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IS INDIA'S HIGH GROWTH SUSTAINABLE?

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PROCEEDINGS

MS. BRAINARD: Good morning. Let's get started. It is a pleasure to welcome you here today to Brookings. I am Lael Brainard. I am the head of the Brookings Global Economy and Development Program. We are here today to talk about the IMF's recent Article IV Report on India's economy and looking in particular at the very strong growth rate, asking whether it is sustainable, asking whether it is enough, and asking how much of it is filtering through the population.

We have an expert panel here who I will introduce in a second. Before I do, I just want to call your attention to that the Article IV report I think is outside on the table and you are welcome to take copies with you when you go. You also, I think, have copies of the India Policy Forum on your seats. That is a collaborative venture that Brookings does with the Indian counterpart institution, the NCAER, and also looks at a lot of macroeconomic issues in there.

Just by chance we happen to have had here in this room two weeks ago the former head and the founding director of Infosys, Narayana Murthy. Interestingly, we asked him to talk about globalization and one of the key things he focused on was the dilemma that although India is now really taking advantage of globalization and is highly integrated into the global economy and growing very rapidly, he said his chief concern was that it had not so far been able to create opportunities for the 650 million people living in rural India and earning a tiny income every day, and I know this panel is very interested in these issues and will talk a lot about them.

I am going to quickly go through the panelists and then I think we are going to have a chance for some presentations by them, maybe a little discussion back and forth among the panel, and we will open it up for you for questions and discussion with the panel.

We are going to start with Charlie Kramer who is the main event today, who is the Division Chief of the Asia and Pacific Department at the IMF. He was the supervisor of the most recent annual review of India's economy and he has also covered a variety of other desks in the IMF, among them Japan, Canada, and the U.S., which are not fair game today, if I am correct.

To my right, Shantayanan Devarajan is the Chief Economist of the World Bank's Human Development Network for the South Asia Region, and the editor of the World Bank Research Observer. Since 1991 he has been principle economist and research manager for Public Economics in the Bank's Development and Research Group. And I think back when I was at Harvard, he was a professor at the John F. Kennedy School of Government.

Finally, to my left, Nirvikar Singh is Professor of Economics and Director of the Business Management Economics Program at U.C. Santa Cruz, a place that we would all prefer to be today, and Co-Director of the Center for Global, International and Regional Studies. I think he was one of the earliest to organize a major conference here in the U.S. on Indian economic reform and I am sure he is delighted to see the growing interest here in India's economic growth and integration into the global economy.

Let me turn it over to Charlie who is going to start by talking about the IMF's findings.

MR. KRAMER: Thanks very much, Lael, and thanks also to Brookings for having me here today.

Today I am going to focus on the question of India's boom, is it real or is it overheating. More generally, if we look at India, we see something that is of a study in contrasts. On the one hand there are a lot of structural problems that are well known in the India economy that have persisted today. For instance, in Bangalore, water is only available 2-1/2 hours a day. Bangalore, as you know, is not some remote village in India. It is the IT hub of India, a major success story. The average manufacturer loses 8-1/2 percent of their output to power outages. That is more than 4 times the percentage than you see in China or Brazil. Sixty percent of manufacturers own generators. That is several times what we see in China and Brazil, at 27 percent and 17 percent, respectively.

It takes 3 months to open a business in Bombay, and this is despite the dismantlement of the license raj since the early 1990s. As my colleague from the World Bank will no doubt emphasize, there are still over 800 million living on under $2 a day in India, so poverty remains a serious problem in the country.

Nevertheless, we see that India is at the beginnings of a pretty remarkable growth takeoff if we compare its performance, for example, to other countries that have experienced a similar takeoff at earlier periods. Over the last decade or so, we have seen growth weighing in at about 6 percent per annum. At that rate, you would see per capita income double every 17 years or so. So this is quite good, and well above the fabled "Hindu rate of growth," for example, in the 1970s when it was ranging around 3 percent. There is no secret why this is. Starting again in the early 1990s there was a widespread program of reform undertaken in India, everything from dismantling requirements to opening to the outside world, slashing tariffs and so forth, and so we see today the payoff of those reforms.

This is not just in the service area. If we are reading the newspaper and watching the news, we all know that service has been a major success story in India. Infosys is one example and there are many others. But actually we see that manufacturing and the industrial sector is doing quite well, too, if you look at the red line that is growing, in the recent period, even faster than overall GDP, so they are major drivers of growth. More informally, we see some major success stories there, too. Probably the most high-profile of them is Tata Steel which as many of you undoubtedly know has just purchased Corus, the former British Steel, for $12 billion. Tata Steel is by no means alone in that category. For example, Hidalco which is another Indian metals company has just made some purchases that make it the largest producer in the world of rolled aluminum, for example, and there are many other examples. There is actually a little bit of an analysis in our report of the boom in outward FDI in India, which is continuing.

So at least some of what we are seeing is real, but at the same time there are some signs of overheating that we have flagged in the report and that I will highlight here today. First and foremost, we see capacity utilization rising to a 14-year high. Actually, it is at the highest level since the series began. On the labor market side, there is a lack of good data, on unemployment, for example, the kind of metric we would use in a developed country. But it is notable that surveys show that wage growth is picking up, and in fact, in India you see it least informally in the skilled sectors, wage growth that is as high or higher than in most other Asian countries. For example, for the managerial, supervisory, and technically skilled workers, we see wage increases that are on the order of about 15 percent a year.

We see these signs of overheating in goods prices as well. Wholesale price inflation, which is the basic metric that is used to assess these types of pressures, in India has picked up by over 2 percent compared to a year ago on a year-to-year basis. And there has been a lot of focus on the role of food prices in this trend, but if you look at the lines on the chart, you can see that even if we take out food and energy, the same kind of trend is present. It is not just due to volatility in a few components. As you can see from the third line, if you strip out the volatile components by trimming you still see the same trend, so there is a fair amount of evidence that underlying inflationary pressures are rising in goods prices themselves.

Turning to the financial side, we also see a boom in the credit markets. I should hasten to add that to a certain extent this is a good development that financial markets have not been very large or very deep in India, and so you are seeing better access to credit, better access to credit cards, loans for housing and so forth, and that is a good development, but coming alongside the other signs of overheating it draws one's attention.

On the stock market side, India at least until very recently had a pretty remarkable boom in the stock market. Last year the Sensex was up 47 percent, of course we have seen some of that come off recently amid the market volatility, and so valuations have been at the high end. If you look at the pink line that is imposed on the vertical, that is the average for India. Just next to the bottom is the price earnings ratio for India as of a few months ago, and again, it would be a bit lower now, but valuations look a little bit stretched.

Another way of calibrating that question is to say that markets build in a pretty optimistic scenario about growth, and to be fair, not wildly out of line with our own projections of growth. We project trend growth at about 7-1/2 percent, but they build in a pretty favorable scenario is one way of seeing it. And again, alongside all the other evidence of overheating, it draws one's attention.

