

Eighth NBER-NCAER Annual Neemrana Conference Summary of Proceedings¹

The Eighth NBER-NCAER Annual Neemrana Conference was held at Neemrana Fort Palace Resort from 21 January to 23 January, 2007 bringing together a diverse group of participants interested in issues of public policy analysis of interest to the Indian economy (See list of participants at the end). The main issues discussed were - challenges facing India, the US and the world economy; global imbalances and global governance; foreign direct investment and entrepreneurship; financing public and private investment; banking and capital markets; long-term growth, governance and inclusion. This is a brief summary of papers/presentations, discussants' comments and general discussion that took place during the course of the conference spread over eight working sessions of approximately two hours each. In addition to the working sessions the conference was also marked by addresses given by Sh. P. Chidambaram, Sh. M. S. Ahluwalia and Sh. C. Rangarajan.

The conference opened with an optimistic note highlighting the recent growth performance of the world, the US and Indian economies, which has been extremely good. The Indian economy in particular has witnessed four years of 8 per cent plus growth. There is unprecedented boom in the economy – stock market is up, savings to GDP ratio is up and so is the ratio of investment to GDP. And, what is even more satisfying is the fact that outward foreign direct investment (FDI) during the current year is almost equal to the inward FDI. All this seems to be a cumulative effect of past and present reforms that have been undertaken by successive governments after 1991.

Some of the key challenges facing Indian economy at this particular point relate to guarding against complacency and not going on a spending spree, cyclical nature of growth, threats related to extreme groups, impact of state elections and capacity of the state to deliver services efficiently. Some other issues, which have serious implications for the future growth of Indian economy, are in the domain of inclusiveness, rural-urban divide, infrastructure and slowdown in agricultural growth, which is performing well below its full potential and is responsible for rural distress. How can we compete with China and other countries in industries that have been vacated by the US? What should be done to improve employment in the organised sector? Delivery of services needs institutional reforms, which may not be possible without raising user charges. Infrastructure is a big issue, scale of investment is huge, but the requirements of infrastructure sector are also very large.

The discussion in the first session was centered on these themes together with the impact of depreciation of exchange rate, problems associated with large inflows, unprecedented credit growth

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and dynamics of coalition politics. It was felt that to overcome these challenges a completely new approach is required particularly with respect to delivery of services, raising resources and investments in infrastructure sector and regulatory regimes.

For the US economy 2006 has been a good year despite some concerns about housing construction, which had collapsed during the middle of 2006. The other indicators such as rate of unemployment and inflation have, however, remained favourable and predictions for 2007 suggest that 2007 will also be a year of healthy growth for the US economy. The down side risks for the US economy pertain to household saving rate, which is -1.5 per cent and rather high current account deficit.

For the global economy short-term worries associated with the US growth have dissipated and competitiveness of Germany in the Euro Area is also showing signs of improvement. The Japanese expansion still remains a worry, but developing countries have witnessed robust growth, which is likely to continue in the near future. The risks facing the global economy are in terms of policies, which the US and other countries outside the US, follow in the next couple of years. In the short-term, concerns were also expressed regarding irrational exuberance of capital markets in most parts of the world. It was noted that while the going has been good for the major economies barring a few exceptions, yet there are several issues related to policy reforms, political reforms, public-private dichotomy and lawlessness, which may come in the way of destabilizing the current growth momentum.

On global imbalances it was argued that these are not a one sided issue, which means that policy actions by the US alone would not be sufficient to correct these imbalances. The rest of the world particularly the European Union and emerging markets would also have to take necessary steps. The gradual adjustment of exchange rate may be able to take care of some of these concerns to a certain extent if one goes by the experience of the 1980s, when the world economy have had to confront similar concerns. On global governance the issues essentially relate to under representation, which is being discussed in the form of a new formula, token down payment, but at the same time fears have also been expressed in certain quarters because some countries may lose in the short-run.

In the area of international trade it was observed that central principle of the general agreement on tariffs and trade (GATT), most favoured nation is being virtually killed by a variety of bilateral agreements including the generalised system of preferences. There seems to be a situation of uncoordinated equilibrium in which developing countries such as India have also been forced to join the race because other countries are looking for their own short-term interests through bilateral deals. These developments obviously have implications for multilateral trade negotiations, which have been held hostage by the politics in all major countries/players. Notwithstanding what happens to the multilateral trade talks the US has an interest in extending/renewing fast track authority even for bilateral deals. Though bilateral deals raise serious issues regarding trade diversion, trade creation, product specific rules of origin and so on, which are becoming increasingly complicated. On issues

related to international migration it was pointed out that currently there is no appropriate framework that deals with movement of people. There is multiplicity of international agencies as well as conventions dealing with issues related to migration. In this context some concerns about the impact of migration on social cohesion were also expressed.

