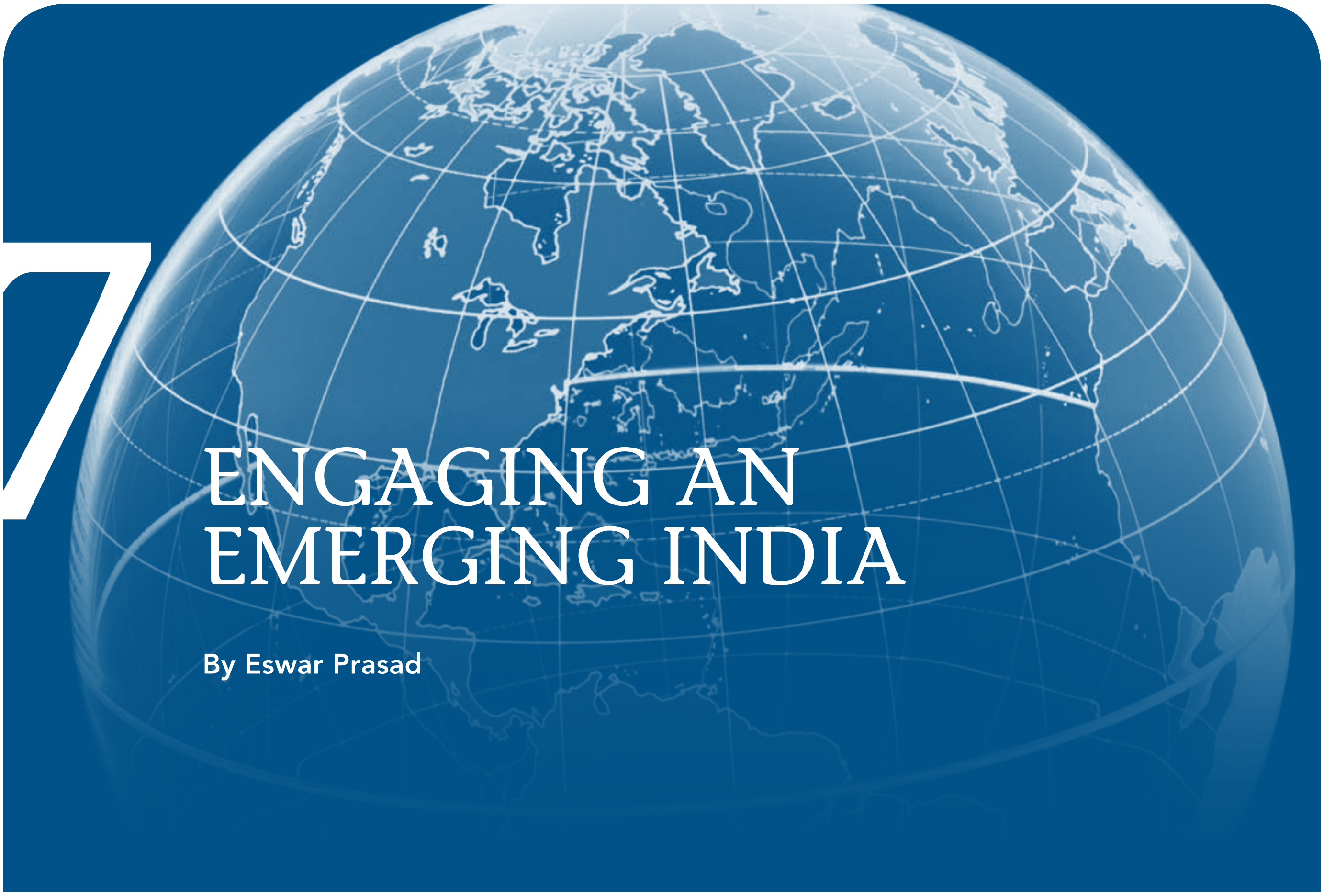

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ENGAGING AN EMERGING INDIA

By Eswar Prasad

India's sustained growth surge since the beginning of this decade has put the country at the center of the world economic stage, along with China, as one of major success stories of recent years. With a burgeoning middle class and a large pool of educated workers, India seems poised to remain on a trajectory of rapid growth for many years to come. But this is far from certain. There are many challenges on the domestic front—including weaknesses in the physical infrastructure and educational system, poor public governance, high fiscal deficits, rising income inequality, and domestic macroeconomic management issues that have arisen through India's integration into the world economy. America must deepen engagement with India to advance our common interests on energy and climate, services and trade and global governance.

THE GLOBAL CONTEXT

India boasts a large pool of educated labor, a young workforce, a booming service sector, and a growing manufacturing sector. Yet the country's economic dynamism masks the fact that it has a weak manufacturing base and that a substantial proportion of its workforce is still engaged in low-productivity activities in the agricultural sector. The recent growth in the manufacturing sector is promising, but this sector remains hampered by restrictive labor market regulations that, for instance, make it difficult for medium-sized and large industrial firms to layoff workers even in economic downturns. This has resulted in a prevalence of smaller enterprises in the manufacturing sector that are not able to reap the benefits of economies of scale, making this sector a lot less dynamic and a less effective source of job creation than it could be. And though the boom in services has boosted GDP growth, it has failed to create large numbers of jobs relative to the rate of population growth. Therefore, India's economic policy will need to focus both on maintaining the service boom and on finding ways to bring more people into higher-productivity sectors like manufacturing.