We see a boom also in the real estate market. Since earlier this decade, we have seen house prices double in some parts of India. This data is a little bit dated as it dates from 2005. We have a little bit of information on some cities and neighborhoods that suggest that this trend has continued in 2006. For example, in some neighborhoods of Pune we have seen real estate price increases pick up from 25 percent to about 50 percent in 2006, a little bit reminiscent of what we have been seeing in some parts of Washington.

So let's come back to the question of whether this is real. We have seen the evidence for overheating, and now let's look at the evidence for the other side, that there is a real pick-up here and go through that. There are three things that we can point to that support the idea that at least some of what we are seeing is an increase in underlying growth.

The first is demographics. Here India stands in contrast to a lot of other countries that we know well in Asia and elsewhere. The first thing is that the dependency ratio is actually falling as opposed to rising in a lot of other countries, that is, the share of the very young and the oldest in the population. As the counterpart to that, we see a big increase in the working age population in that some 140 million people will enter the work force over the next decade. In fact, a key policy challenge is to make sure that all those people can find employment.

A second piece of evidence is the apparent pick-up in productivity, and here I am actually referring to total factory productivity or the productivity that is labor capital, human capital, with all the inputs in the economy. There is some evidence for a pick-up, the question is how large, but it seems to have picked up from about 1-1/2 percent in the 1980s and 1990s, to maybe as high as 3 percent or higher in the current decade.

The third factor that supports a higher growth rate is evidence of financial deepening. Private credit, as I mentioned, is relatively low in India compared to a lot of other Asian countries. For example, it is about 43 percent of GDP in India compared to about 75 percent in Asia at large, but there is evidence as I said of overheating as well. So the question is how to balance these two factors. How do you get sustainable growth with price stability in India? This is the question we grappled with in our report, and the report has a lot of details on this, but let me just give you the broad picture and leave the details maybe for later discussion or for the Q and A period if you like.

We see four steps here. One is that money policy is still pretty accommodative and that the RBI has been and continues to back off the gas pedal over time to keep inflation under control. A second factor is bringing down public debt. Again, there has been some good progress here, too. We think more can be done, and more is actually being done, and this is complementary to the types of steps we think would be desirable on the monetary policy side. A third factor is bolstering the infrastructure, again drawing your attention to what I said about water and power before. There are issues with roads as well, all various parts of the infrastructure. A fourth one is continuing to develop capital markets, both the banking markets and the markets for securities, corporate securities, bonds, and so forth. These were the main focuses of our report, and let me just say a little bit each one in turn.

First of all, on monetary policy, we still gauge monetary policies on the accommodative side despite the tightening that has taken place recently. For example, the Reserve Bank of India, India's central bank, has raised its reserve requirements in several steps recently, it has also raised its key policy rate, the REPO rate, but overall the stance is still somewhat on the accommodative side. Real interest rates are fairly low. That is, interest rates adjusted for inflation are at the lower end of recent experience. And also, money growth remains very rapid. Money is growing at about 20 percent a year every year if you look at the broad-based measure of liquidity. So we think a continued tightening here or a continued withdrawal of accommodation would be helpful in forestalling the risk that we see of further spike-up of inflation going forward.

On the fiscal policy side, fiscal policy has been moving in the right direction, too. In fact, the fiscal accounts are in the best shape they have been in in essentially 10 years. We have seen the overall fiscal deficit, that is, if you combine the state and federal government fall from move-out from about 10 percent of GDP earlier this decade, to close to 6 now. But at the same time, the deficit is still pretty big. Debt is pretty high, too. Debt is about 80 percent of GDP. So bringing that down would be useful from a couple of perspectives. One is, as I mentioned, it would complement a tighter stance of monetary policy, that is, it would help to withdraw some of what we see as the excess demand from the economy.

Another thing that would be useful to do would be to make space for infrastructure spending. I mentioned that infrastructure needs to be enhanced, and obviously there is a role for the government to play here. Just to focus in on that question for a second, we can actually see that compared to China, for example, infrastructure investment is pretty low. Overall infrastructure investment is about 5 percent of GDP in India, and it is about three times that in China, so there is some scope it would seem to ramp that up.

Finally, on the capital markets development side, a lot has been written and said about development of capital markets in Asia, especially, for example, corporate bond markets, but we can see that even by the metric of emerging Asia, the corporate bond market is pretty small in India. It is only around 5 percent of GDP or maybe slightly less. In our report we talk about a lot of different types of measures that can be taken to address the situation. One of them is developing the basic underpinnings of capital markets in India better, the government bond markets and the money markets and making those more liquid and deep. Also through pension reforms to expand the investor base for corporate securities.

So the bottom line is, through the combination of these types of steps, through a better alignment of monetary and fiscal policies, through bolstering the infrastructure, and developing capital markets, we think that India can strike the right kind of tradeoff between overheating and growth and really make growth sustainable and strong over the medium-term.

MS. BRAINARD: The question of sustainability will bring us to your presentation, Nirvikar.

MR. SINGH: I would like to thank Brookings and the IMF also for organizing this and for inviting me. I am really delighted to be here.

If we start with the question which is the title of today's symposium, is India's high growth sustainable, I think there are a couple of subsidiary questions which are very important, and Charlie has talked about the second one, in particular, is India overheating. A more basic question that I would like to say something about is what is India's sustainable growth rate, or equivalently, potential output path. Surprisingly, we do not really have a good answer. There are a lot of ways of doing it. You can do a structural econometric model -- analysis, growth accounting, input-output analysis, and, I think the favorite method in India, export judgment -- so I spent a long time looking through what everybody had been doing.

It is interesting that the Reserve Bank of India in its annual report for 2006 actually addresses this as an important question, what is India's potential output or growth rate, and they quote a couple of studies by their own people, but those studies are as old as 1999, and surprisingly, they have not really been updated. Dani Rodrik and Arvind Subramanian at the IMF did a growth accounting exercise and came up with 7 percent, but that was 3 years ago. The next three names, Arvind Gurmani and Shaka Acharia are key policymakers in India. Tian Sernavasin I think is one of the academics who has been most involved in analyzing Indian economic reform. In the case of Arvind and Shaka, I actually did some signal extraction myself, so you will not find the 7 percent explicitly stated by them, but Tian was pinned down once at a conference and did say 8 percent. The latest study that I think is quite interesting, and I believe there is an IMF study that has also just been done, the Goldman Sachs study is quite interesting, and it is available on the Internet. They have done a pretty good analysis and they come up with a figure of 8.4 percent.

Each estimate has a lot of assumption and qualifications, and what are some of the issues? India has pretty good data, but there are a lot of issues about data quality on what is actually happening both in aggregate and with the component, so I want to put these out on the table and we can come back to them: behavioral parameters, what are the likely responses of individual corporations and so on, to policy and exogenous changes. We typically do not have very good estimates or any estimates in many cases. Then I think the $64,000 question is the political economy aspects of it, I am sure we can spend some time on that, what policy changes are likely, what policies are politically feasible.