The session on FDI, entrepreneurship and resurgence of Indian private sector dealt with issues related to entrepreneurship, manufacturing industry, dynamics of competition and trade and second generation reforms in the industrial sector. The discussion noted that though there has been a significant increase in the new entrepreneurial talent, but growth of entrepreneurial firms is not commensurate with the rise in new entrepreneurial talent. There are several constraints related to capital, legal systems, managerial talent and regulatory issues, which have restricted the growth of entrepreneurial firms. Given India's regulatory framework, which is different from what is happening elsewhere where companies can be managed and run without holding a majority stake, efficient banking markets are important for encouraging firm creation.

This is also echoed in the changes in manufacturing sector, which reveal that there has been a significant increase in value added of the manufacturing sector, but the numbers of companies engaged in manufacturing and listed in the stock market have come down. What this means is that more output is coming from fewer units. Further analysis shows that the consolidation of Indian industry is improving efficiency, but it is neither increasing employment nor wages. The employment in organised Industry in particular is best suited to skilled labour. The explanations for this state of affairs could be found in data inadequacy, distortions in labour market and financial vacuum (several alternatives for service industries, but none for manufacturing start ups in particular).

The dynamics of competition and trade reveal that changes in governance (expenditure, quality and efficiency), structural reforms (education, regulatory systems, labour laws, capital, credit) and policy framework (remaining industrial decontrol, monopolies, rent control Act, FDI, small scale reservation and tariffs) are needed to raise the overall rate of growth. The key issues in India's transition from low to mass manufacturing are basically in the realm of availability of skills, labour market rigidities, low levels of FDI due to investment climate (entry and exit barriers, antiquated procedures and processes, high uncertainty and transaction costs) and poor infrastructure.

The discussion noted that this is the best period in India's development history and at this juncture the future scenario appears to be quite optimistic for India. There are some worries related to global growth, but private sector has demonstrated ability to seize the opportunity. There has been an enormous rise in entrepreneurial talent in the spheres of media, retail, infrastructure, construction and film industry. On the low levels of FDI flow it was argued that this could be due to lack of privatisation, which has been the case elsewhere including China. Further discussion also reasoned that though global growth has been an important contributor to India's growth in manufacturing, but the reduction in interest rates, which declined significantly has also contributed immensely to the growth momentum. In view of China's relatively higher share of value added in the industrial sector it

was emphasised that small-scale reservation and lack of infrastructure could be important factors that explain India's rather low share of manufacturing value added.

The session on financing public and private investment opened with a general background of fiscal situation of states and the centre. The overview revealed that the fiscal deficit of states and the centre is in the region of 6 per cent of the gross domestic product, which is relatively high compared to the levels that exist in developed countries, particularly European Union (3 per cent). Apart from this other issues in financing India's public and private investment relate to sharing of savings (domestic and foreign), structure of taxes and getting an efficient tax system in place.

The experience of the US in taxation illuminates that gains from tax reforms are large, but there are differences between steady state and transition and dealing with transition is not very easy. The general trends with regard to taxation in the developed world reveals that more and more countries, which are members of the Organisation for Economic Co-operation and development (OECD), have shifted to consumption based taxation because taxing capital is more difficult. India's case, however, is different because it has been able to tax capital.

A study on the FDI experience of multinational firms suggests that multinationals are more likely to exploit technologies through licensing in countries with stronger investor protection, therefore, weak investor protection limits the scale of activity by MNC firms. The analysis reveals that liberalisation of ownership restrictions has larger effects in countries with poorly developed capital markets, which means that regulatory/ownership barriers in countries that have developed capital markets are not the only barriers to attracting FDI.

The common perception regarding portfolio flows is that these are highly vulnerable and foreign investors engage in herding. The analysis based on daily data from 2001 to 2005 suggests that foreign investors do not seem to be herding as there are significant inflows and outflows on over 99 per cent of the days, and the extent of herding has decreased over time. The bulk of the increase in foreign investment in Indian stocks was caused by changes in the size, liquidity and ownership structure of Indian firms. The results establish that foreign equity capital is not a destabilising force in the Indian market. On whether local firms carry currency exposure and manage currency risk a simple framework based on stock prices of 100 liquid firms and changes in exchange rate shows that implicit guarantees offered by the central bank shape the behaviour of firms. Firms choose to hedge or not hedge their exposures depending on whether exchange rate flexibility is high or low, and take bets on which way the exchange rate could move.

