Weak Ties

For all the excitement about India's rise, its economic relationship with the United States remains more anemic than it could be. Why?

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On the surface, all the elements are in place for an economic love affair between the United States and India. In the last decade, three American presidents -- including Obama -- have visited New Delhi with the explicit aiming of boosting bilateral trade. India's economy is growing at a very healthy 8 percent clip, and its democratic political system and rule of law -- not to mention its widespread English fluency -- should make it relatively easy for U.S. companies to sell into India and to invest there. The U.S.-India civil nuclear agreement gave hope for billions in commercial agreements between the two countries, and the recent thaw in the U.S.-Indian defense relationship (the Pentagon now conducts more military exercises with India than with any other bilateral partner), has U.S defense companies salivating. Yet the economic relationship between these two natural partners remains far below potential. Why?

The numbers tell the story. U.S. companies are investing heavily in India's economy, but not nearly at the level they are investing in China. In 2008, U.S. foreign direct investment in India was only approximately $3.5 billion (up from $0.7 billion in 2005), while U.S. investment into China was $15.8 billion (up from $1.9 billion in 2005)

The power to improve these figures is largely in Indian hands. Companies invest in Colombia, Vietnam, and other emerging markets because of those countries' explicitly pro-foreign investment policies. In contrast, companies invest in India in spite of its government, where, despite Prime Minister Manmohan Singh's admirable reforms, the legendary "license raj" -- the elaborate red tape required to set up and run businesses in India -- is still much in evidence.

India has instead relied on its inexpensive and well-educated labor force to attract foreign investment. This will not remain an asset for long. Wages are rising in some sectors at the rate of 20 percent per year. Increasingly, companies are looking at the Philippines, Sri Lanka, Vietnam, and other Asian countries as less-expensive outsourcing destinations. And despite its teeming masses, India's well-educated labor pool is actually quite small.

India could attract investment in spite of rising wages by continuing to liberalize and simplify its investment rules. The government's recent steps to permit foreign investment in multi-brand retail by mid-2011 (allowing Wal-Mart, and other foreign grocery store chains to operate in the country), could professionalize the agricultural sector and create additional employment opportunities for rural laborers. India's commitment to simplifying the tax code and labor regulations is a good start, but it must go further.

Bilateral trade is another missed opportunity. Although the United States is India's third-largest trading partner after China and the European Union, India ranks only 14th among the United States' trading partners. The U.S. share of India's market could shrink further due to free-trade deals India has just concluded with South Korea and Singapore, and is in the process of negotiating with Australia, Canada, the European Union, and Japan. For too many years, U.S. and Indian negotiators focused on resurrecting the failed Doha round of multilateral trade talks. Instead, the two countries should finally focus their efforts on the only achievable goal: completing their negotiations for a long-delayed bilateral investment treaty. This alone would significantly boost trade ties and encourage capital flows between the two countries.

Finally, the billions in contracts U.S. firms hoped to obtain as a result of the U.S.-India civil nuclear agreement now look difficult: The Indian Parliament recently passed a nuclear liability law that makes nuclear equipment suppliers potentially liable for accidents for as long as 80 years. While state-supported nuclear equipment makers in France and Russia may be willing to accept such risks, American companies are not. India is increasingly buying U.S.-made military equipment, including some C-130s, military reconnaissance planes, and anti-ship missiles, but U.S. defense companies are hoping for much larger contracts in coming years. To further this trade and a more robust defense relationship in general, the Obama administration should follow through on its pledge to reform the cumbersome U.S. export-control system, which complicates India's attempts to purchase the most advanced U.S. technology, while India should revise its onerous offset regulations and allow greater foreign investment in its defense sector.

It is of course much easier to make these suggestions from outside the government than for either the United States or India to implement them. Both countries have struggled mightily with these issues. Singh's Congress Party-led government has increased the pace of reforms since winning a new, stronger mandate from voters in

2009. Nevertheless, Singh governs an unruly democracy, where many representatives are still hesitant to embrace a closer relationship with the United States. The U.S. government has similar problems reforming decades-old "standard operating procedures," such as its export control laws, at home.

In an increasingly multipolar world, the United States will want to foster the development of new "poles" that generally share U.S. values and can help maintain a healthy balance of power in Asia. An economically strong India is very much in the American interest. Tackling these barriers to economic cooperation in an ambitious, concerted manner would do much to sustain the positive momentum in U.S.-India relations begun by the civil nuclear accord, and is well worth the effort.

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