All of these factors obviously matter for determining India's potential growth rate so that, in this situation, the U.S. has an official or semi-official methodology in that they have a potential output that they calculate. It is a little easier in a mature economy. India is changing very rapidly and some of the structural change of course is making it difficult to get a number. Some of that structural change is itself endogenous to the political system. So I just want to bring out the complexity of trying to answer the fundamental question here.

In the Article IV report of the IMF there is an interesting quote from the finance minister. I do not know how he came up with this figure, but he says if we continue with financial sector reform, India can go from growing at 8 percent to growing at 9.4 percent, so a 1.4 percent increase in the growth rate. I had actually done a similar sort of exercise using an input-output table for India that is quite detailed using a growth theory methodology. What one actually finds is that the sector that is the key constraint on growth -- if you rank them by improving the efficiency of each sector one at a time by 5 percent, what would be the impact on the growth rate -- what comes out on top is electricity, gas, and water supply. This is for 1998-1999 data. Somebody had done this exercise previously with data from 1988-1989 and they got the same answer. We know this, but I think doing this kind of analytical calculation just helps to solidify these kinds of numbers.

I do also want to point out there are several sectors here, other services, other transport services, railway transport services, and trade, in this list of the top 10, and these are all these infrastructure sectors that matter. So I think it is pretty clear where India needs to relax the constraints in order to maintain or even accelerate its growth rate.

Just to reinforce what Charlie said, if the consensus is right, if the ranges that I gave you of 7 to 8-1/2 is right and India is growing at 9 to 9.2 percent, then India is growing faster than it can sustain and it is slightly overheating. Are the measures that the Reserve Bank of India has taken sufficient for a soft landing? Again, unfortunately nobody really knows, not even the RBI, and the lags in monetary policy of course make it hard. I think we will find out in the next, I would say, 6 months, so a stock market correction will help there. Again, I am sort of putting some of this out on the table.

Here is my additional item that I would like to say. I think absolutely critical in terms of establishing foundations for sustainable growth, and that is institutional reform. It is unglamorous, it is slow, and it includes some very nitty-gritty things in terms of budgeting and accounting. There are detailed issues of modifying legal frameworks and procedures, tax administration, civil service reform. These are all really mundane things, but there are a lot of things that can be done. What I would like to say, on an optimistic note, is that a lot of these things are being done piecemeal. That is the way things work in India. Personally, I have done a lot of work on intergovernmental transfers and tax assignments and I think there is actually some room there for radical reform which would improve the efficiency of public service delivery in India and relax some of the political feasibility constraints to reform that currently exist. So I would like to put all that out on the table and stop there.

MS. BRAINARD: Perfect. Shantayanan is going to talk about who is benefiting, or is everybody benefiting.

MR. DEVARAJAN: Like Nirvikar, I want to thank the organizers for inviting me, and in particular I want to thank them for giving me the chance to see my old friend Nirvikar Singh again. We were in graduate school together many years ago.

I think I want to start by pointing out that there is all this talk about India's growth accelerating, but I think we should keep in mind what Narayana Murthy said, which is that even though India's growth rate has clearly accelerated, what is really quite surprising is that the rate of poverty decline has not accelerated. India's poverty was declining at 1 percent a year in the 1970s, in fact, in the 1960s and the 1970s; it is still declining at 1 percent a year in the year 2000. That tells us something about what is the nature of this growth. Basically, and I think all of you really know this, much of this growth has been concentrated in the wealthier higher-income states of India. The difference between the growth rates of the wealthier southern states and the northern states is 3 percent a year. In fact, this is a long-run pattern. If you compare the decade-long growth rate of the poorer states, the middle-income states, and the high-income states, for the low-income states, if you compare the 1970s and 1980s relative to the 1980s and the 1990s, there has been no change in their growth rates. You can see how much higher it is, and this is per capita, this 2-percentage point difference in the middle-income and in the high-income states. This is not growth overall, it is growth in a concentrated group of states, and it is not surprising in that case that poverty has not really been declining any faster because it is the richer states where most of this growth is concentrated.

The second thing, and I think Nirvikar alluded to this, that is important to keep in mind and it is related to this is that while growth has been accelerating, you have not been a comparable increase in employment and this is I think a fairly deep problem. It is quite surprising when I think about it. In India, 93 percent of the labor force is informal. You hear talk, and I think Charlie mentioned this, India has a labor force of 400 million people. The whole IT stuff that gets on the TV and in the magazines and everything else, the total employment of the entire business processing and outsourcing sector in India is about 1 million or maybe 2 million. If you push it to the limit, it is 2 million. So the bulk of the labor force is in a very different situation from what we hear about in the newspapers.

I think one feature of this large informal sector is that size distribution of Indian firms is highly skewed of employment in Indian firms. You have what people often call the missing middle. Another way to look at it is you have a large concentration of very small firms, firms that hire five to nine people, about 40 percent of the firms are little mom-and-pop shops of five to nine people. You can see the Malaysia figure here, but the comparable figure in Korea is 4 percent.

You say, why is that the case? There are lots of reasons for it. I think, in many ways, one of them has to do with the extremely restrictive labor regulations, and it is significant that the labor regulations do not kick in until you hire more than 10 people, so five to nine seems to be a place where everyone wants to be in order to avoid the labor regulations.

I will just give you one example. India has some of the highest severance pay and other restrictions on dismissing workers, the difficulty of firing indexes as it is called, is one of the highest in the world compared to countries like Bangladesh and Turkey, and certainly the United States. I do not want to say that this means we should get rid of these regulations, but it is important to look at regulations that actually protect workers rather than protect jobs and actually help workers who really do need some social protection.

The biggest obstacle that is -- we can all decide whether or not these labor regulations should be reformed or even whether all these nice things that Nirvikar laid out and Charlie laid out should happen -- the biggest obstacle I think that is facing India these days is the politics. There are huge political constraints to doing what one would think are the right things for accelerating growth and reducing poverty. Let me just give you a couple of examples where this is the case.

Charlie actually alluded to water and infrastructure. When you look at infrastructure, and there is no question that India has a huge infrastructure deficit, but you also look at the nature of that deficit, and I am just giving you one example which is drinking water. There is no city in India that has 24/7 water.

Keep in mind there are three cities in Africa that do. Phnom Penh in Cambodia has 24/7 water, let alone most of the other East Asian cities, so that is clearly a huge problem.

The other thing you realize is that the availability of water in terms of hours per day seems to have nothing to do with the supply of water. Here you have at the dark blue is the number of hours per day of water in these cities of India, and on the left is the supply of water in liters per capita per day. You will find that you have four or five cities including Bangalore as Charlie mentioned that get only 2-1/2 hours of water a day, but have a supply of water ranging from about 80 in Chennai, all the way to about 220 in Ludhiana. And keep in mind that Paris, which does have 24/7 water, has about the median supply of water of all of these Indian cities. So there are many Indian cities with considerably more water than Paris that are unable to deliver it.

