SM/08/188

June 25, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **New Formats for Article IV Staff Reports**

The attached paper on new formats for Article IV staff reports provides background for an informal Board seminar to be held on **Wednesday, July 9, 2008**. Key questions appear on page 10. The informal seminar will not call for Gray statements from Directors or concluding remarks.

The staff does not propose the publication of this paper following the informal Board seminar.

Questions may be referred to Mr. Hviding (ext. 34544) and Ms. Mateos y Lago (ext. 37219) in PDR.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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INTERNATIONAL MONETARY FUND

New Formats for Article IV Staff Reports

Prepared by the Policy Development and Review Department

In consultation with other Departments

Approved by Mark Allen

June 25, 2008

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A. The Need for New Formats for Staff Reports[1]

1. **This note presents two examples of possible new formats for Article IV staff reports,** illustrating how these reports could be shortened and delivered more quickly, while maintaining their informational and analytical value for the Executive Board and other users

2. **This initiative is part of the larger effort to refocus and modernize the Fund**, and responds to the Managing Director's call to develop "specific proposals that would allow shorter and more quickly delivered Article IV consultation reports" to enhance the effectiveness of surveillance and to adapt the Fund to a shrinking budget envelope.[2]

The proposed staff report formats are motivated by two common criticisms:

- *Staff reports are often considered to be too long.*[3] Recent initiatives to strengthen surveillance—important as they are—have contributed to a gradual increase in the length of staff reports over the years, and the worldwide information explosion has reduced readers' tolerance for length. Recent efforts to increase the focus of staff reports and reduce their word count appear to have had only a marginal impact on the length of the staff reports. As a result, the typical staff report today may test the average reader's endurance. Complaints about the length of staff reports may also reflect the fact that staff reports contain elements that are important for some audiences but not all (e.g., a recounting of the discussion between the staff and the authorities).

- *Staff reports reach their audiences with a considerable delay after the conclusion of the mission*. The average delay from the conclusion of the mission to Board discussion is about 70 days, slightly lower since 2006 thanks to a reduction in the maximum lag, but further reductions are needed.[4] The lag to publication is even longer: in 2007, the average lag from the end of the mission to publication was 118 days. While surveillance staff reports are expected to have a longer shelf life than a few weeks, such delays inevitably

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[1] Ketil Hviding wrote this paper under the guidance of Tessa van der Willigen (both PDR). The Namibia mock up was prepared by Jung Yeon Kim (PDR) with inputs from Peter Allum (AFR); the India mock up by Charles Kramer (APD) with inputs from Sutapa Amornvivat (PDR). Advice from Peter Doyle (Working Group on Modernizing Publication and Distribution) was highly appreciated.

[2] The MD's Statement to the Committee on the Budget, January 10, 2008. The paper also follows up on some of the recommendations made by the Fund-wide working groups on surveillance and document production created in Fall 2007, and touches on some of the recommendations of the working group on the review process.

[3] The excessive length of staff reports was a recurrent theme in interviews with stakeholders conducted in the context of the 2008 Triennial Surveillance Review.

[4] Decision No. 13815-(06/98) reduced the maximum lag from 90 to 65 days, except for PRGF-eligible countries.

reduce their impact in today's fast-paced world. Thus, innovations allowing the issuance and publication of staff reports more swiftly after the end of the mission are needed.

3. **The formats discussed in this paper build on the realization that staff reports have multiple audiences**. Surveillance is conducted by the Board, and it remains essential that the Board have all the information it needs to come to a view. However, staff reports are also directed to the authorities and—as most are now published—to different parts of the public. The effectiveness of surveillance often relies on how effectively the Fund communicates with other audiences and the format of staff report may be more or less helpful in this context.

B. Examples of New Formats

4. **The two mock-ups presented are intended to illustrate what can be achieved by changing the formats of staff reports** (Text table). They are only meant to be illustrative. It is not the intention to constrain staff from experimenting with other formats, but rather to guide such experimentation by eliciting Executive Directors' views on alternative staff report formats that may be helpful to different audiences. Independent of the ultimate format of staff reports, staff also expects to make efficiency gains in the production and review process, which should bring improvements in timeliness (as well as resource savings). These changes are not discussed in detail in this paper and will be invisible to the audiences of staff reports. The mock-ups are intended to elicit views on visible changes—namely, changes in format—that could contribute to the objectives of timeliness and brevity.

