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Kopi Time E172: ICRIER head Shekhar Aiyar on key aspects of India's outlook

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Welcome to Kopi Time, a podcast series on markets and economies from DBS Group Research. I'm Taimur Baig, Chief Economist, welcoming you to our 172nd episode.

Today we will talk about India, and joining us from New Delhi is Dr. Shekhar Iyer, Director and CEO of ICRIER. ICRIER stands for the Indian Council for Research of International Economic Relations. Shekhar's institute does much more than that, as you will find out. This is not his first time on Kopi Time. He joined us about a year and a half ago in Episode 130 to discuss geoeconomic fragmentation. If you have not listened to that episode, it is a must-listen. I know a lot of people had very, very good feedback about that conversation.

Shekhar Iyer, welcome back to Kopi Time.

Shekhar Iyer

Thank you, Taimur. Thank you for having me back. It is always nice to be invited a second time because it leaves you with the illusion that you did something right the first time. Congratulations on reaching more than 170 episodes. That is amazing.

Taimur Baig

Thank you, Shekhar. I think it reflects tasks unfinished. Last time, we focused on global geoeconomic fragmentation and trade wars, and we did not really discuss India in depth. Your current work focuses extensively on India, so let us start in general before moving to specifics. In general, what, in your view, is going right for the Indian economy now?

Shekhar Iyer

India is the world's fastest-growing major economy. We have held that position for three years in a row. Growth for the past fiscal year is likely to come in at 7.4%, stronger than most analysts expected and excellent by any standard. Several structural reforms have been undertaken, including rationalizing the Goods and Services Tax, implementing an inflation-targeting framework, and expanding digital public infrastructure. These should lay the foundation for sustained growth of greater than 7% for the foreseeable future, and potentially double-digit growth if reform momentum accelerates. Importantly, this growth has not come at the expense of macroeconomic stability. Fiscal, monetary, and financial sector policies have been prudent. Inflation is subdued, the current account deficit is contained, the real effective exchange rate is broadly in line with fundamentals, some models say that we are slightly undervalued while some say that we are slightly overvalued and the public debt-to-GDP ratio is declining. At the same time, public infrastructure spending has surged. Over the last decade, the highway network has more than doubled, airports have tripled, port and rail cargo capacity has increased by 60% to 70%, and electrification has reached most villages. Around 90% of Indian adults now have bank accounts, most of which are linked to digital identities and government services. These are transformative investments for the future. Paradoxically, amid global trade turbulence, India finds itself, almost by accident, in a sweet spot. Countries pursuing a China-plus-one strategy, as well as those seeking to reduce dependence on the United States, are increasingly engaging with India. The EU free trade agreement, under negotiation since 2007, is hardly a coincidence that it is coming to fruition now amid US reciprocal tariffs and blustering threats to annex Greenland. Many countries are keen to strengthen trade and investment links with a stable, democratic country that is not closely identified with any distinct geopolitical group like the Western bloc or the Chinese bloc. Finally, and I think most important of all, there has been astonishing progress on poverty reduction over the last few decades. I don't want to get into the very latest numbers and controversies about how exactly poverty is measured, but rather I'd like to step back a little and look at the long arc of progress. In fact, in my view, the achievement of India and China in reducing poverty since economic liberalization in both countries began in the 70s and 80s respectively. That must count as one of the most sweeping and dramatic improvements in human welfare of all time. Since 1983, to put this in context, the proportion of the global poor has fallen by about 1.3bn people. China and India together have accounted for 85% of that reduction. So, lots of very good things happening in the Indian economy, and by any standards, the performance in the areas that I've outlined has been excellent.

Taimur Baig

I want to talk to you about some of the not-so-great aspects of the Indian economy. Surely not everything is perfect, but before I go there, I want to ask you one follow-up question. You mentioned the GDP statistics. You talked a little bit about the poverty statistics. By and large, the data that we're getting out of India, can we run with them without much scrutiny? Is it good quality data or not so good quality data?

Shekhar Iyer

All data require scrutiny, whether in India, other emerging markets, or advanced economies. India has a generally good track record with data. There are discrepancies between sources, such as consumption surveys and national accounts, but that is to be expected. I do not see a generalized data quality problem. Technical issues are being resolved, and data quality should improve over time. Nothing in this podcast hinges on current measurement controversies.

Taimur Baig

All right, strong growth performance over a long horizon, good progress in poverty reduction, foundations for stronger growth, may well be in place. What are the caveats?

