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Office Memorandum

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mb

cc: Mr. Loser

TO : The Managing Director
The Deputy Managing Director

DATE: November 19, 1982

FROM : Tun Thin PRN

SUBJECT : India--Review of Extended Arrangement and 1983 Article IV Consultation

A mission consisting of Messrs. Tun Thin, Smith, Baumgartner, I. Kim, Burton (all ASD), Hino (ETR), Floyd (FAD), Harrison (IBRD), and Ms. Knauseder (ASD, secretary), visited Bombay and New Delhi during November 1-11, 1982 to review performance during the second year of the extended arrangement and hold the 1983 Article IV consultation discussions. Mr. Grawe of the Bank's New Delhi office was also attached to the mission. Discussions were held with officials from various bodies, including the Departments of Economic Affairs, Commerce, Industry, and Agriculture, the Planning Commission, and the Reserve Bank of India. Senior officials who participated included Mr. M. Narasimham, Secretary, Department of Economic Affairs, and Mr. Manmohan Singh, Governor, Reserve Bank of India; Mr. R.N. Malhotra, Executive Director, also participated in the discussions.

Economic developments in 1982/83 have been affected by a severe drought in the summer months of 1982. While it is still too early to assess the full impact of the drought, the Government now estimates that real growth in 1982/83 (fiscal year April-March) will be only 2 per cent, compared with a program estimate of 5 per cent and 5 per cent in 1981/82. Foodgrain production has been particularly affected and total foodgrain production will be considerably below target and somewhat less than in 1981/82. As a result, agricultural incomes are likely to decline by 2 per cent in real terms. In view of these circumstances, price performance has been remarkable. Following a spurt in prices in June-August 1982, prices have since declined slightly and inflation for the latest 12-month period is no more than 2 per cent. While control over price pressures is by no means assured, inflation is still projected to be near the program estimate of 8 per cent. Beyond constraining monetary policies, the favorable price performance is due to the timely announcement of wheat imports, and ample supplies of sugar and other important items, including basic infrastructure.

Industrial production was about 6 per cent higher in the first quarter of 1982/83 than in the corresponding period of 1981/82. While the program anticipated a slowdown in the rate of industrial growth in 1982/83 from the high rate during the recovery in 1981/82, industrial growth is now expected to be somewhat below the program target. Slower growth derives in part from a prolonged strike in the textile industry and a demand-induced slump in the truck and tractor industries. Some industries have also felt increased foreign competition as a result of import liberalization and increased efforts on the part of foreign companies to penetrate the Indian market as a result of the recession abroad.

Performance in the key areas of infrastructure has improved. After falling considerably short of target in the last two years, capacity additions in electric power have increased considerably to near the program target; both power generation and capacity utilization have also increased. While progress has been made in overcoming problems of project implementation, funding problems are becoming a more serious constraint which threaten future progress in the power program. Coal production and the oil development program are on track. The performance of the Railways has continued to improve so that transportation bottlenecks are not expected to be severe in the near future; supplementary budget allocations of Rs 1.9 billion, encouraged by the program, have allowed investment in the Railways to be maintained at a satisfactory level in 1982/83.

In the field of industrial policy, it is still too early to assess the impact of the measures taken in April to liberalize restrictions on capacity creation and ease antimonopoly and foreign investment regulations. Experience with new more liberal pricing systems for steel and cement has been satisfactory. However, more progress is needed in liberalizing industrial policy. Against this background, the staff team stressed the importance of fresh initiatives in the area of industrial policy, including price controls, in parallel with the measures to strengthen export incentives and liberalize imports.

The stance of monetary policy remains cautious, although it has become less tight following a policy-induced credit squeeze in early 1982. Nonfood credit extended by banks declined in the first quarter of 1982/83 despite the return by the banks to a comfortable liquidity position, but has begun to pick up since July. The overall credit ceiling for September was met with considerable room to spare, and the subceiling on net bank credit to the Government was also below the program limit. Money supply expanded by 10.5 per cent in the 12 months to September 1982 and maintaining the existing pace of credit expansion appears likely to result in growth rates of money and credit slightly below the program limits set for March 1983. Recently announced monetary measures include an increase in interest rates on long-term deposits from 10 to 11 per cent and a relaxation of credit for exports and some sectors facing problems. Given the decline in agricultural production, the authorities intend to maintain a cautious monetary policy so as to contain inflationary expectations. Although additional special food credit requirements may arise (including large needs for food and sugar financing) the authorities do not at this time have a need to request a change in the overall credit ceiling. They wish the understanding to be maintained that consideration would be given to raising the ceiling for unforeseen food credit requirements, although they indicated that the probability of this is very small.

The Central budgetary position remains close to the program projections and there is no indication that the overall deficit will significantly exceed the program estimates. The authorities expect to remain within the subceiling on net bank credit to Government during the remainder of 1982/83. However, the review of the financial position of the Centre and the States has indicated a significant shortfall in savings of both the Centre and the States. The expected shortfall in Central savings arises because surpluses of public enterprises are expected to be lower, partly because of recessionary tendencies in some sectors. There are few details of developments in State savings at this stage, although indications are that overall financial performance has improved. The States have so far implemented additional resource mobilization measures totaling about Rs 6.5 billion in 1982/83 and new resource mobilization in 1982/83 as a whole is now expected to reach about Rs 7 billion, close to the amount of Rs 7.4 billion included in the program. Total public sector savings are projected to be Rs 10 billion (12 per cent) lower than the program estimate. The mission emphasized the importance of resource mobilization efforts to reduce the shortfall in savings in the current year and increase savings as planned subsequently. The authorities assured the staff team that they were equally aware of the importance of resource mobilization and, as in the past, emphasis will continue to be given to this area of policy. They emphasized that in a difficult year such as this raising public savings to 4.8 per cent of GDP from 4.2 per cent in 1981/82 constituted a creditable performance.

Balance of payments developments in 1982/83 have been on track. This is a heartening development considering the difficult international trading environment. Export volume growth in the first quarter of 1982/83 was close to the program target of 7 per cent for the year as a whole. Larger exports under bilateral payments agreements, notably to the U.S.S.R, are an important factor behind the continued strength of exports. Against the increase in exports to the U.S.S.R, India is importing crude oil and related products, although some buildup in bilateral balances is expected over the year as a whole. The projected current account deficit, at SDR 3.3 billion, is slightly reduced from the earlier estimate, but with the lower GDP now expected, the ratio to GDP would be 0.1 per cent higher at 2.2 per cent. However, taking account of the nature of the GDP shortfall, the underlying path of external adjustment remains undisturbed. The program of commercial borrowing is proceeding on schedule and the authorities indicated that commitments during 1982/83 would be near the program ceiling of SDR 1.4 billion. The overall balance of payments deficit is expected to be SDR 1.7 billion, the same as earlier envisaged.

The satisfactory export performance in the first months of 1982/83 provides evidence that the export development strategy, a key element of the adjustment effort, is proving to be effective. This applies in particular to the increased access to imports being provided to exporters. Nevertheless, in looking ahead, the real appreciation of the rupee by about 4 per cent on a trade-weighted effective basis since the beginning of 1982/83 gives rise to concern. The Indian authorities recognized this and emphasized that developments in the exchange rate and competitiveness are being monitored closely and will be kept under review.

Under the 1982/83 import policy, it appears that access to imports has indeed risen considerably and simplified procedures are having their desired effect. Domestic industry also appears to be feeling more strongly the pressures of competition resulting in increased efforts to modernize plants. In this situation, import liberalization has drawn heavy fire from various affected groups, but the authorities have not yielded to this pressure and indicated their determination to maintain their liberal policy because of the benefits that it is yielding to the economy as a whole.

There have been no significant changes in the exchange and trade system since the last Article IV consultation; the discussions have revealed an exchange practice related to nonresident deposits from abroad which will be reviewed by the staff to determine if it is subject to the Fund's jurisdiction. The rupee remains pegged to a basket of currencies with the pound sterling as the intervention currency. Some simplifications have been made to the exchange system since the last consultation. The staff team recommended to the authorities that they further simplify the exchange system and terminate the bilateral payments agreement with Romania.

cc: Mr. Carter
ASD Senior Staff
AFR
EUR
ETR ✓
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MED
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TRE
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Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: October 8, 1982

FROM : P.R. Narvekar and Donald K. Palmer

SUBJECT : India--Briefing Paper for the 1983 Article IV Consultation and Review of the Extended Arrangement

Attached is a Briefing Paper for the forthcoming mission to India. The paper includes comments made by Messrs. Tait (FAD), Wittich (TRE), and Silard (LEG).

Attachment

cc: FAD
LEG
TRE
Mr. Carter

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

India

Briefing Paper--1983 Article IV Consultation and Review of Extended Arrangement

Prepared by the Asian, Exchange and Trade Relations, and Fiscal Affairs Departments

PRN

Approved by P. R. Narvekar and Donald K. Palmer

October 8, 1982

I. Introduction

Messrs. Tun Thin (Head), Smith, Baumgartner, I. Kim and Burton (all ASD), Hino (ETR), Floyd (FAD), and Harrison (IBRD), and Ms Knauseder (ASD, secretary) will visit Bombay and New Delhi during November 1-November 11 to hold the 1983 Article IV consultation discussions and review performance during the second year of the extended arrangement. Mr. Grawe of the Bank's New Delhi office will also be attached to the mission. An advance team will begin technical work in New Delhi on October 28.

The extended arrangement was approved on November 9, 1981; India met all the performance criteria for the 1981/82 program (fiscal year ending March) and made three purchases totaling SDR 900 million. The program for 1982/83 was discussed by Executive Directors on July 9, 1982, following which a further purchase of SDR 600 million was made. The first ceiling date for the new program is September 24, 1982, for which data will be available in late October.

II. Background

Economic developments during 1981/82 were, in most respects, favorable and in line with those envisaged in the program. Real growth was

5 per cent with foodgrain production rising to a record level and industrial output expanding strongly across a broad band of industries, including those where shortages had earlier caused severe bottlenecks. Improved supplies, supported by appropriate demand management, resulted in a sharp slowing in wholesale price inflation which had fallen to 2 per cent by the end of the year. Public finances were strengthened considerably, mainly because of substantial resource mobilization efforts. The improvement was mainly in the Central Government and some aspects of State Government finances came under strain, mainly because of heavy increases in wage costs. Overall public savings rose significantly and financed a sizable increase in real public investment in line with the program projections. Commercial credit policies were also tightened during the year and monetary growth was reduced. However, balance of payments pressures increased, mainly because of an unexpected deterioration in the terms of trade. The current deficit widened to 2.4 per cent of GDP and the overall deficit rose abruptly to SDR 2.2 billion. Nevertheless, there were indications of underlying progress in adjustment in the external position: export volumes accelerated to about 7 per cent (in part because of a depreciation in the real exchange rate) and there was a decline of 8 per cent in the oil import bill because of higher domestic production and moderating demand.

The program for 1982/83 includes measures to promote adjustment in the balance of payments in the medium term. Among these are steps aimed at strengthening public finances; public savings are to rise considerably further to 5 per cent of GDP, and the budget deficit, and that part financed by the banking system, are to be reduced as a proportion of

GDP. Firm demand management policies will aim to maintain control over inflation. Investment is to increase considerably and be allocated in line with established priorities for adjustment. Also a number of structural measures have been introduced to improve industrial efficiency, including a reduction of pricing and other regulatory constraints and a significant liberalization of import restrictions. The authorities have indicated their intention to follow a realistic exchange rate policy, which is envisaged as making a notable contribution to the export drive. The principal economic targets for 1982/83 are shown in Table 1. The program envisaged that growth would again be 5 per cent (given favorable weather), with inflation of 8 per cent as the special supply factors responsible for very low inflation in 1981/82 no longer apply. Exports are targeted to rise by 7 per cent in volume terms while import volume would decline slightly as sizable increases in general imports are more than offset by lower oil and other bulk imports due to rising domestic output. With stable terms of trade, the external current account deficit is projected to narrow to 2.1 per cent of GDP, with the overall deficit being reduced to SDR 1.7 billion.

At this time, the staff has only limited information on developments during the early months of 1982/83. Most important of these, weather during the current monsoon season has been unfavorable. Although drought conditions have now broken, foodgrain (and other agricultural) production will be below target. While a great deal of uncertainty remains, it would appear likely that foodgrain production will be lower than last year. The Government has already arranged 2.5 million tons of precautionary food imports and may purchase an additional 1 million tons to build large stocks to maintain confidence. Prices were unsettled with

Table 1. India: Selected Economic and Financial Indicators, 1980/81-1982/83

	1980/81	1981/82 Original program	1981/82 Revised estimate	1982/83 Program projection
	(Annual per cent changes)			
National income and prices				
GDP at constant prices	7.5	4.8	5	5
GDP deflator	11.1	9.0	9	8.5
Wholesale prices 1/	15.8	11.0	1.9	8.0
External sector (on the basis of SDRs)				
Exports, f.o.b.	11.5	16.2	11.3	11.9
Imports, c.i.f.	39.3	12.4	8.5	3.9
Non-oil imports, c.i.f.	19.1	29.8	22.0	11.2
Export volume	-5.3	5.0	6.7	7
Import volume	12.3	1.6	-0.2	-0.8
Terms of trade (deterioration,-)	-4.9	--	-4.0	--
Central Government budget				
Revenue and grants	13.1 2/	16.8	19.8	14.5
Total expenditure and net lending	19.3 2/	15.5	14.6	11.6
Money and credit 3/				
Domestic credit	25.0	19.4	18.7	18.9
Government	28.4	20.1	20.0	17.9
Commercial sector	18.6	18.9	17.8	19.6
Money and quasi-money (M3)	18.2	15.7	13.2	15.5
Narrow money	16.6	11.3	7.7	12.5
Interest rate (annual rate, one-year savings deposit)	7.0	7.5	8.0	8.0
	(In per cent of GDP)			
Public sector savings	3.6	4.4	4.2	5.0
Central Government savings	2.2	2.9	2.7	3.3
Central Government budget deficit	6.6	6.4	6.0	5.6
Domestic bank financing	4.0	3.1	2.8	2.8
Foreign financing	1.1	0.7	0.7	0.7
Gross capital formation	24.2	25.7	25.2	25.5
Gross domestic savings	22.2	23.7	22.8	23.4
Current account deficit	2.2	2.0	2.4	2.1
External debt 3/	10.9	11.6	10.8	10.5
Inclusive of use of Fund credit	10.9	11.2	11.2	12.0
Debt service ratio 4/5/	7.9	8.5	9.8	11.0
Interest payments 4/5/	2.7	3.1	3.6	4.3
Overall balance of payments (SDRs mn.)	-440	-1,683	-2,170	-1,683
Gross official reserves (months of imports)	6	5	4	4
External payments arrears	--	--	--	--

1/ End-year percentage change.
2/ Provisional actual.
3/ End of period.
4/ In per cent of exports of goods and services.
5/ Including IMF.

the late arrival of the monsoon but the Government's prompt action and the coming of the rains have since calmed the markets. Wholesale prices increased only by 1 per cent in the latest 12-month period, although the increase during the first four months of 1982/83 is already 6 per cent.

Industrial growth has slackened over recent months. Industrial production in the first four months of 1982 was 5 per cent higher than a year ago, about half the growth rate achieved in 1981. In part, this is a normal reduction from unsustainable growth rates achieved last year during the economic recovery. However, the industrial slowdown has been abrupt enough to elicit strong complaints about recessionary conditions from important sections of industry and commerce. Press reports indicate stagnant or falling production levels in a number of industries including aluminium, caustic soda, jute, cotton fabrics, and vehicles. However, the supply of important basic goods and services has continued to expand, and healthy increases have been achieved in production of electricity and coal and in railway freight movements. The Government has refuted the suggestion that there is a general demand recession, and claims that the current problems reflect sectional adjustments to the patterns of supply and demand and the impact of a prolonged textile industry strike. At the same time, it appears likely that tight demand management policies and import liberalization, coinciding with a period of slack export demand, have been contributory factors.

Monetary growth has continued at rates well below the program targets in the early months of 1982/83. At end-July, the narrow money stock was 7 per cent higher than a year earlier, compared with the target of 12.5 per cent growth for 1982/83. The main factor accounting for continued slow money growth is smaller than expected expansion of domestic credit, particularly of credit to the commercial sector which is falling well below the program path. Credit to Government has expanded to the limit of the program provision and, in fact, in August was slightly above the September subceiling for net credit to Government. Nevertheless, the authorities appear confident they will meet the September subceiling. No details are yet available on budgetary developments in 1982/83, although State Government borrowing from the banking system continued at a high level in the June quarter.

The balance of payments recorded an overall deficit of SDR 0.7 billion in the period April to August 1982. This suggests that overall developments are proceeding in line with the estimated deficit of SDR 1.7 billion included in the program for 1982/83. Gross reserves currently total SDR 4.5 billion, equivalent to four months of imports. Reports indicate that exports rose by 6 per cent in SDR terms during the June quarter, excluding oil exported under a swap arrangement. The import bill is reported to have risen by 12 per cent. No other indicators of balance of payments developments are yet available.

III. Policy Issues

The focus of the consultation discussions will be on policies and prospects for external adjustment. The extended arrangement already establishes a policy framework for this and the main targets of economic performance. Thus, the current discussions will involve a review of the progress in implementing the adjustment program, with special emphasis on the areas identified in the review provisions for the program for the second year of the arrangement. These are policies bearing on the resource position of the Central and State Governments in light of the public finance targets for 1982/83; all aspects of export development; and the implementation of the new import policy. The Article IV consultation will also encompass discussions on progress in liberalizing and simplifying the exchange system. As in the case of the previous consultation, the staff proposes to issue a joint Staff Report and review paper for consideration by Executive Directors.

1. Balance of payments adjustment

It will be important to be able to demonstrate that underlying balance of payments developments are consistent with the profile for external adjustment in the medium term which is the program's fundamental objective. The program provides for a reduction in the current deficit in 1982/83 of 0.3 percentage points of GDP, which would about return the balance of payments to the adjustment path originally envisaged; this follows a departure in 1981/82 when the current account deficit widened to 2.4 per cent of GDP, 0.4 per cent more than programmed. While the poor weather will have an adverse impact on the balance of payments--indeed precautionary food imports will cost the equivalent of some 0.4 per cent of GDP--the program targets include a contingency allowance which is expected to cover most of the impact. For this reason, and based on overall developments during the first five months of 1982/83, there is currently no indication or reason to believe that the balance of payments will be significantly off-track in 1982/83. Nevertheless, an important task of the mission will be to thoroughly review balance of payments developments and prospects for 1982/83, and assess the prospects for adjustment over the coming few years.

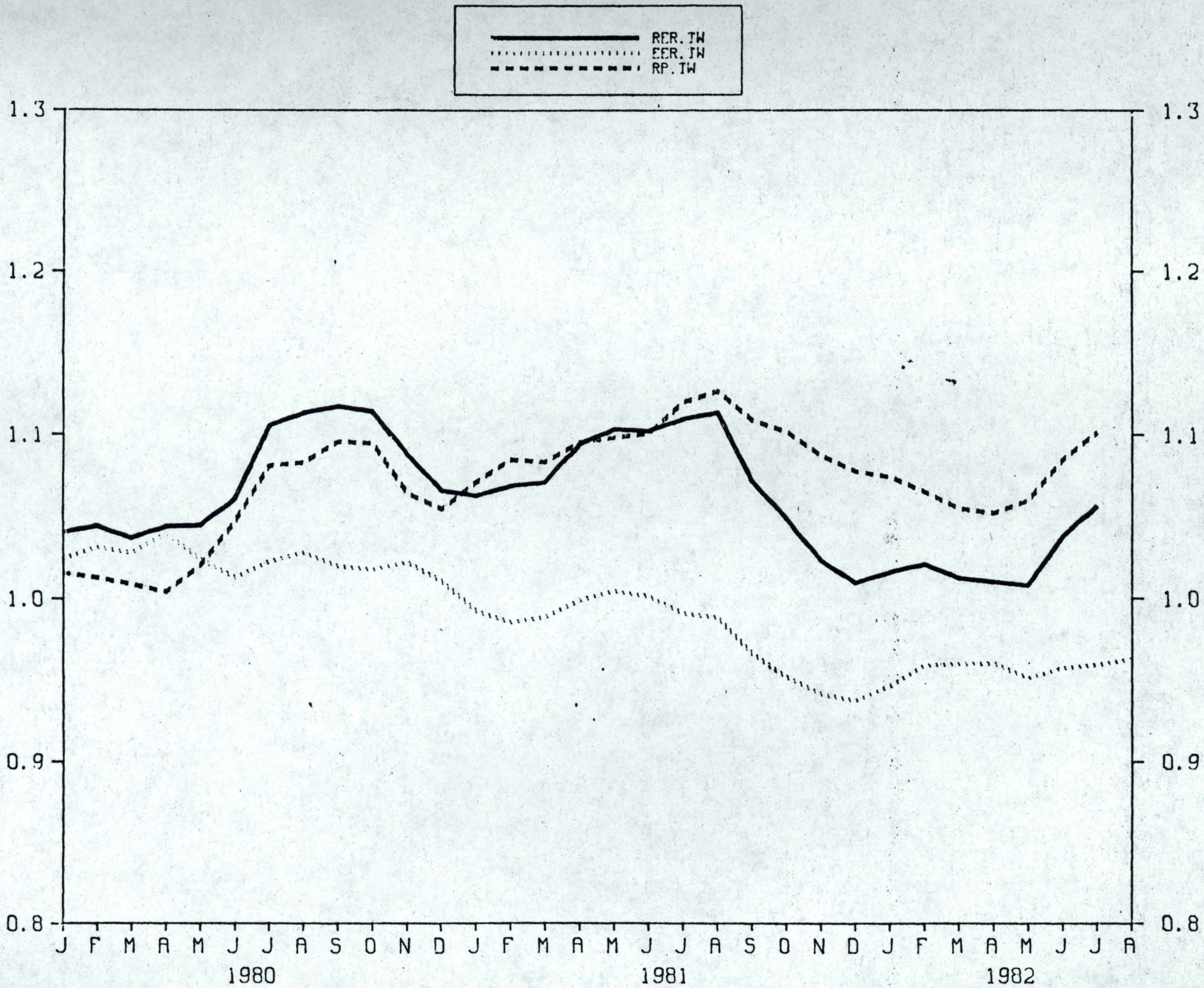
One key program target--and an important indicator of adjustment--is export performance. The program envisaged that export volume would increase by 7 per cent in 1982/83. The letter of intent added the qualification that "this target is feasible provided world market conditions come up to expectations and protectionist measures are not intensified." When the 1982/83 program was drawn up, it was anticipated that world economic activity would pick up sufficiently to accommodate a 7 per cent increase in the volume of exports of the non-oil developing countries during 1982. However, the latest world economic outlook exercise suggests that the growth may now be no more than 3 per cent. The mission will investigate recent export performance and the impact of adverse exogenous factors, including the delay in the recovery in world trading.

Obviously, exchange rate policy is an important instrument to achieve the growth in exports necessary for external adjustment. Policy was effectively implemented in 1981/82 when the export-weighted exchange rate depreciated by 5 per cent in nominal and 9 per cent in real terms (Chart 1). However, during the first four months of 1982/83 the nominal effective exchange rate was largely unchanged, while relative price movements moved 5 per cent against India during this period because of the spurt in inflation related to poor weather. As a result, the depreciation in the real effective exchange rate during the second half of 1981 has come to an end. The real effective rate was broadly unchanged during the first five months of 1982, and with the surge in prices, this measure of competitiveness weakened by 6 per cent in June and July.

The program recognizes the role of exchange rate policy, and in their letter of intent the authorities indicated that the management of the exchange rate was a factor in last year's improved export performance.

Chart 1

India: Exchange Rate Developments, 1980-82



Although the rupee is not obviously "overvalued"--and indeed compared with much of the past India's competitive position has been strengthened--the staff believes that a limited depreciation of the real exchange rate over the medium term would complement other instruments of adjustment. In particular, real exchange rate depreciation would soften the adverse impact of import liberalization on domestic industry and would strengthen export development policies in the aggregate. From this medium-term viewpoint, it would not be appropriate to allow a significant appreciation of the real exchange rate to be maintained.

For the immediate future, the staff will need to obtain further information to assess the urgency of adjusting for developments in June and July and determine whether reversing these changes would go far enough. A major task of the mission will be to review the implementation of exchange rate policy over recent months and, in the light of export performance, to determine what an appropriate policy for the coming months would be. Important considerations will be: (a) the profitability of exports, (b) the relative incentive to export rather than sell in the domestic market, and (c) India's competitive position in export markets. In the last context it will be relevant to keep in view that, while depreciating vis-a-vis the U.S. dollar, the rupee has appreciated significantly against the mark, yen, pound and French franc so far in 1982. Another relevant consideration is that, based on developments so far in 1982/83, wholesale price increases for the year seem likely to be broadly in line with the program target of 8 per cent, i.e., at least as high as inflation in major partner countries. In the event that the mission concludes that an adjustment in the exchange rate is needed, it will be necessary to come to an understanding with the authorities on its size and timing. The mission will need to be able to assure the authorities that the Fund will treat this matter with the utmost discretion. Also, the authorities should be allowed a good degree of flexibility in the timing and manner of implementing the adjustment. While granting this, the mission will emphasize the importance of timely action and indicate that it would be expected that the adjustment would be completed before discussions for the program for the next year take place in April 198~~2~~3.

The authorities have, over the past couple of years, taken a series of measures to reduce disincentives to exports and promote efficiency. With the emphasis now accorded to export development, this policy evolution is expected to continue. The staff will discuss with the authorities their plans and options for strengthening export development policies in the future (including tax, import and industrial policy measures). In the event that the underlying export performance is found to be lagging for reasons other than those related to the exchange rate, the mission will discuss with the authorities specific additional measures needed to encourage exports.

2. Public finances

Public finance issues can conveniently be considered in two parts--Central Government finances and those of the States. Considerable success has been achieved in strengthening Central finances. Most of the principal targets were achieved in 1981/82, and although Central public savings fell marginally short of the program projection, it was considerably higher than in the previous year. The improvement in Central finances mainly reflects the major resource mobilization measures introduced during 1981. Because a number of these only became effective midway through 1981/82, but also because of measures taken in the 1982/83 budget and recent price adjustments, it has been possible to program a further considerable improvement in 1982/83. Central public savings are projected to rise from 2.7 to 3.3 per cent of GDP, and allowing for a sizable increase in Plan expenditures, bank financing of the budget is to be maintained at 2.8 per cent and the overall deficit reduced as a proportion of GDP.

An important task of the mission is to assess whether Central financial developments so far during 1982/83 are on track. At this stage, the authorities will not have systematically reviewed Central financial performance; hence the mission's review will include analysis of available statistical information (as agreed with the authorities during the program negotiations), and will also include some qualitative and judgmental elements. While there is, at this stage, no suggestion of difficulties, should the review indicate that a substantial shortfall from the program targets is likely, the mission will discuss with the authorities steps which will result in a return to the program path. Such a program would need to be in place before Board discussion of the review.

State financial performance fell well short of the program targets in 1981/82. On the positive side, the States raised over Rs 8 billion in additional resources (compared with the program target of Rs 5 billion), but current cost escalation eroded the impact on State savings which were, at best, no higher than the rather modest program target. In financing State Plan expenditures, the States ran up overdrafts with the Reserve Bank totaling some Rs 13 billion whereas the program envisaged overdrafts of only Rs 2.5 billion. The program for 1982/83 provides for some improvement in State finances. It was estimated that with additional resource mobilization of Rs 7.4 billion (of which Rs 2.2 billion had been implemented and Rs 4.6 billion agreed between the Central and State Governments), State savings would increase by 0.2 per cent to 1.7 per cent of GDP and recourse to overdrafts with the Reserve Bank would be reduced to Rs 5 billion (excluding Rs 3.5 billion of bank subscriptions to State Government securities).

The program projections for 1982/83 will be thoroughly reviewed in light of the actual State Government budgets which will be available for the first time, and revised estimates for 1981/82. The mission will emphasize the importance that measures implemented by the States in 1982/83 fully match the program estimate of Rs 7.4 billion. The mission will review progress by the States during the first five months of the year and plans for action over the coming months. In the event that progress toward mobilizing these resources has been inadequate, or that the resource need has increased, the mission will determine with the authorities an appropriate combination of additional resource mobilization and expenditure reduction steps to ensure that State overdrafts with the banking system are contained as planned. For such a program to be effective, it would be necessary that at least some of the steps be in place before the Board discussion of the review.

The Central Government has taken over responsibility for the State overdrafts incurred in 1981/82, and the States will repay the Central Government within five years. The mission will obtain full details of these financial arrangements; it will be necessary to adjust the program targets (but not performance criteria) for the Central budget deficit and Central Government bank borrowing to take account of these accounting transactions in 1982/83.

3. Import liberalization

The 1982/83 import policy announced in April 1982 was a major step in the direction of import liberalization. It was particularly noteworthy because it was taken at a time of serious balance of payments difficulty. At such times, India's policy-makers have traditionally moved to increase protection and conserve foreign exchange. That the Government acted as it did at this time reflects to some extent the influence of the Fund arrangement, but more fundamentally the rising sentiment in favor of more open trading policies. However, while the strength of opposing forces favoring more restrictive policies had waned, it nevertheless remained important.

It is not surprising, therefore, that in the months following the introduction of the import liberalization measures a campaign is being waged on several fronts to reverse the changes. Charges have been made of serious damage to domestic industry, allegations of foreign dumping have been raised, and moves have been made to discredit and try to remove key officials. Because of this, the authorities have established a panel of experts to review the effects of the new import policy. However, the Finance Minister has stated publicly that the import liberalization will not be reversed, and indeed no steps in this direction have been taken.

Against this background, the mission will review progress in implementing the measures to liberalize and simplify the import system, assess their effect in comparison with the authorities' expectations, and update the economically-weighted assessment of their significance which was prepared earlier. This will provide a perspective in which to judge the scope for and pace with which further liberalization and simplification should be taken. The mission will, during this review, explore with the authorities the feasible options they will be considering when drawing up the further measures to be introduced in 1983/84. The mission will emphasize that, despite current opposition, the momentum for liberalization should not be lost in 1983/84.

To deflect the opposition from industrialists it is important that the benefits of the more open and liberal trading and investment environment become quickly apparent. To achieve this, every effort is needed to effectively implement the recent policies aimed at increasing industrial efficiency. As noted above, exchange rate policy can play a role by softening the disruption from import liberalization. In summary, a comprehensive view needs to be taken of the compatibility of various policies influencing the level and pattern of protection for domestic industry, including, in particular, tariff policy. This is likely to be an ongoing issue as it will involve detailed analysis and careful consideration by the authorities. The scope for substantial action in the short run is, in any event, constrained by the present political climate. For the present, efforts can best be directed toward considering, and where appropriate, alleviating the problems of the most severely affected industries whose long-term prospects are favorable. In this, the mission will encourage the authorities to continue to implement policy in the spirit of the April liberalization and not to revert to intensified import controls to protect affected industries. Rather they should examine the scope for reductions in import tariffs on raw materials and intermediate goods which, in a number of cases, could have perverse protective effects.

4. Industrial policies

Import liberalization is one aspect of a broad policy approach to improve the efficiency of the Indian economy, especially that of the industrial sector. Other elements of this program are export, pricing and industrial policy. In the field of industrial policy, a number of steps have been taken over the past two years aimed at reducing regulatory constraints on private business activity. At this stage of the year the authorities are unlikely to be considering new major initiatives; indeed they stress the need for periods of stability to give credibility to their policy stance. The mission will take the opportunity to review progress in the implementation of these measures and discuss with the authorities the scope for further measures which could be introduced in conjunction with next year's program. In particular, steel and cement pricing were partially decontrolled earlier this year and experience with the more liberal arrangements may point to the benefits of extending decontrol to other sectors.

The program gives emphasis to the large public investment program which is directed principally to expanding production capacity in key sectors where bottlenecks have hampered economic performance over many years. The mission will review developments so far in 1982/83 toward meeting the agreed capacity targets for the six key sectors. In particular, the persistent difficulties in expanding electricity generating capacity and efforts and progress in overcoming them will be reviewed. Also, despite considerable progress achieved last year, deepseated problems remain in the railways which could reimpose bottlenecks in transportation if they are not overcome. In light of these concerns, the authorities indicated their intention to increase railway investment in the current year and it will be useful to review progress so far. Developments in the petroleum sector expansion program will also be reviewed, especially as the authorities have indicated that the heavy cost of the program has escalated.

The authorities are at present undertaking a mid-term review of the Sixth Plan. This should allow a useful discussion of the issues involved in adjusting the Plan goals to the availability of resources and an evolving pattern of investment priorities. This issue is emerging as an important unresolved question because resource shortfalls, especially at the State level, have made it apparent to the staff and the Bank that real expenditures targets will not be met in several sectors. Recent press reports indicate the authorities are now estimating that there will be a substantial resource shortfall for the Plan period which would make it impossible to achieve the Plan's physical targets. The staff will stress that every effort should be made to mobilize additional resources and boost public savings, especially by the States. In this effort, the scope for raising coal prices, bus fares, irrigation charges, and electricity tariffs will be discussed again. Such measures could yield substantial additional resources and would, equally importantly, encourage efficiency in resource use. There is also scope to improve efficiency in many public enterprises. Nevertheless, some rationalization of the ambitious goals of the Sixth Plan will be inevitable, and the staff will re-emphasize the importance of protecting real investment levels in sectors critical for balance of payments adjustment.

5. Performance criteria

At the Toronto meetings the authorities raised the possibility that they may request an increase in the credit and external debt ceilings. Such a possibility was foreseen in the program for the second year and was supported in principle by several Executive Directors.

Credit developments during the period up to July 1982 do not indicate that the overall credit ceiling is under pressure. Commercial credit policies were tightened during the second half of 1981/82, resulting in a sharp crunch on credit and Bank liquidity in February and March 1982. The Reserve Bank has since taken several steps to ease credit policy, including reducing the cash reserve requirement and liberalizing refinance provisions. This has been feasible because the control over budget borrowing from the Reserve Bank (implicit in the financial program) and the heavy external deficits have sharply reduced the growth in reserve money. The commercial banks, which were heavily in default of reserve requirements during the February squeeze, have shifted to a highly liquid position despite the slow growth in reserve money, and commercial credit has expanded only slowly. It is not clear whether this is due mainly to weak credit demand or bank caution, and whether it is likely to persist. Nevertheless, by July the annual expansion in commercial credit was no more than 14 per cent, well below the program allowance of 21 per cent for the September credit ceiling and the growth of 20 per cent in 1981.

