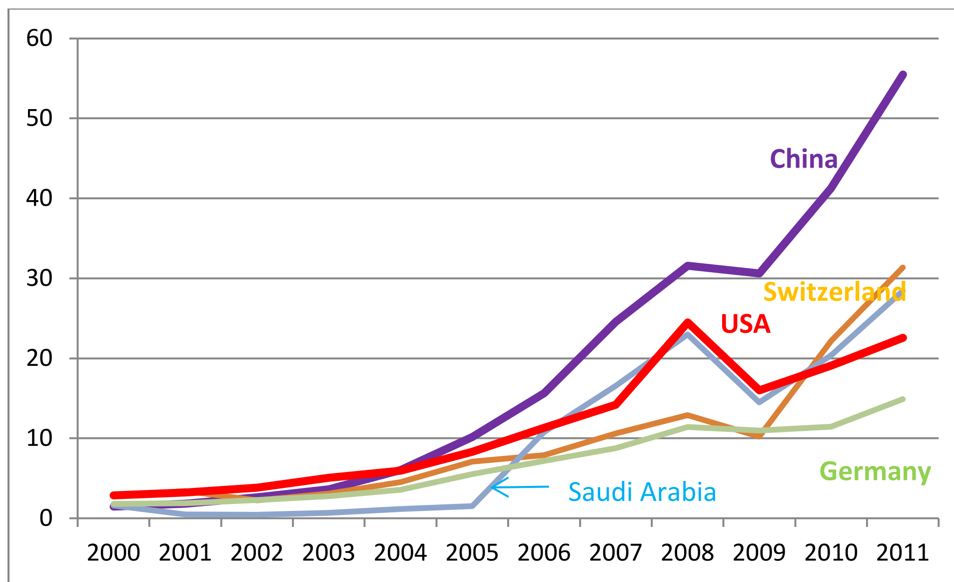
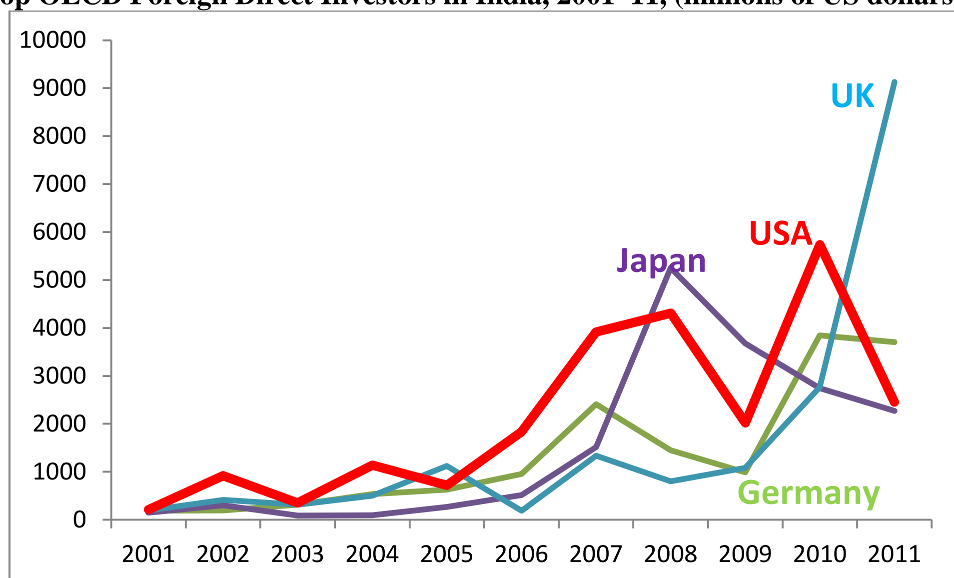


Figure 8b India: top five sources of imports in 2011 (billions of US dollars)



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

Figure 9 Top OECD Foreign Direct Investors in India, 2001–11, (millions of US dollars)



Source: OECD.

Table 1 India-US trade in services, 2006–10

US Exports to India						
Year	**2006**	**2007**	**2008**	**2009**	**2010**	**% Change, 2010-2006**
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.

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