What is going on here? I think it is that water is provided free of charge or at very low prices on the grounds that it is supposed to help the poor, but it really becomes the tool of political patronage, and then attempts to try to reform the water sector, including increasing the price because that is one way of actually holding the water utilities accountable to the customers, are defeated by the groups that are benefiting from the political patronage. If you do not believe me, you can look at this cartoon by Sudir Da, and you can see this is a typical situation. The politician says elect me and I promise to give you free water, and you can see that the poor people are all carrying buckets of water because they are buying this water from the water vendors, incidentally at about 5 to 16 times the meter rates, and they are saying we never got your free water. We would rather pay for it. But think about how difficult it is. They tried to do a marginal reform in the Delhi Jal Board last summer, and it was defeated, it just never went anywhere, and Delhi still has 2-1/2 hours or 4 hours of water a day.

And it is not just water. One of the biggest problems is trying to get any reform in the health system, and I think the latest budget actually shows a huge increase in public spending in both health and education on the grounds that this is the way to help the poor. That is the argument. When you look at where this health spending is going, this is a graph showing you where public health spending is allocated across different quintiles, different groups of the population. You will find that about 33 percent goes to the richest quintile, the richest 20 percent, and only about 8 percent to the poorest 20 percent. You can see also that the reason for that is that the bulk of the spending is on public hospitals, which is very expensive and are usually located in the areas where the non-poor live rather than where the poor live, and that primary health centers are a little bit more evenly distributed because those are in rural areas and so on.

But would that were the case, the problem with the primary health centers is that even if you locate them in rural areas, the doctor is not there 40 percent of the time. This is a graph showing you the absentee rates of doctors primary health clinics by state ranked from the poorest to the richest state, and the average rate in India is about 45 percent, it goes up to about 67 percent in states like Bihar.

Even when the doctor is there, and this is some even more disturbing news, we have done some studies to see what is the quality of that service that the public-sector gives compared to the quality of the service that the private-sector doctor gives. This is in poor neighborhoods in Delhi, so again this is not rural areas. What you find is that unqualified private-sector doctors still give better service than qualified, MBBS public-sector doctors. The qualified doctors know more, but the quality of the service is lower than what these unqualified private-sector doctors give. So you really have to think twice about increasing public spending to the health sector and giving more to these qualified public-sector doctors, many of whom went for even higher training, when the service they give is much worse than what the private-sector will give.

Just to end, I want to say that this is not just a problem with health. Some of you have probably heard about the absentee rates in schools as well, and this is just a map giving you the absentee rates in public primary schools around India. Again, the average rate is about 25 percent, and you can see it behind Charlie's head there, but it again ranges to a high of about 42 percent in states like Jharkhand and Bihar. Keep in mind that just like with the health, it is not necessarily correlated with income, that you have Punjab which is one of the richest states having the third- or fourth-highest absentee rate, and we can talk a little about that in the questions as to why that might be the case.

There seems to be quite a lot of consensus among all of us about what needs to be done in order to accelerate growth and bring down poverty reduction, but I think there are huge political obstacles to getting there. I just want to say there are simply solutions that we might want to consider, and I think let me end with the education example. These are absentee rates of public primary schools. The absentee rates in private schools, pure private schools, are almost zero. There was a proposal in the first draft of the approach paper to the 5-year plan that suggested introducing vouchers for schools so that parents can send the kids either to a public school or a private school and the school has an incentive to try to attract those students. Somehow that plan seems to have disappeared in the final draft of the approach paper, but I would like to suggest that in light of the increase in spending for education and health in the budget, we might want to bring it back. Thanks.

MS. BRAINARD: Thank you. Let me quickly ask a few questions and then open it up for the audience. Charlie, you mentioned the infrastructure constraint, really all the panelists have, and Shanta has also pointed to questions of inequality and persistence of poverty. How do you reconcile those two agenda items which seem to be extremely compelling with the need, as pointed out in the Article IV, to consolidate and continue consolidating fiscally?

MR. KRAMER: The question really is a pretty fundamental one, and the question is how do you spend more on infrastructure while still bringing down the fiscal deficit, and actually it is related to some of the points that were raised by some of the other panelists.

One issue in India as my colleague from the World Bank pointed out is that subsidies are not targeted in India very well. This is not just subsidies for water, implicit subsidies if you will, but also subsidies for fuel, subsidies for kerosene and LPG, for example, and for fertilizer for farmers. These subsidies are not small numbers. We have done some calculations to suggest that as those subsidies are targeted better, something on the order of 2 to 2-1/2 percent of GDP could actually be saved and extended through every year, while at the same time making sure that those subsidies get to the people that really desperately need them.

Another area where some attention can be paid is in tax reform. There are a lot of tax exemptions in the Indian tax system that make the system complicated and also means that the tax base is not as large as it could be, and there is a lot that can be done there to clean up the tax system and it more effective and efficient.

But beyond that, it is more than a question of just spending more money. As you have pointed out, there is really a question of fixing the delivery system for services and for infrastructure in India, and I think the finance minister put it very eloquently when he said you do not fix a leaky pipe just by forcing more water through it. So there is really a lot that can be done not only on the fiscal side, but in all the other areas that my other panelists have mentioned.

MS. BRAINARD: Nirvikar, it sounded like you were pointing to structural constraints on growth. What are your top three -- if you could wave your political wand and sort of say these are the top three -- if you could get some traction on these they would be the biggest?

MR. SINGH: There are two kinds of structural constraints. One is I think a physical constraint in the economy such as the power sector and I think those are fairly obvious. What I would actually emphasize are the institutional constraints. I think that one of my top reforms would be civil service reform because I think one of the things that are holding things back in India are the attitudes, and there is this sort of command-and-control mentality that I think is still quite pervasive among the civil service. They are the best and brightest, but they expect to solve everything. So I think their own incentive system could be improved and maybe more entry and exit into the civil service.

Secondly, I would do a structural reform of the tax system. Charlie mentioned things like base-broadening and improving tax administration. I would say that the Indian tax system is in some ways top heavy in tax and expenditure, and I will quote some figures there that I recently dug up. In India at the local level, so this is below the state and this is several tiers of local government, local governments raise about 1 percent of total government revenue and their spending is about 5 percent of total government revenue. In China, which is a good comparator for India because it has become India's benchmark and because it is the only country of comparable size, below the provincial level, governments raise 23 percent of total government revenue, and subprovincial governments spend 50 percent of total government revenue. So it is an order of magnitude bigger in terms of the responsibilities and authority of local governments, but why is that likely to improve things? I am not saying it is a panacea, and obviously there are questions of scale and so on and there is always an optimum level for everything, but I think a key to improving accountability and the absence issues which Shanta raised are really ones of accountability, and creating more accountability at local levels is absolutely crucial.