5. **The mock-ups illustrate two different approaches, intended to save on length and time by avoiding repetition** between the different sections of the report and between the different stages of production. Resource savings could be expected to accrue along the way, albeit to a different extent under the two approaches. The two examples presented in Attachments I and II illustrate, respectively, a modular approach (based on the 2007 Article IV report on India) and a condensed approach (based on the 2007 Article IV report on Namibia).

Table 1. Key Features for the Modular and Condensed Staff Reports

	Modular report	**Condensed report**
Readability (impact)	**Step backwards**? Less reader-friendly for generalist readers. But specialists may prefer the "pick and choose" modules.	**Strong improvement**: Messages upfront. Repetitions minimized. Reader-friendly for all audiences.
Timeliness	**Strong improvement**: Board date accelerated by up to 5 weeks	**Some improvement**: Board date could be accelerated by a few weeks.
Production costs (efficiency)	**Strong improvement**: Recycles existing materials.	**Some savings**: Drafting process little changed.

6. **The proposed approaches reflect the lessons from the experience with "streamlined consultations."** That experience is not fully comparable to the present effort, since streamlined consultations featured not only shorter and more timely reports, but also a reduced mission size and length. Nevertheless, the experience with streamlined consultations suggested that care needed to be taken in choosing the right countries for shorter (and faster) reports, with the strict word limit (3000 words) sometimes contributing to inadequate treatment of important issues or sketchy characterization of the authorities' views (Box 1).

7. **Both mock-ups include all the necessary elements essential to surveillance under Article IV.**[5] In particular, they reflect the consensus—embodied in the 2007 Surveillance Decision—that surveillance must provide an assessment of external and domestic stability, and of the key policies that matter for this purpose (in particular, fiscal, monetary, exchange rate, and financial sector policies). Although, for presentational purposes, the staff can choose to focus the report on a few areas of particular relevance and the treatment of other issues can be brief and/or refer to the previous year's discussion, the report should nevertheless reflect that such a "health check" has been completed. Moreover, in order to be persuasive all reports need to present or refer to adequate supportive analytical material for staff's views. Finally, to lay the basis for the Board to form its judgment, all reports must include a report on the authorities' views and a clear staff appraisal.

The modular approach [6]

8. **The idea underlying the modular approach is to reuse material prepared at different stages in the production process**. The current production process lasts for 5-6 months (Table 2) and commonly involves the preparation of four to five different documents (brief, concluding statement, back-to-office report, staff report, and, sometimes, a supplement with updated information). While to some extent drawing on previously produced material, the present staff report usually requires much additional work in an effort to integrate an analysis and assessment of the economic situation with a report on the staff's discussions with the authorities. The more direct use of previously produced material would permit the submission of the report to the Executive Board shortly after the end of the mission, thus considerably reducing the time lag between the end of the mission and the Board meeting.

[5] In both cases, informational annexes will include detailed information on Fund relations, exchange rate regime, and Article VIII or XIV status. A debt sustainability analysis would be included where needed.

[6] The modular approach was first proposed by the Fund-wide Working Group on Modernizing Document Publication and Distribution, headed by Kalpana Kochhar, that was created as part of the refocusing exercise.

Box 1. Streamlined Article IV Consultation

Streamlined Article IV consultations were introduced in mid-2006 as a part of the Fund's Medium Term Strategy (MTS). The aim was to enhance the effectiveness of surveillance through greater focus and better resource allocation, across topics and countries. The approach was to be applied only every other year to "non-systemic and stable" country cases where little had changed and/or key policy issues were well-known.