Shekhar Iyer

There are many. I've given you what is a pretty broad silver lining but let me delve into the dark clouds behind that. First, India has far too many people in agriculture, where productivity and incomes are very low. Nearly half the labor force works in agriculture and allied activities, which contributes only about 16% of GDP. India has not experienced the scale of rural-urban migration seen in China, which is essential moving towards a Viksit Bharat. China's urbanization rate rose from 18% in 1976 before Deng Xiaoping began his reforms to 65% today, that's about two thirds. India's is about 35%, one third. So, there's an enormous amount of structural transformation that is yet to happen and shows very little signs of happening right now.

For this to happen, we need good policies both in rural areas and in urban areas. On the rural side, we need to make it much easier to consolidate landholdings and convert land from growing staples to either industrial use or at least to growing cash crops. The average Indian farm comprises 1.08 hectares. This is compared to 187 hectares in the United States. In India, the average size of a herd for a dairy farmer is two to three animals. In the US, it numbers in hundreds. So, without the kind of economies of scale that you would get from larger landholdings, it is essentially impossible to scale, to mechanize, and to modernize.

Shruti Rajagopalan and her colleagues have recently written a fantastic paper describing just how difficult land acquisition in India is. They cover 20 states and go with a fine-tooth comb through all the policies that govern land acquisition. They find that the procedure for change of land use alone rests on more than 50 primary statutes read together with hundreds of government orders implemented through over 70 different offices. In the states that they cover, the procedure for the change of land use needs a landowner to navigate six to eight distinct bureaucratic stages, often with their own conflicting timelines. And in some cases, there is actually no way to move from a low productivity use of land to a high productivity use of land.

And I love the example of Kerala. So, in Kerala, imagine a farmer who's got a waterlogged paddy field, and the farmer has learned that maybe I should grow rubber. Rubber trees don't require too much care. You get steady incomes. So, in any normal functioning market economy, he would drain the field, raise the soil level, and plant rubber saplings. In Kerala, this is a criminal act. You are allowed to grow intermediary crops on paddy fields, crops that grow between the two regular cycles of paddy, because they are regarded as temporary and short term, but you cannot actually change to some other crops without changing the character of the land, which would then lose its wetland nature. This unauthorized conversion of land is subject to up to two years' imprisonment.

Now, some states like Andhra Pradesh and Telangana have made progress, so it's not impossible, but there's a lot of work to be done. On the other side of the ledger, you need a lot of work in cities. Currently, our cities don't have the absorptive capacity that would be needed to absorb the kind of rural urban migration I'm talking about. This is particularly true of tier 2 and tier 3 cities, which need to have much better infrastructure and need to expand greatly over time. But that said, even our tier 1 cities need a lot of work. I'm currently living in Delhi and have been for a few months, and as you and I both know, the kind of pollution levels you get in Delhi in winter is absolutely dystopian.

So, there's a lot of work to be done on the rural side, and there's a lot of work to be done on the urban side.

Secondly, let me come to entrepreneurship, which still remains very shackled by an overzealous and habitually suspicious regulatory state. I'm constantly reminded of Piloo Modi's question to Indira Gandhi on the floor of Parliament, asking why Indian entrepreneurs flourish everywhere in the world except in India. Now, that criticism has lost a bit of its bite recently, to be fair, but doing business in India is still not for the fainthearted.

This is reflected, for example, in the enormous ramp-up in public infrastructure spending. Public infrastructure spending in theory should be crowding in private investment because private investment is complementary to public investment. If you look at the private investment

numbers in India, it remains very anemic. Why isn't it happening? Manish Sabharwal talks about regulatory cholesterol, the idea that the system is so clogged up with regulations, permissions, licenses, and criminal penalties that it impedes entrepreneurship to begin with and then impedes scaling up if somehow entrepreneurship takes root in inhospitable soil.
He and his team have documented that a typical firm is required to comply with provisions under 1,500 acts, fulfill more than 69,000 compliances, and complete more than 6,000 filings at the central, state, and local government levels. Every year, these regulations undergo 9,000 updates, and in order to keep track of them, a firm would have to navigate 3,000 government websites.

Ok, a lot of numbers. From those numbers, it's easy to see, first, that not even the biggest and most morally upright enterprise can possibly be in full compliance with the regulatory landscape, and second, why small firms who don't have access to an army of lawyers are differentially burdened. Third, there is nowhere in the world, I think, which better illustrates the maxim that justice delayed is justice denied. Judicial backlog is a critical systemic crisis in India, with over five crore cases pending across all court levels, especially the lower levels. This massive backlog is driven by a very low judge-to-population ratio, inadequate infrastructure, and excessive government litigation. The government is party to about 50% of all pending cases in India. Cases can take decades. There are over 1.24 crores cases pending in lower courts which are over five years old. This is, pun fully intended, a criminal state of affairs.