So those are a couple of institutional reforms, and I could give a long list, but maybe I will stick with those two.

MS. BRAINARD: Shanta, I guess one point of a little bit of divergence between the two previous presentations and yours is I heard a lot of concern at the macro level about overheating. I did not really hear that from you and so I am wondering where you are on that.

MR. DEVARAJAN: I do not disagree with their concerns on overheating. The question is what importance we attach to that relative to some of these structural changes. I am a little bit more, I should be careful here, confident that the reserve bank and the government will address the overheating problem than be able to overcome some of the political obstacles to reform on the structural side like water pricing and health.

MS. BRAINARD: Let me ask audience members to raise your hands, and I believe we have a microphone. So when you get the microphone, please identify yourselves.

MR. PREEG: Ernie Preeg, Manufacturers Alliance. I have a question for Mr. Kramer and it is about the external sector, exports and foreign direct investment. After all, the Chinese sustained high growth that was export-led, very closely linked to the large inflow of FDI. My question to you actually refers to page 33 of your Article IV report of February. I think with all due respect you are somewhat behind the curve because on exports you have only through June of last year with a growth of about 20 percent, and yet for the first 9 months of the financial year through December, merchandise experts, then you are up 36 percent, service exports have been up 40 percent or more every year in the last 2 or 3 years, so the financial year which ends at the end of this month, you are probably going to see exports up 35 to 40 percent, much higher than the Chinese export growth.

Then on FDI, the bottom corner, you have still got FDI around $3 billion a year through last June, but it is clear that FDI has more than doubled in this financial year through December not counting the Tata Steel purchase in the fourth quarter.

There is one other very significant definitional issue. India, unlike standard practice in China, does not include reinvested earnings as FDI which is normal practice. Companies, when they do FDI, use reinvested earnings; they do not send the earnings home and bring in new investment. Only recently India has given, not in the official statistics but for total, what it is with reinvested earnings and it increases over the last 5 years FDI by 70 percent. On that basis, my calculation is more than doubling and then you add in Tata, 70 percent that FDI this financial year ending this month will probably be in the order of $20 to $25 billion rather than the $3 or $4 billion. It is really getting up there.

So my question is, do you sort of need to update a little bit on this critical external sector which drives sustained high growth? First of all, do you agree with this more updated assessment? Then, how much impact would that have in answering the question: will India sustain the 8 to 10 percent high growth?

MS. BRAINARD: Charlie?

MR. KRAMER: You raise some good points. I should point out that the data in the report, as of the time that it was discussed at the executive board, is from essentially late last year, and you are right, there have been a lot of developments. But quite frankly it surprised us on the upside, for example, in the export area and there has been a lot more buoyancy there, there has been more buoyancy in FDI than quite frankly we anticipated, so you are certainly right about that.

But I think we also need to bear a couple of things in mind. You do some comparisons with China. India's export market share global is still pretty low compared to China's. It is only about 1 percent, and we have seen a pretty gradual rise, so maybe there is a certain degree of catch-up there vis-à-vis other countries. Likewise, the stock of FDI in India is considerably lower than in China, and one of the reasons as pointed out by my co-panelists is the difference in the business environment there.

But you are right; there are a lot of positive changes. Even on the growth side, for example, growth has been much stronger than we expected. We were expecting a slowdown, we have seen a growth surprise on the upside, and we have seen quite frankly an inflation surprise on the upside, too. And actually I should note that the presentation I gave follows the basic outlines of what is in the report, but the data I am using in the presentation was a bit more current, so the inflation picture and some other things may look a little bit different. But you are absolutely right that there has been a lot of surprising news on the upside out of India recently.

QUESTION: Charlie, I was very interested in the way you skipped over some of the particular financial bottlenecks. In other words, the conversation here has been mostly about bottlenecks in production of water, but on the financial side, it seems from reading your report that you have a very particular situation. You had the public sector borrowing heavily, largely pushing it on to banks with a significant government bond debt outstanding. So you start out with that situation and you develop into rapid growth, which presumably is going to include a broadening of credit intermediation. This is what will give people the opportunity to invest sufficiently; it will give people the opportunity to earn money in their savings.

Are you concerned in what way could your starting point, which is a very high level of public debt and relatively low interest rates, could run into trouble once the credit system starts to grow and people start to take up money at a relatively low rate and the government in the form of the reserve bank is reluctant to raise rates? So I am asking sort of a financial bottleneck question as opposed to the physical bottleneck question.

MR. KRAMER: I guess one of expressing your question is consistent with the sort of relatively accommodative stance of monetary policy, is there a chance of a financial boom and then following that a financial crash. It is a question, and it is actually one we looked at in some detail in the report and have looked at in past reports.

Again, as I mentioned in the presentation, part of what we are seeing is financial deepening -- there is better access of households to credit cards, to home loans and that type of thing, and that is good. But as we have seen from experiences worldwide, especially in situations where policies are generally on the accommodative side, credit booms do not always end happily. So one thing we looked at were the questions of how is the RBI paying attention to this trend and what types of steps are they taking on the prudential end to make sure the banks are battening down the hatches and not lowering loan standards which is the classic sign of overextension and that kind of thing.

Here we see some reassuring signs. One issue is that the RBI has been gradually tightening prudential standards actually above the International Basel Capital Standards on real estate risk weight, that is, the weight against which capital has to be held on real estate exposure. They have been raising provisioning levels gradually and generally cautioning banks not to get over-extended. When we talk to the banks and the rating agencies there are also some reassuring signs that banks are not getting overextended in terms of loan-to-value ratios, which are pretty conservative. And looking just at the basic financial stability statistics, things like nonperforming loans and so forth, they are not at an especially high level; they are at about 3.3 percent which is not bad. To be fair, that is a trailing measure of financial stability so one should not rely on that alone, but more generally there do not seem to be sort of early warning signs of cracks in the financial system. So, so far so good I guess would be one answer to your question.

But certainly the stance of monetary policy and the stance of macroeconomic policies more generally can have financial stability implications in the long-run and that is one of the reasons that we pay so much attention to that area in the case of India.

MS. BRAINARD: Let's pick one up here and then one in the back over there.

MS. IRIS: I am Mary Iris. I am wondering if any of you would care to comment on the role of the Doha Development Agenda and the WTO in furthering India's reforms in a positive direction. India, as many of you know, is a leader in these negotiations and we are on the brink of either success or failure in the talks. It seems that the WTO, whether it is opening up services and improving transparency, furthering accountability, adopting broader trade facilitation reforms with respect to customs, lowering tariffs and eliminating perhaps some of the skirting around the rules, would certainly increase revenue, enhance accountability throughout the marketplace and help India adopt some positive reforms. I am just wondering if any of you would care to comment on that. And also whether you detect a strong interest in the corporate community in India to helping influence the political economic in India toward a positive result for India by concluding a successful round.

MS. BRAINARD: Let me ask Nirvikar and Shanta maybe to comment first.