Staff's experimentation with streamlined Article IV consultations involved: (i) fewer and more focused topics; (ii) smaller number of staff; (iii) shorter missions; (iv) shorter staff reports with fewer reporting requirements; (v) no Selected Issues Papers; and (iv) a reduction of the targeted time-lag between the end of the mission and the Board discussion to 45 days.[1]

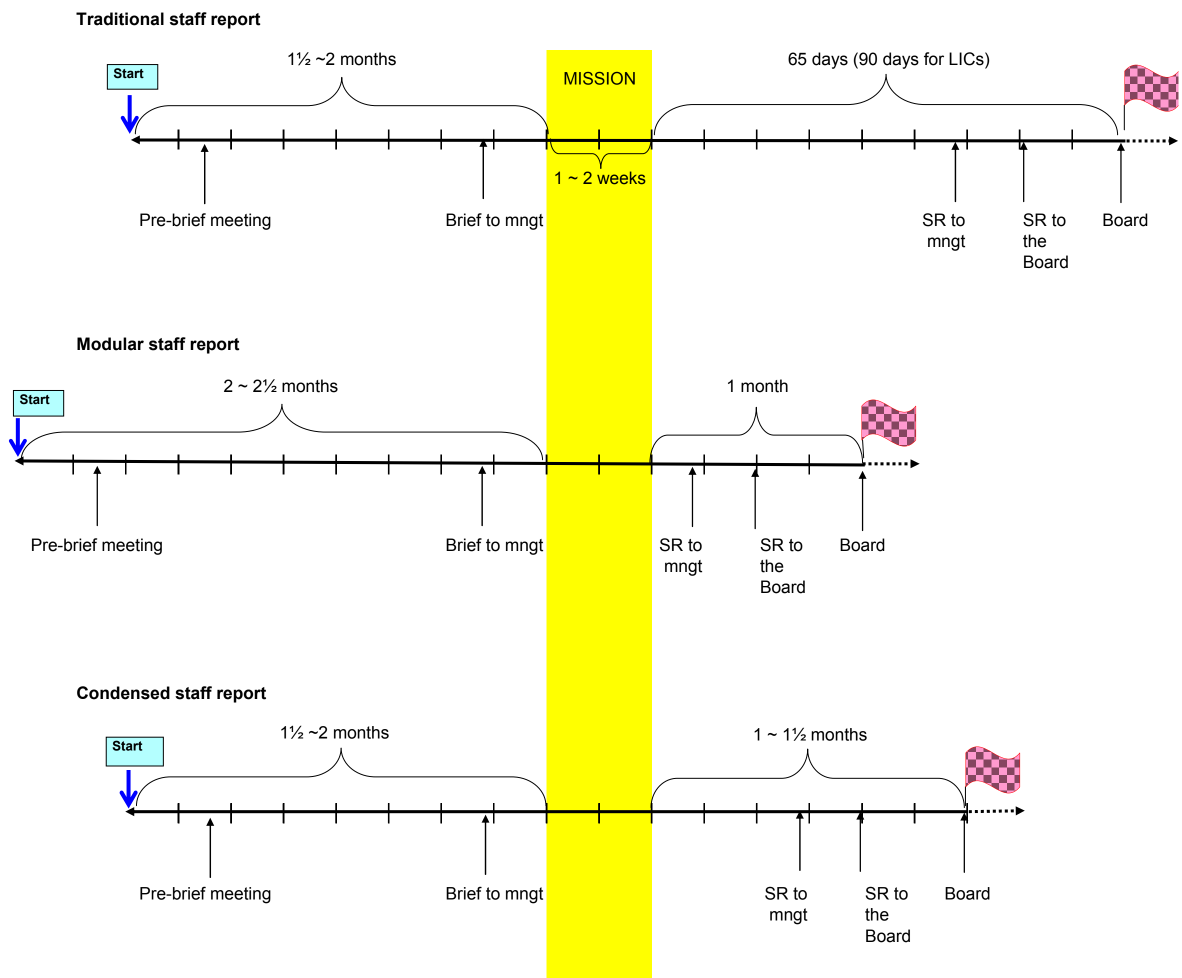
A document and stakeholder review of the 13 streamlined consultations that were completed between July 2006 and May 2007 suggested the following:

- While the health check was viewed as largely adequate and the selected topics generally appropriate, streamlining did not work well for countries with data problems, particularly in developing countries as limited resources seemed to have constrained the required fact-finding.
- Tight word limits were found to have reduced the effectiveness of some staff reports, particularly in presentation of staff's and authorities' views. Specifically, staff's recommendations were not always adequately supported, and previous works was not always explicitly referenced or summarized. There were also cases where the characterization of authorities' views was considered insufficiently nuanced.
- The savings varied significantly, averaging around $115,000 per consultation.[2]

By contrast to the streamlined consultation approach, the two approaches presented in this paper do not foresee a reduction in staff's efforts to analyze the economic situation, including data collection and background material, and focus only on eliminating duplication in outputs. In the condensed report, word count reduction is achieved by removing repetition, leaving the substance uncurtailed.