The authorities' request that the mission be prepared to discuss an increase in the overall credit ceilings follows from their estimate that credit requirements for food stocking will now be heavier than earlier expected. Food credit is provided to the commercial sector and does not affect credit to the Government or the subceiling. With improved weather and cautionary grain imports, official foodgrain and sugar stocks are estimated to rise considerably, and more than earlier projected. If the authorities request a modification of the aggregate credit ceilings for this reason the mission will examine the request and the scope for flexibility. However, on the basis of developments so far it is by no means apparent that these additional food requirements cannot be accommodated within the existing program provisions for commercial credit. Thus, it will be important to review and evaluate credit policies and prospects for 1982/83. Also, the scope for flexibility is limited, and in considering any request for modification, the mission will need to examine aggregate financial developments and prospects closely, keeping in view the importance of maintaining control over inflation.

The authorities have indicated that, because of higher prices for oil equipment imports, the ONGC may contract larger foreign loans than earlier programmed and that an increase in the overall external borrowing ceiling (SDR 1.4 billion) may be needed. The mission will review with the authorities the implementation of the borrowing program for 1982/83 and, if it appears warranted, will discuss a reasonable increase in the borrowing ceiling to accommodate a rise in project-related medium-term borrowing. However, based on loans contracted during the first five months of 1982/83 (SDR 235 million), it appears to the staff unlikely that an increase in oil sector loans could not be accommodated within the existing ceiling.

6. Exchange system

In the decision concluding the 1982 Article IV consultation, the Fund encouraged the authorities to terminate the remaining bilateral payments agreement with a Fund member (Romania) and to liberalize and simplify the complex exchange system as soon as possible. The mission will review progress in these directions over the past year and emphasize the benefits of a reduction in exchange restrictions in parallel with the steps being taken to liberalize trade and other economic policies.

India: Fund Relations
(As of October 4, 1982)

Date of membership:	December 27, 1945.
Status:	Article XIV.
Quota:	SDR 1,717.5 million.
Fund holdings of rupees:	SDR 3,119.3 million (181.6 per cent of quota), including compensatory financing purchases of SDR 266 million (15.5 per cent), and purchases of SDR 1,500 million (87.3 per cent) under the extended arrangement composed of ordinary resources of SDR 750 million (43.6 per cent) and borrowed resources of SDR 750 million (43.6 per cent) consisting of SDR 300 million of substituted SFF resources and SDR 450 million of enlarged access resources.
SDR position:	Holdings amounted to SDR 361.1 million, or 53.0 per cent of net cumulative allocation of SDR 681.2 million.
Trust Fund loan disbursements:	SDR 529.0 million.
Direct distribution of profits from gold sales, July 1, 1976-July 31, 1980:	US$149.3 million.
Gold (from distribution):	804,429.4 fine ounces.
Exchange system:	Linked to a basket of currencies within 5 per cent margins. The current middle rate as of October 4, 1982 is Rs 16.40= pound sterling 1.
Last Article IV consultation:	Article IV consultation and EFF review discussions were held during January 13-27, 1982. The staff report (EBS/82/44, 3/18/82) was discussed by the Board on April 15, 1982.
Last Executive Board discussion of Extended Arrangement:	Discussion of the program for the second year (EBS/82/102, 6/11/82) was held on July 9, 1982.

Table 1: Comparison of Selected Economic and Financial Indicators in Recent Selected Programs

			Current Program Year 1/ (Per cent of quota)						(Per cent of GDP)					
						Overall Balance			Current Account Deficit 4/			Overall Budget Deficit 4/		
Country	Date of Approval 2/	Type of Arrangement	Amount of Arrangement	Fund Credit Outstanding at Beginning Current Program Year 3/	Proposed Purchases During Current Program Year	Previous Year	Original Target	Current Target	Previous Year	Original Target	Current Target	Previous Year	Original Target	Current Target
India	7/82	EFF	291	52	105	-126	-118	-98	2.4	2.0	2.1	6.0	6.6	5.6
Comparator Countries														
Dominican Republic	Proposed	EFF	450	117	150	-309	...	--	6.0	...	4.2	7.5	...	3.4
Ivory Coast	6/82	EFF	450	180	135	-405	-135	-246	15.0	12.0	15.6	11.1	8.6	8.8
Jamaica	4/81	EFF	430	313	135	30	-11/37	-38/10	16.4	14.2	13.7	13.2	...	12.9
Mexico	Proposed	EFF	450	100	144	-340	...	187	4.9	...	3.4	13.5	...	6.8
Morocco	4/82	SB	125	147	87	-92	...	-180	12.5	...	9.9	14.6	...	8.2
Pakistan	11/80*	EFF	297	186	94	-114	-65	-84	5.2	4.8	5.0	5.5	3.8	5.0

Sources: Board papers; and staff estimates.

1/ Current program year refers to the year for which the program is to be negotiated, or the program currently in operation. Original targets refer to targets established in original multiyear arrangement. At the beginning of an arrangement current target refers to original target. When targets have been specified under a program to be canceled and a new program is under consideration, original targets refer to the old program.

2/ Date of approval of current arrangement. If followed by (*), current annual program under negotiation.

3/ Fund credit outstanding, excluding CFF, cereal, oil, and buffer stock facilities, as a per cent of quota prior to beginning of current program year.

4/ Net of official transfers. Values may not coincide with those in staff papers, due to different definition used for intercountry comparison.

Table 1 (Concluded): Comparison of Selected Economic and Financial Indicators in Recent Selected Programs

			Current Program Year 1/										
			(Per cent per year)						(Per cent of M2)				
			Real GDP Growth			Inflation			Domestic Credit Expansion 3/				
Country	Date of Approval 2/	Type of Arrangement	Previous Year	Original Target	Current Target	Previous Year	Original Target	Current Target	Previous Year	Original Target	Current Target	Actual Debt Service Ratio 4/	Actual Reserves/ Imports 5/
India	7/82	EFF	5	4.8	5	1.9	9.0	8.0	21.0	21.2	22.2	10	16
Comparator Countries													
Dominican Republic	Proposed	EFF	2.0	...	2.0	7.5	...	8.0	32.0	...	15.2	27	9
Ivory Coast	6/82	EFF	1.4	3.0	0.2	4.7	9.0	11.3	35.4	...	28.9	30	1
Jamaica	4/81	EFF	2.2	5.1	3.0	9.0	...	8.0	26.1	...	15.9	21	5
Mexico	Proposed	EFF	2.0	...	--	80.0	...	30.0	104.0	...	20.0	52	6
Morocco	4/82	SB	-1.5	...	4.0	12.5	...	12.0	20.2	...	14.6	35	3
Pakistan	11/80*	EFF	6.3	5.8	6.3	9.6	10.0	10.0	16.8	...	...	25.5	7.4

Sources: Board papers; and staff estimates.

1/ Current program year refers to the year for which the program is to be negotiated or the program currently in operation. Original targets refer to targets established in original multiyear arrangement. At the beginning of an arrangement current target refers to original target. When targets have been specified under a program to be canceled and a new program is under consideration, original targets refer to the old program.

2/ Date of approval of current arrangement. If followed by (*), current annual program under negotiation.

3/ Domestic credit or NDA expansion as per cent of broad money outstanding at beginning of period, unless otherwise specified in the program.

4/ Data for most recently available year. Debt service (contractual amounts, net of rescheduling and including Fund obligations) as a percentage of exports of goods and services.

5/ Data for most recently available year. Gross official reserves in weeks of imports.

Table 2: Comparison of Selected Economic and Financial Indicators in Recent Selected Programs

			Year Preceding Current Program Year 1/													
			(Per cent of quota)		(Per cent of GDP)						(Per cent per year)				(Per cent of M2)	
			Overall Balance		Current Account Deficit 3/			Overall Budget Deficit 3/			Real GDP Growth		Inflation		Domestic Credit Expansion 5/	
Country	Date of Approval 2/	Type of Arrangement	Target	Actual	Target	Actual	Deviation 4/	Target	Actual	Deviation 4/	Target	Actual	Target	Actual	Target	Actual
India	7/82	EFF	-98	-126	2.0	2.4	0.4	6.4	6.0	-0.4	4.8	5	11	1.9	21.8	21.0
Comparator Countries																
Ivory Coast	2/81	EFF	-313	-405	15.7	15.0	...	10.8	11.1	1.0	1.5	1.4	7.3	4.7	30.4	35.4
Jamaica	4/81	EFF	-14/28	30	9.9	16.4	2.8	13.3	13.2	-3.1	3.8	2.2	18.0	9.0	23.4	26.1
Mexico	Proposed 11/82	EFF	-340	...	4.9	...	...	13.5	...	...	2.0	...	80.0	...	104.0	...
Morocco	3/81	EFF	-153	-92	6.5	12.5	4.7	7.4	14.6	7.0	4.5	-1.5	11.0	12.5	16.9	20.2
Pakistan	11/80	EFF			5.4	5.2	-0.2	5.3	5.5	0.2	5.7	6.3	10.0	9.6	17.5	16.8

Sources: Board papers; and staff estimates.

1/ Year preceding current program refers to previous year within the arrangement under operation, or year prior to program under negotiation, when applicable. Targets for previous years are only defined when available under an arrangement (including canceled programs) and refer to most recently revised magnitudes.

2/ Date of approval of arrangement in operation during current program year.

3/ Net of official transfers. Values may not coincide with those in staff papers, due to different definitions used for inter-country comparison.

4/ Deviation of actual from original target as a percentage of original GDP target.

5/ Domestic credit or NDA expansion as per cent of broad money outstanding at beginning of period, unless otherwise specified in the program.

cc: Mr. Beveridge
Mr. Hino

✓ETR FILES

cc Mr Smith 6/2/82

From : **Office of Managing Director** June 2/82

To : Mr. Dale

Subject: India - Second-Year Program for Extended Arrangement

I hope the dots will become figures before we circulate the paper. And what about the "dots" referred to in my last summing up?

I shall not be in Washington on the 16th. My last day is July 9th.

MAY 27

INTERNATIONAL MONETARY FUND

May ~~26~~ 27, 1982

TO : THE MANAGING DIRECTOR

FROM: WILLIAM B. DALE

SUBJECT: India--2nd Year Program for EA
(Minister's letter & Statement of Polic

I regard this second year program as fully satisfactory. I understand that a full, and at least in part quantified description of the trade liberalization program has been completed and agreed.

ETR supports the program. I recommend approval.

J

Office Memorandum

CONFIDENTIAL

TO : The Managing Director
The Deputy Managing Director

DATE: May 26, 1982

FROM : Tun Thin and Donald K. Palmer

SUBJECT : India--Second-Year Program for Extended Arrangement

Attached for your review is a draft of the Minister's letter and the Statement of Economic Policies as agreed with the Indian representatives during the recent mission, but also incorporating some modifications proposed by the staff here. Besides a few generally minor gaps that remain to be completed by the Indians, the latter may counterpropose some of our modifications. Also, the drafts have to be approved by the Cabinet and action on coal prices, as mentioned in the penultimate sentence of paragraph 9, p.8, has to be taken before the paper is issued. For the Board discussion on July 9, the paper would have to be issued on June 11. When I discussed these matters with the Indian authorities on the phone on Tuesday, they were not sure that the action on coal could be completed by that time. Since these steps, as well as the contribution of the World Bank, are likely to take a little longer than we anticipated, the paper would be delayed by about a week and the Board discussion postponed to July 16, the last day before the Board recess.

For your guidance.

Attachment

cc: Mr. Carter
LEG
SEC

MAY 26 1982

Office Memorandum

CONFIDENTIAL

TO : The Managing Director
The Deputy Managing Director

DATE: May 26, 1982

FROM : Tun Thin and Donald K. Palmer

SUBJECT : India--Second-Year Program for Extended Arrangement

Attached for your review is a draft of the Minister's letter and the Statement of Economic Policies as agreed with the Indian representatives during the recent mission, but also incorporating some modifications proposed by the staff here. Besides a few generally minor gaps that remain to be completed by the Indians, the latter may counterpropose some of our modifications. Also, the drafts have to be approved by the Cabinet and action on coal prices, as mentioned in the penultimate sentence of paragraph 9, p.8, has to be taken before the paper is issued. For the Board discussion on July 9, the paper would have to be issued on June 11. When I discussed these matters with the Indian authorities on the phone on Tuesday, they were not sure that the action on coal could be completed by that time. Since these steps, as well as the contribution of the World Bank, are likely to take a little longer than we anticipated, the paper would be delayed by about a week and the Board discussion postponed to July 16, the last day before the Board recess.

For your guidance.

Attachment

cc: Mr. Carter
LEG
SEC

CONFIDENTIAL

Mr. Palmer

The Managing Director
The Deputy Managing Director May 5, 1982

Tun Thin T.T.

India - Second Year Program for Extended Arrangement

I headed a mission which visited New Delhi during April 19-May 6 to discuss a program for the second year of the extended arrangement with India. Other members of the mission were Messrs. Smith, Villanueva, Kim, and Gunjal (all ASD), Ms. Kelly (FAD), Messrs. Hino (ETR), and Harrison (IBRD), and Miss Sudo (ASD, secretary); Mr. Grawe of the World Bank's New Delhi office was also attached to the mission.

The mission held discussions with Indian officials including Secretary of Economic Affairs Malhotra, Planning Commission Member/Secretary Manmohan Singh, Reserve Bank Governor Patel, and Commerce Secretary Hussain. Mr. Narasimham also participated actively in the discussions and played a constructive role in reconciling difficult issues. I have been informed, confidentially, that Mr. Narasimham's appointment as Economic Secretary has been confirmed by the Government, and that on Mr. Narashimham's return to New Delhi, Mr. Malhotra will come as Executive Director to the Fund, with Mr. Manmohan Singh taking over from Mr. Patel as Governor of the Reserve Bank.

The negotiations took place against the background of the favorable economic developments during 1981/82, the first year covered by the extended arrangement. Real economic growth was a strong 5 per cent, with good harvests and improved industrial production. Price pressures eased considerably, with wholesale prices increasing by just 2 per cent over the course of the year, although the average wholesale price increase, and that in consumer prices, were about 9 per cent. Financial policies were tightened, both in the commercial and fiscal fields. Indeed, commercial credit policies became unintentionally tight during the final quarter of the year, causing some setback to the industrial expansion and resulting in monetary growth for the full year of 7 per cent, fully 4 percentage points less than envisaged in the program. The authorities have since taken steps to relax credit policies from their over-restrictive stance. The balance of payments current account deficit was 2.4 per cent of GDP, as projected at the time of the recent Board discussion, although the drain on reserves eased somewhat in the final months of the year and the overall deficit was limited to SDR 2.2 billion, some SDR 0.2 billion less than earlier projected but still SDR 0.5 billion more than envisaged in the program.

The negotiations also took place in an environment which appears to be significantly more favorable to economic liberalization. This is evidenced by the support for such policies contained in recent policy statements by the Prime Minister and other government sources, the introduction of major attitude to policy implementation which appears to be pervasive in all key fields and at all levels of the administration. The Fund's involvement in India appears to be playing an important role in support of the forces which are pressing for more outward looking and liberal policies.

The program for the second year

The mission was able to reach agreement (ad referendum) on the program for the second year. A draft letter of intent and statement of policies have been agreed with the authorities, although a new generally minor details remain outstanding which I expect will be settled over the coming few weeks. The following are the main features of the program:

1. Output and prices

The program envisages real growth of 5 per cent in 1982/83, assuming normal weather, with continued buoyancy in the industrial sector. Investment activity is expected to continue to be strong, especially in the private sector following recent policy changes. Savings would also increase with a step up in public savings, and in the private sector in response to policies to encourage financial savings. Although the increase in wholesale prices over the last year has been sharply reduced, this reflects to a considerable extent special supply factors which have caused falls in sugar and some other key commodity prices. Excluding these factors which are not expected to continue to apply, the underlying increase in wholesale prices in 1981/82 would be about 8 per cent (still well below the program target of 11 per cent). The program envisages an increase in wholesale prices of about 8 per cent in 1982/83 on a point-to-point basis, although the average inflation rate would show a considerable decline. This takes into account policies with respect to support and controlled prices which would add to price increases.

2. Balance of payments

Balance of payments projections for the full program period have been reviewed. The current account deficit is projected to decline by 0.3 per cent of GDP to 2.1 per cent in 1982/83 (program 2.0 per cent); to 2.1 per cent in 1983/84 (program 2.2 per cent) and to 1.8 per cent in 1984/85 (same as program). Overall deficits during 1982/83-1984/85 are projected to total SDR 4.4 billion, about SDR 1 billion less than in the original program. These projections confirm that balance of payments adjustment appears to be on track. The projected acceleration in export volumes over the program period remains feasible, and the target for 1982/83 has been maintained at 7 per cent. The import bill is expected to rise by only 5 per cent, with oil imports declining because of increased domestic production, and non-oil imports rising by about 6 per cent in volume terms. The overall deficit is projected to be SDR 1.7 billion in 1982/83, SDR 0.3 billion less than in the original program.

3. Export and import policies

The import policy for 1982/83 included a considerable number of changes which are aimed at promoting efficiency in the economy, with a special emphasis on exports; details of the changes were given in SM/82/58, Supplement 1. The mission has had detailed discussions with the authorities on the objectives of the changes and the economic impact they can be expected to have. On the basis of these discussions the mission has reached the preliminary judgment that the measures provide an important new momentum toward more open trade policies, and are, at the minimum, fully consistent with the commitment made in the original

Statement of Policies to take "significant" measures. The mission also assisted the authorities in preparation of an assessment of the changes as called for in the program. It is anticipated that an economically weighted assessment of the changes adequate to meet the concerns of Executive Directors, and including some quantified aspects, will be forthcoming. However, it will take the authorities some additional time to collect information and prepare this assessment, and a brief return visit of a staff member will probably be necessary. The program provides for a mid-term review of export policies (including the exchange rate), and the implementation and future directions of import policy.

4. Private industry

The authorities are introducing several important measures to further liberalize constraints on private industry. Changes have been made in industrial licensing policy which are aimed at eliminating constraints on production arising from licensed capacity restrictions and provide for increases in licensed capacity automatically as production levels increase. Restrictions on the scope of investment by large scale and foreign investment companies have been eased considerably. Also, the coverage of industrial reservations for small-scale industry has been reduced. Taken in conjunction with steps toward decontrol of cement and steel prices, and import and export policies, these industrial policy measures appear to represent an important move in the right direction.

5. Public investment

The program sets reasonable targets for additions to productive capacity in six key industries, and irrigation. In steel, electric power, and irrigation, the targets represent some slippage from the time-path originally foreseen. In most instances the shortfalls are due to technical factors, although the scale of funding is an emerging concern, especially in sectors which are the responsibility of the States. The Bank staff believes that physical progress achieved so far and projected in 1982/83 is adequate to meet the supply side objectives of the program, and to avoid the occurrence of bottlenecks. However, they are concerned that resource constraints, especially in the States, are constraining public investment to near minimum levels. Under these circumstances, the authorities' intention to protect investments in key sectors becomes of particular importance. The program provides for some necessary reorientation of investment expenditures in 1982/83 to meet needs in the railways, irrigation and electric power sectors. The authorities will also be reassessing investment priorities in the light of the current resource position in the context of a midterm review of the Sixth Plan to be undertaken this year.

6. Public finance

The original Central Government budget estimates for 1982/83, which were presented in March, were somewhat optimistic because they made no allowance for likely cost of living adjustment for public employees and other current cost escalations. At the State level, although sizeable additional resource mobilization measures have been committed, current expenditures are also likely to rise considerably. Because of these factors, and the limit on bank financing established in the financial program, the authorities projected a shortfall in available resources to finance the 1982/83 Plan equivalent to about 4 per cent of the total. To offset this they intend to raise coal prices by about 14 per cent (before the staff paper is issued), and to take other steps (which appear feasible) to intensify revenue collections and reduce current spending at the Centre. With this, total public savings would increase in line with the following table.

Public Sector Savings

(In per cent of GDP)

	1981/82		1982/83	
	Program	Revised estimate	Original program	Proposed program
Central public sector	2.9	2.7	3.2	3.3
State public sector	1.5	1.5	1.6	1.7
Public savings for Plan financing	4.4	4.2	4.6	5.0

Despite the considerable improvement projected in public savings, at this level a reduction of about 2 per cent in Plan expenditures below the budgeted amount would appear to be necessary, although the authorities will make efforts to close the remaining financing gap. Nevertheless, the authorities have undertaken to limit Plan expenditures within the available resources. They will also protect necessary investment in key sectors important to the adjustment effort.

7. Money and credit

The abrupt deceleration in credit and monetary expansion in late 1981/82 resulted in an unanticipated liquidity squeeze at the end of the year. The agreed financial program for 1982/83 allows for somewhat higher rates of increase than originally projected to compensate for this, although the monetary and credit targets for March 1983 are both somewhat below the original program level. Money supply is programed to rise by 12.5 per cent, with total liquidity rising by 15.5 per cent. Total credit would expand by Rs 139.5 billion (18.9 per cent), with net credit to Government growing by Rs 55.5 billion (17.9 per cent) and commercial credit by Rs 84 billion (19.7 per cent). The program provides for a significant redirection of credit towards the commercial sector. Net credit to the Central and State Governments would decline to 3.3 per cent of GDP from 3.5 per cent in 1981/82; Central Government bank financing would be 2.8 per cent of GDP, below the original program target of 3.0 per cent. The authorities believe that the credit ceilings are tight and provide them little flexibility, especially because of expected sizeable commercial credit needs to finance a buildup in foodgrain and sugar stocks. I understand Governor Patel has indicated his reservations to the Finance Minister and asked that they be recorded when the issue is discussed by the Cabinet.

8. External borrowing

The authorities were able to provide the mission with details of the main components of their commercial borrowing program for the remainder of the program period. This indicates that aggregate commercial borrowing contracts (excluding long-term defense loans), which amounted to SDR 0.9 billion in 1981/82, may reach SDR 3.7 billion in 1982/83, and SDR 2.1 billion in both 1983/84 and 1984/85; of these amounts, loans falling outside the external debt ceiling would amount to some SDR 0.6-0.7 billion per annum over the next three years. The ceiling on official and guaranteed borrowing in the 1 to 12-year maturity range in 1982/83 has been agreed as SDR 1.4 billion, with the provision for automatic increase if large but uncertain loans for two projects totaling SDR 1.8 billion are contracted. A subceiling on borrowings with maturities in the 1 to 5-year range has been agreed at SDR 0.2 billion.

9. Phasing

The authorities have accepted the proposed phasing of purchases and schedule of missions during the 1982/83 program as included in the briefing paper.

cc: Mr. Carter
✓Mr. Palmer
Mr. Tanzi
LEG
TRE
MED

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: April 12, 1982

FROM : Tun Thin and Donald K. Palmer

SUBJECT : India: Briefing Paper for Second-Year Program under the Extended Arrangement

Attached is a Briefing Paper for the program for the second year of the India EFF. The paper includes comments received from other Departments (Messrs. Tait (FAD), Cutler (TRE), and Mr. Liuksila (LEG)).

Attachment

cc: FAD
LEG
TRE
Mr. Carter

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

India

Briefing Paper--Second-Year Program for Extended Arrangement

Prepared by the Asian, Exchange and Trade Relations, and Fiscal Affairs Departments

Approved by Tun Thin and Donald K. Palmer

April 12, 1982

I. Introduction

Messrs. Tun Thin (Head), Smith, Villanueva, I. Kim and Gunjal (all ASD), Ms. Kelly (FAD), Messrs. Hino (ETR) and Harrison (IBRD), and Ms. Sudo (ASD, secretary) will visit New Delhi during April 19-May 6, 1982 to discuss a program for the second year of the extended arrangement approved on November 9, 1981. Mr. Grawe of the Bank's New Delhi office will also be attached to the mission.

India met all the performance criteria set for November 1981 and February 1982 (Table 1), and has made two purchases totaling SDR 600 million to date. The review of performance during the first year called for in the arrangement will be discussed by Executive Directors in conjunction with the Article IV consultation on April 15, 1982. Assuming that Executive Directors adopt the draft decision proposed in EBS/82/44, India will make the final purchase of SDR 300 million due during the first year on April 21.

II. Recent Developments

Recent economic and policy developments are discussed fully in the Staff Report for the 1982 Article IV consultation and Review of Extended Arrangement (EBS/82/44) and the accompanying paper on Recent Economic Developments (SM/82/58). In most respects economic performance during

IND.A-15 Doc.3 (4/5/82)

Table 1. India: Quantitative Performance Criteria for the 1981/82 Program 1/

	March 1981 (Base)	November 27, 1981 Actual	November 27, 1981 Program	February 26, 1982 Actual	February 26, 1982 Program	March 26, 1982 Program
	(In billions of rupees)					
1. Bank credit						
Domestic credit	621.26 (25)	690.56 (22)	703.59 (25)	719.61 (22)	733.20 (23)	741.81 (19)
Net credit to Government (subceiling)	258.06 (34)	288.29 (24)	294.29 (26)	292.31 (23)	304.64 (28)	309.81 (20)
	(In millions of SDRs)					
2. External borrowing						
Maturities between 1 and 12 years		106.3	1,400.0	246.2	1,400.0	1,400.0
Maturities between 1 and 5 years (subceiling)		0.6	400.0	25.0	400.0	400.0

Sources: Data provided by the Indian authorities and EBS/81/198.

1/ Figures in parentheses are percentage changes over 12 months.

1981/82 (fiscal year ending March) was in line with or better than envisaged in the EFF program for the first year (Table 2). Real growth was about 5 per cent, in line with the program target, with a record foodgrain harvest and strong industrial growth of 8-10 per cent. Real public investment in most key sectors was in line with the program projection, and private corporate investment also expanded strongly. Abundant supplies were a major factor accounting for a further slowing in inflation; by February 1982 the 12-month increase in wholesale prices had fallen to just 3 per cent. However, financial policies were progressively tightened over the course of the year and contributed increasingly to the much better price performance. Revised budget estimates indicate that the Central Government overall deficit and bank financing of the deficit were both somewhat less than programmed. At the same time, public savings performance improved considerably from the previous year and was broadly in line with the program. Credit policies toward the commercial sector were tightened during the year, so that by February 1982 the growth in broad (14 per cent) and narrow money (11 per cent) were reduced in line with or below the financial program.

The area in which developments deviated significantly from the program's projections was the balance of payments. The current account deficit is now estimated to be SDR 3.5 billion (2.4 per cent of GDP), SDR 0.5 billion (and 0.4 per cent of GDP) higher than programmed. The main factor was a deterioration in the terms of trade, while the program projected a small improvement. Net capital inflows were also somewhat smaller than projected, and the overall deficit is estimated to reach SDR 2.4 billion, SDR 0.7 billion more than programmed. Despite the purchases under the EFF, international reserves have been drawn down

Table 2. India: Selected Economic and Financial Indicators, 1980/81-1982/82

	1980/81	1981/82 Program	1981/82 Revised estimate	1982/83 Program	1982/83 Projected
	(Annual per cent changes)				
National income and prices					
GDP at constant prices	6.5	4.8	4.5-5	4.8	4.5-5.0
GDP deflator	11.1	9.0	...	8.5	6
Wholesale prices	15.8	11.0	8.0	9.0	6
External sector (on the basis of SDRs)					
Exports, f.o.b.	11.5	16.2	11.5	16.1	13.1
Imports, c.i.f.	38.9	12.4	7.4	12.0	6.6
Non-oil imports, c.i.f.	18.5	29.8	18.8	19.0	15.6
Export volume	-5.3	5.0	6.7	7.0	7.0
Import volume	12.1	2.0	-1.4	2.4	2.7
Terms of trade (deterioration,-)	-4.9	0.3	-4.0	-1.0	1.8
Nominal effective exchange rate 1/	-3.8		-5.1 2/		
Real effective exchange rate 1/	3.0		-5.7 2/		
Central Government budget					
Revenue and grants	13.1 3/	16.8	19.8	...	14.5
Total expenditure and net lending	19.3 3/	15.5	14.6	...	9.5
Money and credit 4/					
Domestic credit	25.0	19.4	19.5 5/	18.3	...
Government	34.0	20.1	22.3 5/	17.6	...
Commercial sector	18.6	18.9	17.7 5/	18.9	...
Money and quasi-money (M3)	18.2	15.7	13.7 5/	14.5	...
Narrow money	16.6	11.3	11.0 5/	11.0	...
Interest rate (annual rate, one-year savings deposit)	7.0	7.5	8.0	...	...
	(In per cent of GDP)				
Central Government savings	...	2.9	2.7	3.2	3.2-3.4
Central Government budget deficit	6.6	6.4	6.0	6.6	5.3-6.0
Domestic bank financing	4.1	3.1	...	3.0	2.6-2.9
Foreign financing	1.1	0.9	0.7	1.0	...
Gross capital formation	24.2	25.7	25.2	26.1	...
Gross domestic savings	22.2	23.7	22.8	24.1	...
Current account deficit	2.2	2.0	2.4	2.0	2.1
External debt 4/	10.9	10.6	10.6	10.4	10.4
Inclusive of use of Fund credit	10.9	11.2	11.2	11.7	11.7
Debt service ratio 6/	7.8	8.1	7.8	8.1	8.5
Interest payments 6/	2.7	2.7	2.6	3.1	3.5
Overall balance of payments (SDRs mn.)	-440	-1,683	-2,421	-2,024	-1,551
Gross official reserves (months of imports)	6	5	4	4	4
External payments arrears	--	--	--	--	--

1/ Twelve-month rate of change (March-to-March), the minus sign indicates depreciation of the Indian rupee.
2/ March through December 1981.
3/ Provisional actual.
4/ End of period.
5/ Over 12 months ending February 1982.
6/ In per cent of exports of goods and services.

heavily and at January 1982 were reduced to SDR 4.5 billion, equivalent to about four months of imports.

III. The Framework of the Second-Year Program

The Chairman's concluding remarks at the November 9, 1981 Executive Board meeting identified five general areas which had been stressed in the discussion and deserved attention in framing the second-year program. In brief, these are: (1) the achievement of appropriate public savings targets if necessary by additional resource mobilization and expenditure measures, encompassing the questions of subsidies and efficiency in the public sector; (2) an appropriate monetary policy, including interest rates; (3) a strengthened external sector, with close attention to the competitiveness of exports; (4) the "opening up" of the economy by relaxing controls, especially on international trade, foreign business collaboration and the domestic pricing system; (5) and the monitoring of progress, with the collaboration of the World Bank, in implementing the investment program.

Viewed in the light of developments during 1981/82 these remain a valid list of general issues. Working from this, the staff believes the main issues for the second-year program can be focused more narrowly in the following areas:

(a) Ensuring that policies firmly support external adjustment and that the underlying balance of payments position develops in line with the adjustment profile originally foreseen;

(b) Carrying forward the progress achieved in 1981/82 in raising public savings to finance the investment program, with particular emphasis on the contribution of the States;

(c) Implementing measures to liberalize import restrictions and reduce the incidence of controls on industry and the export sector;1/ and

(d) Adopting a mix of budgetary and monetary policies which consolidates control over inflation and allows adequate room for the expansion of commercial activity.

Beyond these focal issues, the program should include policies in the whole range of areas identified in the original statement of policies. These include policies to promote further agricultural development and diversification;1/ policies to ensure that additions to industrial capacity in key sectors are achieved in line with the program projections, including steps to meet problems encountered in the electric power and railway sectors;1/ policies to encourage, improve the efficiency of, and loosen constraints on, private investment, including foreign business collaboration; policies to strengthen private savings and develop financing for private investment; steps to improve the efficiency of the pricing system by introducing more flexible administration and reducing the scope of price controls;1/ and policies on foreign commercial borrowing which establish reasonable limits (as performance criteria) in line with a sustainable long-term debt-servicing profile and provide for a balanced recourse to market borrowings for project financing.

1. Balance of payments adjustment

The balance of payments deviated significantly from the program projections in 1981/82 (Chart 1), in large part because of an unexpected

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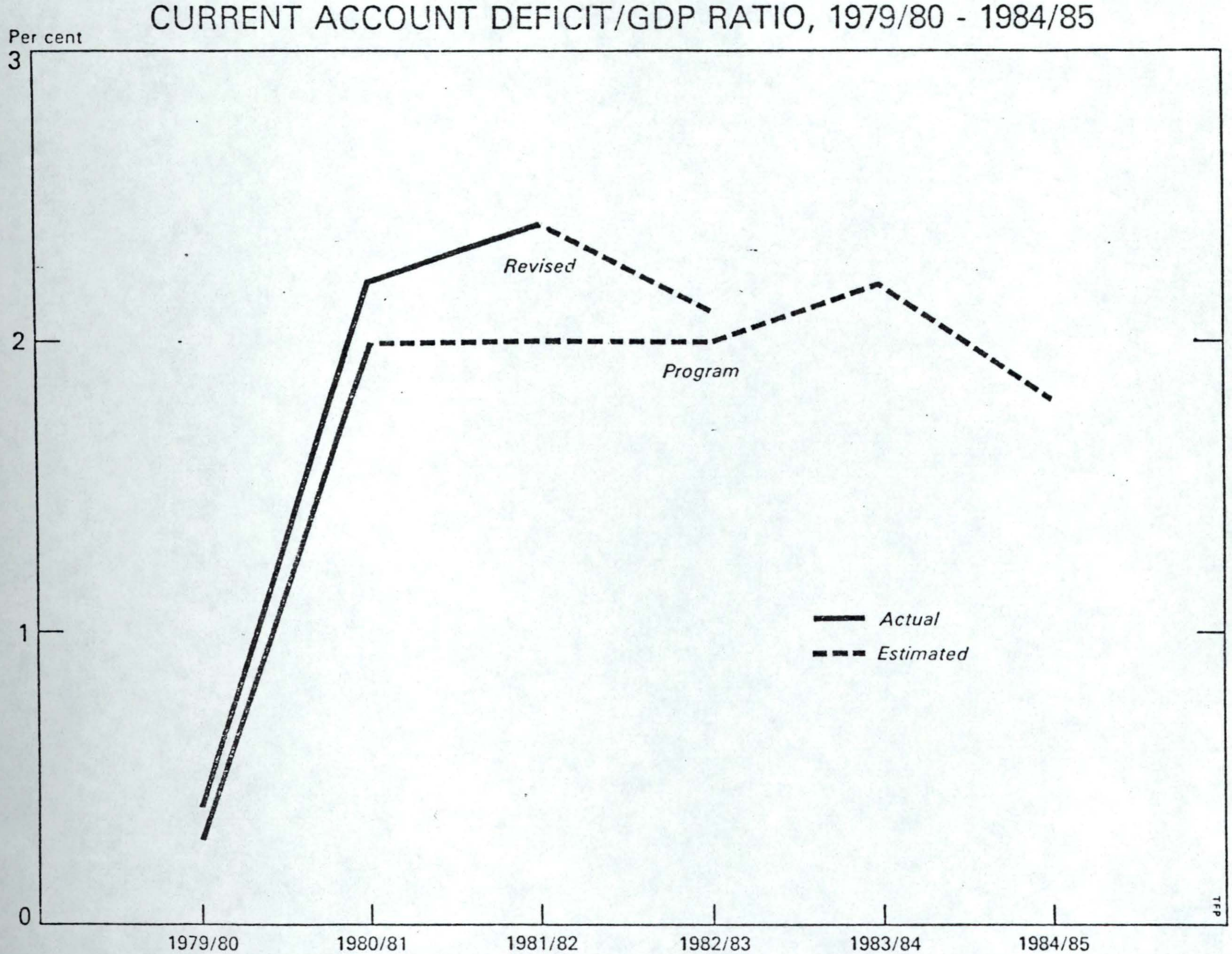
1/ On these issues the mission expects to benefit particularly from the assistance and expertise of the World Bank.