THE CHALLENGE

India and the United States are economic and political partners that share a desire for open, transparent and dynamic global markets. India's rising economic clout has been accompanied by its increasingly assertive role in international institutions and discussions of cross-border issues (both bilateral and multilateral), including trade and climate change. India's relationship with the U.S. has also matured, and there are now significant two-way flows of trade, finance and human capital. If this relationship is well managed, it could foster a productive, mutually beneficial relationship that could help both countries make progress toward their many common objectives. Indeed, India's rising prominence as a spokesperson for the entire group of emerging markets on many issues, including the Doha Round of trade multilateral negotiations, means that this relationship between the U.S. and India has assumed even greater importance.

The new U.S. administration will need to consider several key issues:

> **Energy and climate change:** In the past 15 years, India's carbon dioxide emissions per capita and as a share of world emissions have increased by about half. The country's new push into manufacturing will surely speed up this trend. But India is worried more about procuring sufficient oil to fuel its economic boom than using energy efficiently and reducing emissions. Its climate change policy so far has been based on the quest for technological solutions, and it has not been willing to sign on to emissions reductions or carbon trading—or pricing—schemes. This technology-based approach leaves it out of global climate agreements, reflecting a view it shares with China that developed countries should take the lead in implementing any climate change agreement. The ratification of the Kyoto Protocol foundered in the United States on the lack of inclusion of developing countries. Together, the U.S. and India face steep challenges on climate change and energy policies and should work together to develop international policies and processes.

> **Trade and the Doha Round:** In the Doha Round of World Trade Organization negotiations, India has played a leading role among the Group of 77, the largest intergovernmental organization of developing states in the United Nations, in pushing for reductions in agricultural subsidies in developed countries. However, fears over losing domestic manufacturing share to exports from China have led to a breakdown in negotiations. In response, India has begun to pursue free trade agreements with the European Union and the United States. These bilateral agreements could be corrosive to the cohesion of the world trading system.

> **Domestic capital markets:** India has undertaken a significant liberalization of its financial sector and has also opened up to capital flows from abroad. Its stock markets, in particular, have become sophisticated and relatively deep, partly due to the influx of foreign funds. However, its overall level of financial depth—a measure of the prominence of its financial system relative to the size of its economy—remains low by international standards. Its financial system still has a number of weaknesses that are preventing it from creating a significant number of jobs and that could hinder overall growth. For instance, the government bond market remains relatively torpid and the corporate bond market is very small. The banking system has a very low ratio of nonperforming loans, but this is at the cost of a high level of passiveness in lending, which has resulted in India having one of the lowest ratios of bank lending to GDP among emerging markets. These outcomes are partly the result of restrictive government policies and also the consequence of the government using banks, especially state-owned ones, as a source of deficit financing (by getting them to buy government bonds) and as a redistributive mechanism.

> **Outsourcing:** Growth in the service industry has been the bright spot in the Indian economy, with the service sector as a whole now accounting for more than half of GDP. Even though the high-end services sector (including business processing) accounts for just about 1 percent of India's GDP, this sector has received a lot of attention and is seen in the U.S. as threatening domestic jobs.

AMERICA'S OPPORTUNITY

Given the commonality of interests between the two countries, it will be important for the next U.S. president to build and maintain a constructive partnership with India. Actions in several areas could particularly help build momentum for a deeper, more enduring relationship:

> **Energy and climate change:** The United States should encourage India to adopt sustainable growth strategies and engage with the international community on climate change. Given India's existing stock of inefficient state-owned manufacturing firms and the potential growth of a more dynamic manufacturing sector, the country has an opportunity to opt for more sustainable and efficient technology.

> **Trade and the Doha Round:** The United States should continue to actively engage India in the Doha Round negotiations. For the U.S. to enter a free trade agreement with India would be an unfortunate turn of events for the

world trading system. Although positions have hardened on both sides, there is a lot at stake, and continued dialogue will be essential to not leave the negotiations completely stalled.

> **Domestic capital markets:** The Government of India has in the last couple of years appointed committees to look into specific aspects of financial system reform and to lay out a broader blueprint for reforms in this sector. The United States should encourage the Reserve Bank of India to take the recommendations of these committees seriously. As the recent financial crisis in the United States has made clear, no country has the luxury of not needing to constantly update financial regulation in a way that keeps financial innovation under control without stifling it.

> **Financial flows:** The United States should work with India to increase flows of foreign direct investment to expand the Indian manufacturing sector, and also work to reduce restrictions on foreign investors' participation in India's government and corporate bond markets. Such steps, in addition to increasing financial depth, could also make it easier for India to obtain financing for its massive infrastructure needs.

> **Outsourcing:** The new U.S. administration should proactively ensure the benefits of free trade are broadly spread. Of course, it is important to strengthen the U.S. social safety net and social insurance for those displaced by competition from abroad.

> **Global governance:** The U.S. should support permanent seats at the table for India at the United Nations Security Council, the Group of Eight Summit and other multilateral forums.

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