[1] No formal proposal on a reduction in the maximum lag was made.
[2] Derived from completed streamlined consultations.

Table 2. Illustrative Art. IV Consultation Time Table 1/ 2/ 3/



1/ This assumes no changes in Board circulation period for the staff report.
2/ Time period in weeks. (I------I one week)
3/ ·······► indicates cases (e.g., systemic countries) where Board discussion takes place 3 weeks after the staff report is issued.

9. **Attachment I presents a modular mock up of the 2007 Article IV report on India** where the brief and the concluding statement were largely used "as is," with only marginal updating and adjustments. A report on the authorities' views was added. Under this approach, analytical background notes and other background information on less time-sensitive topics such as policy framework, structural features of the economy, and Bank/Fund relations could be presented on a country web page (a mock-up of this page is

also included). These notes would be available to Executive Directors before or shortly after the staff report has been submitted to the Board. An example of a set of analytical notes is presented in Annex I of the mock up, although a more complete analytical narrative could also be considered.[7]

10. **Under this approach, various options could be considered for the rendering of the authorities' views:**

- The India mock-up includes a relatively comprehensive description of the authorities' views, which would be written after the mission.

- Alternatively, the authorities' views could be rendered in the form of a minute of the mission's concluding meeting (which could also be agreed with the authorities). This would be less resource-intensive and permit greater speed of production.

- Finally, the authorities' views could be presented in the BUFF Statement of the Executive Director representing the country in question, or perhaps in a document prepared by the authorities themselves which could be circulated at the time of the staff report. Some downsides of this approach, however, are clear: it would resemble "surveillance by exchange of letters," permitting less engagement between the staff and the authorities and potentially setting up a more adversarial relationship; there would be a proliferation of different documents complicating the work of Executive Directors and their staff; and there would be less consistency in the presentation of the authorities' views.

11. **The modular approach would work best in countries where the data collection element of the mission is relatively modest.** In these countries, the description of recent economic developments is less likely to undergo substantive change as a result of new data received during the mission, thus the background section can largely be written before the mission.

12. **Besides allowing timelier issuance, the modular approach may be a more effective tool in communicating with certain audiences, though probably not all.** Compared to a traditional, more integrated staff report, the modular approach, especially if combined with an effective use of a country web-page, could be more appealing to outside audiences (press, think tanks, and the public at large).[8] The different modules—certainly the analytical material, but to some extent also the chapters of the staff report itself—would be more self-contained and hence more accessible to readers interested only in some parts.

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[7] Including the analytical notes, the report contains 8,947 words compared to 9,537 for the original report. Without the analytical notes, the report contains only 5,237 words,

[8] All the modules of the staff report—including the analytical background material—would be considered as one single document for the purposes of the transparency policy (selective publication would not be possible).

Moreover, through links to other material on the country web-page, readers could get further background information depending on interests and previous knowledge; and use of the web to disseminate the less time-sensitive information would reduce paper-based circulation to the Board and the public. At the same time, however, the less integrated nature of this kind of staff report may make it less user-friendly for those audiences that need all the modules.

The condensed approach

13. **The idea behind this approach is to shorten the staff report at limited substantive cost by removing repetition,** between the executive summary, the main text, and the staff appraisal. Moreover, through more deliberate use of tables and charts, much of the economic background can be described more efficiently than is often the case. The need to prepare an integrated report would, however, likely delay the issuance to the Board more than in the modular approach; but this longer delay may anyway be inevitable in cases where a complete picture of the economic situation can only be established in the field.

14. **Attachment II presents a mock-up of the 2007 Namibia report using this approach.** With only 2,985 words (against 4,206 words of the original), this report is very short. The shortening of the report was achieved by eliminating repetition between the executive summary and the staff appraisal and through some changes in the lay-out of the report: only small changes were made to the substantive sections of the report. Like the original report, the condensed report is issues-focused, which allowed the staff appraisal to be summarized in a small box at the end of each section, a key innovation of this mock-up. Moreover, section titles were written to allow an easy overview of the content of the different sections.