CHART 1

INDIA

CURRENT ACCOUNT DEFICIT/GDP RATIO, 1979/80 - 1984/85



Sources: Data provided by the Indian authorities and Staff projections.

deterioration in the terms of trade (Chart 2). Revised estimates for 1982/83 discussed during the January mission show that the balance of payments should return to near the adjustment path envisaged in the original program in the coming year. The current account deficit, at 2.1 per cent of GDP, would be 0.1 per cent higher than the original estimate, but would now be slightly lower than the (revised) 1980/81 base level. The improvement would result from the reversal, mainly because of oil price developments, of the unexpected deterioration in the terms of trade in 1981/82. With a sizable step-up now expected in capital inflows, the overall deficit would be reduced to some SDR 1.6 billion in 1982/83, considerably less than in 1981/82 and the original estimate. However, international reserves holdings at March 1983 would be somewhat less than originally projected.

It will be important to ensure that, excluding the impact of any strictly temporary disturbances, policies are adequate to achieve the gradual adjustment of the balance of payments at a pace no slower than originally foreseen in the program. In this context, it will be necessary to thoroughly review balance of payments prospects for 1982/83 and rework the original projections for 1983/84 and 1984/85. There appear to be three main areas of uncertainty which may have important implications for policies.

a. Exports

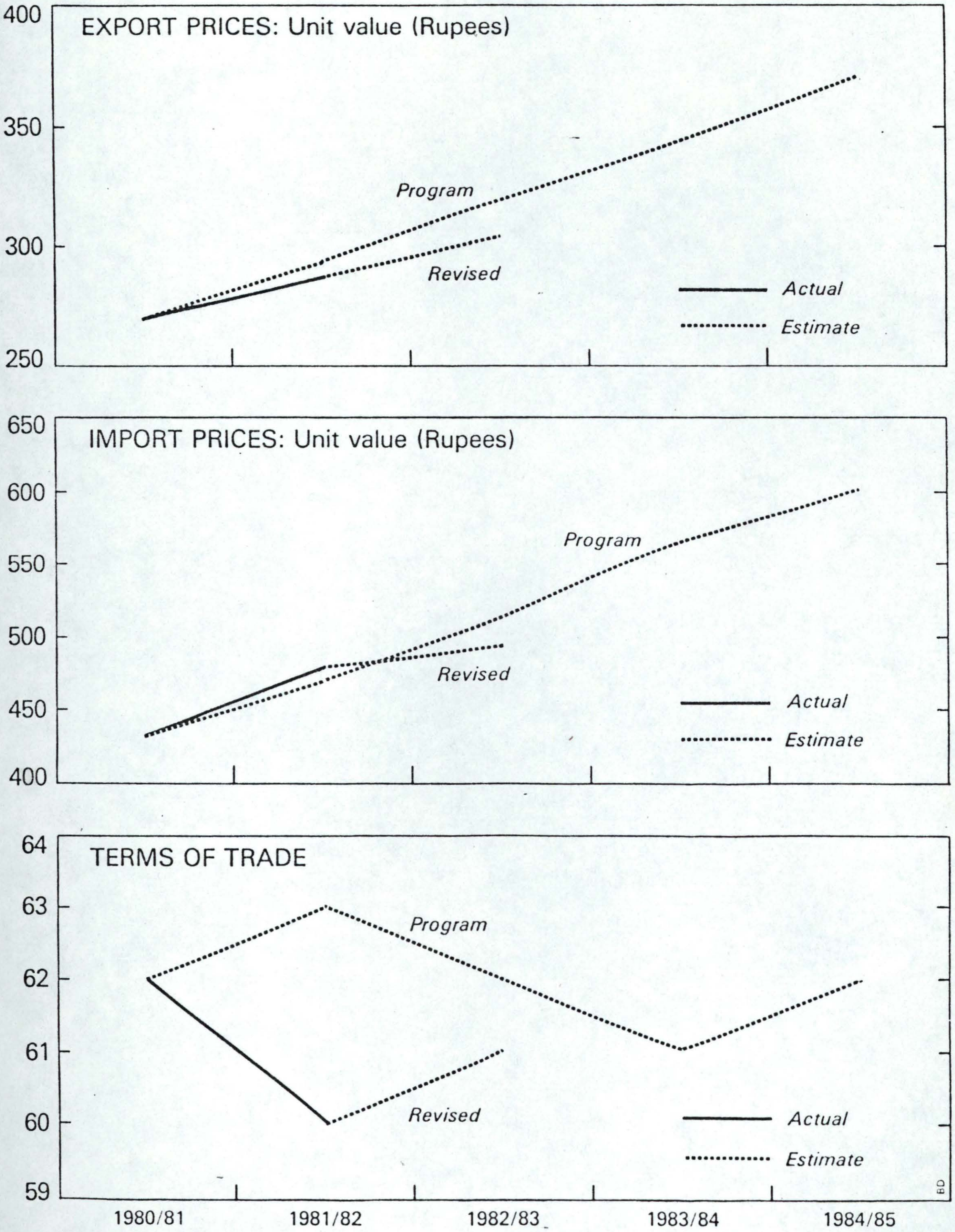
Export volume growth in 1981/82 is estimated to have been 7 per cent, somewhat above the target of 5 per cent. The program envisages an acceleration in export volumes, with growth of 7 per cent in 1982/83, 8 per cent in 1983/84 and 9 per cent in 1984/85. The target for 1982/83

CHART 2

INDIA

EXPORT PRICES, IMPORT PRICES, AND THE TERMS OF TRADE, 1980/81-1984/85

(1968/69 = 100)



Source: Data provided by the Indian Authorities and staff projections.

remains appropriate, but will be difficult to achieve now that the domestic recovery has been completed and in light of the weak international demand conditions. However, export policy developments over the past year will be helpful. A number of impediments to exports (licensing and access to imports) have been eased, the value of export incentives (cash assistance, duty drawbacks, etc.) has increased, and the real effective exchange rate has depreciated (6 per cent in the first three quarters of 1981/82).

Export policies should be adequate to achieve the increase in export volumes projected in the program. The statement of policies for the second year's program should include details of specific improvements in export policies, which were presaged in the original statement. The staff, working in conjunction with Bank specialists, have indicated a number of areas in which measures would be appropriate. These include steps to liberalize exporters' access to imports, and reducing financial disincentives arising from import duties and restrictions, a number of which have been included in the import policy for 1982/83. Measures to liberalize access to imports are outlined in Section 3. Other measures include: (i) an expansion of the scheme for duty-free imports under advances licenses to cover practically all items required for export production and those needed to manufacture intermediate products for export production; (ii) the addition of new items to the duty-free scheme for imports against REP license; and (iii) increases in incentives given to export and trading houses. The mission will explore with the authorities other possible measures to improve the efficiency of the export sector. The possible budgetary implications of measures to tax relief in the export sector would, of course, influence the resource mobilization effort needed.

Exchange rate policy has been implemented effectively over recent months, in line with the objectives of the program. Beyond a reaffirmation of the aims of exchange rate policies, new commitments do not seem necessary at this stage. However, it would be appropriate to again provide that all aspects of export policies (including exchange rate policy) would be subject to review mid-way through the second year. In this way, export policies and developments can be kept under the close surveillance necessary to ensure that export performance is adequate. Exchange rate policy assumes added importance now that further import liberalization is being undertaken.

b. Imports

Efficient import substitution is projected to make an important contribution to the adjustment effort. For this purpose, the program provides for substantial investments in the energy, steel, and fertilizer sectors. Developments in these areas will be assessed with a view to strengthening policies if necessary. The expansion of domestic petroleum production is critical. Developments so far suggest that production will rise even faster than provided for in the original program. In view of this, and the lower growth in prices, the oil import bill may now be on a lower track than earlier projected.

An issue of some potential conflict is the policy relating to the growth in general non-oil imports. The authorities are of the view that substantial volume increases are necessary in the coming few years to support their investment program and development effort. The staff agrees, in principle, with the emphasis on the supply side, and notes especially the importance attached to import liberalization. However, policies to allow the expansion of general non-oil imports must be tempered by the need to achieve external adjustment. Increases in non-oil import volumes should fully accommodate the investment and expanded activity envisaged in the program. The original program provided for increases in non-oil import volumes averaging 6 per cent per annum over the coming three years which were estimated to be adequate to achieve the supply side targets. In view of the extent of Fund financing, concerns expressed by a number of Directors and recent balance of payments developments, it would be inappropriate to aim for increases beyong those necessary to achieve these targets, and financial policies should be designed with this in view.

c. Capital inflows

Despite the poor outlook for Bank and bilateral assistance in the medium term, the World Bank now estimates that based on the build-up in the aid pipeline in recent years, aid flows can be significantly higher than originally expected in 1982/83, and it appears that the conservative program projections for aid disbursements could be exceeded over the next few years. In addition, only small disbursements were projected from commercial borrowing during the program period. It would now be opportune to review the likely levels on capital inflows during the remainder of the program. The debt-servicing outlook will also be reviewed in the light of the likely lower levels of current receipts and increases in the average cost of financing, although it appears that the debt servicing burden during the 1980s will remain manageable.

The program should provide for a reasonable balance in policies providing for financing, taking a realistic assessment of the likely flows of concessional assistance. It appears appropriate for the authorities to utilize more fully their capacity to borrow for project financing on commercial terms, where so far contracts for new loans have been lower than envisaged. Provided that the future debt-servicing burden remains under control, the ceilings on official external borrowing for the second year will be agreed in this light. The ceiling will be comprehensive, including all government and government-guaranteed borrowing on nonconcessional terms, including defense loans. The mission will also explore the possibility of establishing an improved system to monitor and coordinate debt developments and ensure consistency with overall public investment planning. In view of the fact that actual contracting of external debt under the ceiling in 1981/82 was far short of the ceiling, the mission will request a foreign borrowing program of the public sector for 1982/83 which would serve as a basis for setting the ceiling for that period.

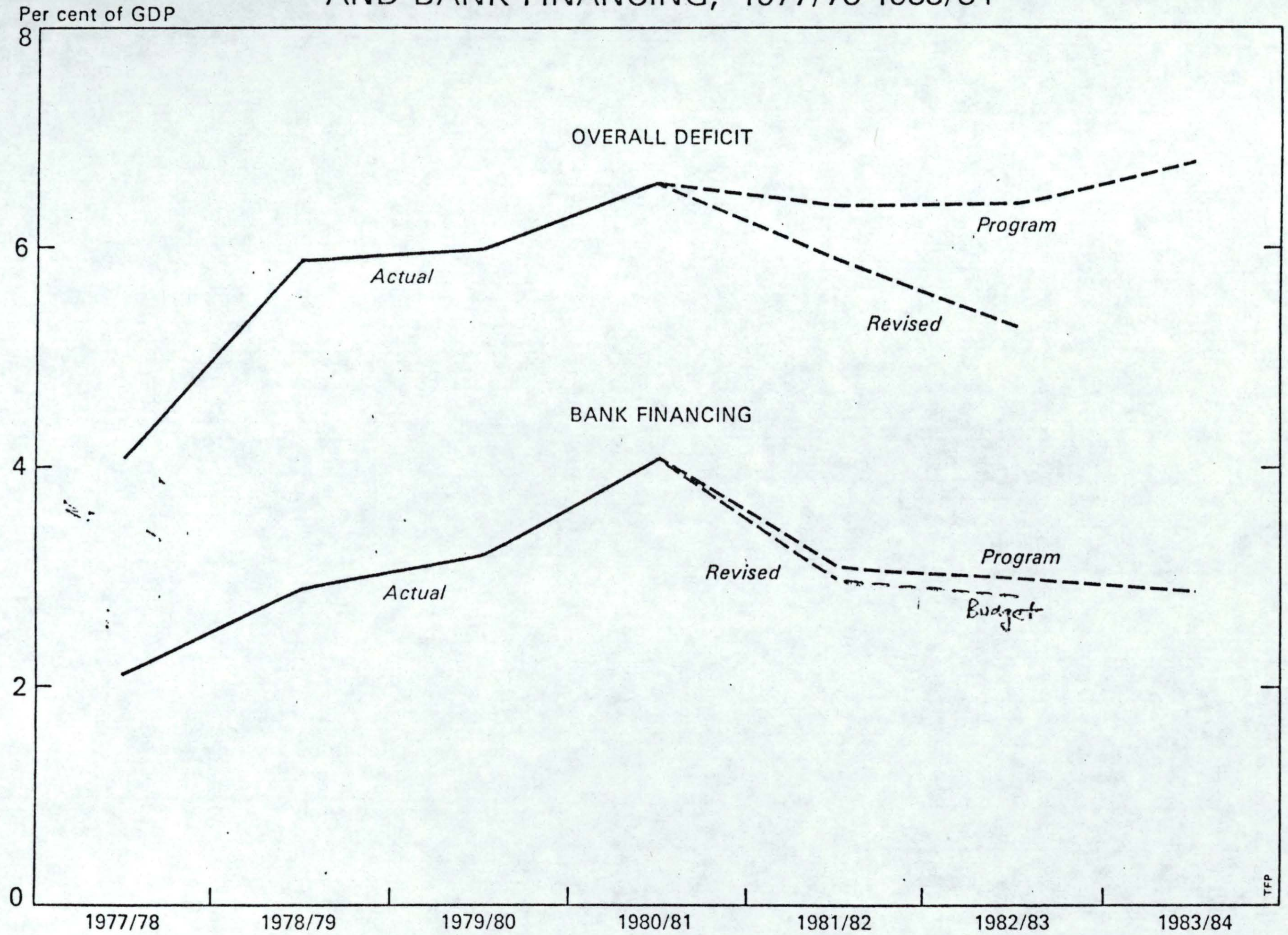
2. Fiscal policy

Fiscal performance improved considerably in 1981/82, broadly in line with the program projections. The overall deficit and that part financed by the banks was less than programmed (Chart 3), but there was a marginal shortfall (although a considerable increase from 1980/81) in public savings. The recently issued Central Government budget for 1982/83 appears to provide a suitable foundation for understandings on fiscal

CHART 3

INDIA

CENTRAL GOVERNMENT: OVERALL DEFICIT AND BANK FINANCING, 1977/78-1983/84



Source: Data provided by the Indian authorities.

policy for the second year. Indeed, in most areas, the budget provides for more substantial progress in the right direction than envisaged in the original program (Table 3). State budgets are not yet available.

It is probably unrealistic to expect that the original objectives of the Central Government budget will be achieved in full. Indeed the authorities emphasize that the budget presents an ambitious goal toward which they will aim, but that the outturn will likely fall somewhat short of the goal because of supplementary expenditures. The estimates implied in the 1982/83 Central budget for the overall deficit, bank financing, and Central savings would establish the most optimistic ends of possible ranges for the program; the mission will aim to reach agreement as near as possible to these levels. For Central public sector savings, the original program estimate would be a suitable minimum; this would provide a target within the range of 3.2-3.4 per cent of GDP in 1982/83. In view of the success in holding the overall Central deficit below the program target in 1981/82, the upper end of the possible range for the overall deficit could be the revised 1981/82 level; this would provide a target within the range of 5.3-6.0 per cent of GDP in 1982/83. Were additional resources considered to be needed to meet the Central Government targets, it would be expected they would be in place before Executive Board consideration of the program.

The original program estimate for State savings was established on the basis of resource measures already in place in 1981. In view of the importance of additional resource mobilization at the State level, it would seem appropriate to establish a somewhat more ambitious target for 1982/83 than originally included. The World Bank agrees that this would

Table 3. India: Fiscal Magnitudes, 1981/82-1982/83

	1981/82		1982/83	
	Program	Revised	Program	Budget estimate
Central Budget				
Overall deficit (Rs bn.) 1/	94.4	88.7	112.3	89.5 2/
(Per cent of GDP)	(6.4)	(6.0)	(6.6)	(5.3)
(Per cent of domestic savings)	(27)	(26)	(27)	(23)
Bank borrowing 2/	45.8	43.0	49.6	44.0
(Per cent of GDP)	(3.1)	(2.9)	(3.0)	(2.6)
Public savings				
Central public sector				
(Per cent of GDP) 1/	(2.9)	(2.7)	(3.2)	(3.4)
State savings				
(Per cent of GDP)	(1.5)	(1.5-1.6)	(1.6)	(...)
Total public sector savings				
(Per cent of GDP)	(4.4)	(4.2-4.3)	(4.8)	(...)

Sources: Data provided by the Indian authorities and staff estimates.

1/ Revised from EBS/81/198 because of minor refinements to statistical definitions.

2/ Staff estimates.

also be an effective way of inducing increases in State electricity, transportation and water-related charges which are also needed on efficiency grounds. The mission will, in consultation with the Bank, attempt to reach agreement on a new target for State public savings which involves a considerable but realistic resource mobilization effort on the part of the States in the coming year. Overall, Central and State public savings will be set to exceed the original program target of 4.8 per cent in 1982/83.

It will be useful to again review progress toward the achievement of the public finance targets during the mid-term review to be conducted in about November 1982. For this purpose it will be necessary to establish a means by which mid-year progress can be effectively monitored. For the Centre, half yearly revenue and expenditure projections will be agreed with the authorities; partial budgetary data available on a monthly basis will be developed for the purpose of monitoring performance. For the States, it will probably be necessary to agree on a level of aggregate new resource measures which would be consistent with the savings target, and to monitor their implementation at mid-year.

3. Import restrictions

The Statement of Economic Policies contains the following statements:

> "It is intended to take further measures to simplify and rationalize the regulations and procedures governing import approval. Policies regarding imports, including capital goods imports, will be flexibly administered. Where appropriate in the interest of economic efficiency, consideration will be given to further imports of selected categories being produced at present. Specific measures contemplated include increasing the access to imports of restricted and banned items permitted under automatic import licenses as well as changes in the classification of items under the restricted, banned and open lists."

Because of the complexity of the import system, it was not possible in the original program to indicate in quantitative terms the extent of liberalization measures to be introduced in 1982/83 and 1983/84. Rather, the authorities are to provide the Fund with their written assessment of the liberalization measures, indicating why they are "significant". It will be necessary for the staff to thoroughly review the assessment of the 1982/83 policy with the authorities, and to ensure that it is accurate and comprehensive. The import policy for 1982/83, introduced on April 5, 1982, included the following liberalization measures:

a. Measures to regularize and simplify procedures

(1) Imports by actual users will be made on the basis of repeat automatic licenses in 1982/83 where the value of automatic license is less than Rs 100,000. There will be no limit on the value of repeat licenses for export-oriented units which export at least 25 per cent of production or at least Rs 100 million. This will save more than one half of the small-scale units and more than 25 per cent of the large-scale units from having to follow the formalities of obtaining fresh automatic licenses;

(2) An increase of 10 per cent in 1982/83 of the value of automatic licenses over and above actual consumption in 1981/82, or 20 per cent in the case of actual users exporting 10 per cent of production of select items or those who would forego a separate supplementary license application;

(3) Use in 1982/83 of supplementary licenses for 1981/82 by actual user who export at least 25 per cent of their production of selected products or at least Rs 10 million;

(4) Issuance of a supplementary license without the recommendation of the sponsoring authority up to 50 per cent of the value of the automatic license for actual users who exported at least 50 per cent of their production of selected products;

(5) One hundred per cent export-oriented units can import all of their requirements under Open General License (OGL);

(6) Net additions to the OGL list of 65 items of raw materials and components and 70 items of capital goods; the authorities estimate imports under the OGL to rise from about SDR 300 million in 1981/82 to about SDR 500 million this year.

b. <u>Measures to promote foreign investment and technology</u>

(1) An increase in the limit for technology imports from $250,000 to $500,000 for imports for modernization under the technical development fund; also, imports of know-how and design against the REP licenses can be made without prior clearance;

(2) Nonresident Indians who invest at least 20 per cent of capital in enterprises in certain industries may import machinery under OGL without indigenous angle clearance.

c. <u>Measures to raise foreign competition</u>

Measures included under (a) and (b) include those which will raise exposure to foreign competition. In addition,

(1) the actual user condition will now apply to only 97 items under OGL; until last year, imports of practically all noncanalized items had to be made by actual users;

(2) imports of machinery, up to Rs 20,000 can be made by manufacturers who exported at least 10 per cent of their production of

selected products and at least Rs 500,000 without the recommendation of the sponsoring authority and without clearance for the protection of indigenous producers;

(3) exporters will be provided substantital flexibility to import any item against their own REP license;

(4) a doubling of the limit on the value of a banned item to be imported under automatic licenses; also, imports of certain canalized items are now permitted under automatic licenses.

The authorities claim that the new measures represent a major move to liberalize imports, and they have been reported in this light in the domestic and foreign press. From the information available, the staff agrees that the 1982/83 import policy includes some important new measures. However, the staff does not yet have full details of the measures and needs to clarify certain features. Therefore, the staff is not yet in a position to reach a judgement as to whether the liberalization effort is "significant". Agreement on this aspect of the program for 1982/83 can only be made on the mission's return following agreement on the written assessment provided by the authorities and the collection of other information by the mission.

As one important feature of the mid-term review in November, the program will provide for a review of the implementation of the import policy for 1982/83, together with a discussion of the future directions of import and supporting tariff policies. The staff will state its expectation that during the mid-term review the authorities will be prepared to seriously discuss the various alternative approaches that would become the basis of the import liberalization program for 1983/84.

4. Financial program

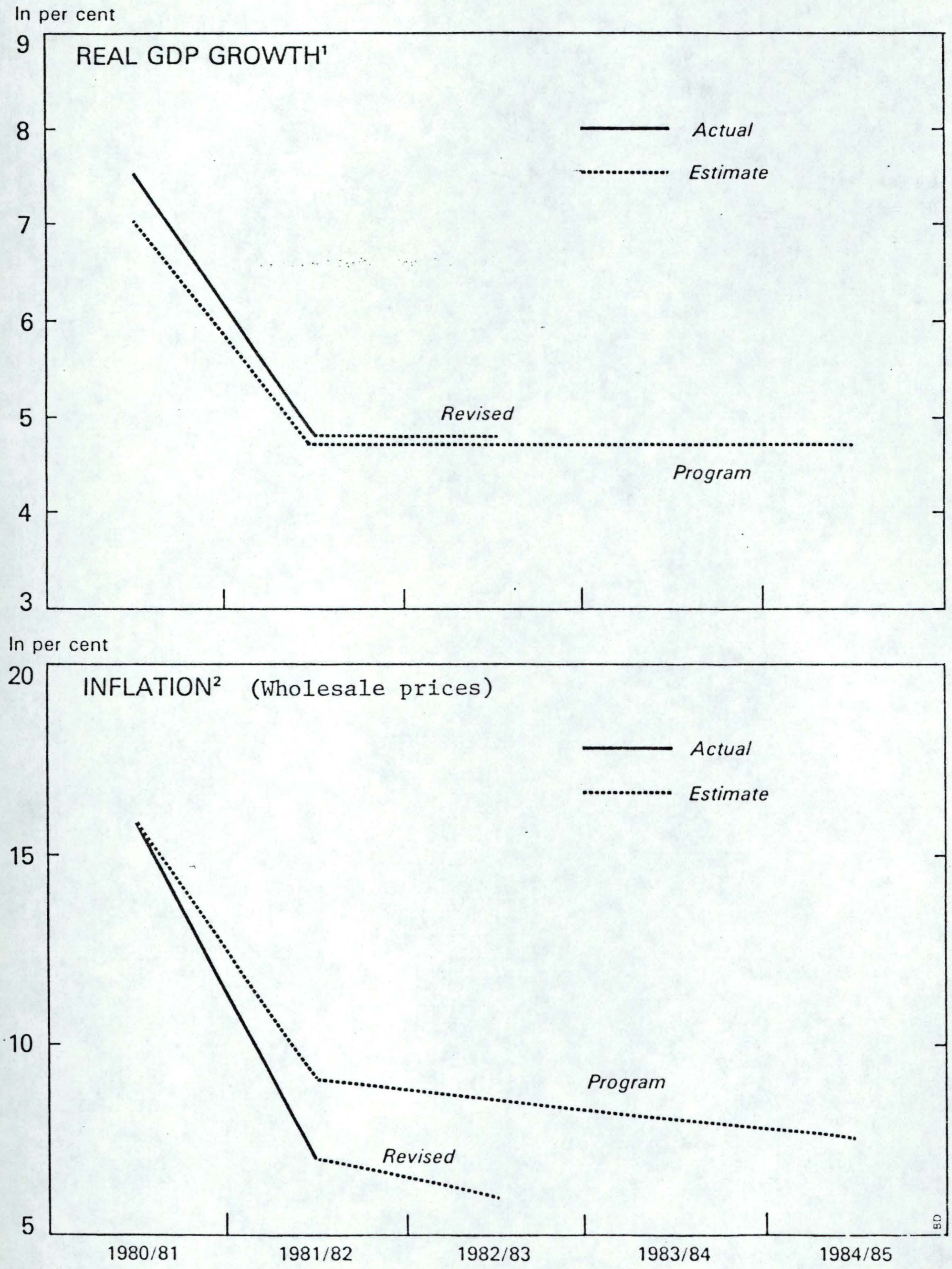
Controlling inflation is a critical objective. The sustained reduction in inflationary pressures over the past two years has been due mainly to the gradual restoration of aggregate supplies in the economy following the 1979/80 drought. Real growth slowed considerably in 1981/82, and although it is expected to remain in the 4.5-5.0 per cent range in 1982/83 (Chart 4), the recovery in domestic supplies is now essentially complete. Because of this, monetary policy has become, and will become more so, the focal point of policies to contain price increases. A feasible target for the coming year, bearing in view the special factors influencing the sharp fall in inflation in 1981/82, would be for an increase in wholesale prices of about 6-8 per cent.

The staff and the authorities agree that the narrow money stock is the most appropriate target aggregate in India for this purpose. With the new availability of a consistent data series, the staff is now able to orient monetary analysis toward a narrow money target and less toward broad money than in the original estimates. The growth in money supply slowed from 17 per cent in 1980/81 to 11 per cent in the latest 12-month period. Staff analysis suggests that the demand for narrow money will grow at a lower rate in 1982/83 because of the expected slower growth in nominal incomes. However, the magnitude of the slowdown in money demand would depend importantly on the extent to which the recent sharp reduction in inflation affects inflationary expectations--a point on which past experience does not provide an unequivocal guide. This issue will be examined further with the authorities. The reduction in inflationary expectations, together with increases in nominal interest rates, is

CHART 4

INDIA

REAL GDP GROWTH AND INFLATION, 1980/81-84/85



Source: EBS/81/198, Data provided by the Indian authorities, and staff projections.

[1] GDP at factor cost (at constant prices)

[2] Point to point at the end of fiscal years.

expected to result in somewhat faster growth in time deposits in 1982/83 than the current rate of 15 per cent. Thus, pending further discussions in India, the staff now estimates the appropriate increase in broad money in 1982/83 would be about the same as that programmed for 1981/82 (15.7 per cent), which would be somewhat above that originally projected for 1982/83 (14.5 per cent). On this basis, and taking account of the external deficit and other liabilities, the allowable increase in domestic credit would be about 18 per cent, broadly in line with the original program and about 1 per cent less than the increase allowed in 1981/82.

The authorities are likely to be particularly sensitive to the subceiling on net credit to Government. They argue that government expenditure financed by borrowing complements private activity, and also point to the broad institutional role of the banks in India as a channel for private savings to the public sector. The staff accepts the general validity of these points, but believes that increased government reliance on bank financing contributed to inflationary pressures over recent years, and that the structural aspects of the program require that the credit ceilings provide adequate room for the commercial sector.

The Central Government budget for 1982/83 implies a reduction in central government bank financing to about 2.6 per cent of GDP from 2.9 per cent in 1981/82. The program originally provided for Central Government bank financing of 3.0 per cent of GDP in 1982/83, although the staff has been of the opinion that a lower target would be desirable. The mission will aim to reach agreement on a target which is less than the original program estimate and as close as possible to the estimate implied by the recent budget. As noted above, some slippage from the budget estimates can be expected, although the program should aim to keep this to a minimum. The subceiling on net credit to Government will be based on this target, taking into account also borrowing from the banking system by the States. The allowance for State borrowing would be broadly in line with that provided in the original program (0.3 per cent of GDP). The subceiling would, on this basis, leave adequate room for the expansion of credit to the commercial sector.

5. Performance criteria and reviews

To summarize, it is proposed that the following performance criteria be included in the program for the second year:

(1) A phased ceiling on total domestic credit, and a phased subceiling on net credit to the Government. In line with the phasing proposed below, ceilings would be established for September 1982, December 1982 and March 1983.

(2) A ceiling on the official contracting of external debts with original maturities between 1 and 12 years, with a subceiling for maturities between 1 and 5 years.

(3) The usual understandings relating to exchange restrictions, multiple currency practices, bilateral payments agreements, and import restrictions for balance of payments reasons.

(4) A mid-term review to include, in particular, policies regarding:

(a) all aspects of export development,

(b) public resource mobilization and the public finance targets, and

(c) implementation of the more liberal import policy for 1982/83.

IV. Phasing

Mr. Palmer's draft phasing of purchases within the second and third program years with which you agreed was discussed with the authorities in January, and the mission's 48-hour report summarized the authorities' reaction. The revised draft in Attachment 1 modifies Mr. Palmer's earlier suggestion which provided for three equal purchases of SDR 600 million in the second program year. The revision has been made to allow for the timing of missions and Board discussions now expected. In essence, the final purchases earlier proposed in program 1982/83 (SDR 600 million in April 1983), has been divided into two, with the first SDR 300 million now being purchased in October subject to the September performance criteria. As a result, the number of purchases has been increased from three to four. The revised schedule maintains the objective that two drawings totalling SDR 1.2 billion would be subject to thorough reviews by the Board, and that the final purchase (April 30) depend on performance during the full financial year.

India: Draft Schedule of Purchases and Fund Missions

Timing of Fund Mission Visits	Purchase Date 1/ (not earlier than)	Amount (SDR mn.)	Conditions
1981	November 9	300	Board approval of the program through FY 1981/82.
1982	January 15	300	Observance of objective performance criteria on November 27, 1981.
January: Mission Consultation and Mid-Term Review	April 15 2/	300	Board discussion of consultation report. Board approval of the mid-term review of policies, plus observance of objective performance criteria on February 26, 1982.
April: Mission Discussion of FY 1982/83 Program	July 30	600	Board approval of the program for FY 1982/83 (including establishment and observance of objective performance criteria for the full fiscal year beginning April 1, 1982, and appraisal of nonquantified objectives for the full fiscal year), plus observance of objective performance criteria on March 26, 1982.3/
	October 30	300	Observance of objective performance criteria on September 24, 1982.
November: Mission Mid-Term Review	January 30, 1983	600	Board approval of the mid-term review of policies including appraisal of progress toward nonquantified objectives, plus observance of objective performance criteria on December 31, 1982.
1983	April 30	300	Observance of objective performance criteria on March 24, 1983.

(Continued)

India: Draft Schedule of Purchases and Fund Missions (Concluded)

Timing of Fund Mission Visits	Purchase Date 1/ (not earlier than)	Amount (SDR mn.)	Conditions
1983			
April: Mission Discussion of FY 1983/84 Program	July 30	500	Board approval of the program for FY 1983/84 (including establishment and observance of objective performance criteria for the full fiscal year beginning April 1, 1983, and appraisal of nonquantitative objectives for the full fiscal year).
	October 30	250	Observance of objective performance criteria on September 30, 1983.
November: Mission Consultation and Mid-Term Review	January 30, 1984	500	Board discussion of consultation report. Board approval of the mid-term review of policies, plus observance of objective performance criteria on December 30, 1983.
1984	April 30	250	Observance of objective performance criteria on March 30, 1984.
April: Mission Discussion of the Program through the end of the arrangement	July 30	400	Board approval of the program (including establishment and of objective criteria for the period beginning April 1, 1984 and extending through September 28, 1984 and appraisal of nonquantified objectives through the end of the arrangement).
	October 30	400	Observance of objective performance criteria on September 28, 1984.

1/ Actual purchase dates will be governed by paragraph 7 of the extended arrangement.
2/ This purchase is expected to be made on April 20.
3/ The text of the extended arrangement will have to be amended to make the March ceilings effective.

V. India: Fund Relations
(As of March 31, 1982)

Date of membership:	December 27, 1945.
Status:	Article XIV.
Quota:	SDR 1,717.5 million.
Fund holdings of rupees:	SDR 2,219.3 million (129.2 per cent of quota), including compensatory financing purchases of SDR 266 million (15.5 per cent), and purchases of SDR 600 million (34.9 per cent) under the extended arrangement.
SDR position:	Holdings amounted to SDR 425.1 million, or 62.4 per cent of net cumulative allocation of SDR 681.2 million.
Trust Fund loan disbursements:	SDR 529.0 million.
Direct distribution of profits from gold sales, July 1, 1976-July 31, 1980:	US$149.3 million.
Gold (from distribution):	804,429.4 fine ounces.
Exchange system:	Linked to a basket of currencies within 5 per cent margins. The current middle rate as of March 30, 1982 is Rs 16.70 = pound sterling 1.
Last Article IV consultation:	Article IV consultation and EFF review discussions were held during January 13-27, 1982. The staff report (EBS/82/44, 3/18/82) was discussed by the Board on April 15, 1982.