MR. SINGH: I am not sure I have that much to say on this in particular. I think India is still feeling its way in terms of its role in these kinds of trade talks. Historically it has been very suspicious of the WTO. There is I think a strong constituency within India that think that anything to do with the WTO must be bad.

But just based on my reading of various commentators and think tanks and so on, I would say that there is a lot more analysis and openness now. I think there is really developing the idea that this can be very positive for India and that India can play a positive role, but I think that still has to become a reality in India.

MR. DEVARAJAN: Just a couple of points I guess to add to what Nirvikar said. I think there are two sets of politics going on here. One is India as a global player and almost being the leader or the vanguard of the BRICs and other large and middle-income countries, and on the other side there are domestic politics. But I would say that we should be a little careful here that we should not oversell the benefit of the WTO in terms of the domestic economy in India because as I was trying to point out earlier, there are so many other problems with the labor market that you might not get a big employment boom even if the Doha Round is successful and we have to be a little careful there.

The other is of course given the increasing inequality, given the fact that many people believe that some people have been left out of the economic boom of the last 15 years, it is very hard to then say let's do some more of it in this environment.

MR. SINGH: Maybe I could just add a couple of things. I think it is also important to look at other aspects of external engagement of India and one is FDI, where you are seeing a slow liberalization, and I think the Special Economic Zones will facilitate that; those are not necessarily being implemented ideally.

The second thing that I want to highlight is that after a hiatus of 8 or 9 years, capital account convertibility was put back on the official agenda. So you are seeing a sort of slow progress on many dimensions.

MS. BRAINARD: Did you want to comment?

MR. KRAMER: No, thank you.

QUESTION: My question is to Shanta referring to your cartoon which you showed. What is happening is that politics is forcing markets not to work for personal rent extraction purposes. What is the correct policy response to that, if you would suggest to that basic issue?

MS. BRAINARD: Do you want to restate the question?

MR. DEVARAJAN: I think the question is given that politics is standing in the way of what might be not just making markets work, but making markets work for the poor which is the key here, what can we do about it? I think actually more cartoons like that, getting public information out there such as what we have been doing with the absentee work, circulating that, getting the public itself to then bring pressure on the small groups that are resisting the reform. To be honest, it has not worked yet with water, but it is beginning to get some traction on the education side and this has demonstrated a little bit of benchmark competition among the chief ministers to see who can bring down their absentee rates the fastest and things like that.

MS. BRAINARD: We have three over here.

QUESTION: I am -- from George Washington University. I am a little embarrassed to ask this question because it violates some of my principles, but China in my judgment never would be able to make the progress that it has if it were a democracy. There are too many tough decisions and a democracy does not respond that well and that quickly. Would India be better off if it concentrated its effort a little more say for 10 years in order to achieve the dramatic changes that are necessary?

MS. BRAINARD: Who wants to take that one?

MR. SINGH: I think the answer to your question is categorically no. The problem in India has not been democracy per se, but that democracy has not functioned effectively, that it has been distorted. And I think the fact you have had no local democracy has been a big hole in India and that has been slowly developing over the last decade and a half. If you look at the trajectory of India over the 60 years, what you are seeing is actually a maturing of the democracy in terms of the institutions and the way that politics is conducted, India has survived an unsuccessful attempt at nondemocratization which was firmly rejected by the Indian people, and I do not think that led to any substantial increase in the growth rate.

So I would say that India can do with more and better democracy, and I will put myself on the line here and say that I think in the long-run that model is more robust than China's model.

MR. DEVARAJAN: There is a variation particularly with what Nirvikar was saying earlier about local democracies, there is a variation across India and you find that in the southern states which are growing much faster, they are growing at Chinese rates of growth, you have a much stronger local democracy, so it can work.

MR. KUX: Dennis Kux from the Woodrow Wilson Center. One area you have not talked about is agriculture, and I wonder if you would all talk a little bit about that. My impression is that has been the drag on the economy and it is also where two-thirds of the people live.

MS. BRAINARD: Charlie?

MR. KRAMER: I will defer to my colleagues on the details, but something like 60 percent of the labor force is in agriculture, so it is a major issue from that perspective. And as you noted, it is a slower performer, it has only grown at about 2-1/2 percent or something like that per year. So it is a drag on overall economic performance and it is an issue from the employment point of view. And in terms of the details of what to do, quite frankly I am relatively innocent to that type of thing where I think my colleagues may have more expertise and more to say. But from a macroeconomic point of view, it is an issue as you have noted.

MR. DEVARAJAN: Agriculture suffers from the same problem of mistargeted subsidies and the wrong kinds of interventions. You have three power policies to farmers in some southern states. The size of that subsidy is about 1 percent of GDP now. One problem with that is that not only do you have very poor power delivery, but there have been very little resources left for other kinds of rural infrastructure. So you have also poor rural roads, rural irrigation systems, and rural electricity as well.

I think it is actually worth keeping in mind the difference between India and Bangladesh where Bangladesh interestingly has much lower agricultural subsidies and Bangladesh has very good rural electricity, reasonably good rural roads, and good rural irrigation. So there is a tradeoff here that farmers are making and are losing on by calling for higher subsidies when they are actually losing out on the infrastructure.

MS. BRAINARD: There is one back there and up here.

MR. PURI: My name is Manesh Puri. Thank you for your presentations. My first question is that, unless you conspired to, I thought it was interesting that both of you converged on water supply as a sector that was constrained and I was wondering if you could talk a little bit more in addition to public information what sort of the next steps are.

Then second, an area that you sort of diverged was on your assessment of the RBI's ability to manage a soft landing, and I was wondering if anyone on the panel or all of you would talk about your confidence or lack thereof and the reasons for it. Thank you.

MR. DEVARAJAN: Why do I get all the hard questions? As I said, beyond the public information campaign which, by the way, should not be discounted because for instance in parts of the southern states we are making quite a lot of progress on that. The other are some pilot schemes. Experiment with raising water charges in a small neighborhood in Bangalore, see how it works, and then promote it.

Let me step back and say what was the problem with the Delhi Water Board Reform? The Delhi Water Board was just introducing a management contract. It was not even privatization, let alone increasing water prices. But the public outcry was so large that they had to quit. One of the problems was that even that reform was insufficiently explained to the stakeholders. They have these community associations, but it was a very poorly done reform. So I think we need to understand that these reforms are not just technical reforms, these are deeply political reforms and the people who are affected need to be told that this is not something cooked up in Washington, D.C., but, rather, something that is actually coming out of a domestic consensus. I will leave the RBI question to my colleagues.

MS. BRAINARD: Nirvikar, do you want to take the first cut at the RBI question to make it easier for Charlie?

MR. SINGH: Sure. Actually, on the water -- in rural areas water use associations and some prototype water markets have been working in India. Basically is the question of improving the efficiency of allocation and management of water.