And then let me make one final point, which is that we tend to be, or at least the Indian government tends to be, instinctually inward looking, and that constrains our development opportunities. While our tariff rates have been going down and there have recently been a flurry of FTAs, our tariffs remain among the highest in the world and our tariff regime one of the most complex. Non-tariff barriers are an even bigger impediment. It takes an average Indian manufacturer 30 days to obtain clearance for an import. Compare this with 12 days for the average G20 country and nine days for the universal emerging markets. This is clearly a state of affairs that needs radical reform.

We also score plenty of self-goals when it comes to FDI, which is a very well-proven vehicle for technology transfer and integrating with global supply chains. One famous example here is Vodafone, who were hit with a retrospective tax assessment under which the Indian government sought to claim taxes on a transaction based on a law which was enacted five years after the transaction in question. Ultimately, Vodafone won its case in international arbitration, and the Indian government refunded the tax claim to them, but the episode is very illustrative of the kind of mindset that needs to change. We need to be rolling out the red carpet for trade and international investment, not seeking out ever more Byzantine methods to discourage these things.

Taimur Baig

Very good. Shekhar, since I want to spend the rest of the conversation discussing fiscal policy, exchange rate, as well as trade, let me squeeze in a couple of structural questions related to the things that you talked about. One would be related to labor market policy. But first, I want to talk to you about the role of technological innovation. You've talked about structural impediments from regulation on the agriculture sector, on entrepreneurship, and so on, and I appreciate that very much. But as you and I have studied and seen in practice during the course of our career, total factor productivity increase is the key for long-term sustained uplift and growth, and that has to come from some degree of technological innovation and value added. What is the state of affairs of that in India?

Shekhar Iyer

Well, again, I think it's a bit like the curate's egg; it's good in parts. There is a lot of dynamism in terms of Indian entrepreneurship, and as Piloo Modi said, you see this everywhere in the world except perhaps in India. But that's not entirely true, because in India too, I think there are a million mutinies going on. There is very good work, especially on the digital side. Almost every adult Indian has now got a bank account. These bank accounts are linked with digital identities. Lots of government clearances and paperwork can now take place virtually. A lot of permissions have been abolished. A lot of stuff that used to come through the public distribution system in kind now takes place directly through cash transfers.

But there's still a long way to go in terms of unleashing the dynamism of the manufacturing sector. Let me come to the labor codes, because you specifically asked about them. There's recently been a very long-awaited notification of the labor codes. This consolidates 29 acts into four, removing many provisions that used to criminalize minor infractions of paperwork, getting rid of many rules that encouraged corruption like mandatory physical records, multiple licenses requirements, and the power to arbitrarily reopen past cases. The labor codes also removed many very dated restrictions on women's labor force participation, like earlier it was very difficult for women to work night shifts in various places. A lot of those regulations have been rationalized. Social security has been expanded to gig workers.

Now, in India, labor is on the so-called concurrent list, which means that it is legislated both at the central and the state level. The ball is now in states' courts, and states have made differential progress. But if states are able to take advantage of the opportunity offered by the codification of the labor laws, then we could see a huge increase in both manufacturing and services employment opportunities.

Taimur Baig

That would be great. Shekhar, I was speaking to an Indian entrepreneur recently who has textile investments both in India as well as in neighboring economies, and he said to me that on a scale of one to ten, if he were to rate his own country, India's market flexibility, he would give that a three, while a certain neighboring economy, a textile exporting powerhouse, it'll be a nine in terms of easiness. So that was illustrated for me because a practitioner who has businesses in both countries is telling me this. But I take away the silver lining from what you just said, which is if the states do make progress in the near term in adopting some of the labor market liberalization that have been implemented at the central level, fingers crossed, maybe that's the Rubicon we need to pass, and it just might be just around the corner.

Shekhar Iyer

Yeah, let's hope so, and certainly the story of your entrepreneur is very true to me.

Taimur Baig

Shekhar, it's budget season. I'm sure you've had your fill of budget-related discussions, and I want to take advantage of some of those things you've been talking about. Maybe a two-part question. First part, just the budget in terms of fiscal transparency and debt dynamics. Where do you see the fiscal stance?