Table 1: Comparison of Selected Economic and Financial Indicators in Recent Selected Programs

			Current Program Year 1/ (Per cent of quota)						(Per cent of GDP)					
						Overall Balance			Current Account Deficit 4/			Overall Budget Deficit 4/		
Country	Date of Approval 2/	Type of Arrangement	Amount of Arrangement	Fund Credit Outstanding at Beginning Current Program Year 3/	Proposed Purchases During Current Program Year	Previous Year	Original Target	Current Target	Previous Year	Original Target	Current Target	Previous Year	Original Target	Current Target
India	11/81	EFF	291	52	105	-141	-117	-90	2.4	2.0	2.1	6.0	6.6	5.3-6.0
Comparator Countries														
Bangladesh	12/80	EFF	351	116	117	-81	-107	-84	10.9	12.6	11.7	10.6	10.1	8.1
Ivory Coast	2/81	EFF	450	180	155	-409	-135	-303	17.6	12.0	15.8	12.2	8.6	8.8
Jamaica	4/81	EFF	430	313	135	7	28	36	16.5	9.5	14.8	14.9	...	12.9
Morocco	Proposed	SB	125	147	87	-92	-180	-180	12.5	9.9	9.9	14.6	8.2	8.2
Pakistan	12/81	EFF	297	25	128	-4	-97	-52	3.3	4.9	4.1	4.6	5.3	5.1
Yugoslavia	1/81	SB	400	190	133	-83	-124	-124	1.2	0.8	0.8	0.1	-0.1	-0.1
Zaire	6/81	EFF	400	43	149	-263	-140	-227	9.8	4.6	8.2	5.6	1.0	1.0

Sources: Board papers; and staff estimates.

1/ Current program year refers to the year for which the program is to be negotiated, or the program currently in operation. Original targets refer to targets established in original multiyear arrangement. When targets have been specified under a program to be canceled and a new program is under consideration, original targets refer to the old program.
2/ Date of approval of current arrangement.
3/ Fund credit outstanding, excluding CFF, cereal, oil, and buffer stock facilities, as a per cent of quota prior to beginning of current program year.
4/ Net of official transfers. Values may not coincide with those in staff papers, due to different definition used for intercountry comparison.

Table 1 (Concluded): Comparison of Selected Economic and Financial Indicators in Recent Selected Programs

			Current Program Year 1/										
			(Per cent per year)						(Per cent of M2)				
			Real GDP Growth			Inflation			Domestic Credit Expansion 3/				
Country	Date of Approval 2/	Type of Arrangement	Previous Year	Original Target	Current Target	Previous Year	Original Target	Current Target	Previous Year	Original Target	Current Target	Actual Debt Service Ratio 4/	Actual Reserves/ Imports 5/
India	11/81	EFF	4.5-5.0	4.8	4.5-5.0	8.0	9.0	6.0	21.5	21.2	20.9	7.8	4.0
Comparator Countries													
Bangladesh	12/80	EFF	7.4	7.2	1.0	11.2	11.0	16.0	44.4	38.9	39.0	17	5
Ivory Coast	2/81	EFF	1.4	3.0	3.0	4.7	9.0	10.7	39.6	...	36.1	30	1
Jamaica	4/81	EFF	1.9	4.0	5.2	10.0	...	9.8	-17.0	...	-3.1	21	5
Morocco	Proposed	SB	-1.5	4.0	4.0	12.5	12.0	12.0	20.2	14.6	14.6	35	3
Pakistan	12/81	EFF	5.7	5.7	6.1	11.6	10.0	10.0	13.8	17.5	17.5	23	11
Yugoslavia	1/81	SB	2.2	2.5	2.5	2.5	39.0	15.0	22.7	17.4	17.4	23	6
Zaire	6/81	EFF	1.1	4.0	2.0	35.4	35.0	35.0	54.4	...	...	27	16

Sources: Board papers; and staff estimates.

1/ Current program year refers to the year for which the program is to be negotiated or the program currently in operation. Original targets refer to targets established in original multiyear arrangement. When targets have been specified under a program to be canceled and a new program is under consideration, original targets refer to the old program.

2/ Date of approval of current arrangement.

3/ Domestic credit or NDA expansion as per cent of broad money outstanding at beginning of period.

4/ Data for most recently available year. Debt service (contractual amounts, net of rescheduling and including Fund obligations) as a percentage of exports of goods and services.

5/ Data for most recently available year. Gross official reserves in weeks of imports.

Table 2: Comparison of Selected Economic and Financial Indicators in Recent Selected Programs

			Year Preceding Current Program Year 1/													
			(Per cent of quota)		(Per cent of GDP)						(Per cent per year)				(Per cent of M2)	
	Date of	Type of	Overall Balance		Current Account Deficit 3/			Overall Budget Deficit 3/			Real GDP Growth		Inflation		Domestic Credit Expansion 5/	
Country	Approval 2/	Arrangement	Target	Actual	Target	Actual	Deviation 4/	Target	Actual	Deviation 4/	Target	Actual	Target	Actual	Target	Actual
India	11/81	EFF	-98	-141	2.0	2.4	0.4	6.4	6.0	-0.4	4.8	4.5-5.0	11.0	8.0	21.8	21.5
Comparator Countries																
Bangladesh	12/80	EFF	-112	-81	13.1	10.9	-2.4	11.5	10.6	-1.0	7.2	7.4	11.0	11.2	28.7	44.4
Ivory Coast	2/81	EFF	-313	-409	15.7	17.6	-0.7	10.8	12.2	0.3	1.5	1.4	7.3	4.7	30.4	39.6
Jamaica	4/81	EFF	28	7	9.9	16.5	2.8	13.3	14.9	-1.8	3.8	1.9	18.0	10.0	6.0	-17.0
Morocco	3/81	EFF	-153	-92	6.5	12.5	4.7	7.4	14.6	7.0	4.5	-1.5	11.0	12.5	11.9	16.4
Pakistan	12/81	EFF	-63	-4	5.7	3.3	-2.5	5.2	4.6	-0.6	5.5	5.7	10.0	11.6	17.8	13.8
Yugoslavia	1/81	SBA	-73	-83	2.5	1.2	-1.5	0.1	0.1	--	3.2	2.2	20.0	39.0	22.2	22.7
Zaire	6/81	EFF	-197	-263	5.9	9.8	3.9	2.9	5.6	3.8	2.0	1.1	45.0	35.4	39.0	54.4

Sources: Board papers; and staff estimates.

1/ Year preceding current program refers to previous year within the arrangement under operation, or year prior to program under negotiation, when applicable. Targets for previous years are only defined when available under an arrangement (including canceled programs) and refer to most recently revised magnitudes.

2/ Date of approval of arrangement in operation during current program year.

3/ Net of official transfers. Values may not coincide with those in staff papers, due to different definitions used for inter-country comparison.

4/ Deviation of actual from original target as a percentage of original GDP target.

5/ Domestic credit or NDA expansion as per cent of broad money outstanding at beginning of period.

cc: Mr. Palmer

INTERNATIONAL MONETARY FUND

March 18, 1982

ETR
FAD
LEG
SEC
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CDF
1) ~~MG~~
2) BF

Attached are anoted copies of the MD and DMD on India--Extended Arrangement.

Attachments

cc: Mr. Carter

RECEIVED
MAR 18 1982
EXCHANGE & TRADE RELATIONS

Tun Thin

INTERNATIONAL MONETARY FUND

March 16, 1982

TO : THE MANAGING DIRECTOR

FROM: Williams B. Dale

Subject: India-- Staff Report for 1982 Art. IV
And EFF Review

I find this a good and thorough paper. Public savings by the centre were not fully up to target, but state and private savings seem, on present evidence, to have exceeded expectations. Overall fiscal and monetary performance has been good. On the whole, the structural measures are on track.

The BOP performance was worse than expected, mostly for price reasons, but the prospect for 1982/83 seems to be for it coming back almost to original track. Import liberalization will be important in the second year program. I recommend approval.

M. Dale
Mr. Narasimham would like the discussion to take place in the Board on April 15 (Thursday).
Yes
JL
March15

→ N. Dale (1)
Mr. Narasimham would like the discussion to take place in the Board on April 15 (Thurs)

Office Memorandum

CONFIDENTIAL

TO : The Managing Director

DATE: March 15, 1982

FROM : Tun Thin TT.

SUBJECT : India - Extended Arrangement

15 — yes

JR March 1

As I indicated in the 48-hour report following the recent mission to India, a team of Indian officials visited Washington during March 2-9, 1982, primarily to discuss the government budget for 1982/83 which was presented to Parliament on February 27.

As you noted in your response to the mission's 48-hour report, the postponement of the Board discussion occasioned by the timing of the 1982/83 budget should only be for a very short while. Under the "four-week rule", Board discussion could be envisaged in mid-April. A postponement to April 26, as suggested because of the congested schedule of Board meetings at that time, would have the following implications: Because of conflict with the Asian Development Bank meeting in Manila (April 28-30), and the Helsinki meetings (May 9-14), it would force a postponement of the discussions with the authorities for the program for the second year, now envisioned for April 21-May 7, until May 17-31. This would make it impossible for the Board to consider the second year's program before the Board recess (July 19-30). You will recall that the authorities are anxious that the second year's program be in place before Mr. Narasimham's final return to New Delhi, which cannot be postponed beyond the Board recess. For these reasons, while recognizing the serious inconvenience, it would seem desirable to schedule the Indian report for consideration before April 16.

As to the other points you raised, the difficult timing of the recent mission was made necessary by unexpected delays in finalizing the program for the first year. We intend that future review missions will take place at more appropriate times. The timing of reviews is also linked to the issue of phasing. The extended arrangement provides that purchases will not exceed SDR 900 million before June 30, 1982, and SDR 2,700 million until June 30, 1983, and that purchases during the period from July 1, 1982 to June 30, 1983 and from July 1, 1983 to the end of the extended arrangement (November 8, 1984) will be subject to such phasing as shall be determined. To date a decision has not been taken on the detailed phasing (dates and amounts) within the second year and in the third year and up until November 1984. This matter will be dealt with in the briefing paper for the forthcoming mission.

cc: The Deputy Managing Director
Mr. Carter
ETR
FAD
LEG
SEC
TRE

MAR 16 1982

INTERNATIONAL MONETARY FUND

March 16, 1982

discussion 15 April

TO : THE MANAGING DIRECTOR

FROM: WILLIAM B. DALE WBD

SUBJECT: India -- Staff Report for 1982 Art. IV And EFF Review

I find this a good and thorough paper. Public savings by the Centre were not fully up to target, but State and private savings seem, on present evidence, to have exceeded expectations. Overall fiscal and monetary performance has been good. On the whole, the structural measures are on track.

The BOP performance was worse than expected, mostly for price reasons, but the prospect for 1982/83 seems to be for at coming back almost to original track. Import liberalization will be important in the second year program.

I recommend approval.

Office Memorandum CONFIDENTIAL

TO : The Acting Managing Director DATE: February 3, 1982

FROM : Tun Thin

SUBJECT : India--1982 Article IV Consultation Discussions and Review of Extended Arrangement

I headed a mission to India during January 13-27 to conduct the 1982 Article IV consultation discussions and to review performance under the extended arrangement approved on November 9, 1981. The mission included Messrs. Smith, Villanueva, Kim, and Gunjal (all ASD), Ms. Kelly (FAD), Mr. Hino (ETR), Ms. Chin (secretary, FAD), and Mr. Harrison (IBRD). The Indian representatives included Economic Affairs Secretary Malhotra, Planning Commission Member/Secretary Manmohan Singh, and Finance Ministry Chief Economic Advisor, Bimal Jalan. Mr. Narasimham participated in the discussions.

During our stay in Delhi, the Prime Minister announced a Cabinet reshuffle. Among the key changes were the move of Finance Minister Venkataraman to Defense, with Pranab Mukherjee shifting from Commerce to Finance. Also, the Prime Minister announced the new 20-point economic program of the Government which includes two new points of particular significance: (1) liberalization of investment procedures and the streamlining of industrial policies, and (2) improvement in the efficiency of public sector enterprises.

India met the performance criteria set for November 27, 1981 and on January 15, 1982 made the second purchase of SDR 300 million under the EFF.

1. Economic situation

The Indian economy has continued to recover from the set-back in 1979/80 and is estimated to grow by 4.5 per cent in 1981/82, broadly in line with the program target of 4.7 per cent. There has been a strong expansion in industrial output, aided by the general easing of infrastructural bottlenecks, particularly in the coal, power, and railway sectors. Labor relations appear to have improved. Foodgrain output is now expected to be 134 million tons, somewhat below the target of 138.5 million tons, because a dry spell reduced yields from the autumn crops. Real public investment has been broadly in line with, and in some cases will exceed program targets for 1981/82. Considerable lending by term-lending institutions and substantial issues of debentures by corporations suggest that private investment is also buoyant.

Inflation (point-to-point) is expected to be 7-8 per cent in 1981/82, well below the program projection of 11 per cent and considerably lower than the rate of 15.4 per cent in 1980/81. The general easing of inflationary pressures, which mainly reflects the improved supply position, is also associated with restrained financial policies. The expansion in narrow money in the first nine months of 1981/82 was 5.2 per cent, compared with 8.6 per cent in the same period of 1980/81; broad money expansion slowed to 15 per cent in 1981, in line with the program target of 15.7 per cent for 1981/82. Credit policies have been progressively tightened since mid-1981 in response to a rapid growth in commercial credit early in the year. There have been some increases in expenditures from the original budget, but the Central Government budget and borrowing from the banking system to finance the deficit, have evolved broadly in line with the program estimates, and although firm estimates are not yet available, the authorities are confident of observing the February and March ceilings on total domestic credit and the subceiling on net credit to Government.

The current deficit in the balance of payments seems likely to be in line with the program target of 2 per cent of GDP in 1981/82. The target growth of 5 per cent in export volume is also likely to be exceeded. However, imports are rising more slowly than programmed, reflecting in part the resurgence in domestic supplies; the import system remains largely unchanged. Net earnings from invisibles are now expected to decline sharply, reflecting lower investment income on foreign reserves and some reduction in remittances from Indian workers abroad from last year's high level which was affected by the repatriation of workers from some countries. The authorities now estimate the overall deficit at SDR 2.1 billion, somewhat higher than the programmed level of SDR 1.7 billion. International reserves have fallen from SDR 5.9 billion in March 1981 to SDR 4.4 billion at end-December. Reserves currently cover four months of imports, compared with six months a year ago.

2. Report on the discussions

The review provisions of the EFF cover, in particular, the areas of: (1) resource mobilization, including interest rates, and the pricing policies of both the Centre and the States, and (2) all aspects of export development. Although data are not yet fully available, the mission's tentative assessment is that the adjustment program is broadly on track. The gap in information relates to 1981/82 revised budgetary data which will be available only on February 27 when the 1982/83 budget is presented to Parliament. However, on the basis of some tentative figures given to the mission, it appears that most of the targets for the public sector will be achieved. Firm conclusions can only be reached after we discuss and analyze the revised budget estimates for 1981/82 with Indian representatives who will visit Washington for this purpose in the first week of March. This will necessarily involve a postponement in the Board discussion which had been tentatively slated for March 24.

The outlook for 1982/83, as far as can be seen at present, is also broadly in line with the program projections. Given favorable weather, overall growth should again be 4-5 per cent, and inflation would be largely unchanged at 7-8 per cent which would again be less than originally projected. On external account, the authorities do not expect that the somewhat more adverse developments in the current year will recur, and revised balance of payments estimates for 1982/83 are broadly in line with the program projections.

(1) Budgetary policy and resource mobilization

For the Central Government budget, on the basis of the available information, it appears that the targets for the overall deficit and its bank financing component will be met. The mission was unable to assess developments in Central budget savings, which will be reviewed in Washington when revised 1981/82 budget estimates are available. However, it appears that the savings efforts of the public sector enterprises have been broadly in line with the program estimate for 1981/82. Also, the States have performed somewhat better than expected. Their total resource mobilization efforts have exceeded the original projection, and although expenditures have also risen, the State savings targets will be met.

Because of the timing, it was not possible to have detailed discussions on budgetary policy in 1982/83. However, the mission suggested that, in the interests of consolidating the control over inflation while supporting commercial sector activity, there was scope to tighten budget financing policies further. To this end, a larger reduction than the currently envisaged marginal cut (from 3.1 to 3.0 per cent of GDP) in Central Government deficit financing from the banking system should be considered in 1982/83. The authorities indicated they would give consideration to these views. However, they emphasized that, rather than "crowding out" the commercial sector, expenditures financed by public sector borrowing generally played a complementary role supporting commercial activity. They agreed that controlling inflation was critical, but believe that there is sizable scope for government borrowing from the banks while maintaining an appropriately tight rein on the expansion of narrow money.

(2) Pricing and industrial policy

There have been several further price adjustments recently. The coal rail tariff was raised by 10 per cent in October 1981, thus indirectly raising coal prices. Effective December 3, 1981, aluminum retention prices were raised by 18-20 per cent, and on December 24, 1981, the price of white printing paper was raised by 20 per cent. Most importantly, effective January 1, 1982, railway freights were increased by 10-15 per cent to mobilize additional resources to cover rising costs and protect self-financed investment levels of the railways. There appears to have been progress in raising electricity tariffs in a number of States and further action is likely to follow recommendations from the World Bank. The authorities were noncommittal about the possibility of a further increase in coal prices, although it appears that action in the area of cement pricing is likely shortly. Few new initiatives in policies relating to private investment have been taken in 1981/82, with the focus of efforts being on implementing the major steps introduced in 1980/81. The authorities indicated the need for some stability in industrial policies, and that changes were best introduced in steps. However, further measures are under consideration and, with the new 20-point program, the Government is now publicly committed to reducing constraints on the private sector.

(3) Private savings

Available evidence suggests that private savings performance has been favorable in 1981/82. Following the upward adjustment in some bank deposit rates in 1981 and the recent slowing in inflation, real interest rates on bank deposits have become more favorable. Partly as a result, the growth in time deposits in the first three quarters of 1981/82 (15 per cent) has been proceeding in line with that envisaged in the financial progam. Outside the banking system, financial savings in the form of company deposits and debentures have risen sharply, partly because of an increase in the ceiling rate on debentures. Other forms of private savings also appear to have increased.

(4) Export policies

Exports are estimated to have grown in volume terms by 7 per cent in the first half of 1981/82. It therefore seems likely that the program target of 5 per cent for the year as a whole will be achieved. The favorable export performance reflects the improved supply position, especially for agricultural items where growth rates have rebounded. However, export policies have been fully supportive. The trade-weighted effective exchange rate depreciated by 5 per cent in 1981, and with the improved relative price performance over recent months, there has been a noticeable improvement in real terms. The rupee's position vis-a-vis competitor country currencies has also strengthened. In addition, the premium provided by export incentives appears to have increased and the downward drift in export prices relative to those in the home market (largely reflecting terms of trade developments) appears to have been arrested. The authorities have reiterated their intention to continue to strengthen export policies in the future.

(5) Production and investment policies

With the notable exception of electric power, additions to capacity in key sectors have been in line with, or have exceeded, program targets established for 1981/82. Delays in the delivery of equipment appear to be the main reason for the underachievement by a wide margin of the target for new electricity-generating capacity. However, there has been a significant improvement in capacity utilization rates reflecting better management, which will mitigate the adverse impact on power supplies. There has been a considerable improvement in the efficiency of the railways due to better management. The authorities concede that a continuation of this improvement will require a step-up in investment after years of neglect, and although some steps toward this have been initiated, resource constraints will limit possible progress.

(6) Phasing of purchases

The proposed phasing of purchases for the second and third years of the program was discussed (Mr. Palmer's memorandum of January 8). Mr. Malhotra made two main comments. First, the level of international reserves has important implications for domestic and international confidence. With this in view, he requested that the substantial reserve loss in 1981/82, which will be considerably larger than expected, be taken into consideration when the schedule of purchases for 1982/83 is set. Second, published official statistics refer principally to developments during fiscal years. Confidence and ultimately the Government's ability to carry through its program can be aided by favorable presentation of reserve developments. Also, foreign exchange budgeting is made on a fiscal year basis. For these reasons, he would much prefer that drawings suggested for April in both 1983 and 1984 be advanced slightly so that they come before the end of the financial year in March. They suggested that this matter be taken up again during the negotiations for the second year's program in April.

cc: The Managing Director (on return)
Mr. Carter
ETR
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RES
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Office Memorandum

TO : The Managing Director DATE: January 8, 1982

FROM : Donald K. Palmer Jr.

SUBJECT : India - Schedule of Purchases, Missions, and Balance of Payments Timing

Mr. Palmer
Mr. Tun Thin
I agree

The briefing paper does not include one issue which I would like to bring to your attention.

Upon your return from China, Mr. Dale reported to you on the intensive bilateral discussions which had taken place with several Executive Directors. In addition to issues relating to conditionality, we were asked a number of questions on balance of payments need, phasing of purchases, reviews, program periods, and the timing of Fund purchases on India's balance of payments. In the course of answering these questions, it became evident that some doubting Directors (especially Germany, the United States, and the United Kingdom) wanted to have these responses in a more official written form. Mr. Dale asked the staff to prepare a supplement which would incorporate the substance of the staff replies. He mentioned to Mr. Narasimham that a supplement would be issued and briefly described its contents; Mr. Narasimham objected strongly, expressing concern that it would be seen in New Delhi as a "reopening" of the negotiations.

I recommended that the supplement contain the schedule dated October 28 (attached) which had been agreed with the Legal and Treasurer's Departments. The Asian Department did not agree with this approach. Because the supplement was already late, the differences of views were compromised by including three paragraphs on pages 4 and 5 of Supplement 2 (also attached). (In order to clarify the substantive importance of these three paragraphs and of the attached October 28 schedule, also attached are Tables A and B which show the changes which could have been made in the original staff paper to reflect the practical implications of the detailed schedule.)

yes

I believe that the forthcoming mission provides a timely opportunity for the staff to inform the Indian authorities as to the plans of the Fund management with respect to the timing of negotiations, reviews, and purchases over the remainder of the three-year arrangement. In the absence of such a clarification, there could remain a potential for misunderstanding, which could arise in April on the occasion of the negotiation of the second-year program.

Attachments

cc: The Deputy Managing Director (on return)
Messrs. Tun Thin, Evans, Smith, and Wittich
Mr. Carter

Office Memorandum

TO : Mr. Tun Thin

DATE November 13, 1981

FROM : Donald K. Palmer

SUBJECT : India - Tentative Schedule of Purchases and Fund Missions

In the course of reviewing my files on the Indian program, I came across the attached "Tentative Schedule of Purchases and Fund Missions."

I wish to record my understanding that this material was excluded from Supplement 2 of EBS/81/198 in order to accommodate the sensitivities of the Indian authorities and not for any substantive reasons. Of course the numbers for any particular program period may need to be reviewed in the light of actual balance of payments developments, which could imply adjustment in either direction.

Attachment

cc: The Deputy Managing Director
Mr. Finch

October 28, 1981

India: Tentative Schedule of Purchases and Fund Missions

Timing of Fund Mission Visits	Purchase Date 1/ (not earlier than)	Amount (In millions of SDRs)	Conditions
1981			
	November 9	300	Board approval of the program through FY 1981/82.
1982			
	January 15	300	Observance of objective performance criteria on November 27, 1981.
January: Mission Consultation and Mid-Term Review			
	March 25	300	Board discussion of consultation report. Board approval of the mid-term review of policies, plus observance of objective performance criteria on February 26, 1982.
April: Mission Discussion of FY 1982/83 Program			
	June 30	600	Board approval of the program for FY 1982/83 (including establishment and observance of objective performance criteria for the full fiscal year beginning April 1, 1982, and appraisal of nonquantified objectives for the full fiscal year), plus observance of objective performance criteria on March 26, 1981, plus compliance with any performance criteria established in the January review.
October: Mission Mid-Term Review			
	November 30	600	Board approval of the mid-term review of policies including appraisal of progress toward nonquantified objectives, plus observance of objective performance criteria on October 1, 1982.
1983			
	April 30	600	Observance of objective performance criteria on April 1, 1983.

India: Tentative Schedule of Purchases and Fund Missions (Continued)

Timing of Fund Mission Visits	Purchase Date 1/ (not earlier than)	Amount (In millions of SDRs)	Conditions
1983			
April: Mission Discussion of FY 1983/84 Program			
	June 30	500	Board approval of the program for FY 1983/84 (including establishment and observance of objective performance criteria for the full fiscal year beginning April 1, 1982 and appraisal of nonquantified objectives for the full fiscal year).
October: Mission Consultation and Mid-Term Review			
	November 30	500	Board discussion of consultation report. Board approval of the mid-term review of policies, plus observance of objective performance criteria on September 30, 1983.
1984			
	April 30	500	Observance of objective performance criteria on March 30, 1984.
April: Mission Discussion of the Program through the end of the Arrangement			
	June 30	400	Board approval of the program (including establishment and observance of objective performance criteria for the period beginning April 1, 1984 and extending through September 28, 1984 and appraisal of nonquantified objectives through the end of the arrangement).
	October 31	400	Observance of objective performance criteria on September 28, 1984.

1/ Actual purchase dates will be governed by paragraph 7 of the extended arrangement.

The analysis uses 1978/79 as a base, which was the year prior to the adverse balance of payments shift, and was also a year in which the balance of payments was in approximate overall balance. It indicates that the balance of payments loss deriving from the excess of actual and projected import prices for these items over the levels which would have resulted had increases been in line with world inflation rates, would be as follows:

	Estimated Terms of Trade Loss (In billions of SDRs)
1981/82	2.7
1982/83	2.8
1983/84	3.4
1984/85	3.7

It is readily seen that the estimated cost to the balance of payments from the adverse shift in the terms of trade, which amounts to 1.7-1.8 per cent of GDP in each year, is substantially in excess of the financing to be provided by the Fund during the EFF program period. It is also substantially in excess of the projected overall deficits, which reflects both progress in achieving external adjustment, and especially in 1984/85, sizable project-related borrowings.

One question relates to the following sentence which appears in the final paragraph of the letter of the Finance Minister to the Managing Director, dated September 28, 1981 (see page 54 of EBS/81/198).

> "In particular, the Government will review with the Fund the progress made in implementing the program, normally about midway through each year, as part of the ongoing dialogue with the Fund."

The staff paper proposes a total amount of SDR 5 billion for the duration of the extended arrangement and proposes that until June 30, 1983 purchases shall not exceed SDR 2,700 million, and further proposes that purchases during the period from July 1, 1982 to June 30, 1983 and from July 1, 1983 to the end of the extended arrangement (November 8, 1984) shall be subject to such phasing and shall be determined. Of the total amount of SDR 5 billion requested by India, SDR 900 million would be available in support of the program through March 1982. While the phasing and timing of missions during the first program period has been proposed, the paper does not deal with the timing of future Fund missions, including mid-term review missions, and the periodic phasing of purchases through the end of the proposed arrangement.

As in the case of similar arrangements, it is expected that a Fund mission will visit India to discuss programs for each of the Indian fiscal years 1982/83 and 1983/84, which begins April 1, and also for the remaining period through the end of the arrangement. With respect to each of the FY 1982/83 and 1983/84 programs, it is expected that a Fund mission will visit India for a mid-term review of policies in each such year. Under normal procedures, the Executive Board would consider each of the programs and each of the mid-term reviews in order to take decisions relating to the program and the periodic phasing of purchases from the Fund and the performance conditions applicable to those purchases.

Another question relates to the possible effect of the timing of Fund purchases on India's balance of payments. At the time of the preparation of Table 2 of EBS/81/198 it had been assumed that the timing of purchases from the Fund would be such that the full SDR 5 billion would be purchased before the end of the Indian fiscal year 1983/84. As explained above, the proposed extended arrangement covers a longer period of time and, in accordance with normal Fund practice, it is expected that purchases will be phased over the duration of the arrangement, with a substantial amount to be scheduled for purchase between the end of FY 1983/84 and the end of the extended arrangement.

An additional question relates to the projected financing of India's balance of payments by drawing down its gross international reserves. On the basis of the present balance of payments projections, total gross international reserves are projected to decline by SDR 2.3 billion during the period April 1981 to March 1985, with the foreign exchange component projected to fall from SDR 5.5 billion 1/ to SDR 3.2 billion. The substantial extent of projected use of gross reserves is indicated by the implied decline in import coverage of reserves of the equivalent of about three months of imports over the four-year period.

III Pricing System for Major Commodities

The following information has been prepared in response to questions concerning the scope, administration, and objectives of official pricing policies in India.

The Indian price control regime covers a range of producer and consumer goods. Backed by the Industries (Development and Regulation) Act of 1951 and the Essential Commodities Act of 1955, the regime has been an important feature of the Indian economy since the inception of economic planning in the 1950s. Price control was intensified during the early 1960s when there were sharp rises in prices of essential goods

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1/ India's gold holdings on March 31, 1981 were 1.64 million ounces, or the equivalent of SDR 0.3 billion if valued at SDR 35 per ounce. Valuation at market prices, or at some intermediate price, would yield a substantially higher figure for the value of India's gold holdings.

Table A. India: Balance of Payments--Monetary Movements

(In millions of SDRs)

	1981/82	1982/83	1983/84	1984/85
Monetary movements (Increase in assets -)	1,683	2,024	2,655	793
IMF - purchases	900	1,200	1,600	1,300
- repurchases	--	--	-66	-100
Other	783	824	1,121	-407

In response to a question, the timing of purchases from the Fund may be presented in alternative forms:

Table B. India: Timing of Fund Purchases

(In millions of SDRs)

Indian Fiscal Years		During the Arrangement	
1981/82	900		
		November 9, 1981-November 8, 1982	1,500
1982/83	1,200		
		November 9, 1982-November 8, 1983	1,700
1983/84	1,600		
		November 9, 1983-November 8, 1984	1,800
1984/85	1,300		
	5,000		5,000

Mr. Finch / BF
JAN 8 1982

Office Memorandum

TO : The Managing Director

DATE: January 8, 1982

FROM : Tun Thin

SUBJECT : India--Briefing Paper for Article IV Consultation and EFF Review

Attached for your approval is a Briefing Paper for the Article IV Consultation and EFF review with India. The paper includes the comments from Messrs. Tanzi (FAD), Wittich (TRE), and Liuksila (LEG). Mr. Palmer intends to raise an additional issue in a separate memorandum.

I will be leaving Washington on Friday, January 15.

Attachment

cc: The Deputy Managing Director (on return)
Mr. Carter
ETR
FAD
LEG
TRE

INTERNATIONAL MONETARY FUND

Mr. Tun Thin:

p. 1 - Very good paper, see a few observations, and also my remarks on Mr. Palmer's note.

p. 3 - is that not a worrying shift? (squeezing productive private sector because of growing budgetary deficit?)

p. 4 - why?

p. 5 - this is very important

p. 6 - yes - in all the following questions one should be guided by the World Bank's advice

p. 9 - yes, this is fundamental

p.10 - yes

p.13 - yes

INTERNATIONAL MONETARY FUND

INDIA

Briefing Paper--1982 Article IV Consultation and Review of Extended Arrangement

Prepared by the Asian, Exchange and Trade Relations, and Fiscal Affairs Departments

Approved by Tun Thin and Donald K. Palmer

January 8, 1982

I. Introduction

Messrs. Tun Thin (Head), Smith, Villanueva, Kim and Gunjal (all ASD), Hino (ETR), Ms. Kelly (FAD), and Ms. Chin (FAD, secretary) will visit Bombay and New Delhi during January 13-27 to hold the 1982 Article IV Consultation discussions and review performance under the extended arrangement approved on November 9, 1981.

India met the performance criteria set for November 27, 1981 and is eligible to make the second purchase of SDR 300 million under the EFF on January 15, 1982 (Table 1).

II. Recent Economic Developments

Information on recent economic developments was updated in EBS/81/198, Supplement 2, and only limited additional details are available. Briefly, the current economic situation can be characterized as one in which output is expanding strongly, especially in the nonagricultural sectors, and severe bottlenecks are, for the moment, less constraining. It appears that the rate of growth of 4.8 per cent projected in the program for 1981/82 can be achieved (Table 2). Financial policies are restraining demand in line with the program objective, and following recent steps to tighten further credit

IND.A-15 Doc.3 (1/8/82)

Table 1. India: Quantitative Performance Criteria for the 1981/82 Program 1/

	March 1981 (Base)	November 27, 1981 Actual	November 27, 1981 Program	February 26, 1982 Program	March 26, 1982 Program
				(In billions of rupees)	
1. Bank credit					
Domestic credit	621.26	690.56	703.59	733.20	741.81
	(25)	(22)	(25)	(23)	(19)
Net credit to Government (subceiling)	258.06	288.29	294.29	304.64	309.81
	(34)	(24)	(26)	(28)	(20)
				(In millions of SDRs)	
2. External borrowing					
Maturities between 1 and 12 years		106.3 2/	1,400.0	1,400.0	1,400.0
Maturities between 1 and 5 years (subceiling)		0.6 2/	400.0	400.0	400.0

Sources: Data provided by the Indian authorities and EBS/81/198.

1/ Figures in parentheses are percentage changes over 12 months.

2/ Dollar figures reported by the authorities have been converted into SDRs at the end-November conversion rate of US$1.181 = SDR 1.

Table 2. India: Selected Economic and Financial Indicators, 1978/79-1981/82

	1978/79	1979/80	1980/81 (Prov.)	1981/82 Program estimate
	(Percentage changes)			
Real growth rates				
GDP at factor cost	5.9	-4.5	7.0	4.8
Agriculture	1.8	-11.8	14.0	1.4
Manufacturing	14.2	-1.9	4.1	7.3
Inflation 1/	3.3	23.3	15.4	11.0
Broad money (M3) 2/	21.2	17.3	18.2	15.7
Domestic credit	17.4	22.4	24.6	19.4
Net credit to Government	14.3	25.0	34.2	20.1
Exports (f.o.b.)	3.1	12.3	13.3	16.2
Imports (c.i.f.)	10.0	30.1	41.2	12.4
	(In per cent)			
Ratios				
Savings				
Gross domestic savings/GDP	23.9	21.2	23.7	23.7
Public savings/GDP	4.8	3.7	3.6	4.5
Central government savings/GDP	...	...	2.3	3.0
Gross capital formation/GDP	23.7	21.8	25.5	25.7
Central Government overall deficit/GDP	5.2	6.2	6.2	6.2
Of which: Bank financing	2.5	3.3	3.4	3.1
Current account balance/GDP	0.6	-0.3	-2.0	-2.0
External debt service/current account receipts 3/	10.5	9.0	8.2	8.1
External debt/GDP 4/5/	12.7	12.0	10.7	10.1
	(In billions of SDRs)			
Current account balance (deficit -)	0.5	-0.3	-2.6	-3.0
Overall balance (deficit -)	1.1	0.2	-0.7	-1.7
Gross official reserves 5/6/	5.7	6.1	5.9	5.1

Sources: Data provided by the Indian authorities and EBS/81/198.

1/ End-year percentage increase in the wholesale price index.
2/ End-year percentage increase.
3/ Excluding debt service payments to the Fund.
4/ Excluding Fund credit.
5/ Outstandings at the end of period.
6/ Gold is valued at SDR 35 per ounce.

policies, the commercial sector may be beginning to experience a moderate financial squeeze. Inflationary pressures are continuing to ease and the current inflation rate of 7 per cent is well below the program target of 11 per cent by the end of the year. However, on the external front, the balance of payments deficit during the first eight months of 1981/82 (fiscal year April-March) reached SDR 1.6 billion and is expected to exceed the program estimate of SDR 1.7 billion for the year as a whole.