On the RBI side I did not take a position in my presentation, but certainly it is very complex. The RBI itself has multiple objectives. It has to do many more things than say the Fed in the U.S., so it is in a very unenviable position. On the whole I would say though that in the past they have done a pretty good job and what you can see right now is that they are erring on the side of caution in terms of tightening because they certainly do not want to put on the brakes too hard.

I think what is going to help them is the global stock market correction, and I think that that is actually going to make their task a little easier, so I am certainly optimistic.

MS. BRAINARD: Charlie?

MR. KRAMER: I guess I am more or less in the same camp. Let me be clear that our baseline is essentially for a soft landing in the economy and there I think we can point to two factors. One is that the RBI does have a good track record in maintaining price stability in the economy compared -- especially to central banks in a lot of other emerging market countries we have seen pretty low inflation by that standard. The key as we point out in the report is related to the RBI to not fall too far behind the curve and essentially continue to withdraw accommodation so that we do not get a spike in inflation down the road and inflation expectations do not get entrenched, and that is essentially what we think needs to be done.

MR. SHAH: My name is -- Shah from Business Times. India is a global player after listening to all the speakers and India-U.S. relations including the Japanese -- despite all these things, the political climate in India is uncertain as the leaders of national and state elections as reflected in two states the coalition party has been defeated. That shows that the masses are not very happy -- despite all these things, India is making progress economically, but what do you think about the future of the country, first on the political prospects and development and economic process because we have heard about democracy and strategy, but what is the real picture for the country --

MS. BRAINARD: Who wants to take that one? The question is really on the disjuncture between the domestic political trajectory and the global economic trajectory of India and how does that impact the future prospects.

MR. KRAMER: Let me take the easy parts of your question and leave the other parts to my colleagues.

One part of your question is how do we see the prospects for India macroeconomically, and the prospects are really quite good, actually. As I mentioned, we see trend growth at about 7-1/2 percent. That is certainly below where some optimists put themselves, but it is quite frankly a situation where a lot of countries would trade places with India. You have a doubling of living standards every 13 years or so at that pace, and that is not bad at all by any standard. Could it be higher? It could be higher with reforms. Are there policy challenges to maintaining growth at 7-1/2 percent? There certainly are. One of them is containing inflation, but there are other policy challenges, too, and on the question of how these policy challenges are grappled with.

You also raised the question about the international environment. One thing to point to you including in contrast to China is that India is not that open a country by Chinese standards. For example, trade is only about 40 percent of GDP, whereas it is over 60 percent for India. So in the past the global environment has not been as important as it has been for example for some other countries like China.

But that is changing. As we pointed out, exports are growing very fast, imports are growing very fast. India is integrating more and more with the global economy both as a matter of macroeconomic developments, but also as a matter of policy. For example, the recent budget has cut import tariffs further and we have seen those come down quite substantially over the last couple of years, so that the international environment will matter more and more certainly for India as we go forward.

MR. DEVARAJAN: I would say that the election results, not just these recent ones but even the ones in 2004, are in many ways encouraging because this shows that, first of all, India has the largest group of poor people voting, and it also shows that it keeps the politicians on their toes. You could have gotten away with a lot more inequality had they not had these elections. So I am quite encouraged, and I think the poor electorate is becoming increasingly more vocal and are demanding their rights and I think that is healthy for India's future both economically and politically.

MR. MARTIN: Michael Martin from Congressional Research Service. Going back to the beginning of the presentation with Mr. Kramer and he had a slide comparing the growth of India as a takeoff, an interesting term to use, but going back and time. Then the other presenters went on and at times did direct or indirect comparisons with China, a longstanding historical practice with India and China.

Let me continue that longstanding tradition for a moment. In the presentations you talked about commonalities or regionalism in the development. You have coastal China, you have southern India, you have northern India, and you have western China. Distribution of benefits and inequities or unevenness if you want to put it that way. Some subpopulations becoming quite wealthy quite quickly, whereas some people actually some of us would argue in China have actually gotten poorer under the reform process. So you have some similarities.

But on the other hand, contrasts, with China arguably an export-led growth path, India not so. China with a budget very much focused on investment in developing infrastructure, India less so. China with a reform process that seemed to start in the rural areas with the agricultural reforms and moving to an urban area, India maybe not a similar pattern.

My sort of general question is I have thrown out a couple of different aspects, what lessons may there be learned from the experience that China has gone through over the last 30 years particularly given that China has not always experienced a smooth development path? Let us not forget the events of 1988 and 1989 that started out with some significant economic problems, very high inflation in the country, which led to certain political problems, and current tensions inside China about the unevenness of the development.

MS. BRAINARD: A China-India comparison. Also, where you think the China-India comparison is unhelpful because I do think we hear so much of it now.

MR. DEVARAJAN: I will pick up the challenge there because I think what the China-India comparison teaches us is that there are alternate routes to development. It is interesting because there was the Washington consensus at one point, and perhaps it was a misnomer, but at least I think what the experience of China and India both illustrate is they are both alternatives to what might be a caricature of the Washington consensus. So it does give quite a space, particularly India shows that you do not necessarily have to have just manufacturing growth, it was basically a service growth driven growth period. China shows that you can grow without a very sturdy financial sector on the financial stability side, and then there are all the other democracy aspects of it.

I think the inequality on the one hand, the regional inequality that you pointed to, might superficially look like that means that both countries almost automatically have to go through a widening inequality when they grow, the coastal provinces and the southern states, but I do not buy that completely. I think a lot of the inequality in India is due to the political economy of the different states. You have northern states which have much more social fragmentation around caste lines and around ethnic lines, and you have a slightly more homogeneous electorate in the southern states and that has done more for the growth differential than some natural selection.

MR. KRAMER: Let me just go into one of the aspects that my colleague mentioned and actually it goes back to something that I mentioned in the presentation which was on the employment front and employment generation, for example.

One area of very striking difference between India and China is in the creation of low-wage, low-value-added manufacturing jobs. Obviously China has been a huge success, but India has really, really lagged. If you look at India you see much more job creation in high-value-added manufacturing, high-value-added services, and there I would actually draw your attention to the analysis that was done, the working paper that came out I think last year by Kalkana Kochar and some others in our research department that drills into the sort of different development paths. There the debate is has India skipped a traditional stage of development in terms of generating lots of low-wage, low-value-added manufacturing jobs and jumped to a different stage or is there still a need to go through reforms, for example, to improve primary education, through infrastructure, deregulate, for example. So there is an interesting sort of angle on that that is really relevant I think to the policy debate in India right now.

MS. BRAINARD: I am going to take maybe a few questions together and then give the panelists last words. Do you have a question?

MR. DEVARAJAN: The author of that paper is here.

MS. BRAINARD: Please do, yes.

QUESTION: On this paper that Mr. Kramer just mentioned, also addresses the issue of the difference in state performance relating to governance, we have different measures of governance in states, and you can see that the poorly governed states which also happen to be ones in the north are growing much slower and higher rates of poverty and so on.