Shekhar Iyer

So, I think really that that's the most heartening thing about the budget, which, if I may say, is a worthy but unspectacular budget that makes incremental progress in the right direction. So, the nice thing is that fiscal consolidation is continuing. The fiscal deficit in the last fiscal year was down to 4.4%. Just a couple of years ago it was 6.4%, so there's been very good progress. Now, for the next year, there's only a marginal fiscal consolidation plan to 4.3%, but this is occurring despite a big ramp-up in capital expenditure.

The capital expenditure is very high, at 12.2 lakh crores. But even more important than this headline, there are also grants-in-aid to states. If you add up the grants-in-aid for capital expenditure together with the central government's capex number, it amounts to about 4.4% of GDP, which is basically almost exactly equal to the fiscal deficit. So, one way to think about this is that the government is borrowing entirely to finance new investment, and that's a good thing.

What about debt dynamics? Well, Sajjid Chinoy of JPMorgan has done some interesting r minus g calculations, suggesting that perhaps the most important number here is just nominal growth. The government's goal is to achieve a 50% debt-to-GDP ratio by fiscal year 2031. Currently, we're at about 55%–56%. He calculates that in order to get from 55% to 50%, the center will need to reduce the fiscal deficit to 3.6% of GDP with a 10% nominal rate of GDP growth. However, if the rate of growth is just one percentage point lower, at 9%, then the fiscal consolidation will need to be 3%. So clearly high growth is a very important element of the debt reduction strategy.

Another wildcard I should mention here, which Dr. Kavita Rao has been emphasizing, is that India is soon going to have a re-based GDP series. When that happens, that may throw all these things I've said about debt dynamics out of the window. For example, if nominal GDP happens to be 10% lower in the rebased series, that means that the corresponding fiscal effort to reach government goals will need to be much higher.

Taimur Baig

Shekhar, we have seen this in the past. I think it was about a decade ago when nominal GDP was revised up substantially and debt dynamic improved, but it also came at the expense of the revenue ratios falling substantially. So, you know, no free lunch, right? On one hand, debt dynamic improves, but then revenue ratio for India, which already is pretty anemic, looks worse, despite the heroic advancements in the receipts around GST.

Shekhar Iyer

Absolutely. There's a lot of uncertainty about that. And then the other thing that I should mention is that so far, I've only talked about the center, where the performance has been good and the fiscal consolidation has been steady and gradual. In the states, it's the other way around. So, it looks as if there's a monotonic increase in the debt-to-GDP ratio in states. The states are quite heterogeneous. Some are less responsible than others, and ultimately what's happening at the state level could undo or offset whatever good things are happening at the central level. And in this context, let me also mention something which people have kind of let slip under the radar a bit because it happened at the same time as the budget and the FTAs. This is the long-awaited report of the 16th Finance Commission.

It does several good things. It wraps the states' knuckles in terms of the unconditional transfers that they are making. It urges them to cease off-budget financing and bring everything above the line. But one thing that I wanted to highlight is that when you have a formula to allocate central revenue to the states, in the old system there was a 2.5% weight on tax revenue efforts at the state level. So, you were rewarded for better tax receipts. That has now been removed, so it's now zero.

I worry that this will disincentivize tax efforts precisely at the time that it's needed most. Perhaps I'm worrying too much about it. 2.5% was never a very big weight, and some fiscal experts have told me that states never took that seriously when they were endogenizing their decisions. But anyway, this is just a long way of saying that you have to watch what's happening in the states when you're thinking about the debt situation and debt dynamics in India.

Taimur Baig

Very good. Ok, so the second part of the fiscal question is related to sectoral focus. We began this discussion by talking about agriculture and how productivity has been poor there. So, does the budget do anything heroic in terms of tackling those issues of the agriculture sector?

Shekhar Iyer

Ok, let me put it this way. We have in ICRIER, my organization, perhaps the preeminent agricultural economist in India, Dr. Ashok Gulati. He has done some work comparing the returns on the fertilizer subsidy to the returns on agricultural research and development, and the numbers are striking.

For one rupee spent on the fertilizer subsidy, there is a return of 88 paise in terms of output. For one rupee spent on agricultural R&D, the return is 11 rupees. For every million rupees spent on the fertilizer subsidy, an estimated 26 people are lifted out of poverty, whereas the corresponding figure for agricultural R&D is 328 people. These are differences of an order of magnitude. They are a factor greater than 10.

And yet, when you look at the budget, there is this complete persistent imbalance between the amount we spend on the fertilizer subsidy, which in the current budget is 1.7 lakh crores, versus what is spent on R&D expenditure, which in the current budget is 0.1 lakh crore. So, this is a big opportunity missed, I think. It is certainly true that it is politically difficult to make reforms to the fertilizer subsidy, but there is never a better time to have done it than a time when growth is rapid and the macroeconomy is stable.