The current year is likely to prove to be a fairly good, but by no means exceptional, year for agriculture. A dry spell reduced yields from the 1981 kharif (autumn) harvest which, at some 77.4 million tons, is expected to be below the 1978/79 record. However, conditions for the rabi (spring) crop are favorable, and food production is now expected to be 135-136 million tons. Although somewhat less than the target of 138.5 million tons, this would be 2-3 per cent above the 1980/81 level. Prospects for nonfoodgrain crops--especially sugarcane and groundnuts--are for a substantial production increase in the current year.

The recovery in industrial production and infrastructural services which began about a year ago is continuing. A mid-year review conducted by the Finance Ministry in November revealed widespread improvement in the availability of key items--especially electric power (up 14 per cent), coal (up 10 per cent), railway freight traffic (up 16 per cent), steel (up 26 per cent), and cement (up 17 per cent in five months). The IBRD staff believes that increases of 8-10 per cent in each of the key areas of industry and infrastructure are likely in 1981/82 as a whole. They also indicate that there are signs of an associated upswing in private investment in industry, although this is hard to document.

Primary liquidity has expanded strongly over the past year, emanating principally from Reserve Bank financing of the budget deficits, and to counteract the impact on credit expansion, the authorities have issued restrictive direct credit guidelines to the banks, and progressively increased the cash and statutory liquidity ratios. Most recent indications are that these actions have been reasonably successful in containing credit. The ceiling on total domestic credit and the subceiling on net credit to Government for November 1981 have both been observed. Credit to Government and to the commercial sector are both now expanding at a somewhat slower pace than provided for in the financial program. The increase in total liquidity in the year to November 1981 was 16.7 per cent, about 1 percentage point less than in 1980/81; the program envisages a decline to 15.7 per cent for 1981/82 as a whole.

The rate of increase in wholesale prices has slowed markedly in 1981/82. To a considerable extent this is attributable to the improved supply position for sugar where prices are now lower than last year. However, the slowdown in inflation is not universal, partly because of the direct and indirect effect of substantial adjustments to fuel and other controlled prices over the past year. Nevertheless, it now appears likely that wholesale price inflation will be about 7 per cent in the year to March 1982, some 4 percentage points less than the program estimates and less than half of that in 1980/81. However, the increase in consumer prices is likely to be about 13 per cent, somewhat higher than in 1980/81.

International reserves have fallen from \$6.9 billion in March to \$4.7 billion at end November. Reserves currently cover four months of imports, down from six months just one year ago. The heavy reserve drain is of concern in India, but details of the underlying causes are scant. Trade data suffer from serious delays and difficulties of interpretation. However, it appears that the larger than expected external deficit reflects developments on trade account, and possibly, sluggish performance of workers' remittances. One factor is revisions to trade data for 1980/81 which indicate a larger trade deficit in that year. It appears that, valued in terms of SDRs, exports rose by some 16 per cent in the first half of 1981/82 when compared with the same period a year earlier, During the same period imports rose by 21 per cent in terms of SDRs, considerably above the target.1/ New commitments of foreign loans in the period up to the present are well within the ceiling amounts established under the extended arrangement; up to November 27, commitments in the maturity range of 1 to 12 years amounted to SDR 126 million (compared with the ceiling of SDR 1.4 billion), while those of maturities of up to 5 years amounted to less than SDR 1 million (compared with the subceiling of SDR 400 million).

III. Policy Issues

There is a natural compatibility between the joint tasks of the mission--to conduct Article IV consultations and to review performance under the extended arrangement. The focus of the consultation discussions would be policies and prospects for external adjustment, where the extended arrangement already establishes a policy framework and outlines the major targets to be achieved. It would be appropriate that both the consultations and the EFF review should, at this time, address the issue of the

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1/ When valued in dollar terms the growth in exports is only about 4 per cent, while the growth in imports is also reduced to 8 per cent.

implementation of the agreed adjustment program. While the consultations will provide a format for a wide-ranging discussion of policies and prospects, the review provisions of the extended arrangement identify key policy areas for special and formal attention. These are policies regarding: (1) resource mobilization, including interest rates, and the pricing policies of both the Centre and the States, and (2) all aspects of export development. In view of the considerable overlap between the consultation and the review, and the extent of complementarity between them, the staff proposes to issue a joint report for consideration by Executive Directors.

The mission will collaborate closely with the World Bank resident mission in New Delhi, and with the Bank's economic mission which will be in India throughout the mission's visit. Mr. Harrison from the Bank's economic mission will also be attached to the Fund mission. The Bank's expertise will be heavily relied upon in the areas covered by Section III.1 below, and export policies and import restrictions.

1. Production, investment and economic efficiency

A major element of the supply policies of the adjustment program is the effort to expand productive capacity in key sectors to alleviate bottlenecks which have persistently crippled economic performance. Targets for the expansion in productive capacity have been established for six industries--coal, electric power, nitrogenous fertilizer, railway freight, steel, and cement. It would be timely at this stage to review developments so far in 1981/82 toward meeting the agreed capacity targets for this year, and to discuss, in a preliminary way, the targets for 1982/83 which will be agreed in connection with the program for the second year.

There are several potential problem areas. Reports indicate that there has been substantial slippage in the planned installation of new power-generating capacity. Additions to installed capacity in 1980/81 were only some 1,643 MW, well short of the target of 2,687 MW, and it appears that new capacity in 1981/82 may only reach 2,500 MW, also well short of the target of 3,212 MW. The reasons for this poor performance need investigating--especially the suggestion that limitation on access to equipment imports has been a major factor. Although performance by the railways has improved considerably in 1981/82, there are indications that some bottlenecks remain--especially in transporting coal. The World Bank had indicated that funds allocated to the railways may need to be increased to enable the projected increases in freight traffic to be realized; this will be investigated further with a view to any necessary corrective action being taken in the 1982/83 Plan. Developments in the coal and steel sectors also deserve careful attention in view of the concerns expressed by Executive Directors over plans in these sectors. Beyond the six identified sectors, developments and prospects in the oil sector will be reviewed closely, because policies and prospects are evolving quickly with especially important implications for the balance of payments.

Official pricing policies have a major role to play, not only in mobilizing resources for investment, but in promoting overall economic efficiency. In view of the progress already achieved in mobilizing resources, it is appropriate that the efficiency aspects of pricing policies receive increasing attention. The program recognizes the need for flexibility in pricing with the objective of achieving economic pricing of key items. This will encourage the adaptation of technology in line with shifting relative resource costs. While further increases in steel, aluminum or fertilizer prices will be expected during the program period, it is appropriate that the present review focus particularly on the outstanding issues on energy pricing, particularly coal and electric power. Prices for a number of other items, including steel and fertilizer, were raised considerably earlier this year. Indeed, the rapid increase in fertilizer prices appears to be impinging on fertilizer usage and if carried too far quickly could jeopardize necessary agricultural advancement. Aluminum prices were raised by about 20 per cent on December 3, 1981. Also, the authorities announced in December increases of 10-15 per cent in railway freight charges, and further increases in this sector should, for the immediate future, focus on passenger fares.

The main emphasis during discussions should be on coal and electricity pricing, a focus which the Bank agreed is appropriate. The mission will explore a possible future path of action of increasing coal prices toward economic levels. While this is a complex issue, and prices were raised by 30 per cent as recently as February 1981, further and ongoing steps will be necessary over the course of the program and should not be long delayed. In the case of electricity tariffs there is an equally strong case for developing a coherent policy of pricing, especially as low tariffs appear to be encouraging an inefficient growth in demand. The objective is to explore mechanisms for ensuring that the States are responsive to the need for tariff adjustments--especially in those States (e.g. Uttar Pradesh, Bihar and Orissa) where large operating losses have been recorded. The authorities will be reminded that an active pricing policy is an element of the program which was accorded considerable importance by

Executive Directors. It would be expected that the program for the second year to be negotiated in April would provide for substantial concrete progress.

There is need also to examine other aspects of efficiency. Capacity utilization rates in many sectors are low, and in some key areas improved utilization would have a major impact complementary to new investments. This is particularly so in electric power generation where in some States (e.g. West Bengal) utilization rates are as low as 30 per cent, nearly half what could be considered normal. Utilization rates are also low (and falling) in the cement industry, and are below the norm upon which pricing policies are based. The program had envisaged that utilization rates in both the public and private sectors would improve with the alleviation of bottlenecks in infrastructure. The mission will investigate the causes for continued low capacity utilization in key sectors with the aim of identifying the scope for specific policy initiatives to promote an improvement in industrial balance.

Industrial policies relating to the private sector have been significantly liberalized over the past year. Here too there is a need for stocktaking, to review whether the policy changes have been effectively implemented and to identify any new initiatives that are necessary. Three aspects of industrial policy in which the program envisages further significant action are incentives for export industries, improved access to foreign technology and the easing of excessive restrictions, including those on large enterprises. The staff will review with the authorities progress and plans for policy action in these areas.

2. Public finances

The authorities will be in a position to provide a thorough review of progress in implementing the 1981/82 Central Government budget. They will also be able to provide for the first time full details of the State budgets for 1981/82, and to identify the budgetary measures undertaken by the States; however, they will probably not be in a position to review in detail implementation of the State budgets. Limited information should also be available on developments in the financial position of the public enterprises. From this information, incomplete as it will be at this stage, the staff will be in a position to review progress during 1981/82 toward the main targets established for public finance. These include the public sector savings rate and its components, the overall Central budget deficit, and borrowing from the banking system to finance the deficit.

The most critical aspect of this review relates to the achievement of the public savings targets. The starting point will be the calculations prepared jointly by the staff and the authorities on the prospects based on resource mobilization measures already in place (Table 10 of EBS/81/198). These calculations will be reworked jointly with the authorities to ascertain whether developments in 1981/82 are on track. It will be essential that any divergences from the program for public sector financing be identified quickly, and corrective measures instituted promptly. In the event that a substantial shortfall from the targets appears likely in 1981/82, the staff will aim to reach agreement with the authorities on the policy measures necessary to return the public savings projections to the program path as quick as possible. In practical terms this is likely to mean the immediate implementation of additional resource mobilization measures which should be in place before Board discussion of the review. This could involve advancing some of the price, subsidy or tax measures which would otherwise have been implemented in conjunction with the 1982/83 budget.

The 1982/83 budget will be presented to Parliament toward the end of February. The authorities, therefore, will be in a position to fully discuss policy initiatives that may be taken. The staff will emphasize that the 1982/83 Central budget should be framed to fully meet the targets established in the original program relating to public savings and borrowing from the banking system. Beyond this, the possibility of achieving a more substantial reduction in the ratio of bank financing to GDP (than the shift from 3.1 per cent in 1981/82 to 3.0 per cent programmed for 1982/83) will be examined. The staff believes this would be useful in helping to consolidate financial stability and providing somewhat greater flexibility for policies to foster expansion of the commercial sector. With respect to the State budgets for 1982/83, sizable additional resource mobilization measures will be needed. The staff will investigate the framework for Central coordination of State finances and encourage the Central authorities to fully use their influence to increase resource mobilization at the State level. Possible measures would include bus fares, sales taxes, and levies on the affluent farming community which is lightly taxed. However, the major potential for State resource mobilization is in the fields of electricity prices and irrigation charges, and the authorities will be advised to concentrate their efforts in these directions.

3. Private savings and monetary policy

The sharp reduction in the rate of increase in wholesale prices in 1981/82 appears to be due to nonmonetary factors, especially the improved supply position. This process now appears to be complete and a substantial further reduction over the coming months does not appear likely. Looking ahead to 1982/83, and the remainder of the program period, the recent reduction can probably best be seen as a deviation from the progressive decline originally foreseen. As such, it cannot reasonably be expected that a further reduction below about 7 per cent can be aimed at in 1982/83.

Generally, wholesale prices are the yardstick for inflation used by the authorities and the press in India. There is also evidence that the general public reacts more to developments in the wholesale price index than the consumper price index, which normally reflects developments in the former with a lag. There is nevertheless some ambiguity as to the extent to which the deceleration in wholesale prices reflects a general easing in inflationary pressures, as the consumer price index continues to increase at double-digit rates.

Against this background, an important task of the mission will be to review interest rate policy as provided for in the program. The objective is that interest rates should encourage the desired growth in private savings, which is a key element in the adjustment program. The authorities have indicated their intention that "interest rate policy will be deployed flexibly keeping in mind progress in reducing inflation." (Paragraph 15 of the Statement of Policies.) There is evidence that, whatever the appropriate measure of inflation, expectations of future inflation rates (which influence savings behavior) have been reduced over recent months. Also, the authorities did raise interest rates by up to 1.5 percentage points in 1981 in response to the concerns expressed by the Fund. The staff will examine with the authorities the role of interest rates in encouraging private savings, bearing in mind the important influence on savings behavior of efforts to expand the scope of financial intermediation, and developments in alternative financial assets.

In this latter context, i.e. the overall structure of interest rates in the economy, present bank deposit rates appear somewhat on the low side, and some restructuring of rates may be useful. Company debentures are subject to an interest rate ceiling of 13.5 per cent, company deposits pay up to 15 per cent, and on November 6 the authorities increased the ceiling rate on preferential shares from 11 to 13.5 per cent. The margin between these rates of return and the maximum time deposit rate of 10 per cent appears very large and more than enough to cover the unsecured feature of claims on companies, many of which are "blue chips".

Monetary and credit developments so far in 1981/82 have been in line with the program targets. However, some further reduction in credit and liquidity growth rates will be necessary if the targets for 1981/82 as a whole are to be achieved. Recent policy initiatives, including raising cash and liquidity ratios and tight direct credit ceilings, aim to achieve this further reduction. The staff will examine the adequacy and relative significance and incidence of these various instruments of monetary control. Looking to 1982/83, the staff will re-examine with the authorities the likely growth in the demand for liquidity in view of the changed inflationary outlook. Lower inflation may allow a reduction in the program's tentative target for monetary expansion in 1982/83 unless velocity declines substantially because of improved inflationary expectations. Should it appear feasible to lower the monetary growth target, this would reinforce the desirability, as discussed above, of adjusting the target for Central budget deficit financing from the banking system.

4. External policies

It is likely that the current account deficit will be somewhat higher than 2.0 per cent of GDP--perhaps about 2.2 per cent--and the overall deficit seems likely to exceed SDR 2 billion. It will be important to thoroughly review balance of payments developments in 1981/82 and to determine to what extent the profile for external adjustment projected under the EFF might be affected by this year's adverse developments. This year's developments serve to underline the existence of a real balance of payments problem, and in the context of adjustment, the importance of export development.

y.c.

a. Export policies and the exchange rate

Major initiatives to encourage export development have been taken over the past year, and an appropriate starting point for the review of export policies is to analyse progress in implementing these measures. There are indications that in some areas--e.g. the concessions available to 100 per cent export-oriented units--policies have not been administered with sufficient flexibility. The objective of these policies must be to maximize the export drive, and concern about the potential leakage of benefits in the home market can result in policies being rigidly applied and ineffective.

Beyond this, the staff will review with the authorities progress and plans toward implementing additional export development measures, including steps to remove existing discouragement to exports. These would include a number of the outstanding recommendations of the Tandon Committee on export promotion, including extending fiscal and import concessions to less than 100 per cent export-oriented units; expanding the scope and simplifying the advance licensing (duty exemption) scheme for exporters; liberalizing access to foreign technology for exporters; improving the duty drawback system; and liberalizing access to imports. The possible adverse impact of some of these measures on budget revenues would also be borne in mind. It would be expected that further significant steps (based on the above list but possibly including other measures) would be in place when the program for the second year is negotiated.

The program recognizes the importance of exchange rate policy. The Chairman's summing up of the Board discussion on India's program last November states "We shall of course look at the competitiveness of exports and shall take into account all the relevant factors that need to be assessed in looking at the external position of a country--including exchange rate developments." Thus, a prime task of the mission is to assess if (a) the profitability of exports is adequate, (b) domestic sales have not become more attractive than sales abroad, and (c) India's competitive position vis-a-vis her competitors in the export markets has not been eroded. On the favorable side, the nominal effective trade-weighted exchange rate has depreciated by 4 per cent since April 1981; combined with the improved price performance in India, this has resulted in a larger depreciation in real terms over recent months (Chart 1). The mission will discuss present and prospective exchange rate policies. The mission will ascertain the trend in the volume growth of key export products, and examine all the relevant factors affecting the export growth. If the mission concludes that exchange rate policy needs to be strengthened to achieve the program targets on export growth in 1981/82 and 1982/83 in volume terms, the mission will press for a significant depreciation of the rupee against the U.S. dollar, in the form of a gradual depreciation in the early months of 1982.

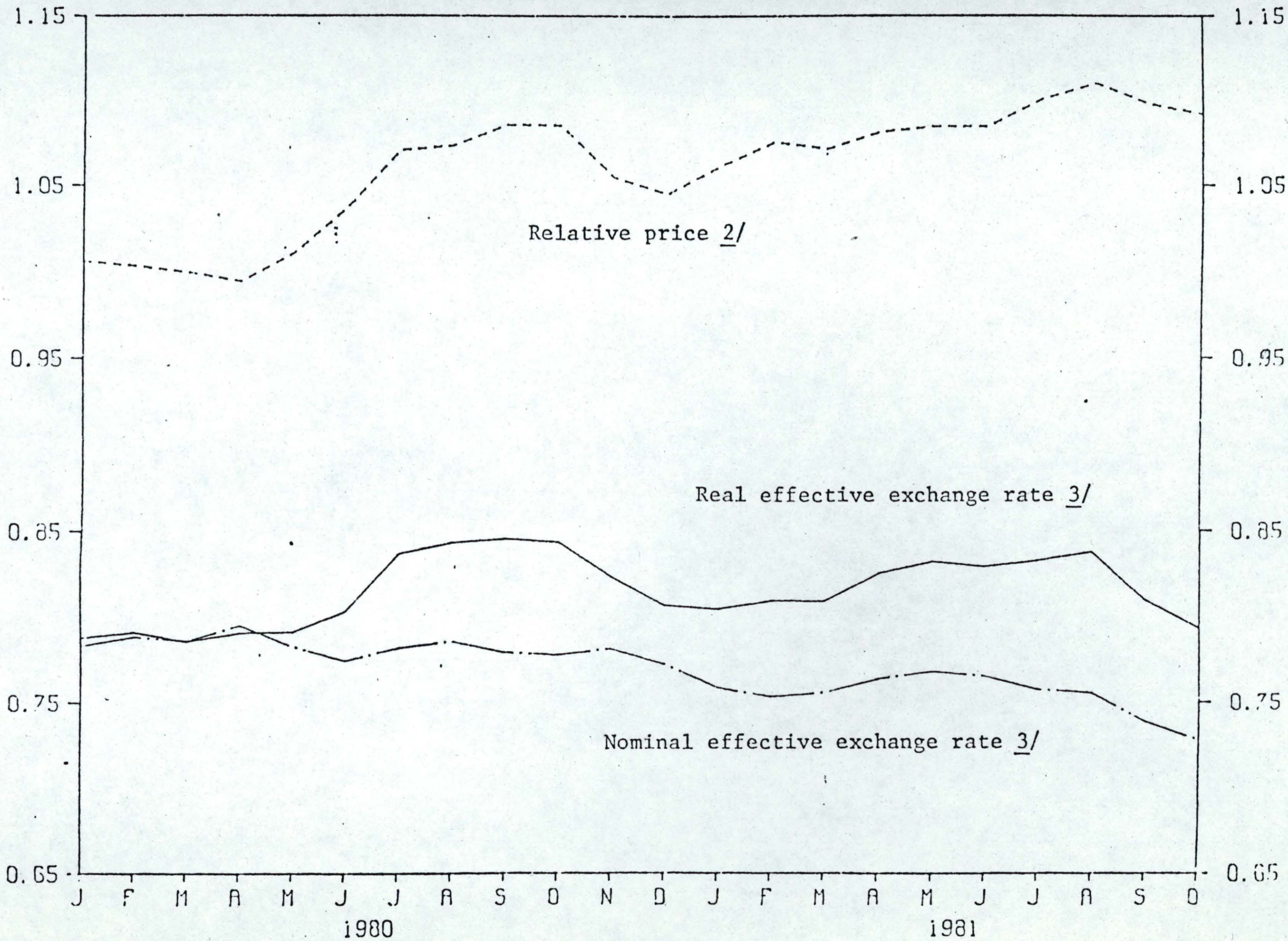
b. Import restrictions

Although restrictions have been eased considerably over recent years,

Chart 1

India: The Real Effective Exchange Rate and Its Components, January 1980-October 1981 1/

(1970/1971 = 100)



Source: IMF, International Financial Statistics.

1/ Trade-weighted.

2/ Indian prices over partner countries' prices.

some areas, highly restrictive. The authorities take the alternative view that, judged in terms of the politically feasible, the scope for further liberalization is limited. However, they recognize that apparently small changes can have a major effect on the economy. The EFF program provides that "the import programs for 1982/83 and 1983/84 will contain significant steps aimed at liberalizing imports". The staff will examine with the authorities the changes in import policy which are being considered for introduction in the 1982/83 policy, and review with them whether these changes, taken as a whole, can be considered to be "significant". The import policy for 1982/83 would normally be announced prior to the Executive Board discussion which is expected to be in late March. While it will be possible to provide, on the basis of these discussions, broad information on the changes which will be introduced, the staff will not be in a position to fully assess their significance until subsequent discussions are held in April on the program for the second year. The mission will inform the authorities that the staff expects to receive from the authorities in April their memorandum evaluating the significance of import liberalization measures. To help the assessment of the significance in quantitative terms, the mission will suggest that a system be established whereby up-to-date movements of imports could be monitored according to licensing classification.

The staff believes that there is considerable scope to liberalize imports by simplifying procedures; administering regulations flexibly; and reducing restrictions in certain areas, particularly in the case of capital goods. The policy aim should be to reduce the importance of considerations of domestic productive capability and essentiality in import policy, to encourage greater exposure of industry to foreign competition, and to promote increased reliance on the tariff. A relaxation of the "actual user" criterion in allocating import licenses would also be a substantial change in the right direction. Tariff reform would also be a useful complement to import liberalization. The aim would be to reduce excessive protection levels afforded many industries and the tariff bias in favor of capital-intensive investment; generally, a more uniform and lower tariff structure would be preferable. Ideally, it would be useful to establish an analytic framework within which each liberalization measure can be seen as contributing toward the achievement of a coordinated long-term policy goal. The mission will discuss with the authorities the feasibility of reviewing the system of protection and establishing such a framework; this would necessarily involve collaboration of the World Bank and the Fund. If this is feasible, the mission will try to establish a tentative timetable for the completion of the study and discussion of the major recommendations.

c. External debt

The mission will investigate the authorities' program for foreign borrowing during the program period in order to be in a position to provide more concrete details than has been possible so far. At the time the EFF program was constructed, the authorities were considering two major projects in the steel and electric power sectors with a combined foreign exchange cost of about SDR 3 billion. It was agreed that "if commitments in respect of the two projects... should, or are expected to, materialize during the first year of the program period, the ceilings for 1981/82 would be reviewed at the time of the mid-year review." (EBS/81/198, p. 41.) The staff will review with the authorities progress in completing the financing arrangements in respect of these two major projects. It appears that arrangements for the Paradip steel project have now progressed far enough for loan commitments to be included under the external debt ceiling. Under these circumstances, the staff may agree to a revised debt ceiling which is increased by up to the amounts under this project if this is necessary.

There have been recent press reports of discussions with certain countries for major purchases by India of military equipment. In the context of obtaining more complete information on the external borrowing program, the staff will inquire into the financing details of these military transactions with a view ascertaining in particular their implications for both the debt ceiling and budget deficits for 1981/82 and the future profile of external debt.

1981

IV. India: Fund Relations
(As of November 30, 1981)

Date of membership:	December 27, 1945.
Status:	Article XIV.
Quota:	SDR 1,717.5 million.
Fund holdings of rupees:	SDR 1,953.8 million (113.8 per cent of quota), including compensatory financing purchases of SDR 266 million (15.5 per cent). Excluding purchases under this facility, Fund's holdings of rupees were SDR 1,687.8 million (98.3 per cent of quota). Following purchases of SDR 300 million (17.5 per cent of quota) under the EFF in December, Fund's holdings were SDR 2,253.8 million (131.2 per cent), including CFF purchases, and SDR 1,987.8 million (115.7 per cent), excluding CFF purchases.
SDR position:	Holdings amounted to SDR 468.3 million, or 68.8 per cent of net cumulative allocation of SDR 681.2 million.
Trust Fund loan disbursements:	SDR 529.0 million.
Direct distribution of profits from gold sales, July 1, 1976-July 31, 1980:	US$149.3 million.
Gold distribution (From distribution):	804,429.4 fine ounces.
Exchange system:	Linked to a basket of currencies within 5 per cent margins. The current middle rate as of December 22 is Rs 17.20 = pound sterling 1.
Last Article IV consultation:	Article IV consultation discussions were last held during April 7-22, 1980. The staff report (SM/80/151, 6/23/80; and Supplement 1, 7/28/80), was discussed by the Board on August 7, 1980.

Office Memorandum

TO : The Managing Director DATE: July 29, 1981

FROM : Donald K. Palmer and P.R. Narvekar

SUBJECT : India Extended Arrangement--Resource Mobilization Commitments

You will recall that Mr. Tun Thin's memorandum of July 8 had submitted drafts of paragraphs relating to resource mobilization, export policies and import policies from the draft Statement of Policies for the Indian program. In your comments on the draft paragraphs you endorsed the view that "...... consistent with the practice followed in several recent extended arrangements, the draft should specify more precisely resource mobilization targets both for the three-year program period of the EFF and on an annual basis; this would include annual targets for the levels of major public finance variables." You added the handwritten comment that "I agree with Mr. Dale's comments. One has to find some acceptable language in the mobilization targets which clarifies the commitments while respecting the parliament."

During yesterday's meeting with the Indian Ambassador, we briefly explained the general approach being taken with respect to resource mobilization. The purpose of this brief note is to describe in somewhat more detail the approach which has been presented to Mr. Narasimham and which is being discussed in London this week.

Pages 11-13 (attached) of the draft Statement of Policies deals specifically with resource mobilization. In addition, Mr. Narasimham has ** been given the two attached tables and has been advised that they will have to be completed and will be included in the staff paper (although not attached to the Statement of Policies). As you will see, on page 12 we are asking that the Indian authorities undertake to meet certain savings targets (both central government and total public sector) expressed as a percentage of GDP. If these general commitments are stated in the Statement of Policies, it will then be possible to complete the attached Table 2, which will show the projected trends in public sector savings. The data in Table 2 can be derived using the projections contained in Table 1 regarding expected movements in GDP and prices. This approach has been explained to Mr. Narasimham so that, if the program goes to the Board, there will be no misunderstanding about how the staff will present the resource commitments in the staff paper.

** I would like this to be made clear in our report.

Attachments

cc: The Deputy Managing Director
Mr. Tun Thin (on return)
Mr. Beveridge
Mr. Watson

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: May 14, 1981

FROM : Donald K. Palmer

SUBJECT : India

I understand that there will be a meeting on India tomorrow and it would be useful to have a written statement of views. In addition to Mr. Tun Thin's back-to-office report and the draft statement of economic policies, I have read the preliminary report of the two World Bank staff members who were part of the Fund mission; I recognize that this draft report will need to be reviewed by the Fund mission team, and that they may well differ with the Bank on some points. I have also had the benefit of hearing the views of others, especially Mr. Tun Thin, in the meeting in Mr. Dale's office on Tuesday.

I hope I am not too pessimistic, but on the basis of present information, I am concerned that we do not have a case which can be defended in the Board as meeting the terms of the Extended Facility Decision. My broad reaction should not be misinterpreted; with some improvements (interest rate increases, administered price changes) in domestic policies, I believe that it would be possible to make a very good case for a one-year stand-by arrangement accompanied by the same amount of Fund financing as is now envisaged in the first year of the three-year arrangement.

The Extended Facility Decision states that the Fund will pay particular attention "to the policy measures that the member intends to implement in order to mobilize resources and improve the utilization of them and to reduce reliance on external restrictions." As regards the third point, the statement of policy does not suggest that there will be any significant reduction in India's reliance on external restrictions. This is not unexpected given the well-known Indian position on maintaining a heavily controlled trade and payments system. Still, I must note that nothing positive can be cited on this point.

As regards the improvement in the utilization of resources, the Fund paper dealing with an EFF would of course rely mainly on World Bank judgments. My reading of the preliminary report of the World Bank staff is that they will give relatively good marks to India's public investment program, in terms of its priorities and general focus; they have not, however, had a chance to evaluate the annual plan for 1981/82. They note that if the investment side of the Five-Year Plan is carried out, "the ratio of public to private investment for the Sixth Plan thus becomes 53:47, a significant turnaround from the 46:54 ratio" of the previous plan. Their comments reveal that total investment in real terms will not increase significantly between the previous and the current Sixth Plan so that the transfer from private to public investment accounts for the bulk of the real growth in public sector investment. They state that "given the low levels of efficiency which have historically characterized public sector investment and which are recognized in the high ICOR of 5.7 projected in the new Sixth Plan, one could question whether greater returns might be expected from a plan which gave greater scope to private investment."

It is the issue of mobilization of resources that raises the most difficult problems. As far as the private sector is concerned, interest rates have been raised only to modest extent. The latest projections with respect to inflation suggest that the average increase in the next year will be 2 percentage points higher than had been expected earlier. This implies that clearly negative real interest rates will continue at least for the first year of the three-year program period. Given the demonstrated responsiveness of private savings to interest rate incentives throughout the Asian Area, one could expect to hear Board criticism of India's interest rate policy.

As regards the public sector, the relative shift in emphasis from private to public sector investment implies a huge increase in public sector savings. The preliminary report of the Bank staff raises a number of serious doubts in this regard. As Mr. Tun Thin has explained, the Indian authorities do have plans to raise administered prices in a number of areas, thus improving the overall level of public sector savings, but they are not in a position to give overall commitments in this regard. The Bank draft makes a good case for prompt, substantial increases in prices in such key areas as power, coal. However, the authors of this paper appear to be quite skeptical that additional resource mobilization will take place on anything like the scale envisaged in the new plan.

These doubts are translated into a different set of concerns when one turns to the balance of payments. The draft letter of intent is vague on expectations for the future when it states at the end of paragraph 3 "For these reasons it is expected that the balance of payments deficit will widen for several years before adjustment is achieved in the second half of the 1980s." This may well be a realistic judgment but it does not offer much comfort if one has to defend the program as having a foreseeable target date by which the magnitude of the balance of payments "gap" ($3 billion?) will return to a level which can be met by normal sources of financing without substantial reliance on IMF financing. It may well be that it would be more realistic to envisage a six-year period of IMF financing. If that were to be the strategy, it would be desirable to scale down the annual increments of Fund financing in early years (together with the size of the investment program). This outlook may be an additional argument for proceeding now with a one-year program, followed up by relatively smaller annual levels of Fund resources than are now envisaged for the second and third years of the three-year program.

cc: Messrs. Goode, Tun Thin, and Watson

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: May 14, 1981

FROM : Richard Goode

SUBJECT : India: Extended Arrangement

B

Mr. Dale suggested that written comments from FAD on the proposed EFF for India might be useful. The following comments are based on a quick examination of the papers circulated immediately before a meeting held by Mr. Dale on May 12 and discussion at that meeting.

It appears to us that there are grounds to question whether the present program meets the criteria established for use of Fund resources under the extended facility. The issue would inevitably arise as to whether the Fund was supporting a general development plan rather than a program designed to correct structural imbalances in production, trade, and prices while strengthening the balance of payments. It appears that no improvement in the balance of payments would be expected during the three-year period of the EFF, and I understand that the recent mission could not foresee an improvement until several years later.

The Sixth Plan places a praiseworthy emphasis on developing domestic energy production, but it contemplates an increase in the proportion of investment in the public sector, much of which will consist of infrastructural outlays of the type that in the past have yielded relatively small returns. It would be essential to ascertain the nature and extent of the World Bank's endorsement of the priorities in the investment program.

I have not noted clear undertakings in the letter of intent regarding such structural matters as import and exchange restrictions, pricing policies, and interest rates.

More specifically, in the fiscal area, efforts to mobilize domestic resources will have to be strengthened if the plan objectives are to be attained. At this stage, statements on revenue and expenditure are general in nature. Reference is made to rationalization of the tax system, improved tax administration, and selective tax measures. The statements of intent regarding subsidy policy are not specific enough to be convincing. The problems of nonfinancial public enterprises are recognized in the letter of intent, but specific actions to reduce losses and to raise the financial return on investments are not outlined. On an aggregate level, I cannot identify from the material available the likely development of the main fiscal aggregates over the program period. While I recognize the sensitivities of the Indian authorities and the impracticability of their making specific commitments on matters that have not yet been brought before Parliament, it would seem essential for the staff to conduct more detailed discussions on measures to mobilize resources and other policies.

cc: Mr. Tun Thin
Mr. Palmer
Mr. Watson

Office Memorandum

TO : Mr. Palmer DATE: May 6, 1981

FROM : Paulo Neuhaus PN

SUBJECT : India - EFF Program

1. Introduction

This memorandum discusses possible areas where the Indian EFF program could be significantly strengthened. The major challenges, as recognized by the staff and the authorities, are the resource mobilization effort in support of the ambitious investment program, and the improvements in the efficiency of resource allocation with a view to reducing the exceptionally high capital-output ratio. While broadly aware of the need to eventually step up resource mobilization and improve allocative efficiency, the authorities have largely resorted to a very gradualistic approach in light of the political repercussions of the adjustment measures. However, the success of the program hinges on the early adoption of further adjustment measures, especially because the inflation forecast for 1981/82 has now been revised from 9 to 11 per cent, with consequent deleterious effects on real interest rates, internal resource generation of public enterprises, fiscal expenditures, and the real effective exchange rate. Incidentally, the need to strengthen policies in the areas of public pricing, subsidies, the efficiency of public enterprises, and interest rates was highlighted by the Managing Director in the March 28, 1981 meeting to discuss the briefing paper for the EFF negotiations. In light of the sizable purchase envisaged, the draft of the program and particularly the program for 1981/82 as agreed so far could be construed as entailing a significant weakening of Fund conditionality, thus setting an undesirable precedent for future Fund programs.

2. Further adjustment measures

The thrust of additional measures should be on resource mobilization and a comprehensive reform of trade and related industrial policies. With respect to resource mobilization, the overall focus of the program on reducing subsidies and maintaining realistic administered prices and interest rates is adequate, but additional measures are desirable in 1981/82 and care should be exercised throughout the program to avoid slippages of implementation. (This underscores the importance of subsequent reviews of the program which are discussed below.) The envisaged resource mobilization measures would also have a beneficial allocative effect as they would entail a better use of energy and other publicly supplied goods and services, a more efficient allocation of credit, and a dampening of inflationary pressures.