15. **With the caveat that some reports may need to exceed 3,000 words, this approach could be used without restrictions.** It could be used in particular when the data collection purpose of the mission is important or when there is no written concluding statement—both circumstances that preclude the use of the modular approach and the reaping of the corresponding benefits in timeliness.

16. **The increased readability of condensed reports would likely increase their impact on outside audiences.** In particular, the issues-focused format of the report and the use of boxes to contain the staff appraisal would likely be a more effective way to communicate staff's key messages. Moreover, although not tailormade for web-based distribution, the condensed approach could also be integrated into a country web portal.

Intermediate approaches?

17. **Intermediate approaches would be possible.** The two approaches could be seen as extreme cases that span a larger set of possibilities: while the modular approach focuses on timeliness, the condensed approach focuses on brevity (see Text table above). Elements of both approaches could be used to construct intermediate types of reports. For example, the modular approach could borrow elements of the condensed approach; in particular an issues-focused background section could replace the more descriptive background section presented in the modular approach. Or different modules of the modular approach could be integrated

into fewer, broader modules. And, as mentioned above, altogether new approaches are possible and should not be discouraged.

18. **At the same time, the downsides from a proliferation of formats should be considered.** The condensed approach remains close enough in spirit to the traditional staff report to be easily recognizable, but the modular approach is a more radical departure from traditional reports. And there is a risk that a range of different options will confuse external audiences. A careful communication strategy will be essential in this regard, especially during a period of experimentation.

C. Resource Implications

19. **The resource implications of the two approaches differ significantly.**

- The resource savings from the modular approach could potentially be large. Although some work will inevitably merely be shifted from after to before the mission, and the approach is dependent on an effective review process before the mission, staff estimates that from two to three weeks of an average mission team's time—or $35,000 to $50,000—could be saved per consultation using this approach.[9]

- The potential resource savings from the condensed approach are much more uncertain, as a shorter report is likely to require more editing and could therefore be more resource intensive rather than less; however, the shorter length could create some offsetting savings in review and Executive Board members' time.

20. **Overall, the resource savings are thus likely to be positive but small unless the modular approach were to become quasi-uniformly adopted.** A more precise estimate of potential resource saving is, however, only possible after staff has gained experience with implementing the new formats.

D. Possible Additional Steps to Consider

21. **The impact of the format changes discussed above would be considerably greater if the following additional changes were envisaged**:

- Reducing the Board circulation period—currently of three weeks for 59 countries and two weeks for the rest.

- Changes in transparency policy to promote faster publication, for example, by moving to a regime where the member's consent is presumed unless explicitly denied within, say, a week of the Board meeting.

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[9] Assuming three economists working full time on the staff report. The potential acceleration of the Board date does not translate into net savings as some work would be shifted to before the mission.

- A reshaping of country pages on *imf.org* could be combined with the reshaped staff reports to generate additional benefits in terms of accessibility and outreach.

E. Key Questions

- Do Directors find that the two mock-ups constitute useful possible new formats for staff reports?

- Which features of the two approaches do Directors find particularly attractive or unattractive? In particular, what is Directors' reaction to:
    - a) the separation of different elements in the modular approach compared with the fully integrated nature of the traditional and condensed approach, and in particular;
        - (i) the separation of the background section from the other modules;
        - (ii) the separate presentation of the staff's and the authorities' views;
        - (iii) the possible use of a minute from the mission's concluding meeting (possibly agreed with the authorities) to convey the authorities' views;
        - (iv) the possible use of the ED's BUFF Statement or a note drafted by the authorities to convey the authorities' views;
        - (v) the separation of the analytical background from the economic background and the staff's appraisal;
        - (vi) web-based distribution of the analytical background;
        - (vii) the use of web-based informational annexes to convey information about the structure of the economy.
    - b) the systemic elimination of repetition in the condensed approach, including the presentation of the staff appraisal in small boxes with key messages?

- How do Directors find that the two approaches would serve the different audiences of staff reports: the Executive Board, the authorities, the media, research institutions and think thanks, and the public? To what extent would the increased timeliness of the modular approach be helpful in communicating with the different audiences?

- Are Directors supportive of further consideration of additional steps: (i) reduction in Board circulation period; (ii) changes in transparency policy; or (iii) web presentation?