So yes, I think there was an opportunity missed. That said, let me also say that I think maybe people expect too much out of the budget. The budget is one day of the year, and there are 364 other days of the year when unspectacular reforms should be proceeding apace. So, my hope is that what's happening off budget is actually more important than what's happening on budget.

Taimur Baig

Sure, but at the same time, it seems to me that the shiny part of the Indian economy where the authorities have a lot of focus is manufacturing and not agriculture. That is grabbing all the headlines. So, let's talk a little bit about what the budget did for the manufacturing sector.

Shekhar Iyer

So, there's are lot of sops for the manufacturing sector. There's a lot of rhetoric in the budget about the importance of MSMEs, which account for the bulk of manufacturing employment in India, and there are certainly some good initiatives there, in particular in terms of increasing access to finance for some of these small and medium firms which may not have the kind of collateral or credit histories which are very easy to deal with in the banking system.

In particular, what the government has done is that it has linked government procurement with a trade receivables discounting system called TReDS for MSMEs. I know that sounds like geek speak, but it's actually quite important to ensure that MSME suppliers are paid on time and that they can use government orders to procure credit. So that's great.

There are a number of very worthy programs and initiatives, in my view. All these feints at industrial policy are ultimately far less important than horizontal structural reforms to lift all boats. As we said a minute ago, a lot of that stuff should be happening on the other 364 non-budget days of the year. There is a truckload of empirical evidence to suggest that the returns from broad-based measures to cut red tape, lower regulatory burdens on businesses, free up labor markets, land markets, and international competition are far higher than the returns from subsidizing favored industries.

Taimur Baig

I hope this message resonates because I think it's a very critical one, and I'll make sure that when we create a summary, not an AI-generated summary, but my own summary of this podcast, I will stress on this point because I think you and I both agree that that's where the critical foundation of future uplift of growth lies.

Shekhar, economists have long talked about how India sort of went through premature deindustrialization, and when it should have been ramping up manufacturing, it sort of let services blossom. So, what is the state of the services sector, and how is this budget directly or indirectly helping the services sector?

Shekhar Iyer

So indeed, in India, Arvind Subramanian and Devesh Kapoor have recently written this book about India's development journey since independence, and it's a great book in many respects. They talk about India as a precocious democracy, not in the sense of having done things early, but in the sense of having done things in a different order from the universal pattern. And what you are mentioning is one of the key elements of that precocious democracy, that in India, instead of going from agriculture to manufacturing to services, we seem to have continued to be very heavily in agriculture, and then, to the extent that a shift has taken place, it's taken place to services, not to manufacturing.

Now look, we have a good record in services, especially on the balance of payments, where services are becoming increasingly important. If you look at global capability centers, there are a bunch of multinationals which are coming into India and using global capability centers not just for back-office operations, which are sort of low value-added, but increasingly high-level design work, R&D, very high value-added, very good jobs.

The budget itself again has targeted initiatives for certain sectors in services. I guess the most notable is that foreign companies providing cloud services to global customers through domestic data centers get a tax holiday till 2047. There are also some provisions reducing the amount of paperwork for global capability centers to provide services for global clients, and these are both excellent measures.

Both given the increasing importance of the digital economy and more generally the role of service-led exports, which, as I said, is becoming a very critical part of our balance of payments. But that said, the same fundamental point that I made about manufacturing also applies to services. General reforms to ease entrepreneurship and job creation across the board, in my view, are much more important than industry-specific SOPs.

So, to take one example, we were just talking about labor codes notification. State-level implementation of the new labor codes is of much greater importance to the services sector than anything in this budget.

Taimur Baig

Very good. So, I fully agree with you that a lot of these reforms, whether they happen at the grassroots level through the states, are perhaps more critical than the big announcements on budget day and the discussions the weeks after. So, the other 364 days are critical.

Shekhar, you have written extensively over the course of your career on geoeconomic fragmentation, especially over the last few years. Put that thesis that you have—that the forces of fragmentation are ruinous for trade and commerce and, by extension, ruining growth potential or profitability potential—into context with the recent trade deals that India has been embarking upon, whether it is with the EU or the UK, or for that matter the deal with the US.

Shekhar Iyer

Ok, very encouraging developments. Let me start with the EU FTA. I think here the critical thing is that for years our competitors, countries like Bangladesh and Vietnam, have enjoyed preferential access to the European market that India has lacked. And these are precisely the kind of labor-intensive sectors which we want to build up and become a jobs factory for India, sectors like apparel and footwear.