A package of additional resource mobilization measures would include:

(a) An increase in interest rates on time deposits of the banking system by 1.5-2.0 percentage points, and corresponding readjustments of lending rates. This is clearly defensible in light of the upward revision of the inflation forecast for 1981/82 by 2 percentage points, and would still entail negative real returns to deposits in maturities of up to 3 years. A possible schedule for deposit rates could be:

Maturity	Current rate	Proposed rate
1-2 years	7.5	9.0
2-3 years	8.5	10.0
3-5 years	10.0	12 0

Concurrently, the authorities may wish to increase the current yield of 12 per cent on 6-year National Savings Certificates and the 15 per cent ceiling on deposits with public companies.

(b) Immediate increases in electricity charges by the State Electricity Boards, which are currently recognized as unrealistic. Beyond the generation of internal resources, this would moderate the seemingly insatiable demand for energy by the industrial sector and discourage the bent toward energy-intensive projects (for example, two major aluminum projects are currently envisaged over the Plan period despite the notorious power shortage).

(c) Immediate increases in transportation and water (mainly for irrigation) charges by the States.

(d) Phased increases in coal and steel prices before the November 1981 mid-term review of the program. Despite recent increases, domestic coal prices are still quite low by international standards; in the case of steel, some of the identified supply scarcities which underline the major programmed Plan investments are partly due to inadequate pricing. Therefore, cogent efficiency arguments beyond the resource mobilization aspects support the proposed price increases.

A major shortcoming of the program as agreed so far is the omission of significant trade liberalization. Despite the important measures geared to export promotion, the elaborate and inefficient structure of import protection with primary reliance on quantitative restrictions would remain largely unchanged with obvious negative repercussions on industrial efficiency, relative profitability of exports vis-à-vis the domestic market, and fiscal revenue collection. Therefore, the program would be greatly enhanced by an undertaking to initiate in 1981/82 a comprehensive review of trade and related industrial policies with a view to a phased shift to begin no later than 1983/84, from widespread quantitative restrictions and licensing to reliance on price signals (including exchange rate and streamlined import duties) as instruments to achieve protection and external balance. This would provide a clear and unambiguous rationale for Fund support in the magnitudes proposed or even beyond, up to the maximum amounts permissible under current guidelines on Fund access.

3. Review clauses

A major challenge of the Indian program will be the implementation of the adjustment measures, particularly in the grey areas such as administered prices, interest rates, exchange rate, and selective import liberalization where there are still few specifics beyond a broad commitment to a flexible approach. To prevent slippages in implementation, and to detect areas where further initiatives may be required in light of new developments, it would be desirable to attach more weight to the interim reviews of the program. In light of the uncertainties surrounding the program for 1981/82, this would be particularly germane to the mid-term review scheduled around November 1981. Accordingly, on the basis of precedents such as the 1980 Pakistan extended arrangement (which is attached for reference), purchases after a specified date (e.g., February 1, 1982) could be made contingent on reaching understandings pursuant to the interim review, with appropriate references to that effect incorporated in the extended arrangement and the letter of request (see para. 3(c) of the Extended Arrangement and para. 3 of the letter of request for Pakistan). Similar clauses, if deemed appropriate, might be introduced in the programs for the subsequent years.

Attachments

cc: Mr. Nowzad

ETR

cc: Mr. Palmer

Office Memorandum

CONFIDENTIAL

TO: The Acting Managing Director

DATE: April 28, 1981

FROM: Tun Thin

SUBJECT: India--Discussions on an Extended Arrangement

I headed a mission which visited India during April 9-22 for discussions on an extended arrangement. The mission included, from the Fund staff, Messrs. B. Smith, Singh, Lipschitz, I. Kim, Neuhaus (ETR), and Miss Singh, and from IBRD, Messrs. Wall and Grawe. A large measure of agreement on an EFF program has been reached, and I expect accord will be reached without great difficulty on the matters which remain outstanding.

1. Economic situation

The Indian economy recovered in 1980/81 (fiscal year ended March) following a severe setback in 1979/80. Real growth reached at least 6.5 per cent, mainly because of a strong rebound in agriculture from the previous year's drought-reduced level. Industrial activity was sluggish in the first half of the year with the continuation of crippling bottlenecks in basic industry and infrastructure. However, with an upturn in electricity and coal production, a strong industrial revival was initiated in the second half, and prospects for industrial output and investment for the coming year are good. If rainfall during the coming monsoon season is favorable, real growth of about 5 per cent can be expected in 1981/82.

The authorities intended that fiscal policy be tightened from the excessively expansionary stance in the previous year, but the projected deficit was exceeded, and taking account also of net bank subscriptions to dated government securities, net government recourse to the banking system rose sharply further to account for over half of total credit expansion in 1980/81. However, because of slower growth in credit to the commercial sector (partly reflecting lower foodstock financing needs), and an adverse shift on external account, monetary expansion was unchanged at 17 per cent, although a reduction to 15 per cent had been envisioned in the Trust Fund program. Inflationary pressures eased somewhat during the course of the year, largely in response to the improving supply position; wholesale prices rose by about 16 per cent over the 12 months, some 5 percentage points less than in the previous year. However, inflation has proved to be more persistent than the authorities had expected.

The balance of payments shifted from a surplus of SDR 0.2 billion in 1979/80 to a deficit of SDR 1.2 billion in 1980/81. Exports rose by about 13 per cent mainly on account of prices, but imports rose by 37 per cent. The oil import bill rose by as much as 80 per cent, to account for nearly half of the total, while non-oil imports rose by some 14 per cent. The rise in oil imports was due both to higher prices, and to increased volumes to compensate for the disruption to domestic supplies resulting from unrest in the northeastern region. In fact the crisis in Assam, which now appears to have been settled, accounts for as much as one half of the balance of payments deficit in 1980/81. About two thirds of the overall deficit was financed by the Fund (from the Trust Fund and a CFF purchase), and the balance by a modest drawdown of reserves. International reserves currently amount to SDR 6 billion, equivalent to about five months of merchandise imports.

2. The need for adjustment and economic prospects

Experience over the past few years illustrates the need for, and points a direction for, structural reform. The mission's briefing paper outlined an adjustment strategy which would form a suitable foundation for the extended arrangement. Briefly, reforms are most needed in the industrial and trade sectors. The critical need is for a step-up in investment in basic industry, energy, and infrastructure to overcome bottlenecks which have become major constraints on overall growth. Domestic savings performance was good in the second half of the 1970s, mainly because of buoyancy in household savings, but fell in the drought year of 1979/80, and is likely to be under some pressure in the future if the terms of trade continue to worsen and remittances from workers abroad slacken as expected. The main need is to increase public sector savings. Since tax collections are already high, raising public savings will depend critically on the strength of policies to reduce subsidies and increase surpluses of public enterprises. In the external sector, a vigorous export effort is essential, including measures to offset traditional biases in favor of production for the protected domestic market. On the import side, the more liberal policies of the past few years need to be strengthened selectively by ensuring freer access to necessary imports and exposing domestic industry to greater competition.

With such a strategy, it should be possible to achieve a step-up in the growth rate to about 5.2 per cent per annum as projected by the authorities in the new Sixth Five-Year Development Plan while adjusting the balance of payments position at a satisfactory pace. Indeed, there are indications that the external position may not be under as severe a strain as earlier expected, and the projected deficit for the coming three years has been reduced somewhat to about SDR 6 billion. The overall deficit is projected to be unchanged at SDR 1.2 billion in 1981/82, even after allowance is made for a sizable step-up in non-oil imports, because of a large increase in domestic oil production. The deficit is projected to widen over the course of the program period, but at its peak in 1983/84, the current account deficit is not expected to exceed about 2.5 per cent of GDP, and would gradually decline beyond the program period.

3. Review of the discussions

The mission held discussions with a range of high-ranking officials including Finance Minister Venkataraman, Planning Commission

Member/Secretary Manmohan Singh, Economic Affairs Secretary Malhotra, and Reserve Bank Governor Patel. Mr. Narasimham participated actively in the negotiations.

By the conclusion of the mission, a large measure of agreement had been reached on a policy program in line with the adjustment strategy outlined above. The World Bank participants in the mission are satisfied that, based on the elements agreed so far, the program will be adequate to warrant Bank endorsement of the investment program and its priorities. They will prepare a suitable statement for inclusion in the EFF paper after review at Bank headquarters. It is expected that the IBRD's statement to the India Consortium meeting on June 9-10, 1981 will also include an assessment of the investment program.

a. Elements of the program upon which agreement has been reached

(1) Amount and phasing

The authorities are, as indicated earlier, requesting an extended arrangement for three years for the amount of SDR 5 billion (excluding the reserve and first credit tranches). In keeping with the projected balance of payments deficits for the period 1981/82 to 1983/84, the amount would be backloaded to provide SDR 1.2 billion in the first year, SDR 1.6 billion in the second, and SDR 2.2 billion in the third.

(2) Public investment

Public investment is to be stepped up substantially and the sectoral allocation adapted to reflect the priorities of the new Sixth Five-Year Development Plan. The highest outlay is for the energy sector, which will absorb 27 per cent of the total; the main emphasis is on electric power, petroleum, and coal. Agriculture, including irrigation and flood control, will absorb a further 24 per cent of the total, with a major effort directed toward expanding irrigation. In the industrial sector, large allocations have been made for basic industries where bottlenecks have occurred. The World Bank considers the pattern of allocation of resources to be generally appropriate, with the notable exception that amounts allocated for the railways appear inadequate in view of the problems in the transportation sector.

(3) Supply-side indicators

The program will include indicative projections for real public investment and additions to productive capacity in six major sectors, mainly in the public sector. Projections have been made initially for 1981/82 and 1984/85, the final year of the Plan period. Projections for intervening years will be agreed later during the program period. It is hoped that, by this means, the implementation of the physical investment objectives can be tracked from year to year against the Plan's objectives. This is considered useful because shortfalls in real investment levels have been a recurrent feature of past Indian Plans.

(4) Private industry and investment

A more flexible approach is being taken to private industry in order to increase efficiency and promote investment. The program would include a number of new policy measures, introduced progressively since July 1980, including the regularization of unlicensed capacity, the extension of automatic capacity expansion provisions, concessions to export industries, the easing of access to foreign technology, and implementing policies favoring small-scale industries with greater emphasis on economic efficiency. These represent significant advances and it is expected that the momentum of policies in this direction will be maintained in the period ahead.

(5) Pricing policies

Given the wide coverage of administered prices in India, pricing policies have an important role, both in mobilizing resources in the public sector and in encouraging an efficient allocation of resources throughout the economy. Recently, adjustments, many of which are substantial, have been made to agricultural procurement prices, foodgrain issue prices, and prices for important items including coal, iron and steel, aluminium, petroleum products and railway freights. Flexibility in administered pricing will be continued, directed particularly toward the objective of resource mobilization.

(6) Public finance

In order to finance a share of the step-up in public investment, a large increase in savings by the Central and State Governments is planned. Although a number of initiatives, including tax and price measures, were taken in 1980/81, the desired impact on public savings has been eroded by the effects of inflation and higher import costs on current expenditures. Public sector resource mobilization efforts thus present a major challenge for the future. The pricing policies outlined above will constitute a principal instrument, and while the tax effort is already high, further tax measures are also planned. To maximize the benefit of resource mobilization measures, parallel efforts will be made to restrict recurrent expenditures and improve the management of public enterprises. Toward these objectives, the recently adopted budget for 1981/82 represents only a limited advance. The mission believes that if the public sector savings targets for the Plan period are to be reached, and the real level of investment achieved, the authorities will have to adopt a more aggressive policy with respect to resource mobilization in future years.

(7) Private savings

To provide a stimulus to private savings and their mobilization by the financial system, interest rates on medium-term bank deposits have been raised by 0.5 to 1.5 percentage points, and the ceiling on interest rates on company debentures has been raised by 1.5 percentage points. Also, a new six-year National Savings Certificate is being issued at an attractive interest rate of 12 per cent. The program provides that interest rates would be reviewed in light of progress in reducing inflation.

(8) Credit ceilings

The financial program aims to contain the growth in broad money to 15.7 per cent in 1981/82, compared with 17 per cent in 1980/81. This is judged to be appropriate to support real growth of 5 per cent and the feasible reduction in inflation to 11 per cent. Consistent with this, a ceiling increase in total domestic credit of 19 per cent, and a subceiling increase for net credit to Government of 21 per cent, have been agreed for 1981/82. The authorities were most reluctant to agree to more than one intermediate ceiling point, but following extended discussions, it was agreed that phased ceilings and subceilings would be established for September and December 1981; since they were not prepared for this, ceiling amounts for these dates are still to be negotiated.

(9) Export policies

A number of significant steps have been taken to strengthen exports. In addition to measures taken in the context of industrial policy noted above, other measures were taken in the 1981/82 import policy to ease access of exporters to foreign inputs and technology. The evolution of policies to encourage export development will be continued in the second and third years of the program.

(10) Import restrictions

Although some steps, which could be construed as a net intensification of import restrictions, were taken in the 1980/81 and 1981/82 import policies, the authorities emphasize that the more liberal import policy introduced in 1978/79 has been maintained essentially unchanged. For subsequent years of the program, selective liberalization measures to further ease access to imports of capital goods and technology and to the export sector, are envisaged.

(11) Exchange rate

The main impediment to exports at present is inadequate supplies and other factors not directly related to profitability. While no exchange rate adjustment seems needed at present, the authorities recognize the importance of exchange rate policy and intend to follow a realistic policy consistent with the need for export development and external adjustment.

b. Matters remaining outstanding

While the above represents the main elements of a possible EFF program, several matters remain to be agreed, mainly because the Indian authorities were not sufficiently advanced in their preparations at the time of the mission for agreement to be reached. In addition to some minor and technical questions, the main issues still to be resolved are the following:

(1) Phasing of credit ceilings

Ceilings on total domestic credit and net credit to Government, in line with those agreed for 1981/82 as a whole, remain to be negotiated for September and December 1981. Drawings during the first year would be phased to provide SDR 0.5 billion on approval, SDR 0.4 billion following the September 1981 ceiling and SDR 0.3 billion following the December 1981 ceiling.

(2) External debt ceilings

Ceilings for the first year of the program for official external borrowing commitments with maturities between one and twelve years, with a subceiling for maturities in the one to five-year range, have yet to be agreed. The authorities' intentions concerning borrowing commitments for several major projects are as yet uncertain. Partly for this reason they preferred ceilings on loan disbursements but we argued for ceilings on commitments, especially because of the long lag with which statistics on disbursements become available, making more difficult the effective monitoring of external debt developments.

4. Considerations for the future

I believe that the remaining issues will be resolved satisfactorily during coming discussions with the Indian authorities. It is my belief that, unless there are unexpected delays, a program can be agreed and submitted for Executive Board consideration as originally expected, following the Aid India Consortium Meeting in early June.

The mission left India with the belief that, as far as it has so far been agreed, the program was generally satisfactory and that India's external adjustment prospects appear good. The Indian authorities are, of course, extremely sensitive on issues related to national sovereignty. However, there were no major differences between the authorities and the mission on the needed direction of policies, especially as there had been a full exchange of views over the preceding few months. Discussions centered rather on the instruments appropriate to achieving the objectives, and the pace of their implementation, with the authorities favoring generally a more gradual approach. For example, their reaction to the suggestions that we made relating to the mobilization of resources, especially regarding further increases in the prices of commodities like coal, steel, and electricity, was that such increases were under constant consideration and the timing of their implementation would depend on circumstances, both political and economic. Thus, the Fund's influence on India's economic decision-making processes is felt only with a time lag and this situation seems unlikely to change unless India faces more severe economic difficulties. Over the course of the program the Fund's ability to maintain satisfactory policy understandings with India would be contingent, to a greater degree than in most other cases, on the authorities and the Fund maintaining a common perception of the country's needs on the basis of frequent dialogue.

cc: The Managing Director (on return)
Mr. Watson
ETR

March 25, 1981

Mr. Palmer
cc: Mr. Finch
Mr. Neuhaus
ETR files

MEMORANDUM TO FILES

Subject: India--Meeting with Managing Director, March 23, 1981

Messrs. Tun Thin, Narvekar, Palmer, and I met with the Managing Director and the Deputy Managing Director on March 23, 1981 to discuss the briefing paper for the India EFF negotiations.

Following representation of the various issues which were raised in Mr. Tun Thin's covering memorandum of March 19, 1981, the Managing Director indicated that he attached considerable weight and favor to India's request for Fund assistance, both because of India's size and importance and because the request has come at an early stage, before India's emerging difficulties become acute. He agreed that the staff's efforts should be directed at a medium-term program with an emphasis on the supply side as this was appropriate to meeting the underlying structural problems which faced India. In constructing such a program, due regard should be paid to India's record of sound policies and the early timing of the approach; care was needed to ensure that policy action was not requested simply for action's sake. At the same time, and since the program would be highly visible and in some ways controversial, care was equally needed to ensure that the associated implementing measures were sufficiently strong to convince Executive Directors of the program's viability. In this connection, public pricing, subsidies, the efficiency of public enterprises and interest rates were cited, by way of examples, as areas where policies could be strengthened. The staff's view that a discrete exchange rate adjustment was not necessary during the first year of the program appeared reasonable; however, the Managing Director considered it important that the option to adopt a more active exchange rate policy be kept open for implementation, if necessary, in subsequent years of the program.

The Managing Director indicated that he shared Mr. Palmer's concern that the World Bank's role, as indicated in Mr. Tun Thin's memorandum, appeared to be limited. With a program so heavily oriented toward the supply side, it would be necessary to strengthen the World Bank's involvement. While it was not necessary for the Bank to enter into a Structural Adjustment Loan, the Bank must provide its assessment of the program's supply-side policies in a general way, going beyond the sectoral assessments which had been proposed. The proposed involvement of Bank staff in the work of the mission was welcome, and could be strengthened if possible. Mr. Tun Thin indicated that the Bank may be in a position to provide the necessary assessment of India's policies in connection with the June meeting of the India Consortium. The Managing Director indicated that, were this not feasible, presentation of India's request to the Executive Board may need to be delayed beyond June as presently scheduled; a delay of some months would not cause great difficulties for India.

Bruce J. Smith
Division Chief,
Division A

cc: Messrs. Tun Thin
Narvekar
Palmer ✓
Division A Files

Mr. Finch

INTERNATIONAL MONETARY FUND

March 20, 1981

Note: A meeting has been scheduled with the management on Monday morning.

Office Memorandum

Mr. Palmer

cc: Immediate Office
Messrs Gerhard
Newham

TO : The Managing Director
The Deputy Managing Director

DATE: March 19, 1981

FROM : Tun Thin

SUBJECT : India--Briefing Paper for EFF Discussions

Attached is the briefing paper for the EFF discussions with India. Comments have been received from TRE (Mr. Wittich) and LEG (Mr. Liuksila).

Mr. Palmer (speaking also for his other colleagues in ETR) considers that the proposed program, as presently described, is inadequate for an EFF. In his view, the program rests mainly on the continuation of existing policies in the financial field; the policy changes envisaged to achieve the program targets are rather tentative (e.g., real interest rates are sharply negative but no deposit rate increases are likely). There is insufficient evidence that the proposed investment program will yield the desired supply response and assist the balance of payments to the extent needed in the post-EFF period. This doubt is heightened by what is perceived as an insufficiently active participation by the World Bank. It would be preferable that the Bank show its full support for the Indian investment program by negotiating a structural adjustment program, or alternatively a general program loan. Mr. Palmer suggests for your consideration that agreement be sought now on a one-year stand-by arrangement of a substantial financial magnitude, pending intensive work by the Indian authorities, the Fund, and the Bank to overcome these difficulties; agreement on a three-year EFF could then be reached in 1982.

My view is that India's basic problems can only be overcome by a program with a strong emphasis on the supply side and a medium-term focus, neither of which could be addressed adequately in a one-year stand-by arrangement. Beyond this, a delay of one year is unlikely to contribute greatly to confidence in the power of the investment program to assist in improving the balance of payments. We agree that in this area the Fund must rely heavily on the expertise of the Bank. In the public investment program of India's new Five-Year Plan, a large step-up is planned in expenditures in areas, viz., domestic energy, steel, fertilizer, and railways, which have been identified by the Bank as being of top priority. We have been in touch with the Bank, and have requested that a Bank economist participate in discussions in India, especially on the investment program. The Bank would give its views on the public investment program in sectors of special concern before the arrangement was considered by Executive Directors, which we now expect to be in June. In addition, the Bank staff would be working with us throughout the duration of the EFF, in particular to monitor progress in the implementation of the investment program. (The above has been specifically agreed with the World Bank.)

The Asian Department has been closely in touch with the Indian authorities and believes that the program for the first year includes a sufficiently wide range of policy initiatives. The measures that have been taken, especially in the budget for 1981/82, are in line with the discussions we have had; these measures relate particularly to industrial and investment policy, pricing, and export promotion. In any event, it is envisioned that policies will be reviewed every six months, so that areas where policies need strengthening can be identified and suitable adjustments made without delay.

The interest rate question raised by Mr. Palmer is one aspect of the general question of increasing savings which has been fully addressed on pp. 6-8 of the attached briefing paper.

Attachment

cc: ETR
LEG
TRE
Mr. Watson

Office Memorandum

TO : Messrs. Palmer, Wittich, Liuksila DATE: March 16, 1981

FROM : Bruce J. Smith

SUBJECT : India--Briefing Paper for EFF Discussions

May I please have your comments on the attached draft by close of business on Wednesday, March 18.

Attachment

cc: Messrs. Tun Thin
Narvekar

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

INDIA

Discussions for Extended Fund Facility

Prepared by the Asian Department

(In consultation with the Exchange and Trade Relations Department)

Approved by Tun Thin and Donald K. Palmer

March 16, 1981

A staff team consisting of Messrs. Tun Thin (head), Smith, Singh, Lipschitz, Kim (all ASD), Neuhaus (ETR), and Miss Singh (ASD) will visit New Delhi and Bombay during April 9-22 for discussions to finalize an extended arrangement with India.

1. Background

India's balance of payments moved sharply into surplus in 1975/76 (fiscal year April-March) and during the following years, international reserves were built to some SDR 6 billion, equivalent to six months imports. Policies to stimulate growth and make fuller use of available resources were initiated in 1977/78 and became fully effective in 1978/79, and by the end of that year the absorption of the large surpluses was largely complete. However, the balance of payments position weakened sharply further in 1979/80. Most importantly, severe drought and associated infrastructural bottlenecks resulted in a severe cutback in supplies and, in fact, real GNP declined by 4 per cent, while growth-oriented financial policies set at the beginning of the year were not adapted to the changed environment. Also, the terms of trade worsened sharply, with import prices rising by some 26 per cent owing mainly to higher oil prices. Inflation, at a rate of 20 per cent, emerged early in the year following a prolonged period of price stability, and the overall balance of payments shifted to deficit in the second half of the year. Although the economy has recovered over recent months (real growth of about 6.5 per cent appears likely for 1980/81 as a whole), and inflation has eased somewhat (14 per cent is projected for 1980/81), the balance of payments deficit has widened and is expected to reach SDR 1.3 billion. The main factors have been a continued weak export performance largely because of inadequate domestic supplies, a further deterioration in the terms of trade, and disruption to domestic oil production.

A growing payments imbalance is projected for the coming several years, partly reflecting the expected sluggish growth in world demand for India's exports and the likelihood of further adverse shifts in the terms of trade. Also, the import bill will need to grow sharply to support supply side adjustment policies, and it will take time to develop a substantial supply response which will aid the trade balance; adjustment policies will in this case tend to intensify payments pressures before they yield substantial results in the second half of the 1980s.

The Indian authorities have indicated that they anticipate an overall balance of payments gap of about SDR 11 billion in the four years to 1984/85, after counting normal receipts of foreign assistance. To finance the deficit, the authorities are requesting that the Fund provide SDR 5 billion under a three-year extended arrangement. They envisage that the remaining balance of payments gap will be covered by a drawdown of international reserves, some increase in official assistance, and borrowing on international capital markets on commercial terms.

2. Framework of the EFF program

The program would be built around a framework of supply side policies, for which the newly issued Sixth Plan may provide an appropriate foundation, balanced by necessary demand management and other policies. The program will be constructed bearing closely in mind the relevant guidelines of the 1974 decision establishing the EFF. This decision indicates, in particular, that programs must attempt to overcome "structural imbalances in production, trade, and prices with particular attention to policies to mobilize resources and improve utilization of them and to reduce reliance on external restrictions."

a. Supply-oriented policies

The program would aim to step up the rate of aggregate growth and improve its composition in line with the targets for the Sixth Plan. The Plan provides for overall growth of 5.2 per cent per annum in the period up to 1984/85, compared with some 4 per cent over the past five years. The stronger focus on policies promoting agricultural expansion, which has been responsible for a new resilience in this key sector over recent years, must be maintained. Agricultural policy should now be focused more broadly to overcome domestic shortages in nonfoodgrain production, such as oil seeds and pulses, in order to reduce import needs and contain inflation. Agriculture can also play a major direct role in external adjustment through increased exports. However, in pursuing these goals, care needs to be exercised that the internal terms of trade are not shifted too abruptly in favor of agriculture because of the recent upsurge in political action by the farmers' lobby; in particular, farm input and support prices must be set with reference to changes in economic costs and bearing in mind the need to avoid excessive food and fertilizer subsidies.

However, the main focus of supply policies will be on overcoming infrastructural bottlenecks and improving industrial performance. This will require a combination of measures. There is a need for a substantial step up in investment in infrastructure and basic industry to overcome the present severe impediments to overall growth. In the Indian context, the bulk of this investment will be in the public sector. It is important to ensure that such investments are allocated efficiently; new investment should encourage a factor use that is appropriate to the new price relationships of the 1980s, and not be guided excessively by the symptomatic shortages and past investment patterns. In the private sector, too, there is a need to increase and strengthen the efficiency of investment. The authorities have indicated that private investment policies are being liberalized, and recent policy changes free large enterprises, and those in the export sector, from some investment restrictions. The authorities should be encouraged to move further to eliminate unnecessary constraint and discouragement to efficient business investment. Equally important, official policies should promote the adaption of technology to reflect shifting relative resource costs; to promote this, major investment goods and their components, such as steel and energy, must be priced realistically and without subsidies.

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What are they?

The progressive liberalization of import restrictions in the three years up to 1978/79 has removed some of the long-standing constraints on industrial investment and efficiency. Although there was a selective tightening of restrictions in some areas in 1980/81, and import duties have been raised in the 1981/82 budget, the distinctly more liberal import policy of recent years remains basically intact. The authorities should be encouraged to explore means to further liberalize imports in selected areas and to increase the access of Indian producers to up-to-date foreign technology. Selective liberalization in key areas could contribute significantly to improving economic performance.

b. Domestic financial policies

To achieve the step-up in the growth rate, the authorities intend to raise domestic savings from the equivalent of 22.8 per cent of GDP in 1979/80 to 25 per cent by 1984/85; this would require a marginal savings rate of 31 per cent. There is scope to increase savings by the public sector, including the internally-generated resources of public enterprises, which amounts to about 5 per cent of GDP and has not increased over the past six years. Preliminary Plan projections are that about one fifth of total savings will be generated in the public sector, (5% of GDP) ? and that public savings will finance about half of the public sector investment program. Of the total amount of public sector savings projected, about half is estimated to accrue on the basis of current tax and pricing policies, while the remaining half will require major new resource mobilization efforts. The authorities recognize that this will pose a daunting challenge and, indeed, it provides a major policy focus for the EFF program. Because of an already high tax burden (some 20 per cent of GDP), the scope to increase taxes is limited. Nevertheless, the authorities envisage that selective tax measures, including steps to reduce tax evasion and strengthen tax administration, can realistically be expected to contribute about one third of the additional resources needed.

The Plan indicates that the major emphasis of public sector resource mobilization policies will be in the area of public pricing, with a view to reducing subsidies and increasing profits of the large public enterprise sector. Following recent substantial increases in prices for several important items (e.g., petroleum products, coal, steel, and fertilizer), the authorities are likely to be cautious about proceeding rapidly to adjust prices further. They will also wish to adopt a pragmatic approach with respect to the principal subsidies on food and fertilizer for social and political reasons. While bearing this in mind, it is essential that the program provide, within a reasonable time perspective, for price adjustments of the order needed to meet the resource mobilization targets. In addition, as noted above, public pricing policy must also promote the efficient allocation of resources. In this connection, the aim of policy should be for prices for items such as petroleum, coal, steel, electricity, and irrigation to adjust flexibly to reflect changes in economic costs.

Equally strong efforts are needed to increase private savings. Private savings rose sharply in the years up to 1978/79, associated with high agricultural incomes and a surge in remittances from abroad, but weakened in 1979/80 as a result of poor agricultural performance and the adverse shift in the terms of trade. The authorities are of the opinion that structural improvements in the financial system and the framework of fiscal incentives have resulted in an upward shift in the marginal savings rate of the private sector which is likely to endure. While this appears reasonable, it is also true that interest rate policy has, at least until recently, not been supportive of the efforts to increase private savings. However, upward adjustments of interest rates on longer-term bank deposits and some preferential loan rates were made in the 1981/82 budget, an encouraging move in the right direction. There is evidence that real interest rates have a significant, positive impact on savings in India, and the program should aim to restore the incentive to savings provided by attractive interest rates. While the recent adjustment is a step in this direction, the authorities stress that attractive real rates can best be achieved through efforts to reduce the rate of inflation. While accepting this emphasis, a more flexible approach to interest rate policy may be needed in subsequent years, especially if progress in reducing inflation to single digit levels is delayed.

c. External policies

The trade account has weakened substantially over the last few years as exports have performed poorly and imports have burgeoned. Export volume has, in fact, declined over the past three years as exportable surpluses have been reduced or eliminated, while residual import requirements for other items have risen sharply. It is, therefore, crucial that efforts to augment aggregate supplies focus particularly on productive investments in the external sector, and that they be supported by appropriately constraining financial policies. Beyond this, there is a need to strengthen export promotion policies to reverse the steady erosion of India's share of world exports over several decades. The Government is currently considering the report of an expert committee containing recommendations on various aspects of export promotion, the most important of which will be incorporated as major elements of the EFF program.

After a considerable improvement up to the end of 1978, India's international competitive position has slipped somewhat over the past two years with the re-emergence of domestic inflation. The authorities have indicated that they "would be pursuing a realistic policy in regard to exchange rates keeping in view, inter alia, their objectives with regard to the overall balance of payments and export promotion." A more explicit commitment regarding exchange rate policy would be politically sensitive and, in the authorities' view, counterproductive. The staff does not believe that a discrete change in the exchange rate is necessary at present, and believes that the above statement, which has been agreed by the authorities, provides a suitable policy framework for the program. The staff will emphasize that agreement on this basis would not preclude the possibility that specific understandings relating to the implementation of exchange rate policy may be needed subsequently during the program period depending upon intervening balance of payments and other developments.

3. Balance of payments adjustment and program implementation

India's economy has benefited from sound management over many years and, prior to the onset of the present difficulties, the economy was particularly well placed. Even now, India's economic position is more favorable than that of many oil-importing less developed countries, and although large in absolute terms, the external imbalance is small relative to the size of the economy. The authorities have been quick to react to the emerging imbalance, and have taken a number of adjustment measures, some in the context of the program for 1980/81 agreed with the Fund as the basis for a Trust Fund loan, and others associated with the 1981/82 government budget. They also emphasize that an early request for an EFF program is being made in order to preclude a serious crisis.

At the same time, the authorities recognize that policies must be adequate to promote external adjustment of sufficient magnitude to achieve a viable balance of payments and debt position in the second half of the 1980s. Staff projections suggest that without a step-up in growth and a sizable reallocation of resources to the external sector to accelerate exports and achieve substantial import replacement for energy and other items where India enjoys comparative advantage, the external position is unlikely to adjust within the coming decade. However, if the program is implemented successfully, adjustment within a reasonable time frame can be anticipated. Staff projections indicate that the current account deficit would rise from the equivalent to 1.7 per cent of GDP at present to about 3 per cent in 1984 before receding and returning to the current level in the late 1980s. The debt service ratio would rise considerably over coming years from the present low level of 10 per cent of exports, reflecting a hardening of the average terms of borrowing (including the Fund) as India taps borrowing on commercial and near commercial terms for the first time on a sizable scale. Even so, the debt service ratio would remain manageable throughout the peak years of the mid-1980s before turning downward toward the end of the decade.

The program for the first year would include sizable first steps to implement the above program building upon initiatives announced in the 1981/82 government budget, the new industrial policy announced recently, and measures relating to public sector pricing and export promotion. It would encompass measures to (a) promote savings (including the recent increases in interest rates, tax increases announced in the budget, and increases in administered prices); (b) increase investment (based upon a projected 20 per cent increase in Plan expenditures in 1981/82 and important tax and licensing concessions allowed for private investment); (c) improve the efficiency of investment (including recent measures to liberalize business investment, steps to ease bottlenecks and improve capacity utilization, and price rationalization); and (d) promote export development (based on the findings of the expert committee and the new industrial policy).

4. Program monitoring and performance criteria

During exploratory discussions the authorities indicated that, because of seasonal variability, they would have difficulty agreeing to the setting of credit ceilings more frequently than every six months. Although there are precedents for such a deviation from normal practice, there does not appear to be special merit in the Indian argument against more frequent ceilings, as seasonal variability in credit needs is a common feature which has been dealt with flexibly in many other cases. As a compromise, the staff has suggested that credit ceilings be set with reference to three dates each year, and in the absence of new considerations, the credit program will be prepared on this basis. The authorities have also been reluctant to agree to the setting of a subceiling on net credit to

Government within the overall credit ceiling. However, such a subceiling is most desirable, especially because the focus of the program is on stepping up public investment.

In agreeing to a credit program, the staff team will be guided by the need for monetary policy to support more rapid growth and supply side policies, and thus not to tightly constrain the balance of payments deficit. While the authorities seek to reduce inflationary pressures considerably further in 1981/82, progress here will depend primarily on reducing supply shortages with monetary policy supporting but not directly contributing substantially to a reduction. Based on projected real growth of 5 per cent and inflation of 9 per cent in 1981/82, an expansion in total liquidity of about 15 per cent appears to be a reasonable target, although subject to adjustment on account of further information provided by the authorities. In agreeing to the subceiling on net credit to Government, the team will take account of the need to maintain reasonable control over government financing needs when viewed in a longer-term perspective and, in the context of 1981/82, allow room for sufficient expansion of credit to the commercial sector within the constraint established by the overall credit ceiling.