- Would Directors support experimentation by the staff with one or both of the two formats presented, and with intermediate approaches?

MOCK-UP OF THE "MODULAR APPROACH:"

INDIA

STAFF REPORT FOR THE 2007 ARTICLE IV CONSULTATION

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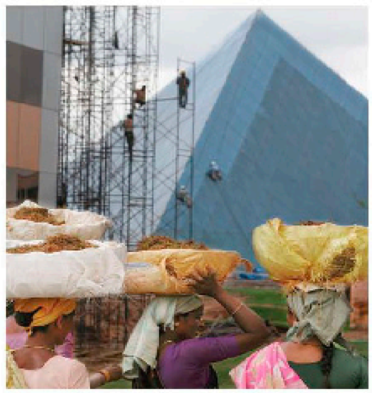
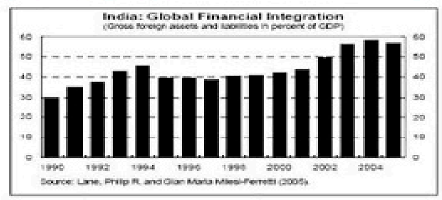


Selected Economic Data (2007/08, proj.)	
NGDP	US$ 912bn
GDP per capita (2006/07)	US$ 809
GDP growth (%)	8.7
CPI	5.9
Central govt bal. (% GDP)	-4.5
General govt bal. (% GDP)	-6.8
Broad Money (y/y change, %)	22.8
Credit to Commercial Sector	21.7
CA balance (% GDP)	-1.5
Overall balance (% GDP)	8.0



Managing Financial Globalization, Addressing Supply Constraints to Growth

Swelling capital inflows have highlighted key policy challenges. Inflows are exacerbating tensions in the monetary policy framework among exchange rate management, monetary independence and financial openness.

Strengthened monetary operations and communication, along with greater exchange rate flexibility, could increase monetary policy effectiveness. In addition, deeper financial markets could help channel capital to its most productive use, accommodate higher exchange

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To:
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Convert

INTERNATIONAL MONETARY FUND

INDIA

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Article IV Consultation with India

Approved by Kalpana Kochhar and Matthew Fisher

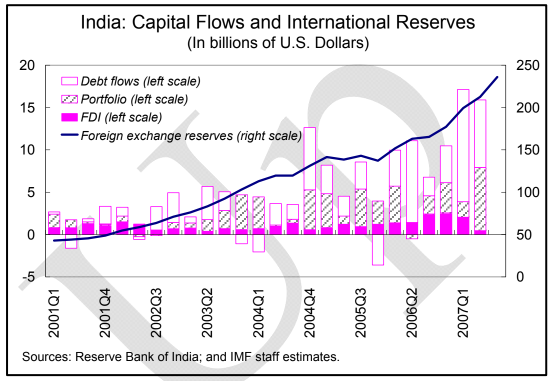
December 26, 2007

- **Discussions:** Mumbai, October 29–November 2; Delhi, November 5–12.
- **Team:** Ms. Kochhar (head), Mr. Kramer, Ms. Poirson, Ms. Richter-Hume, Ms. Oura, Ms. Topalova (all APD), Mr. Jobst (MCM), Mr. Felman (Senior Resident Representative), Ms. Kohli, and Mr. Mohapatra (Resident Representative office).
- **Focus of the consultation:** Managing financial globalization; addressing the supply constraints to inclusive growth.
- **Selected issues:** Monetary policy challenges from financial globalization; monetary policy communication; pattern of corporate financing; social safety net; derivatives market development; competitiveness; inclusive growth.
- **Exchange rate regime:** Managed float. India is an Article VIII country but maintains restrictions subject to approval under Article VIII.
- **Outreach:** Staff seminars at the Reserve Bank of India and the Ministry of Finance.
- **Consultation cycle:** The mission recommended a continued 12-month cycle.
- **Pre-brief meeting:** September 24, with FAD, MCM, PDR, and RES.
- **Economic statistics:** are adequate for surveillance purposes, but weaknesses remain. The mission discussed shortcomings of balance of payments data.
- **Thrust of policy changes since 2006 consultation:** The authorities and the Fund have generally agreed on broad policy priorities. In concluding the 2006 consultation, Executive Directors agreed that vigilance was needed to guard against overheating risks, called for further progress in reducing public debt, and urged greater progress in addressing structural obstacles to job-intensive, inclusive growth. The authorities have tightened monetary policy, and public debt/GDP has come down (mainly due to rapid growth), but limited progress has been made in structural reform.