Earlier on, countries like Bangladesh and Vietnam had something like a 10% to 17% tariff advantage over India, depending on which line you were talking about precisely. That playing field, according to the EU–India FTA, has been leveled. So, this offers Indian producers a tremendous opportunity in precisely the kind of jobs-rich manufacturing sectors that we would like to get developing.

My colleague Shoumitro Chatterjee at Johns Hopkins has done some calculations where he looks at countries' market share in Europe for low-skilled manufacturing goods relative to their labor incomes. The results are very interesting. Vietnam and Bangladesh are exporting their export share in the EU is about equal to their potential, given their labor force characteristics. China exports 18% to 20% more than suggested by its labor force characteristics. India exports about 18% less, giving us a headroom of about USD160bn, which we should be able to achieve simply by living up to our potential, not even overshooting, but simply meeting the potential that we already have.

So, the opportunity is large and obvious, but at this stage it's only an opportunity. We'll need to do a lot of other things right in order to realize the full potential of this and other FTAs. And here, let me repeat myself; remember that imports are the lifeblood of exports. To develop into an export powerhouse, we must ensure easy and cheap access to high-quality inputs from all around the world, and yet our import regime is among the world's most complex and burdensome.

Consider for a minute the UK FTA. The UK schedule in that FTA has three categories: zero duty, excluded, or quota-based access. India's schedule has more than 20. If you look at our MFN tariff schedule, it's full of exceptions and conditionalities and includes more than 140 unique tariff rates. This is the kind of complexity that invites disputes, delays, and standards issues.

I'll give you another example. Volkswagen was recently asked to pay USD1.4 bn in fines because it imported auto parts in separate consignments taxed at 5% to 15% rather than as a single shipment, which would have been taxed at over 30%. From the firm's perspective, this is very intelligent and rational tariff design. From the authority's perspective, it's tax evasion. Either way, the problem is that complexity damages credibility.

If we learned this lesson with the Goods and Services Tax, which was recently rationalized, there is no reason why we cannot apply the same logic to tariffs and seek to radically simplify the whole system. It needs to be rationalized and simplified, quite apart from the fact that the level needs to be brought down. We should take advantage of all these free trade deals that we are signing to do these things which we should have been doing anyway.

Taimur Baig

Let me trigger a little differentiation between the tone of the EU-India deal and the US-India deal. The EU clearly wants its companies to have greater access to Indian markets, but at the same time they're making a bunch of carrots available for India, not just on trade but also on immigration. The US is doing very little of that, and the tone is, of course, far more blustery and confrontational. How do you see the India-US trade relationship going forward, given the announcements and the details that we've seen so far?

Shekhar Iyer

Well, I think that's the rub of the matter. We haven't really seen much detail on the US FTA. There's much more uncertainty about it. We have a good idea of what the final EU agreement is going to look like, but not so for the US. In addition, there is the Supreme Court judgment hanging over President Trump's power to impose reciprocal tariffs to begin with, at least using the instruments that he's been adopting. So, there's a lot of uncertainty.

But look, in principle, to the extent that the reciprocal tariff of 50% has been reduced to 18%, that's much better, and again it means that the playing field has been leveled with Vietnam and Bangladesh in labor-intensive sectors. If you look at the joint statement issued by the US and India, it specifically mentions many industries which are important to India, like pharmaceuticals and gems.

The agreement also commits India to lowering a number of non-tariff barriers like import licensing and redundant testing requirements. While this may be viewed as a concession that India is making to the US, in my view it's fantastic, and we should have been doing it anyway, so we should very much welcome that concession.

But my big concern, coming back to geoeconomic fragmentation, is that this FTA might seek to circumscribe our engagement with other economies around the world. There has already been a lot of reporting on Russian oil. President Trump initially posted that India has committed to stop buying Russian oil. There's no mention of that in the joint statement, and India has not made any such commitment publicly.

The joint statement also contains a reference to actions to address the non-market policies of third countries. This is a not-so-subtle reference to

China. In my view, we should strive to maintain our freedom of action vis-à-vis Russia, China, and every other country in the world and not let ourselves become subject to coercion or pressure from one particular country that wants an exclusive relationship.

Although the multilateral trading system is currently in disarray, and if you look at the adjudication body of the WTO, the appellate body is defunct because the US has for many years been refusing to appoint judges to the appellate body. That said, we should still strive to make sure that whatever FTAs we sign are consistent with the multilateral spirit of the WTO.