India is in the process of entering international commercial credit markets for the first time to raise substantial amounts of project financing. While disbursements from these borrowings are likely to be small initially, it is important that the program guard against a serious deterioration in the debt service profile beyond the program period.

Therefore, the program will contain a ceiling covering commitments for loans with original maturity of over 1 year and up to 12 years contracted by the Government or publicly guaranteed, with a subceiling on maturities up to five years. The amounts of the ceilings for the first year will be agreed bearing in mind India's long-standing prudent policies with regard to debt management which are reflected in the present favorable debt profile, and the authorities' desire to complete financing arrangements for several large projects early in the Plan period. Alternatively, in the event that the authorities express a strong preference that the ceiling be framed in terms of loan disbursements, such ceilings would be supplemented by a provision which would allow for the close monitoring of loan commitments throughout the program period.

In addition to the formal performance criteria, which will include as well the usual understandings relating to exchange and trade restrictions, an effort will be made to devise mechanisms by which progress in implementing supply side policies can be monitored. Critical in this connection will be attempts to monitor, in collaboration with the IBRD, implementation of the investment program. In addition, supply side targets may be established to monitor performance in several key sectors.

5. IBRD activities and collaboration

In view of the program's emphasis on the supply side, it is essential that there be full collaboration with the IBRD and that the Bank provide an assessment of, and generally agree with, the investment program. The staff of the two institutions have been collaborating closely, and the Bank has undertaken to provide an assessment of the investment program to meet the Fund's requirements prior to the submission of India's request for consideration by the Executive Directors. In view of the Bank's own work timetable, this may possibly involve some delay in Fund Board consideration of the program, a fact which has been brought to the attention of the authorities. The Bank has indicated that it places great importance on efforts to overcome infrastructural bottlenecks, promote rapid export expansion and develop domestic energy production, objectives which are fully in accord with the thrust of the EFF program.

What if IBRD assessment is unfavorable?

There is considerable uncertainty surrounding the Bank's future lending program. Although aggregate assistance is expected to continue at about $2 billion per annum, the share of IDA funds is likely to fall considerably. As the Bank has no current plans for a structural adjustment loan to India, it would be desirable that the Bank increase program ? loan support. There are no current plans to provide general program loans, but the Bank is exploring the possibility of several sector loans with a large program content which would, in the aggregate, have a wide sectoral coverage.

6. Financing arrangements

The Indian authorities have indicated their wish to leave the SDR 330 million available under the reserve tranche (if this becomes possible) and the first credit tranche (SDR 429 million) undrawn to meet possible emergency needs. Of the total amount of the proposed arrangement of SDR 5 billion, $2.6 billion would be provided from borrowed resources. It has been proposed that purchases be phased corresponding to the projected pattern of balance of payments deficits; it is, therefore, envisaged that there will be a marked backloading.

The team will indicate that the borrowed resources would be provided under the enlarged access policy on terms and conditions which have yet to be determined. It will reiterate that, were some part of the SFF subsequently to become available, the allocation of these funds among potential borrowers would have to be decided upon by the Executive Board.

File Briefing

February 5, 1981

cc: R. Palmer

MEMO TO FILES

Subject: India--Discussions with IBRD, February 3, 1981

Mr. Tun Thin and I met with Mr. Hopper and Mrs. Hamilton to discuss collaboration with the Bank in relation to the possible EFF arrangement with India.

Mr. Hopper provided the following review of his recent visit to India:

1. The Sixth Plan has now been approved by Cabinet. The Cabinet approved an increase in public sector Plan expenditure of some Rs 7,500 crores, bringing the total to Rs 97,500 crores. Of the additional amount, some Rs 3,400 crores will be financed from additional external borrowing, Rs 3,000 crores from additional taxes, and Rs 1,100 crores from domestic borrowing.

2. The Plan will be available to the Bank and Fund after February 17 when it is presented to Parliament. In the meantime, the Bank has controlled access to its contents in Delhi.

3. The Bank's preliminary view is that the sectoral allocation of Plan expenditures is disappointing. Much smaller allocations have been made for key infrastructural areas, such as power and railways, than officials responsible for these sectors considered necessary. Also, the authorities admit that the pattern of allocations will not allow any reduction in the capital output ratio, which is disappointingly high.

4. The balance of payments forecasts contained in the Plan are now well out of date, especially as they are presented in constant price terms and make no allowance for likely shifts in the terms of trade. Projections of the Ministry of Finance show a large deficit, and those of the Reserve Bank an even larger one. The Bank currently estimates that the overall deficit in 1980/81 will be some $1.8 billion.

5. It now appears uncertain that the Bank will be able to increase its lending to India over the coming few years. The possibility would be further reduced were the investment priorities in the Plan to be, in fact, unsatisfactory. The Bank would be looking especially for strong action to overcome infrastructural bottlenecks and promote rapid export development. Such action is considered to be especially important as it would signal that the economic base necessary to support the balance of payments beyond the 1980s is being built.

Mr. Tun Thin explained that the Fund would need the Bank's assessment of India's investment program for the coming three years before putting the EFF proposal forward for Board approval. Mr. Hopper indicated that the Bank's Economic Report would probably not contain an investment analysis, although this analysis was considered to be a priority area and every effort would be made to provide an assessment to the Fund so as to avoid a delay in Board consideration of an Indian request. Mr. Hopper also noted that the actual allocation of Plan expenditures may turn out to be very different from the projections outlined in the Plan document.

Bruce J. Smith
Division Chief,
Division A

cc: Messrs. Tun Thin
Narvekar
Palmer
Division A India Desks

ETR

Office Memorandum

cc: Mr. Palmer

CONFIDENTIAL

RECEIVED JAN 16 1981 EXCHANGE & TRADE RELATIONS

TO : The Managing Director
The Deputy Managing Director

DATE: January 15, 1981

FROM : Tun Thin

SUBJECT : India--Discussions on a Possible Extended Arrangement

I visited Delhi during January 8-13, accompanied by Messrs. Bruce Smith and Anoop Singh, for discussions on a possible extended arrangement with India. Mr. Narasimham also joined the discussions.

1. Economic developments during 1980/81

Since the June 1980 negotiations for a Trust Fund program, the Indian economy has progressed broadly according to expectations. Weather returned to normal during the 1980 monsoon season and agricultural production is expected to reach a new peak following the severe setback in 1979/80 (fiscal year ended March). Progress in overcoming the crippling bottlenecks in the key infrastructure and intermediate good sectors was delayed; however, by the third quarter there was important improvement in the critical electric power, coal and transportation sectors and the anticipated revival in industrial activity appeared to be getting under way. If the fourth quarter is as favorable, real growth of about 6 per cent will be achieved in 1980/81 as a whole. The improvement in the supply position together with a slowing in monetary expansion have already contributed to an easing of inflationary pressures in recent months, and the authorities now expect inflation to be about 12-13 per cent in 1980/81, down from 20 per cent in the previous year. Details of budgetary developments are scant, but it appears that largely because of additional expenditures the overall deficit will be larger, perhaps considerably, than budgeted; government recourse to the banks has consequently also increased considerably faster than projected in the financial program. However, because of the drawdown of food stocks, commercial credit expanded only modestly, and there was a larger than projected overall deficit on external transactions. As a result the authorities believe that the growth in domestic liquidity will be contained at about 15 per cent in 1980/81 as envisaged in the Trust Fund program. Reflecting the increase in the oil import bill, the overall balance of payments is now expected to shift from a surplus of SDR 0.3 billion in 1979/80 to a deficit of about SDR 1.3 billion in 1980/81, a somewhat larger deterioration than earlier projected.

2. The Sixth Plan and the framework for Fund support

Until the recent upturn, economic performance has been generally disappointing since the return to power of Mrs. Gandhi's Government in January 1980. While to a considerable extent the problems were carried over from the time of the previous Government, Mrs. Gandhi has not been immune from widespread criticism on this subject. Although her political popularity remains strong, she is fully alive to the need for bold actions to strengthen economic performance.

The discussions took place as the authorities are finalizing the Sixth Five-Year Plan and preparing for its approval and adoption by the Government. The Plan, which will guide policies through 1984/85, aims at adjusting the economy to the deterioration in the country's external terms of trade, and increasing its resilience to an anticipated further deterioration. This will be achieved principally through increased exploration and development of domestic energy sources, and efforts aimed at eliminating present bottlenecks in the key infrastructure and intermediate good sectors. Efficient import substitution and more vigorous attention to the export sector will be important planks of policy. The authorities explained that important strides in these areas have already been made through changes in the administration of industrial licensing, export policy including industrial licensing affecting export industries and liberalization of import policy and procedures. With further policy initiatives and good weather conditions it should be possible to achieve an annual average growth rate of at least 5 per cent during the Sixth Plan period.

Accelerated investment will be largely financed by increased domestic savings (projected to rise by some 2 percentage points to 25 per cent of GNP over the five years). However, supply response lags may delay attainment of the target increase in export volumes of 10 per cent per annum until the end of the Plan period. Also, rapid increases in imports will be needed to support the higher investment and growth rates. These factors will result in a widening balance of payments deficit over the Plan period. The balance of payments gap is projected to peak toward the end of the Plan period when the current account deficit as a proportion of GNP would reach about 4 per cent. This would be progressively reduced during the Seventh Plan period. After allowing for normal increases in aid and other net capital inflows, the authorities project that the uncovered balance of payments gap for the four years through 1984/85 would total about SDR 11 billion. Part of the gap is expected to be covered as a result of efforts to attract additional external assistance. However, the authorities are now requesting that the Fund provide about SDR 5 billion (excluding amounts available under the reserve and first credit tranches) under an extended arrangement to cover much of the remaining gap for the next three years. Of this amount, some SDR 2.6 billion would be from borrowed resources. The arrangement would be backloaded in line with the expected pattern of deficits (drawings have been tentatively slated at SDR 1 billion, SDR 1.7 billion and SDR 2.3 billion in successive years). The extent of balance of payments need, and the amount of the arrangement would be finalized during future negotiations.

The discussions were for reasons of confidentiality confined to a small group of senior officials including Finance Minister Venkataraman, Economic Affairs Secretary Malhotra, and Member/Secretary of the Planning Commission Manmohan Singh; Mr. Narasimham played an active and constructive role. The authorities expressed their appreciation of the new role of the Fund in providing enlarged access to its resources under terms allowing for a longer adjustment period and supporting measures on the supply side. As they explained it, their approach to the Fund at this stage is intended to be an exercise in crisis avoidance rather than one of crisis management. The Prime Minister has been briefed and has approved the approach to the Fund although it is likely to be politically unpopular. The authorities intend also to seek additional World Bank support, both in its role as Chairman of the India Consultative Group and also through its own structural adjustment facility which would augment ongoing annual Bank lending of $2 billion. They expressed a keen interest in the forms of Fund/Bank collaboration under the EFF and the Bank had agreed to provide its full cooperation with the EFF arrangement.

3. Elements of a possible EFF program

The policy program proposed by the authorities is supply-oriented and is broadly in line with that suggested by the staff in the mission's briefing paper. It would have the following main elements.

(1) Investment program. A substantial step-up in investment expenditures focused particularly on overcoming infrastructure bottlenecks and promoting rapid growth in domestic energy, export and efficient import-saving industries.

(2) Industrial policy. To eliminate present constraints on growth, the major investment effort during the Sixth Plan will be in the infrastructure and basic industry sectors and therefore, inevitably, in the public sector. However, the stimulation of private investment in industry will be an important policy objective and policy initiatives in this area have already been taken. The recent changes recognize the technology and efficiency advantages of large enterprises; free export production from most existing regulations on size and capacity extension, liberalize these very regulations for investment initiatives; and facilitate the import of technology in key industries and sectors. Policies will continue to be formulated with this thrust.

(3) Energy. Steps will be taken to achieve a rapid increase in domestic energy production, especially of oil and coal. Policies will also aim to promote a more efficient use of energy resources.

(4) Public sector pricing and budget subsidies. Public pricing will be administered flexibly. The aim of policy with respect to the wide range of items provided by the public sector, including especially petroleum, coal, steel, electricity, and irrigation would be for prices to reflect their economic costs. The authorities have already moved significantly in this direction and most recently, on January 13, prices of petroleum products were raised by between 7 and 17 per cent with a view to considerably reducing the deficits of domestic oil companies. More flexible administered pricing policies will also be designed to increase the contribution of public sector enterprises to the development effort. While the Government would have to adopt a

pragmatic approach with respect to the principal subsidies on food and fertilizer, steps would be taken when possible to effect a reduction in the subsidy burden over the course of the program period.

(5) Budgetary policy. Budget finances will be organized to promote a step-up in public savings to enable the enlarged public investment program to be financed without excessive recourse to the banking system. The tax burden in India is already substantial and the scope to increase taxes is limited. However, consideration will be given to selective measures for additional resource mobilization. It will be necessary also to restrain nondevelopment expenditures (including subsidies).

(6) Private savings. Efforts will be made to generate increased private savings in line with the aggregate savings target. Structural improvements in the financial system and more rapid growth have induced a high marginal savings rate in the private sector. These influences are being reinforced by a strengthening of fiscal incentives. Further support will be provided by an adjustment and rationalization of interest rates, if necessary.

(7) Import restrictions. The aim of the authorities in seeking Fund support for their adjustment program is to continue the present policy of liberalizing imports as the balance of payments situation permits.

(8) Export and exchange rate policies. A number of initiatives have already been taken and further steps are under consideration to strengthen export policies. Measures taken so far include the virtual elimination of licensing restrictions on investment in export industries, and further liberalization of imports for exporters. The authorities recognize that exchange rate policy also has an important bearing on export competitiveness. They indicated that they would be pursuing a realistic policy in regard to exchange rates keeping in view, inter alia, their objectives with regard to the overall balance of payments and export promotion.

(9) Performance criteria. Ceilings on total domestic credit, with a subceiling on net credit to Government will be established in each year of the program. There would also be an annual ceiling on external debt, and the usual understandings relating to exchange and trade restrictions.

With your approval, a mission will visit India after presentation to Parliament of the 1981/82 budget on February 28--probably in the second half of March--to negotiate a program for an extended arrangement.

cc: Mr. Watson

ETR
FAD
LEG
TRE
ASD Senior Staff

1980

Office Memorandum

TO : The Managing Director
The Deputy Managing Director

DATE: December 31, 1980

FROM : Tun Thin

SUBJECT : Mission to India

Attached for your approval is a draft briefing paper for the forthcoming mission to India for exploratory discussions on an EFF program. It has been cleared with Mr. Palmer. For want of time, we were not able to get the comments of FAD, LEG and TRE, but copies are now being sent to them.

We have been in consultation with the World Bank on the EFF proposal and have their full cooperation. Mr. McNamara is planning to visit India in February to discuss the Bank's plans for lending to India. Bank officials regard the EFF proposal--its size, policy content, etc.--as vitally relevant to those discussions.

Attachment

cc: Mr. Habermeier
Mr. Goode
Mr. Nicoletopoulos
Mr. Palmer
Mr. Watson

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

INDIA

Exploratory Discussions for an Extended Fund Facility

Prepared by the Asian Department

(In consultation with the Exchange and Trade Relations Department)

Approved by Tun Thin and Donald K. Palmer

December 31, 1980

In response to an invitation by the Indian authorities, a staff team, consisting of Messrs. Tun Thin, Bruce Smith, and Anoop Singh (who is in India at present on his way back from Colombo) will visit New Delhi during January 8-12 for exploratory discussions concerning a possible extended arrangement with the Fund.

I. A Possible Medium-Term Strategy

1. Supply and investment policies

Events of the past several years clearly illustrate the central role of policies to augment aggregate supplies. Four years of stable prices and large external surpluses, which were associated with a period of sustained increases in production, ended in 1979/80 when severe drought (in conjunction with a deterioration in the international environment) brought an abrupt weakening of the balance of payments and a surge in inflation. Although weather has since returned to normal, the economy has not rebounded as expected and, in particular, it continues to suffer from acute shortages in critical areas. Ironically, the main problem is not in agriculture, the largest and most important sector, which has shown a new resilience as a result of strengthened policies over recent years. Rather, it is the industrial sector and basic infrastructure which present the major problem. Shortages and bottlenecks in the electric power, coal, cement, steel, and transportation sectors have hampered production in a wide spectrum of industries, contributing importantly to sluggish exports, increased imports, weak business investment, and inflation. While some of these difficulties are perennial, they have intensified greatly since the beginning of 1979.

A determined effort to break this cycle of shortages will require, as much as an increase, an improvement in the efficiency of investment--which has been disappointingly low. This would involve a thorough review of industrial policies, including policies relating to foreign investment, in order to eliminate unnecessary constraint and discouragement to efficient business investment. The present Government appears to be discarding some of the excessively constraining regulations introduced by its predecessor, although no clear industrial policy has yet emerged.

At the same time, there is need for a sizable step-up in investment, directed particularly toward overcoming infrastructural and industrial bottlenecks. The World Bank, in its lending program, will continue to include financing for projects in several of these key areas, including, especially, electric power. The Bank is currently providing assistance totaling $2 billion per annum, and expects that lending will continue at this rate for the coming few years, although the proportion of IDA financing will inevitably decline from 80 per cent at present. India can also count on receiving continued sizable external assistance from other sources, and amounts provided under the extended arrangement would also add to available investable resources over the coming few years. It is worth noting that foreign official financing has the advantage that it may be applied with a degree of flexibility to augment flows of investment to particular sectors, including several where bottlenecks are most severe. However, the scope to increase domestic investment by mobilizing additional foreign assistance is small in the Indian context. Also, India has not borrowed extensively on foreign commercial markets and the authorities are unwilling to tap high-cost borrowing on a large scale.

2. Domestic savings

In their preliminary projections for the Sixth Five-Year Plan (1980/81-1984/85) the authorities estimate that in order to achieve overall growth of 5.3 per cent per annum (compared with about 4 per cent over the past five years), a marginal savings rate of some 31 per cent will be required. If achieved, this will raise the gross savings/GNP ratio by over 2 percentage points to some 25 per cent over the five years. Of the total savings, about 20 per cent will have to be generated within the public sector to assist in financing public investment needs. Because of an already high tax burden, the scope to increase taxes is quite limited. In these circumstances, the emphasis should best be placed on reducing subsidies and increasing the contribution of profits from the large public enterprise sector. However, following substantial increases in prices for several important items (petroleum, coal, and fertilizer) over the past year, the authorities may be unable to proceed too rapidly in this direction in the immediate future.

Private savings rose sharply in the years up to 1978/79, but appear to have been weak in 1979/80. Developments in real income, especially in the agricultural sector, largely account for this pattern. Although rates on bank deposits were raised by up to 1 percentage point in September 1979, the present level of interest rates is low both in relation to the level of inflation in India (20 per cent) and interest rates on world markets; rates on fixed deposits range from 2.5 per cent up to a maximum of no more than 10 per cent for deposits of more than five years. Interest rates on bank loans are not as low, ranging up to 19 per cent, partly because of the reimposition in June 1980 of a 7 per cent tax on interest earnings of banks. Under these circumstances a more flexible interest rate policy can play an important role in encouraging private savings and promoting the efficient allocation of credit and investment.

3. External policies

Export growth over the past three years has been disappointing, averaging no more than 6 per cent per annum. Export volume has, in fact, declined as exportable surpluses for important items (e.g., steel and sugar) have been reduced or eliminated. In contrast, imports have risen by an average of 18 per cent per annum over the same period. While oil accounts for over half of the increase in the import bill, there have been sizable increases in imports of fertilizer, steel, cement, and edible oils to compensate for inadequate domestic supplies. Under these circcumstances, an improvement in the aggregate supply position, coupled with appropriate financial policies, would result in a considerable strengthening of the trade account. Investments directed specifically to promote domestic production in particular sectors--e.g., domestic energy, cement, and fertilizer--could yield substantial import savings (and in some cases, exports) within a reasonable period.

Import restrictions were progressively eased after 1975/76, culminating in a major liberalization in 1978/79. Since then, the overall position has been about maintained, although some steps were taken in the 1980/81 import policy which could be interpreted as a shift in the direction of policy in light of the weakening balance of payments. There is no doubt that there is a strong sentiment in India favoring a tightening of import restrictions as a means of conserving foreign exchange, even though tight import restrictions in the past were a major impediment to economic efficiency and growth. While it may not be possible to achieve a further major import liberalization to expose Indian producers to greater foreign competition in the present environment, selective measures to liberalize access to imports and technology in key areas should be feasible and the mission will encourage the authorities to adopt this course.

The effective exchange rate for the rupee, adjusted for relative price changes, depreciated by over 20 per cent between 1975 and the end of 1978. However, with the re-emergence of domestic inflation and the strengthening of the pound sterling, there has been a gradual appreciation in the real effective rate for the rupee since the beginning of 1979. At the time of the April 1980 consultation discussions there was no evidence that the competitive position of Indian producers had worsened perceptibly as a result of this appreciation. However, it would be unwise for the authorities to allow this trend to continue in the future, and the need for balance of payments adjustment suggests that a resumption of the 1975-78 trend would be preferable.

II. The Principal Elements of an EFF Program

It is premature to have a firm position as to the specific contents of an EFF program, particularly as the present visit has, as one of its purposes, to collect information on which these decisions will later be based. However, it is important that the authorities be aware, if only in broad terms, of the actions and policies which would be a necessary basis of the program. While the program which is outlined below provides for actions in a wide range of areas, including those primarily within the sphere of the IBRD, it would also provide for measures to mobilize resources, improve their utilization and reduce reliance on external restrictions, and thus is designed to be in accordance with the 1974 Decision establishing the EFF.

The program would include, as performance criteria, phased credit ceilings, external debt ceilings, and the normal understandings relating to exchange and trade restrictions. In addition, the program would include undertakings in the following areas consistent with the above strategy. We are in close consultation with the World Bank in all these areas, especially those for which the Bank has primary responsibility.

(1) The investment program

A detailed sectoral investment program, presumably in connection with the Sixth Plan, directed particularly at overcoming the existing difficulties and promoting a faster but reasonable rate of growth. The World Bank has agreed to provide its expert assessment of such a program.

(2) Industrial policies

An industrial strategy aimed at encouraging business investment and promoting efficient industrial expansion. Steps will be needed to ease restrictions within the framework of regulations governing industrial licensing, debt equity norms, size and monopoly position, and location. Remaining regulatory impediments to business investment and economic efficiency in industry will be justified on clear and overriding social considerations.

(3) Agriculture

Measures to encourage the transfer of the new-found dynamism in foodgrain production into increased output for other major export (e.g., jute and sugar) and import (e.g., oilseeds) crops. Support pricing policies, especially with respect to foodgrains, need to take a balanced account of both the need to provide incentives to farmers and their fiscal burden.

(4) Energy

Measures to promote the domestic production and conservation of energy, and a commitment to continue the present policy of passing on promptly increases in import prices for petroleum and petroleum products.

(5) Subsidies

Clear statements of policy with regard to the future of the major budgetary subsidies--e.g., food and fertilizer--and targets for the budgetary savings to be made in this area.

(6) Public sector pricing

A commitment to pass on cost increases through a flexible policy of adjusting administered prices for the wide range of other items provided by the public sector (including coal and steel). Public sector pricing and management policies should aim to ensure that the financial returns of these enterprises and their contributions to financing development are increased to appropriate levels.

(7) Public sector savings

A program of other tax and expenditure measures necessary to generate the public savings necessary to finance the public investment program will....

(8) Private savings

A set of measures designed to promote the increase in private savings necessary to meet the aggregate investment target.

(9) Import restrictions

A commitment to retain the present more liberal import regime and to undertake a further general liberalization as the balance of payments position allows. Beyond this, measures are needed to liberalize imports in specific areas, especially in those areas where access to foreign goods and technology would have a substantial impact in overcoming domestic shortages and bottlenecks.

(10) Exchange rate

While it is not expected that a discrete change in the exchange rate would be called for in connection with the first year's program, the program will include a commitment to follow a flexible exchange rate policy designed especially to promote export development. The authorities will be made aware that a continuation of the recent appreciation of the rupee would be considered inconsistent with this objective.

III. Amount of Fund Assistance

Under present policies, India could purchase up to SDR 7.7 billion over the coming three years, i.e., 450 per cent of its quota of

SDR 1,717.5 million. Of this amount, up to SDR 3.2 billion 1/ could be provided from the Fund's ordinary resources, and SDR 4.5 billion from borrowed funds.

The authorities had earlier indicated their desire to purchase only that amount which is available from the Fund's ordinary resources (SDR 3.2 billion). However, it now appears likely that the balance of payments need over the coming three years may be larger--perhaps of the order of SDR 4-5 billion--although this will be subject to detailed scrutiny by the mission. Because of the possibility of a greater balance of payments need, the authorities are now considering a larger amount, including borrowed resources. However, they need to be aware that utilizing borrowed resources would entail "mixing" purchases from ordinary and borrowed resources throughout the period, in line with the decision which establishes the borrowing facility. The actual amount of Fund financing to be provided to India and its phasing will be discussed during this mission but will be negotiated ad referendum only during the final phase of discussions, currently expected to take place in March 1981.

In considering the use of borrowed resources, the authorities may be influenced by the possibility of receiving an interest rate subsidy. The staff team will emphasize that the present subsidy applies only to the SFF, which will probably be fully committed before India's request is considered, and that it is not possible to indicate whether or not a subsidy will be agreed for subsequent use of borrowed resources.

1/ Including SDR 0.3 billion from the reserve tranche and SDR 0.4 billion from the first credit tranche.

India's debt burden is modest at present--external debt is equal to some 15 per cent of GNP and debt service absorbs less than 10 per cent of current account receipts. Work is now under way, in consultation with the World Bank, to determine whether large-scale borrowing from the Fund would impose an excessive service burden during the late 1980s. However, it does not now appear that borrowing SDR 4-5 billion from the Fund will create an unmanageable debt problem.

India: Fund Relations

Date of membership:	December 27, 1945.
Status:	Article XIV.
Quota:	SDR 1,717.5 million under the Seventh Review.
Fund holdings of rupees: (As of November 30, 1980)	SDR 1,224.5 (106.9 per cent of quota), including compensatory financing purchases of SDR 266 million (86.8 per cent). Excluding purchases under this facility, the India's holdings were SDR 958.5 million (83.7 per cent of quota).
SDR position: (As of November 30, 1980)	Holdings amounted to SDR 519.8 million, or 92.1 per cent of net cumulative allocation.
Trust Fund:	Total disbursements as of November 30, 1980 amounted 525.46 million.
Direct distribution of profits from gold sales:	US$149.33 million as of November 30, 1980.
Gold distribution:	804,429.4 fine ounces.
Exchange system:	Linked to a basket of currencies within 5 per cent margins. The current middle rate as of December 22 is Rs 18.70 = pound sterling 1.
Last Article IV consultation:	Article IV consultation discussions were last held during April 7-22, 1980. The staff reports (SM/80/151, 6/23/80; and Supplement 1, 7/28/80), were discussed by the Board on August 7, 1980.

ETR

Office Memorandum

cc: Mr. Palmer
Mr. Woolley

CONFIDENTIAL

TO : The Managing Director
The Deputy Managing Director

DATE: July 10, 1980

FROM : Tun Thin

SUBJECT : India--Trust Fund and Article IV Consultation Follow-up Discussions

RECEIVED JUL 11 1980 EXCHANGE & TRADE RELATIONS

Together with Messrs. Smith, Sundararajan, Lipschitz, and Miss Sudo, I visited Delhi during June 20-24 to discuss a Trust Fund program and update information obtained during the Article IV consultation discussions held in April. Mr. Deshmukh was also present during the discussions.

The accidental death of Mrs. Gandhi's son Sanjay during our stay has created a power vacuum within Mrs. Gandhi's Government, extending the period needed for the Government to consolidate its position following her party's success in the recent state elections.

Latest data suggest that the falls in agricultural production (10 per cent) and real GNP (3 per cent) largely because of drought in 1979/80 (fiscal year ended March) were somewhat steeper than earlier estimated. Recent reports indicate a normal beginning to the 1980 monsoon which, if it continues, is expected to promote a recovery of economic growth to at least 6 per cent in 1980/81. The authorities are aiming to reduce inflation substantially from the rate of 20 per cent over the past year. However, increases in administered prices and continued import price escalation make it unlikely that the inflation rate will fall below 10 per cent in 1980/81. Revised balance of payments projections for 1980/81 show few changes from those discussed in April, although the overall deficit is now expected to be somewhat larger at SDR 0.9 billion.

There have been several important policy developments since the April discussions. The 1980/81 Central Government budget, which was presented on June 18 is, as we considered necessary, considerably less expansionary than that in 1979/80. The budget deficit (after counting receipt of the expected Trust Fund loan of Rs 5.4 billion) is estimated to be Rs 14.2 billion, little more than half that of Rs 27 billion in 1979/80. Taking account of net subscriptions by the banking system to market borrowings, net government recourse to the banking system as a percentage of the money stock at the beginning of the year is expected to decline from 17 per cent in 1979/80 to 12 per cent in 1980/81. A number of measures to increase taxes have been introduced, although by past standards the new tax effort is relatively small. The most important is a 7 per cent tax on the interest earnings of commercial banks and major government term-lending institutions. This will have the effect of raising lending rates, and thus go part way toward the upward adjustment to interest rates we have recommended. Measures have also been introduced to stimulate private savings by broadening tax concessions and reducing the surcharge on noncorporate income taxes.

Considerable progress has been made since the April mission in making necessary adjustments to administered prices. Most importantly, domestic prices for petroleum products were raised by up to 79 per cent in

June to cover fully increased costs; substantial losses in the domestic petroleum industry in the early months of 1980 resulted in a surge in bank credit which threatened to undermine the policy of credit restraint. Also, fertilizer prices have been increased by almost 40 per cent to reduce the budget subsidy, and railway freight rates and passenger fares have been raised. Together with the increase in taxes, these adjustments will reduce disposable incomes by about 3 per cent. Nevertheless, further adjustments in important administered prices, including food, coal, and steel, may be necessary during coming months.

Attached is a copy of the statement of policies for 1980/81 agreed ad referendum with the authorities as the basis upon which a Trust Fund loan for the second period will be extended to India; the amount of the loan will be about SDR 0.5 billion. The program is based mainly on the supply, budgetary and pricing policies already introduced, complemented by a monetary program for 1980/81. Consistent with the above growth and inflation targets, the expansion in money supply in 1980/81 will be limited to 13 per cent, some 3 percentage points lower than in 1979/80. Total domestic credit is projected to expand by 16 per cent, a 5 percentage-point reduction from 1979/80 made possible almost entirely by the slower growth in net credit to the Government. During our meeting with Finance Minister Venkataraman, he affirmed the Government's commitment to reducing monetary expansion and restoring relatively stable prices.

The mission also collected information on exports to determine whether India would be entitled to a purchase under the Compensatory Financing Facility for an export shortfall in 1979/80. Preliminary calculations, based on information available prior to the mission, indicate a shortfall of somewhat less than SDR 0.4 billion, or about 30 per cent of quota. If the shortfall is confirmed, the staff will prepare a paper for consideration by Executive Directors concurrently with consideration of the Article IV consultation and Trust Fund loan now scheduled for August 8, 1980.

Together, the Trust Fund loan and CFF purchase would cover most of the balance of payments deficit projected for 1980/81. The authorities have indicated interest in making further use of Fund resources to cover deficits expected over the next several years. For 1981/82, a further substantial amount could be provided within the first credit tranche, but upper tranche conditionality would be necessary for Fund assistance in 1982/83 and beyond.

Attachment

cc: Mr. Watson
ETR
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ASD Senior Staff
Division A

भारत सरकार
वित्त मंत्रालय
आर्थिक कार्य विभाग
GOVERNMENT OF INDIA
MINISTRY OF FINANCE
Department of Economic Affairs
नई दिल्ली/New Delhi.(India)

सचिव
SECRETARY

June 27, 1980.

Mr.J. de Larosiere
Managing Director
International Monetary Fund
Washington, D.C. 20431.

Sir:

1. India hereby requests a loan from the Trust Fund administered by the International Monetary Fund as Trustee in accordance with the Instrument to Establish the Trust Fund ("Instrument") annexed to Executive Board Decision No.5069-(76/72), adopted May 5, 1976, as amended by Executive Board Decisions No.5563-(77/150) TR, adopted October 28,1977, No.6202-(79/121) TR, adopted July 23, 1979, and No.6466-(80/68) TR, adopted April 9, 1980, in respect of the second period, July 1, 1978 through December 31, 1980, in the amount that will be available to India under the provisions of the Instrument to meet its need for balance of payments assistance.

2. In accordance with Section III, Paragraph 1 of the Instrument, (a) the Ministry of Finance, which has been designated as the fiscal agency for India pursuant to Article V, Section 1 of the Articles of Agreement of the International Monetary Fund, shall act as the fiscal agency for India in all operations and transactions under any loan agreement with the Fund as Trustee; (b) the same method of authenticating

communications used in operations and transactions on the account of the Fund shall apply to any operations and transactions of India with the Fund as Trustee.

3. In accordance with Section II, Paragraph 3(d) of the Instrument, I submit the attached statement, which sets forth the economic and financial policies that India will pursue in the twelve-month period April 1, 1980 through March 31, 1981, in order to strengthen India's balance of payments position.

Very truly yours,

(R.N. Malhotra)

<u>Statement by the Government of India on Certain Aspects of Its Economic Policies.</u>

India's economic situation deteriorated in 1979/80. The year was characterized by supply constraints and infrastructure problems in the fields of power generation, coal, railway transportation, and the ports. Severe drought was experienced in large parts of the country with the result that agricultural production declined by about 10 per cent as compared to 1978-79. Industrial production declined by about 1 per cent due to power shortages and shortages of raw materials. The drought was responsible for a decline of 2.2 per cent in hydro electric power generation and problems regarding coal supply and other factors were responsible for a decline in thermal capacity. There was also a decline of 3.3 per cent from 1978-79 in the revenue earning tonnage carried by the railways. The deficiencies in the three major sectors of power, coal and railways led to a decline in production and severe underutilization of installed capacities in various major industries including steel, cement, non-ferrous metals, and newsprint. As a combined result of all these unusual factors, 1979-80 witnessed a decline of about 3 per cent in the real gross national product.

2. The supply constraints, higher import prices, necessary adjustments of administered prices, and aggregate demand pressures resulting from large budget deficits and the highly liquid state of the economy led to the emergence of severe inflationary pressures during 1979/80 and the wholesale price index rose by 20 per cent. To combat inflationary pressures, credit policies were tightened progressively during the year, and despite a sharp increase in the Government's recourse to the banking system to

finance the budget deficit, monetary expansion slowed to an estimated 16 per cent from 21 per cent in 1978/79.