The discussion noted that the topics covered in the session - tax reforms, FDI, FII flows and fluctuations in currency markets are important issues in the Indian context. Finding resources for financing public sector investments is a formidable task. Similarly, creating goods and services tax in India continues to be a big challenge. In the same way issues related to controlling fiscal deficit are important, but the real question is the level to which the fiscal deficit should gravitate? Also, how the fiscal autonomy should be handled in a federal set up of the kind that exists in India? The real

question in the behaviour of multinational firms is what motivates them to invest in countries with different policy frameworks? Given India's low tax base whether concessions on taxes to Special Economic Zones (SEZs) are justified? Also, in what way the financial weaknesses impact the system is also important.

The session on banking and capital markets was devoted to examine whether international financial crises are a relic of disappearing archaic system and are Indian banks in a position to handle fuller capital account convertibility. It was observed that the more recent experience with respect to inflation targeting and exchange rate movements suggests that inflation targeting is far more durable than exchange rate regimes and durability is a big contrast with the previous systems. The analysis shows that no inflation targeter has ever experienced a banking crisis, which explains why it is pervasive in the OECD countries and is spreading quickly outside these countries. Many aspects of Bretton Woods system (exchange rate, monetary policy, capital mobility etc) have been completely reversed, which leads one to believe that financial crises are not a feature of inflation targeters and are a thing of the past.

On the preparedness of Indian banks to handle fuller capital account convertibility it was observed that the levels of fiscal deficit and domestic debt are still too high in India. And, for fuller convertibility the government financing from banks should come down, which means that statutory liquidity ratio (SLR) has to be reduced. Further Indian public sector banks are relatively small and not as financially strong as they should, which means that they need to be able to raise capital. In addition, banks will need to acquire the skills to gauge and monitor variety of risks and for that to happen proper information systems (IT and MIS) need to be put in place and strengthened. And, to mitigate risks associated with fuller capital account convertibility, markets and instruments need to be developed. At the moment it seems that the RBI Committee's recommendations, though risk-sensitive, would render Indian banks un-competitive and could lead to regulatory arbitrage. The discussion noted that credit flow has increased and banks are being stretched because net interest rate margins have dipped during the recent years.

A paper on contracts theory argued that a contract provides a reference point for the parties' trading relationship: more precisely for their feelings of entitlement. This is complimentary to the generally held view that a contract provides parties with a set of rights and obligations, and that these rights and obligations are useful, among other things, to encourage long-term investments. The model developed in the paper shows that a party's ex post performance depends on whether he gets what he is entitled to relative to outcomes permitted by the contract. A party who is shortchanged shades on performance, which causes a deadweight loss. A flexible contract allows parties to adjust their outcome to uncertainty, but causes inefficient shading. The analysis provides a basis for long-term contracts in the absence of non-contractible investments, and elucidates why "employment" contracts, which fix wage in advance and allow the employer to choose the task, can be optimal.

The session of long term growth covered varied issues ranging from electoral economics in new, old and fragile democracies to system of trade preferences and why is underdevelopment so persistent. On electoral economics in new, old and fragile democracies the question that is often raised is – do incumbent politicians use economic policy (especially fiscal policy) to help their re-election efforts? The experience shows that there is little evidence of a regular and statistically significant increase in economic activity before elections. The little evidence that people have regarding political cycles is primarily driven by the experience of new democracies. There are significant deficit and expenditure cycles in new democracies and this is true for both presidential and parliamentary systems. It is the combination of newness and fragility, which is the key to political deficit cycles in new democracies. But, even in new democracies the voters do not reward deficit spending at the polls and low inflation is rewarded only in developed countries. The results for India also suggest that there are no fiscal or expenditure cycles and this is true even at the sub-national level. The only variable that seems to have some correlation is the road construction, which rises in an election year.

The study on trade preferences examined the structure and efficiency of Bangladeshi firms engaged in apparel exports to the US and EU. In general the EU apparel market is characterised by restrictive rules of origin, EBA preferences, no quotas and tariffs that range from 12 to 15 per cent. And, the US apparel market has less restrictive rules of origin, there are no country specific quotas and tariffs are in the neighbourhood of 20 per cent. The results indicate that more firms export to the EU than to the US and exporters to the EU are single market firms, but exporters to the US are multi-market firms. These results also suggest that firms that supply majority of their products to the EU are less productive compared to firms that supply to the US market. Based on the evidence reported in the paper the authors contend that preferences provided through EBA are far less beneficial than they seem due to costs related to rules of origin as firms employ capital intensive technology and are less productive. The implication is that trade preferences may have hidden costs and need to be designed with caution.