For too long, India has been a backbencher when it comes to setting the rules of the multilateral trading system. We are now large enough, powerful enough, and attractive enough as a trade partner to be one of the founding members of the next avatar of multilateralism. A good step in that direction would be to be very careful about the spirit of the FTAs that we sign today.

In my view, close partnership with any given trading partner is always welcome, but not any action that seeks to put us in a particular camp and restrict our dealings with rival camps. I've already spoken to you last time about the kind of calculations that various economists have done on the costs of geoeconomic fragmentation, and they remain as large as they were when we last talked, so we should make every effort to avoid it.

Taimur Baig

Absolutely. Shekhar, I'll give you one example that may not be seen very clearly from the Indian side, but when one looks at the India-US and Bangladesh-US trade deals side by side, one sees some jeopardy that could befall Indian exporters. I'll give you an example. The US will allow duty-free exports of textiles from Bangladesh into the US provided Bangladesh imports US cotton. Where does Bangladesh import cotton from now? Its India.

So, as you can see, these sort of third-market spillovers and forcing one country to deal with another country, but at the same time having other implications, I find quite disturbing and really sort of infringes on countries' sovereignty. Bangladesh should be free to import cotton from whoever they want, but in this case, to get access to the US, it has to be US cotton.

Shekhar Iyer

Yeah, I couldn't agree more. That's a great illustration of the point I was trying to make.

Taimur Baig

Absolutely. Shekhar, one conjunctural discussion, because trade-related discussions are not just about tariffs, they're about competitiveness. And one aspect of competitiveness is the currency. We are having this discussion in the first quarter of 2026. The year of 2025, when the Indian economy was doing pretty well, but the rupee was fairly lackluster and has faced some degree of volatility in recent months.

So, we've talked about rather big structural issues, but I just want to focus on them for a second, if I may. What's your sense?

Shekhar Iyer

Look, we should not be worrying about the level of the rupee. We should let it float. And in fact, it's very heartening to see the RBI governor recently coming out and stating in no uncertain terms that the Central bank does not target a particular value for the exchange rate. I think that's bang on.

It's very important not to conflate, as some people do, a strong rupee with a strong economy. The exchange rate acts as a shock absorber. It allows adjustments to occur along this essentially monetary margin rather than much more painful adjustments in the real economy.

The other thing to remember is that inflation in India, because we are an emerging market, is structurally higher than that in many of our advanced country trade partners. So, it's only natural for some depreciation to occur naturally. This is simply what we learned in grad school as uncovered interest rate parity.

To give you one example, consider our exchange rate against China. Although the rupee has depreciated in nominal terms against the renminbi by about 15% since the pandemic, China is currently undergoing deflation as a result of weak demand and the fallout from the property sector. So, if you look at real effective terms, the rupee has in fact appreciated against the renminbi by about 10% since the pandemic.
So, seeking to further strengthen the rupee for whatever misplaced notions of national pride one might have would artificially support Chinese exports to India at a time when there is already some unease about the bilateral deficit with China. So that's just one example. There are many more, but the general principle is we should strive to

keep the level of the rupee separate from other policy discussions and allow it to act as a natural shock absorber.

Taimur Baig

Very, very well said, Shekhar. Last April, I was in Washington, D.C. during the IIF meetings, and the Treasury Secretary Scott Bessent talked about what he thought was a right dollar policy. As you know, US Treasury Secretaries in the past have always advocated a strong dollar policy, but in this current administration there are some voices which are going for a weak dollar policy.

Bessent's point was a good middle ground. He said that to him, strong dollar means the US economy remains attractive and US dollar assets are attractive for foreign investors. So, I think the same thing with India. As long as India is an attractive investment destination, both for Indian corporates as well as foreign corporates, the level of the rupee should be left to the market's devices. Investors will figure that out on their own.

Ok, so through this conversation, a few times we have brought up the word China. And the China story, in my view, and I think you concur with me, is an absolutely fascinating one. The country is sort of going through a huge tech-led growth path, whereas even till the very recent past it was the old-school cheap manufacturing scaling up and so on.

So, as China shifts from producing large-scale goods in the manufacturing medium- and low-end sector to move up the higher end of the technological ladder, what should India's strategy be vis-à-vis China?

Shekhar Iyer

We should seek to engage. First, on geoeconomic grounds, we need to seek diversification. If you look at our trade with China, it's very small compared to other parts of the world, and we should seek to increase it.

Secondly, China has got lots of stuff that we will really need, including for our green transition.