3. The balance of payments position also weakened considerably in 1979/80 in the wake of severe deterioration in the terms of trade. The import bill rose by 24 per cent and this was largely because of a steep increase in the prices of oil and oil products and other items including fertilisers, and ferrous and non-ferrous metals. Imports of some major items increased because of the shortfall in indigenous production. Large imports of essential items of mass consumption, such as edible oils, also contributed to the increase in the import bill. Exports were sluggish as a result of the fall in domestic output, weak foreign demand for some items, and the effects of restrictions on access to some foreign markets. The trade deficit of SDR 2.2 billion in 1979-80 was more than twice that in 1978-79 and for the first time in recent years, there was a deficit on current account. The overall balance of payments surplus was reduced to about SDR 0.3 billion in 1979/80 from SDR 1.1 billion in the previous year and the overall position shifted to deficit in the second half of the year.

4. The main objectives of economic policy in 1980/81 are to encourage renewed economic growth and to restore relatively stable prices while containing the balance of payments deficit within reasonable bounds. Granted a return of average weather, and assuming a generally stable international economic environment, real economic growth of at least 6 per cent appears feasible in 1980/81. The Government is committed to reducing the rate of inflation substantially. We expect to be able to make considerable progress toward this objective in 1980/81. However, large increases in petroleum and fertilizer prices recently announced, and continued rapid rises in

prices for imports will limit the feasible reduction in the rate of inflation. The combination of renewed growth with reduced inflation will require financial policies that contain demand pressures while meeting the legitimate needs of producers. Restraining financial policies will need to be supported by special efforts to increase supplies, including measures to alleviate production bottlenecks and improve investment climate and industrial relations.

5. The central Government budget 1980/81 projects deficit (covering changes in cash balances and the net issue of Treasury bills) of Rs. 14.2 billion (after counting receipt of the expected Trust Fund loan of Rs. 5.4 billion), compared with an estimated deficit of Rs.27.0 billion in 1979/80. Net market borrowing (including net amounts subscribed by the banking system) is projected to amount to Rs.25 billion in 1980/81, compared with Rs. 19.6 billion in 1979/80. Total current revenues are expected to rise by 10 per cent, with tax revenues increasing by 8 per cent. While new measures to increase taxes have been introduced, changes have also been made to stimulate savings. The surcharge on noncorporate income taxes has been halved cutting the maximum marginal rate of tax from 72 to 66 per cent. Existing concessions to encourage long-term savings through life insurance, provident funds and similar instruments have been broadened and the exemption limits for the income and wealth taxes have been raised. A 7 per cent tax on the interest earnings of commercial banks and major term lending institutions has been introduced; this will raise interest rates on loans extended by these institutions. Total budget expenditures are projected to rise by 11 per cent. A substantial effort has been made to restrain the growth in nonplan expenditure. Central Plan expenditures are budgeted to increase by 27 per cent

over the revised estimate of 1979/80, with over a third of the increase being financed by additional resources generated by Government undertakings.

6. A major effort is being made to increase the flow of resources to the public sector. Of the increase in tax revenues about one-third will result from new tax measures which are expected to yield some Rs. 4.5 billion in a full year. In addition, railway freight rates and passenger fares have been raised to cope with the higher cost of operation and to do away with the subsidization of the railways from the general budget. Prices for petroleum products have been increased sharply to reflect fully increased import costs. Fertilizer prices have also been raised to reduce the subsidy burden which would otherwise have been borne by the budget. The combined impact of the increases in the prices of petroleum products and fertilizers, higher rail charges and budgetary levies will amount to over 3 per cent of Gross Domestic Product. These actions reflect a major adjustment effort in the face of the sharp increase in imported oil prices and inflationary pressure.

7. In order to achieve our objective of substantially reducing inflationary pressures, monetary policy must be directed to reducing the rate of growth in money supply below the rate of 16 per cent in 1979/80 and the average of 20 per cent over the previous three years. The progressive tightening of credit policies since late 1978, culminating in the introduction of new credit ceilings and higher interest rates in the latter part of 1979 has, with some delay, proved successful in containing the expansion of bank credit to the commercial sector. A continuation of generally

restraining credit policies will be necessary in the current year. We intend to limit the growth in money supply to about 13 per cent in 1980/81, i.e. 3 percentage points below the corresponding figure for 1979-80. Taking into account the balance of payments prospects discussed in paragraph 11 below, the increase in total domestic credit is planned not to exceed 16.3 per cent by the end of March 1981. Consistent with the budgetary policies outlined above, net credit to the Government is estimated to increase by 15 per cent by the end of March 1981. This will leave adequate scope for growth of credit to the commercial sector, sufficient to support the desired rate of economic expansion in that sector.

8. A number of steps have been initiated by the Government and further measures are planned, to augment supplies and ease production bottlenecks in the industrial sector. A major effort is being made to improve performance in the power, coal, railways, and ports sectors. These steps have already started showing results; there has recently been a perceptible easing of congestion at the ports, coal production has risen and the efficiency of the transport network has improved. Adjustments to administered prices for basic products have been introduced to ensure that adequate returns on invested capital are obtained. We propose to keep administered prices under review. Efforts are being made to improve the utilization of existing industrial capacity, especially in the steel, cement, aluminium and fertilizer industries. Investment in several of these industries is also being stepped up; e.g., four large gas-based fertilizer projects are being developed. Also, a number of incentives for higher investment and savings have been announced in the central government budget for 1980/81. The policy guidelines for insertion

of the convertibility clause by public financial institutions in their agreements governing financial assistance to private sector units have been substantially liberalized, which should remove the present inhibitions to investment. The tax holiday in respect of new industrial undertakings, ships and hotels has been modified, and an additional depreciation allowance in the year of installation equalto 50 per cent of the normal depreciation on new machinery and plant has been made available for the five years ending March 1985.

9. Measures to encourage agricultural expansion are the cornerstone of the Government's efforts to increase national production, generate employment opportunities and improve living standards for the mass of the people. A major program is underway to substantially expand the area of agricultural land under irrigation, to promote the use of improved seeds and fertilizers, and to provide better and more widely available extension services to farmers. The Annual Plan for 1980/81 calls for an increase of 2.5 million hectares in the area under irrigation. These measures are complemented by frequent adjustments to support prices for major agricultural crops to ensure adequate financial returns to farmers. During the past year varying, but in some cases considerable, increases have been made in the support prices for rice, wheat, groundnuts, gram, cotton, and sugarcane.

10. One of the major objectives of go-vernment policy relates to the evolution of a viable energy strategy. Towards this end, it is proposed to lay special emphasis on stepping up the production of coal fro-m 106 million tons in 1979/80 to 113.5 million tons during the current year. As noted above, administered prices of petroleum products have been recently revised upwards

substantially which will moderate the demand for petroleum products. The Plan outlay for the petroleum sector for 1980/81 has been stepped up by nearly 25 percent as compared to the preceding year with a view to rapidly developing our own oil resources. The Plan provision for power sector has also been stepped up by over 11 per cent during the current year as compared to 1979/80.

11. Policies to improve aggregate production can be expected to relieve the supply shortages which constrained exports in the past year. Specific policies to encourage exports have also been adopted and improved. The import policy for 1980/81 contains additional liberalization measures for exporters, and the Government has also decided to set up an Export-Import Bank. Although world demand for India's exports is expected to be sluggish, export earnings are projected to increase by 13 per cent in 1980/81. However, imports are expected to grow by as much as 31 per cent. The bulk of the increase-about 60 per cent-is accounted for by the projected increase in the petroleum import bill caused largely by higher prices. The more liberal import policy adopted over recent years has been generally maintained for 1980/81 and should continue to contribute to alleviating shortages and promoting production in the domestic economy. On present prospects, the balance of payments current account deficit is expected to increase to about SDR 2 billion in 1980/81, while an overall deficit of about SDR 0.9 billion is projected (before counting the Trust Fund Loan). However, the overall deficit may be larger, especially if weather is again unfavorable. While the extent of the deterioration in the balance of payments expected in 1980/81 is of concern,

and prospects for the next few years are uncertain, the likely deficit in 1980/81 can be financed without undue strain. International reserves presently amount to nearly SDR 6 billion. We intend to continue the prudent debt management policies followed so far.

12. Since September 1975, the Indian rupee has been pegged to a basket of the currencies of major trading partners; the margins were widened from 2.25 per cent to 5 per cent on either side of the peg in January 1979. The basket peg has been maintained unchanged since 1975, resulting in reasonable exchange rate stability and competitiveness in external trade. During the period of the program, the Government of India does not intend to introduce any multiple currency practices or impose new, or intensify existing restrictions on payments and transfers for current international transactions, or enter into any new bilateral payments arrangement with Fund members; furthermore, it does not intend to introduce new, or intensify existing, restrictions on imports for balance of payments purposes.

13. The Government of India believes that the policies set forth in this memorandum are adequate to achieve the objectives of the program but will take any further measures that may become appropriate for this purpose. India will consult with the Fund on the adoption of any measures that may be appropriate, in accordance with the policies ~~fm~~ of the Fund on such consultation.

E.T.R

Office Memorandum

CONFIDENTIAL

cc: Mr. Palmer

TO : The Acting Managing Director

DATE: April 29, 1980

FROM : Bruce J. Smith

SUBJECT : India--1980 Article IV Consultation and Trust Fund Discussions

Messrs. Sundararajan, Woolley, Lipschitz, Mrs. Goodger and I visited Delhi and Bombay during April 7-22.

The mission held the Article IV consultation discussions and had preliminary discussions regarding a Trust Fund program. The staff team concluded that India would have balance of payments need in 1980/81 (financial year April-March) to justify a Trust Fund loan--the absence of need prevented India from making use of the Trust Fund during the first period or earlier during the second period--and a broad degree of agreement was reached on policy needs for 1980/81. Nevertheless, the authorities were unable at the present time to indicate their intentions, particularly relating to budgetary policy, with the degree of authority that they considered necessary to submit a Trust Fund program. Following national elections in January 1980, which saw a change of government and the return of Mrs. Gandhi's party to power, State elections are scheduled in several major States for May 27-30; finalization of the new Government's budgetary policy for 1980/81 has been delayed, pending the State elections, and the budget is now expected to be presented on about June 15. It has been tentatively agreed that a staff team will return to India after the announcement of the budget to complete a Trust Fund program.

India's economic position has deteriorated considerably since the last consultations in November 1978. Real GDP is estimated to have fallen by about 2 per cent in 1979/80, inflation is running at a rate of about 20 per cent per annum following three years of stable prices, and the balance of payments shifted to deficit in the second half of 1979/80 after four years of surpluses. Severe drought cut foodgrain production by about 9 per cent in 1979/80. Water shortages also reduced the supply of electric power, and interrelated bottlenecks in the power, steel, coal, cement and transportation sectors resulted in stagnation in industrial output. Shortages of key commodities initiated upward price pressures in early 1979 which intensified as the supply position tightened and adjustments were made to administered prices of some major industrial inputs.

The 1979/80 budget was also perceived to have an inflationary bias, which was aggravated by unforeseen expenditure for drought relief and higher subsidies. To accommodate the large increase in government recourse to the banking system--which almost doubled to the equivalent of 4 per cent of GDP--credit to the commercial sector were progressively tightened. This, together with the reduced surplus on external transactions, resulted in a slowing in monetary expansion; money supply rose by

15 per cent in 1979/80 compared with 19 per cent in the previous year. However, bank credit to the commercial sector has accelerated in the early months of 1980 to accommodate higher petroleum and other import prices which have yet to be passed on to end-users.

The authorities expect to implement more restrained financial policies in 1980/81 as a step toward restoring price stability. Allowing for the economic recovery which would accompany the hoped for return to normal weather in the 1980 monsoon season, a further reduction in the rate of monetary expansion to about 12 per cent is planned. However, in view of the need to increase further the administered prices for key commodities, including food, coal, fertilizer, and petroleum products--the necessity for which the mission stressed--a reduction in inflation below about 10 per cent does not appear feasible. The authorities indicated their intention of taking as restrictive a stance as possible in the budget to be announced in June. They emphasized, however, that demands for increases in development expenditures are expected and that the scope for raising additional tax revenues is constrained by the already high tax burden, and the need to pass on higher costs for petroleum--which will cut real income by some 2 per cent on top of the decline already being experienced because of the drought.

Although an overall surplus of SDR 0.3 billion was recorded for 1979/80 as a whole, the balance of payments shifted to deficit in the second half of the year, and is expected to weaken further in 1980/81. The terms of trade are estimated to have deteriorated by about 10 per cent in 1979/80, and a further fall of some 6 per cent is projected for the coming year. The oil import bill is estimated to increase almost threefold over this two-year period, and in 1980/81 is projected to absorb almost two thirds of aggregate export earnings. The shift estimated in the current account is from a surplus of SDR 0.4 billion in 1978/79 to a deficit of almost SDR 2 billion in 1980/81. An overall deficit of about SDR 0.8 billion is projected for 1980/81, of which Trust Fund financing would provide some SDR 0.5 billion.

Because of the magnitude of the addition to the oil import bill and the limited scope for reducing consumption, adjustment is likely to be a prolonged process, and the authorities envisage that balance of payments difficulties will persist for several years at least. In the meantime, they are planning several types of financing. There is scope to draw upon reserves, which currently amount to SDR 6 billion or about seven months of imports, but the authorities are reluctant to allow the reserve level to erode too far. Much of the deficit for 1980/81 can be financed by a Trust Fund loan, and the authorities envisage further use of Fund resources in the coming few years. Some steps to increase borrowing on international capital markets on hard terms have been taken, but there is considerable reluctance to undertake large-scale borrowing at high cost except when the loans would be linked to specific high-yielding projects.

The Indian rupee has been pegged to a basket of currencies since September 1975. No change has been made to the basket peg during this time, but the margins were widened from 2.25 per cent to 5 per cent on either side of the peg in January 1979. Despite the surge in inflation over the past year, the improvement in the competitive position of Indian producers in international markets achieved over the previous several years of stable prices appears to have been maintained.

You should be aware that Reserve Bank Governor Patel, joined by others, criticized the lack of progress in the Fund toward assisting the developing countries to meet the emerging payments crisis. Governor Patel suggested, in particular, that the Fund act as an intermediary to reduce the burden of high interest costs on borrowings by poor countries.

cc: The Managing Director (on return)
Mr. Tun Thin (on return)
Mr. Watson
CBS
ETR
FAD
INST
LEG
MED
RES
SEC
TRE
ASD Senior Staff

BLUE FOLDER

Office Memorandum

TO : The Acting Managing Director

DATE: March 28, 1980

FROM : W. John R. Woodley and Donald K. Palmer

SUBJECT : India--1980 Article IV Consultation and Possible Use of Trust Fund--Briefing Paper

Attached is the Briefing Paper for India for your approval. It has been cleared with Messrs. Surr (LEG), Rhomberg (RES), and Wittich (TRE).

Attachment

cc: The Managing Director (on return)
Mr. Tun Thin (on return)
LEG
RES
TRE
Mr. Watson

CONFIDENTIAL

INTERNATIONAL MONETARY FUND

INDIA

1980 Article IV Consultation and Possible Use of Trust Fund--Briefing Paper

Prepared by the Asian, and Exchange and Trade Relations Departments

(In consultation with the Legal, Research, and Treasurer's Departments)

Approved by P.R. Narvekar and Donald K. Palmer

March 28, 1980

I. Introduction

Messrs. Tun Thin (Head), Smith (ASD), Sundararajan (ASD), Lipschitz (ASD), Woolley (ETR), and Mrs. Goodger (ASD), will visit Bombay and New Delhi during April 7-22 to hold the 1980 Article IV consultation discussions and, if circumstances warrant, negotiate ad referendum a financial program for a Trust Fund loan in the second period.

II. Economic Background

The Indian economy during 1979/80 (fiscal year April-March) has been characterized by severe drought through most of the year, a sharp worsening of industrial relations, serious shortages of coal, power and transport services, and the resurgence of inflation after several years of price stability. Led by a 6 per cent fall in agricultural output, real GDP is expected to decline by about 2-3 per cent. Industrial output remained stagnant in the first eight months of 1979/80, and available data for selected industries suggest that it is unlikely to show much improvement in the remainder of the year. The wholesale price index rose at an annual rate of 22 per cent during the first ten months of the year, compared to 2 per cent in the same period of the previous year. While the overall economic situation has deteriorated sharply since the last consultations, the availability of comfortable stocks of external reserves and foodgrains, the continuing liberalized framework of import policy, and the relative price advantage built up over the previous four years of stable prices, leave the economy in a fundamentally stronger position than in any previous period when similar difficulties were faced.

India: Selected Economic Indicators, 1977/78-1979/80

	Fiscal Years Ended March		
	1977/78	1978/79	1979/80
		(Percentage changes)	
Real GNP	8	4	-2 1/
Agricultural output	14	2	-6 1/
Industrial output	4	8	-- 1/
Broad money	21	21	16 2/
Narrow money	18	19	14 2/
Reserve money	15	25	21 2/
Total domestic credit	15	21	17 2/
Net bank credit to Government	22	14	23 2/
Wholesale prices (end-year)	--	3	21 2/
Consumer prices (end-year)	3	3	8 2/
Exports (f.o.b.)	7	2	5 2/
Imports (c.i.f.)	21	9	14 2/
		(In billions of SDRs)	
Trade balance	-0.6	-1.0	-1.2 2/
Overall balance of payments	1.7	1.1	0.2 2/
Gross reserves (end-year)	4.6	5.7	5.9 3/

Sources: Reserve Bank of India Bulletin and data provided by the Indian authorities.

1/ Official estimate.
2/ Calendar year 1979.
3/ Gold valued at SDR 35 per fine ounce.

The decline in agricultural output in the current year is due chiefly to poor monsoon rains through most of 1979. It would have been more severe, but for the belated arrival of winter rains which has improved the rabi harvest of wheat and gram. Total foodgrain output is expected to fall from the record harvest of 131 million tons in 1978/79 to about 121 million tons in 1979/80, reflecting mainly the lower output of rice and coarse grains. To overcome the effects of the drought on employment and consumption, the authorities have expanded the food-for-work programs in rural areas, released additional grains through the public distribution system, and have not raised the prices of publicly distributed grains, despite large increases in both the procurement prices and the free market prices. As a result of these factors, the stock of foodgrains declined to 19 million tons by the end of December from the peak of 21 million tons at the end of August. The decline is expected to continue, but the stock is expected to remain adequate provided the 1980/81 harvest is normal.

The stagnation of industrial production in the current year was caused mainly by the interrelated shortages of coal, power, and transport. Although electricity generation increased by about 5 per cent in the first eight months of 1979/80--compared to 12 per cent in 1978/79--it fell short of demand in almost all regions, particularly in the eastern industrial belt. The electric power supply could not be stepped up to match demand, owing to coal shortages and the consequent underutilization of existing power-generating facilities, poor maintenance, and the failure to complete major power projects on schedule. For a variety of reasons--such as floods, labor unrest, transportation difficulties, etc.--coal output has remained unchanged, at about 105 million tons per annum, since 1976. This in turn has affected railway transport and, in addition to its impact on thermal power generation, has limited the production of steel, fertilizers, and cement. In the current year, the pervasive effects of inadequate energy supplies were coupled with a sharp increase in industrial unrest. The number of man-days lost due to strikes, lockouts, and political disturbances rose by almost 50 per cent in the first eight months of 1979 and affected a wide range of industries both directly and indirectly. Industrial unrest in the coal mines and petroleum refineries compounded the energy shortages. In the final quarter of 1979/80, the labor unrest and the drought continued to adversely affect the major seasonal industries such as sugar refining, coal, and hydroelectric power generation. Thus, the normal seasonal rise in production during December-March is likely to be subdued.

Inflationary pressures in 1979/80 were mainly due to a slow adjustment of financial policies to the fairly rapid deterioration of domestic supply conditions. Inflationary expectations were also rekindled, initially by the measures announced in the 1979/80 budget, and were sustained by the subsequent drought, supply shortages, and political uncertainty. In addition, cost-push factors, arising from the increase in administered prices of a large number of intermediate goods like steel, coal, aluminum, and petroleum products, added to the inflation. The supply difficulties were not foreseen when financial policies for 1979/80 were first formulated, and fiscal policy for 1979/80 thus continued the expansionary stance initiated in 1978/79. However, monetary policy had already assumed a more cautious posture in late 1978, reflecting concern about the excessive growth of liquidity. As economic growth weakened during 1979/80, monetary policy was progressively tightened; this was not successful initially, but it has become more effective in containing credit expansion in recent months. In contrast, fiscal policy was even more expansionary than originally envisaged, owing largely to unanticipated expenditures--such as drought relief. As a consequence of these developments, narrow money expanded at an annual rate of 13 per cent during the first ten months of 1979/80, compared with the 15 per cent expansion during the corresponding period of 1978/79.

Excess demand pressures and a worsening of the external terms of trade led to a sharp reduction of the surplus in the overall balance of payments from SDR 1,133 million in 1978/79 to SDR 226 million in the first ten months of 1979/80. Total exports (in terms of SDRs) were 6 per cent higher during April-November 1979/80 than in the same period of 1978/79, owing mainly to larger exports of tea, jute, and certain agro-based items from the depressed levels of the previous year. Exports of engineering items and gems and jewelry, which constituted a quarter of total exports in the past two years, declined; the former, due to domestic supply problems, the latter to the slackening of world demand. During the same period total imports rose by 19 per cent. Despite a fall in the volume of industrial imports because of slow industrial growth, aggregate imports rose sharply as a result of the steep increase in world prices of petroleum and the large-scale imports of certain key commodities, including fertilizers, cement, and edible oils, to augment inadequate domestic supplies. For 1979/80 as a whole, imports are likely to accelerate because of higher petroleum prices and additional imports of petroleum products to offset shortfalls in the domestic production of energy, while export growth is likely to remain subdued because of persistent supply constraints. Thus, the overall balance of payments position, which was in approximate balance during October-December, is expected to move into deficit in the final quarter. An overall surplus of only about SDR 100 million appears likely in 1979/80. Gross international reserves at end-1979 were SDR 5.9 billion (with the gold component of 8.36 million ounces valued at SDR 35 per ounce), equivalent to seven months of estimated 1979/80 imports.

III. Topics for Discussion

The present economic position can be characterized as one of inflationary pressures and an external position shifting to deficit. The inflationary pressures have arisen in part because demand management policies have not been able to fully adjust the economy to supply shocks emanating from the drought and the industrial shortages. The weakening balance of payments reflects both this excess demand and the deteriorating external terms of trade. Insofar as the widening current account deficits have resulted from transitory supply shortfalls, and because exchange reserves are comfortable, there is no need for a major adjustment of macroeconomic policies. The task of the authorities need involve only the drawing down of the sizable stocks of foreign reserves and foodgrains to increase supplies and some tightening of demand. The objective should be to reduce the rate of inflation without endangering investment and growth. However, the uncertain outlook for the world economy in the period ahead and the need to find permanent accommodation for higher oil prices make cautious financial policies doubly important. While it is premature to envisage the balance of payments as again constituting a major economic constraint in the foreseeable future, policies to accelerate export growth, to conserve energy, and to promote the exploitation of domestic energy resources are needed over the medium term.

1. External adjustment

Over the last several years there has been need for policies to reduce a large and persistent balance of payments surplus. The required adjustment was to be accomplished not by using the exchange rate which was maintained virtually unchanged in effective terms, but by liberalizing trade and pursuing expansionary domestic policies. These policies were initially slow to act, but were particularly successful in 1978/79. Indeed, the expansionary fiscal policy and the sharp increase in public investment in that year, served to raise total investment above savings--thus producing a current account deficit--for the first time in several years. Moreover, the supply management through liberalized import policies supported the investment effort and contributed to price stability. A similar outcome may have occurred in 1979/80, but for the emergence of supply difficulties.

Balance of payments prospects for 1980/81 are for a continued weakening and a moderate overall deficit. A resumption of economic growth will require a much larger non-oil import bill, both because of the Government's conscious policy to alleviate domestic supply constraints and because the liberalized trade system will allow a greater growth of private sector imports in response to rising income. In addition, higher prices for fuel oils will add some US$2-3 billion to the import bill. Strong domestic demand and slow growth and difficult access to major export markets will militate against any major increase in the volume of exports. Also, there are signs that the growth of workers' remittances from abroad is beginning to slacken. Clearly in these circumstances, the need for measures to reduce the overall surplus has passed.

The liberalization of import restrictions, which continued in 1979/80, served the needs of adjustment in recent years. In the present circumstances, the more liberal framework of import policies that has resulted should facilitate the resumption of growth and thereby help strengthen the economic position in both the short and medium term. Insofar as the present environment is not propitious for further liberalization, the mission will support the maintenance of the more liberal trade system that has emerged over the past few years and discourage any reversal of this trend. Moreover, with a weakening of the external position, a continuation of the expansionary financial policies of the past two years is clearly inappropriate for 1980/81.

Despite some rationalization of export promotion schemes, there has been no growth in overall export volume since 1977/78. In the last two years, this was due mainly to a decline in agricultural exports, partly reflecting greater domestic consumption. In the current year, both industrial and agricultural exports have been affected by insufficient domestic production. The effects of the weakness of the production base have been exacerbated by the frequent changes in incentives, quota restrictions, and bans governing exports. While stable export cash assistance rates have been provided for a group of commodities, notably engineering goods, for a wide range of other products the rates have been changed frequently. Furthermore, since 1978 export quotas have been relaxed or removed for various agricultural products, but new quotas and bans have been introduced for several industrial goods. These changes were motivated by the desire to hold down domestic prices of goods in short supply and reflect variations in the perceived availability of exportable surpluses. It is arguable, however, that they serve mainly to weaken the penetration of export markets and in the longer term to reduce incentives for expanded production of the commodities concerned. The staff team will discuss the recent changes in export incentives and emphasize the need for a stable structure of such incentives and for a strengthening of investment and industrial policies to promote the expansion of exports.

As regards exchange rate policies, the basket peg maintained for the rupee since 1975 has kept the rupee stable in effective terms over the past year, although the higher rate of inflation in India in 1979/80 has led to some loss of external competitiveness. However, this has only partly offset the gains in the past four years. While the trade-weighted (as well as the export- and the import-weighted) real effective value of the Indian rupee increased by about 8 per cent in 1979, owing mainly to domestic inflation, this followed a 20 per cent decrease during the previous three years. It will be useful to explore with the authorities their attitudes toward exchange rate policies under present circumstances, especially the impact of recent developments on export growth over the medium term. For the immediate future, both the level of the exchange rate and the system of setting the rate appear generally satisfactory.

Since the last consultation, the bilateral payments agreement with Bulgaria has been terminated. The mission will inquire as to further progress toward eliminating the remaining bilateral agreements with Romania and various nonmembers.

2. Energy and industrial production

Even in years of good economic performance, India has been critically constrained by the availability of energy. Most of the supply bottlenecks that have plagued the Indian economy in the current year are primarily attributable to inadequate production in the energy sectors--coal, electric power, petroleum. Over the past 15 years, the growth of energy consumption has averaged more than twice the pace of real GNP, but investment in the energy sectors has lagged behind plan schedules, and completion of new power-generating facilities has been subject to long gestation lags. As a result, energy shortages have been normal occurrences in India over the past decade. The extent of this shortage has been particularly severe in 1979/80, owing to the coincidence of drought and labor unrest. There was an estimated shortfall of electric power of about 15 per cent in 1977/78 and 10 per cent in 1978/79; for the current year, the shortfall is estimated to be in the range of 20-25 per cent. The pervasive effects of power shortages are underscored by the recent World Bank estimate that the output loss due to the shortage has varied between 2-3 per cent of GNP annually in the recent past. Against this background, better performance of the energy sector is a critical issue, and the role that industrial and import policies can play in overcoming the problems of these sectors bears further examination.

The staff team will also examine the longstanding issue of administered pricing policies and their effects on supplies of major industrial inputs, including energy. Administered prices of several important intermediate goods, including coal, petroleum products, steel, and cement were increased in 1979. These price increases were delayed decisions reflecting inadequate adjustments in the past. The team will discuss the scope for further upward adjustments, as one element of the policies designed to increase output in these critically important industries and to strengthen the financial position of the public sector enterprises. In particular, recent increases in the world prices of petroleum products have not been fully passed on, and an appropriate adjustment of domestic prices appears to be warranted in light of the need to conserve energy.

While the major reasons for the poor industrial performance in the current year were the shortage of energy inputs and the labor unrest, the team should also examine the impact of recent changes in industrial policies on the present industrial climate. There is some evidence that the current policy of prohibiting large corporations from producing a wide range of products in order to promote small-scale production of these products has aggravated the industrial shortages and inhibited private investment.

3. Domestic demand management

Since 1978/79 expansionary fiscal policies have reflected the authorities' desire to use the large exchange reserves and food stocks to promote investment and growth. The Central Government overall financing requirement increased from Rs 21 billion in 1977/78 to Rs 32 billion in 1978/79, and, despite the sharp increases in excise duties in the last budget, to Rs 47 billion in 1979/80. The turnaround in the economy in 1979/80 led to a higher deficit than had initially been budgeted. Actual expenditures exceeded the budgeted levels on account of additional current expenditures on drought relief, subsidies on foodgrain distribution and fertilizer sales, and major wage concessions. Recent information suggests that State Government budget deficits have also exceeded original estimates by a sizeable margin. Partly because of the elections and the subsequent change in economic management, there has been no opportunity for an interim fiscal adjustment to reduce deficit spending in line with the more constrained supply situation, and demand management has had to rely mainly on monetary instruments.

Starting in November 1978, the monetary authorities attempted--albeit with only limited success--to reduce the growth of credit. Given the fiscal situation and the need to finance food stocks, the burden of credit stringency was necessarily borne by the nonfood commercial sector. However, in most cases the commercial banks were unable to implement new ceilings and cash reserve and statutory liquidity requirements during the early months of 1979.

Policies were progressively tightened, culminating in a new system of credit ceilings and higher interest rates in September 1979. Lending rates of commercial banks were raised by 3 percentage points, and deposit rates by between a half and one percentage point. However, there has been only a slight slowdown in the growth of credit to the commercial sector since September. The staff team will examine the need for additional measures to combat inflation in 1980/81.

The budget for 1980/81 holds the key to the financial strategy for the coming year. The new Government has delayed the budget, in order to consolidate its views on fiscal policy and thus far has only presented an interim budget based on the continuation of existing tax rates. Presentation of a new budget is expected soon after the return of the Fund team. In the context of the need for tighter overall financial policies, a further large budget deficit will reduce the scope for credit to the commercial sector. If the squeeze on the commercial sector is pushed too far, the objective of restoring growth could well be thwarted. The mission will discuss the need for achieving a balance in the resources flowing to the various sectors and will analyze fiscal policy in the context of the prospective overall financial situation in 1980/81.

4. Quota

The mission will inquire as to when India expects to be able and willing to consent to the increase in its quota under the Seventh General Review; what steps have been taken so far by the authorities; and what steps will still be necessary before such a consent might be forthcoming.

5. Trust Fund

India did not qualify for access to the Trust Fund during the first period of Trust Fund assistance because of the strong balance of payments position. However, with the weakening of the balance of payments, India may become eligible for a Trust Fund loan in the second period. India's maximum access to the Trust Fund could be about SDR 500 million. Tentative projections for 1980/81 indicate that a balance of payments need is likely to be present, but the precise size of the need cannot be adequately assessed until the mission reviews current and prospective developments and policies. In the event that a balance of payments need for a 12-month period ending before May 1981 can be established, the mission will negotiate *ad referendum* a one-year financial program with first credit tranche conditionality, which would serve as the basis for a Trust Fund drawing.

The aims of the program would be to substantially reduce the rate of inflation and consolidate import liberalization efforts by containing demand pressures and alleviating supply bottlenecks. By keeping the overall balance of payments deficit within reasonable limits by means of demand management, the program will encourage a consolidation of past import liberalization efforts and discourage a reversal of this trend. The Indian financial system appears at present to be highly liquid, and there is as yet little evidence that financial policies are adequately containing increases in the price level. In these circumstances, additional monetary restraint would seem appropriate to contain demand. Financial policies, and especially budgetary policies, complemented by appropriate industrial and import policies, will play an important role in ensuring an adequate expansion of output.

Preliminary staff projections, based on the assumptions that inflation will be limited to 10 per cent in 1980/81 and that income will increase by 7 per cent in real terms, suggest that an appropriate financial program would require a reduction of the growth of both broad and narrow money to below the rates in calendar 1979 of 16 per cent and 14 per cent, respectively. Some slight increase in the rate of expansion of bank credit to the commercial sector may be necessary, but this should be offset by a slower rate of credit expansion to the Government. Given the likely balance of payments outcome, the overall growth of domestic credit should probably be limited to about the rate in calendar 1979, that is, 18 per cent.

Since a prospective program would also aim at supporting and consolidating the recent import liberalization, the program will contain an intention that the authorities will continue their current policies with respect to import controls. Finally, the program would include the standard understanding on exchange practices and import restrictions.

Fund Relations with India

Quota:	SDR 1,145 million. The proposed maximum quota under the Seventh Review is SDR 1,717.5 million. India has not yet agreed to the quota increase.
Fund holdings of Indian rupees:	85.50 per cent of quota, as of February 29, 1980.
Use of Fund resources:	India made extensive use of Fund resources during 1974 and 1975. All repurchases were completed by July 1978.
SDR position:	The total allocation of SDRs to India was 564.38 million. Holdings as of March 12, 1980 were SDR 513.05 million, or 90.9 per cent of net cumulative allocation. India could be designated for a maximum of SDR 27.8 million under the Designation Plan for March-May 1980.
Operational budget:	Indian rupees equivalent to SDR 10.1 million have been included in the operational budget for March-May, 1980.
Gold distribution:	804,429.4 fine ounces.
Distribution of profits:	US$42.02 million in the first period and US$45.89 million in the second period.
Exchange rate:	On September 24, 1975, the former peg to the pound sterling was terminated and the rupee was linked instead to a basket of currencies of India's major trading partners, within margins of 2.25 per cent, with an initial middle rate of Rs 18.3084 = L 1 stg. Since end-January 1979, the margins have been

increased to 5 per cent. So far, the buying and selling rates have been adjusted 36 times on the basis of the currency basket; the current middle rate of Rs 17.85 = pound sterling 1 has been in effect since March 18, 1980. As of that date, the rate per U.S. dollar was approximately Rs 8.24 and the rate per SDR, approximately Rs 10.43.

Last Article IV consultation:

The last consultation discussions with India were held in November 1978. The Executive Board discussion took place on February 26, 1979 and the following Decision No. 6055-(79/34) was adopted.

1. This decision is taken by the Executive Board in concluding the 1978 consultation with India pursuant to Article XIV, Section 3, of the Articles of Agreement.

2. The Fund welcomes the steps taken to relax restrictions on foreign payments and terminate bilateral payments agreements and hopes that the remaining bilateral payments agreement with a Fund member will soon be terminated.