On what determines overall growth the author questions the conventional wisdom of relating growth to geography, catch up, factor accumulation or other factors (demography, institutions and policy). The results of the study though a bit controversial, suggest that geography does matter, but considerably less than claimed, institutions matter the least and policy (exchange rate) matters the most. Further the middle class that believes in values, entrepreneurship, level playing field and merit is an important driver of growth. A paper on why is underdevelopment so persistent suggests that there is no straightforward reform path that commands broad support. This was examined with the help of two examples of reforms for enhancing access to education and low entry barriers into industry in an economy. For broad based support there is a need to enhance access even while increasing competition and sequencing of reforms matters – endowment enhancing comes first before competition enhancing. In terms of shaping wider acceptance for reforms it is important to emphasise

more on opportunities and less on loss of rents and once the constituencies fall in place they develop their own momentum. In nut shell pro-market reforms are welcome if they also broaden opportunities.

The discussion on India's regulatory experience observed that there has been a sea change in private sector participation in infrastructure over the last 15 years, which has been made possible by higher growth and structures of governance that have been put in place. There is more transparency in regulation as orders are open to challenge – telecom is an example. Despite these improvements the regulation story in India is like Dr. Jekyll and Mr. Hide as there is regulatory capture (backdoor entry, breaching of rules), padding up of costs, by and large continues to be a monopoly of former bureaucrats and open to government interference. It is hoped that over time the system will improve when stakeholders start challenging the system, which is evident from the cases that challenged monopoly of government service providers in telecom.

In the concluding session on growth, governance and inclusion the issues discussed were - poverty and well being in the US, globalisation and mobility, gender discrimination and citizenship and accountability. The paper on poverty and well-being in the US noted that problems in measurement of poverty such as differences in household surveys and national accounts, estimates based on income and consumption, poverty line and price indices are not unique to India. This was highlighted through the example of official estimates of poverty in the US, which indicate that poverty fell in the 1960s, but is the same now as it was in the early 1970s. Better measures, however, suggest that there is a sharp decline in poverty. Further analysis of how the well-being of single mothers has changed in the US since early 1990s reveals that income and consumption estimates provide different results on recent trends in their well being. The general view is that consumption based evidence should be preferred over the income based evidence the dis-aggregated analysis of consumption, however, provides a complicated picture of changes in the well being. There is modest improvement in housing conditions, greater resources are being devoted to work expenses, there is a fall in non-market time and uninsured fraction has grown. The puzzling differences are mainly at the bottom of the distribution indicating that under reporting may be an issue.

The differences in responses to globalisation and their impact on mobility were highlighted through case studies drawn from schooling choices (local language versus English) in Mumbai and diamond exporters. The results of case studies suggest that underlying networks shape mobility in each of these two cases. For example, schooling choices in Mumbai suggest that English schooling increased, but differentially by caste and gender because there is occupational persistence across generations at the level of caste for the boys, but not for girls. And, the results for diamond industry also suggest that success in this business depends on family background and community networks. The community networks provide access to supplier credit and these networks strengthen most rapidly in communities with worse outside options. These two examples indicate how difficult it is to predict the responses to new opportunities without understanding the underlying networks. For example, increase in bank credit can increase mobility in some cases, but destroy networks in others, which is

what happened in the case of diamond industry. In the discussion a few questions were raised in the context of the peculiar nature of the two case studies picked up for the analysis.

A study on gender discrimination and returns to self-employment in rural India revealed that female casual labour is paid 27 per cent less in agriculture and 32 per cent less in non-agriculture. This is not only true at the national level, but is also a fact in 13 of the 18 states for which the analysis was carried out. Moreover, the ratio of female to male participation is higher in casual rather than formal labour markets and this ratio declines as one moves from casual to salaried workers. The main factors that determine participation and wages include gender, asset ownership and social status and being landless is a major factor as it increases the propensity to participate in the labour market by 43 per cent in agriculture and 25 per cent in non-agriculture. The analysis also shows that casual labour markets do not reward human capital and these markets are not competitive, therefore, growth reinforces the existing inequality due to differences in status and ownership. And, land rental restrictions reduce the supply of land to the poor and further exacerbate discrimination.

On citizenship and accountability the discussion was mainly focused on theoretical issues in the relationship between democracy and legitimacy. It was argued that the relationship between these two concepts is contingent, and to develop institutions that are accountable the gap between these two concepts needs to be bridged. The paper also looked at different *institutional* aspects of accountability and dealt with questions of institutional design, electoral accountability, delegation, social mobilisation and decentralisation. The discussion highlights different facets that go into making of a politics that is more accountable and responsive. In particular, norms and expectations citizens hold each other to, the design of institutions and the manner in which power is organized, all matter for accountability. The paper strikes a cautionary note against any quick fixes and argues that purely administrative solutions, that by pass the messy process of politics, are not likely to succeed or be enduring. The only alternative is creativity and improvisation that uses the small openings and incentives that entrenched structures provide and transforms them into virtuous cycles of hope.

List of Participants

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