More broadly, stepping away from the conjuncture, I think the 21st century has the potential to be the century of the two Asian giants, China and India, so we should seek every opportunity to deepen our relationship with China, of course subject to security considerations.

My ICRIER colleagues Nisha Taneja and Sanjana Joshi have recently written an excellent policy brief about how best to engage with China, which outlines several strategies. An interesting thing they say is that the biggest problem is not so much tariffs that China puts on Indian imports, but non-tariff barriers.

If you talk to pharmaceutical businesspeople in India, they say that China does not permit retesting by third-party labs if products fail some kind of initial random sampling, which means that the testing lab's decision is final, non-transparent, and non-appealable. Another major impediment that Indian exporters face is the lack of information on regulatory and documentary requirements, which are often only present in Mandarin. We don't have enough Chinese speakers who can penetrate those documents and figure out the right procedures to follow.

So, a lot of NTBs rather than tariff barriers, and this is something that could in principle be solved quite easily if there's goodwill on both sides. The suggestion that my colleagues make is that we should have a high-level joint task force of trade and technical experts which would facilitate the sharing of trade-related information, regulations, translations, and monitor and resolve non-tariff barriers through regular consultations and perhaps some kind of joint testing facilities.

We should also be inviting much more FDI from China, which is now the global technology leader in many industries, including green technology. This would simply be repeating the kind of successes that China had in its not-so-distant past when it was inviting FDI into China with an explicit eye on using that investment to move up the technological ladder itself. There's no reason why we cannot replicate that strategy.

There's a recent very illuminating paper by Rakesh Mohan and Janak Raj which underlines the case for much greater engagement with China on macroeconomic grounds related to the green transition. They do calculations on India's climate financing needs for meeting our own net-zero commitments and find that until 2030 there will need to be an inflow of foreign capital for financing the transition of about 1.4% of GDP annually, net of the current account deficit.

When you look at India's capacity to manage this kind of inflow without drastically expanding our monetary base and incurring inflation, this is only possible through a combination of a larger current account deficit and an increased domestic savings rate. This is a complicated macroeconomic lens of saying something quite simple: to meet our climate goals, we will need to expand our imports, specifically imports needed for the green transition, where China has a tremendous cost advantage over other countries.

Take battery storage technology. This is going to become increasingly important for India as we integrate renewable energy sources into our grid, and China is the world's most efficient producer of this technology. In other words, if we are serious about meeting our net-zero targets, greater trade with China is inevitable.

So, we should take advantage of the post Galwan thaw that we currently have to greatly increase our engagement in terms of trade, FDI, and people-to-people contacts. We should be striding into this century together.

Taimur Baig

Right. Shekhar, now of course I would like to think that this century is not just India and China's, but also broadly Asia, which includes Southeast Asia, my region. My final question for you is that when I look at an electronics product, it may say "made in China," "designed in the US," or "assembled in India," but the fact of the matter is they're actually made in Asia. Components move from Singapore to Vietnam to Malaysia, Korea, Taiwan.

Will India become part of that supply chain? Because right now India is doing a pretty good job of assembling a lot of Asian-made products, but not historically having the OEMs made in India. Do you see signs of that transition taking place? And related to that, that transition would require India to become a little more integrated with Southeast Asia. Where do we go there?

Shekhar Iyer

Absolutely. This is very necessary, and I'm optimistic about our chances. There are two aspects to it: hard infrastructure and soft infrastructure. We're doing very well on the hard infrastructure - ports, logistics, airports, highways. All of that is going reasonably well as you can expect.

What's lagging is the soft infrastructure: labor laws, land acquisition laws, regulations stifling entrepreneurship, predictability of the tax system, quality control orders that come suddenly and are disguised as quality measures but are really responses to vested interests. These are the things that fundamentally need to be fixed. They are not easy to fix. They're less visible than hard infrastructure projects, so it's harder to get political credit for them. But progress is being made. The labor codes have been notified. There is a Jan Vishwas Bill in the works, which looks precisely at deregulation and simplification.

Once hard and soft infrastructure work in tandem, it becomes much easier for India to integrate into Southeast Asian supply chains. We have a labor cost advantage in terms of labor. There's no reason we shouldn't be part of these chains. Other things are holding us back, and I'm optimistic that these shackles are gradually being unshackled.

Taimur Baig

I share your optimism, Shekhar. Thank you so much for your time and insights.

Shekhar Iyer

Thank you very much Taimur. Great pleasure. Thank you for having me on again.

Taimur Baig

Great to have you, Shekhar. I'd like to thank our listeners for listening in as well.

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