MS. BRAINARD: The last two questions here and then the last thoughts of the panel.

QUESTION: I have a quick comment and two questions and I will make it really fast. My comment is: India overheating is a little doubtful because given the problems that all of you laid out, I think the performance has been really good so I do not think it is a question of overheating as against the question of sustainability. That was my comment.

My question is: can all the panelists comment on the Indian budget that just came out? The corporate sector says that it is not very pro-corporate because of all the taxes it included. And also I would like to ask about you said that the monetary policy has to be tightened with inflation and what did you exactly say just by that? Would you mean that the bank rate has to be increased more, or could you be more specific about tightening the monetary policy?

MS. BRAINARD: One more question.

QUESTION: I am not an economist so my question might sound a little bit naïve. When you look at the -- you are skewed toward portfolio investing rather than capital -- is there a danger if the economy tumbles somewhere that there will be a massive outflow of the portfolio investment, which might make the landing a bit tough rather than a soft landing? That is one question.

A quick second question is that on an anecdotal basis I am an engineer by profession and whenever I go to India one of the things I see is the very poor on-stream performance of the already installed capacity, but there is always money being put into adding new capacity in some thousands of megawatts. When I talk to some of my former colleagues from the engineering days, they say that is because governments do not provide money for maintenance which will provide jobs, which will improve the on-stream factor and bring up quite a lot of percentage of power without adding new power, and there are also power losses and transmission losses. None of these things are given priority by the government. They are willing to put more money into new plants rather than maintaining what they have. I have never ever seen a study on this. Thank you.

MS. BRAINARD: I think we have five questions, but I am not sure I will remember them. Corporate bias to the budget, how specifically would you do the tightening in terms of monetary policy, concerns about portfolio investment versus direct investment, and bias in terms of power and infrastructure toward new investment rather than maintenance, and I am forgetting one.

MR. KRAMER: Overheating versus sustainability.

MS. BRAINARD: Overheating versus sustainability, and any other thoughts you have of your last 90 seconds each. Charlie, do you want to start or do you want to finish?

MR. KRAMER: Let me take the last one first, if I may. To us, quite frankly, the issues of sustainability and overheating are not really different issues. The question is really in the end how to have sustainable growth, and part of that is price stability. What we see in the record, not in India but in some other countries, is that when central banks get behind the curve, when they keep the foot on the gas for too long, eventually they have to slam on the brakes and that is harmful for growth. It is destabilizing.

The other aspect of that is that high and unstable rates of inflation are also harmful for growth. They are not just harmful for growth, but they are also harmful for the poor. So we do not see these two issues as really different issues, they are essentially two sides of the same coin. The longer-run question is how to get a sustainable rate of growth and that has a lot to do with the structural reforms that we have been discussing today.

In terms of how the RBI is tightening the monetary conditions: there are a lot of options. You have excess liquidity, you have operations to that would move excess liquidity, you have policy rates that can be raised and so forth, so there are a lot of different options that are available.

You asked about the budget. There are some positives and some less positives in the budget. One positive is it does bring about a tightening or a further reduction in the fiscal deficit. We are still crunching the numbers since the budget only came out last week, but it is a bit less than a half percent of GDP or so, so that is positive I think.

What we missed in the budget was progress in the types of issues that I mentioned, subsidy reform, for example, and broadening the tax base, and we see that there is more than can still be done in those areas.

MR. SINGH: Just briefly on the power sector, there actually is awareness and studies of efficiency. It is just again very difficult to implement the reforms necessary to raise the level of operation.

Overall I would like to say that I think very few people 10 years ago would have predicted that India would be where it is now and I think on the financial issues and risks of outflows and so on, India is actually in a very strong position. It can sustain external shocks quite well, much better than people would have predicted 10 years ago, and you are certainly not going to see anything like what happened in Indonesia in 1997. Maybe it will not be as rapid a recovery as Korea, but I think if you look at the numbers, nobody is predicting less than 7 percent as a sustainable growth rate and 10 years ago people were still arguing whether six was sustainable. I think to go to the top end of that range, 8-1/2 percent, that is also very believable. Beyond that I think one really needs to get into a lot of issues of microeconomic reforms, and maybe the one other major issue that has come up, to make the growth more inclusive which means, to use the government's term, more broad-based. I think the key there is going to be besides improving public service delivery, generating more jobs for the masses, and such, I think there is a new social contract required which will involve the government, the corporate sector, and workers, the unions and so on, and I think that agenda still has to be articulated in the form of a new social contract in order to work out the solution. Right now people are not willing to deal with it as such, but I think that that will be a key challenge that India faces.

MS. BRAINARD: Shanta?

MR. DEVARAJAN: Just on the power sector question, I think the other thing in addition to what Nirvikar said is that is important to keep in mind that the way the Indian public finances are structured, capital investments come from the central government, from the federal government, through the centrally sponsored schemes, but operations and maintenance is the responsibility of the state governments. So guess what happens, they take on lots of investments, but then the state government runs out of money and they stop doing the O&M and in fact the next time around they take on even more investment and still are unable to maintain it. So there is a structural problem there that needs fixing.

On the question about you said none of us has commented on the budget, I do not think we have done it explicitly, but I think implicitly we were commenting on the budget with some of the comments I was making about the increase in health and education spending. What I would say is that it is fine to increase health and education spending, but it has to be accompanied by institutional reforms to make that spending effective because up to now there are some serious problems as to whether that increased public spending is actually reaching the poor and making their lives better off.

I should say also parenthetically that the importance of the budget is declining over time as India becomes an increasingly more open and more liberalized economy and so we should really look at the whole policy framework of which the budget is just one component.

Let me end also by answering the question about overheating versus sustainability. I think I agree with Charlie with one qualification, that overheating is one of the threats to sustainable growth, but there are others including what Nirvikar was saying, the increasing inequality can be another threat. What I spend my time thinking about is how we can get growth going in states like Bihar, Andhra Pradesh, Orissa, and Madhya Pradesh. That is the big challenge, and there are 400 or 500 million people living in those states. This is not a small country. I think the lessons from the recent experience with growth can be transferred to these other states, and that is the opportunity we have. I was just at a conference in Bihar called Resurgent Bihar where they brought in examples from Andhra Pradesh, from Kerala, from Karnataka and so on, and I think there is a sense that if Andhra Pradesh can do it, if Tamil Nadu can do it, we can do it Bihar.

MS. BRAINARD: I just want to remind you there are copies of the India Policy Forum on your seat. Please take them with you. I could not convince one of the editors, Barry Bosworth, to come up on the podium, but he is actually here so you should give him a hard time on the way out. Many of these issues are actually addressed in deeper research papers in that. Then again there are copies of the Article IV. Please take those on your way out.

I want to really thank our colleagues from the IMF for doing this. I think this was a really good conversation, and thank you also to Nirvikar and Shanta for coming over to comment on the Article IV. So thank you all very much.

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