I. Economic Background

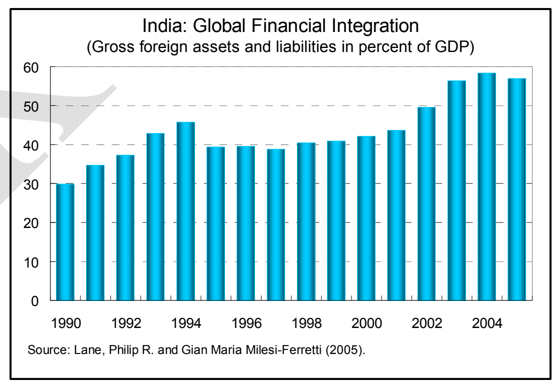
A. Economic Context

1. **India is no longer financially closed**. During the past decade, gross international assets and liabilities rose by 15 percentage points of GDP. Inward and outward FDI, portfolio inflows, and commercial borrowing set new records. Financial integration is set to continue: global portfolio weights on India are rising, thanks to its strong economic prospects, while gradual capital account liberalization continues.



India: Capital Flows and International Reserves
(In billions of U.S. Dollars)
Sources: Reserve Bank of India; and IMF staff estimates.

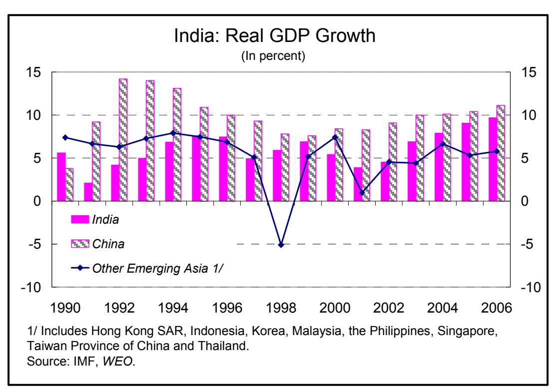
2. **Financial integration is the payoff from reforms adopted in the 1990s, but also poses policy challenges.** Reforms cut business regulations, freed interest rates, and slashed tariffs, unleashing a productivity-driven growth boom that attracted capital inflows. But inflows are straining the macroeconomic policy framework; further comprehensive reforms are needed to align that framework with current realities.


India: Global Financial Integration
(Gross foreign assets and liabilities in percent of GDP)
Source: Lane, Philip R. and Gian Maria Milesi-Ferretti (2005).

3. But rapid growth is stressing infrastructure and labor markets, worsening already serious shortages of electricity and skilled labor. Pressures on skilled wages—growing the fastest in Asia—are contributing to income inequality. Moreover, while the poverty rate has dropped, consumption by the poor has not kept pace with that by the better-off.

B. Recent Economic Trends

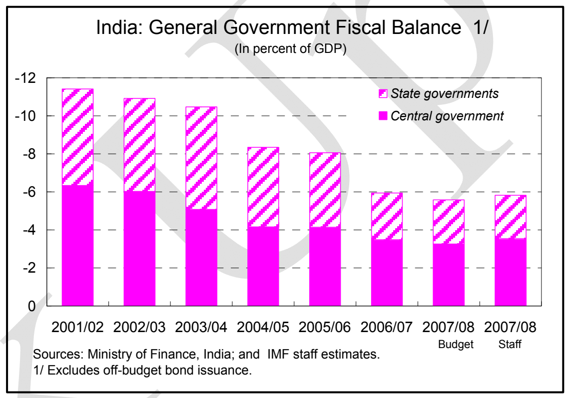
4. **Growth remains strong, led by investment** (Figure 1)**.** During April-June 2007, real GDP rose by 9.3 percent y/y, extending one of Asia's best growth performances. Capacity utilization is high, although high-frequency indicators point to a moderate recent deceleration in activity. Strong corporate profits have fed booming investment and driven stock prices to all-time highs (Figure 2).



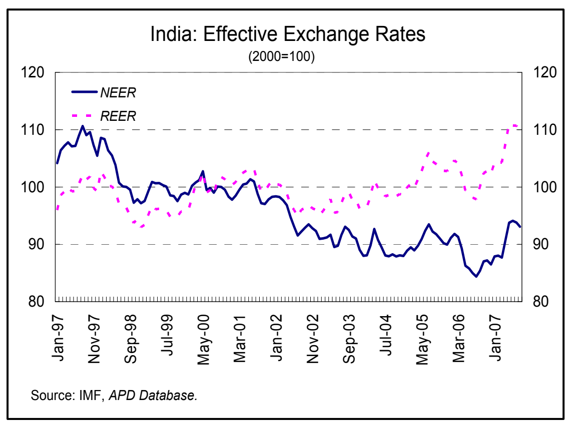
India: Real GDP Growth
(In percent)
1/ Includes Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan Province of China and Thailand.
Source: IMF, *WEO*.

5. **Inflation has ebbed.** Starting in the second half of 2006, rising headline inflation, rapid credit growth, and buoyant real estate prices fed concerns about overheating (Figure 3). In response, the Reserve Bank of India (RBI) has tightened the monetary stance. Since October 2006, it has raised the repo (lending) rate by 75 basis points, increased reserve requirements by 200 basis points, and withdrawn excess liquidity, lifting the overnight rate back into the policy band. WPI inflation has come down to under 4 percent y/y (partly reflecting decelerating food and oil prices), below the RBI's projection of 5 percent for this fiscal year.[1] On the back of lower inflation and monetary tightening, real prime lending rates have risen, while credit growth has slowed and the real estate market is reportedly cooling.

6. **Capital inflows remain strong, putting upward pressure on the rupee (Figure 4).** Inflows are driven by India's bright outlook and ample global liquidity, and more than finance the current account deficit (projected at 2½ percent of GDP in 2007/08, compared with a capital account surplus of 5 percent of GDP). External commercial borrowings (ECBs) dominated inflows in 2006/07; this year, equity portfolio inflows have swelled. Since August 2006, the rupee has appreciated by 12 percent in real effective terms (mostly due to the inflation differential), after remaining roughly stable since 2000.[2] Reserves are up by over $50 billion since end-March, reflecting RBI foreign-exchange intervention.



Sources: Ministry of Finance, India; and IMF staff estimates.
1/ Excludes off-budget bond issuance.



Source: IMF, *APD Database*.

7. **Modest fiscal consolidation continues, mainly due to revenue buoyancy amid strong GDP growth (Figure 5).** Staff estimate that in 2006/07, the general government deficit (excluding off-budget subsidies of 1 percent of GDP)[3] declined by ¾ percentage point to around 6 percent of GDP—achieving one target of the Fiscal Responsibility and Budget Management Act (FRBMA) two years early.[4] Both central and state levels achieved faster-than-expected consolidation. Central

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[1] Fiscal year runs April-March.

[2] The REER appreciation is somewhat overstated, as India's CPI is biased upward due to outdated weights.

[3] Bond were issued to oil producers and the Food Corporation of India to offset subsidy-related losses.

[4] Principal targets for 2008/09 are a 6 percent general government deficit, and central government revenue balance.

government gross tax revenue rose by 1¼ percentage points of GDP, with buoyant corporate taxes reflecting high profits. State revenues have been strong, reflecting good performance of the VAT (now nationwide, except for Uttar Pradesh). But burgeoning current expenditure has kept the central government's current (revenue) deficit high, at 2 percent of GDP, while capital spending has stagnated.

8. **Banks are liquid and have regulatory capitalization well above Basel norms.** In recent years, an emergent middle class, rising incomes, and financial deepening have fed a retail credit boom. NPL ratios have fallen to low levels, partly due to rapid credit growth. Recently, higher domestic interest rates have moderated the credit boom, and there are indications of a pickup in NPLs.

C. Medium-Term Prospects

India: Summary of Medium-term Projections

(In percent of GDP unless otherwise indicated)

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Real GDP growth at factor costs (% change)	7.5	9.0	9.4	8.7	8.3	8.2	8.2	8.1	8.0
Agriculture (% change)	0.0	6.0	2.7	2.8	2.5	2.6	2.7	2.7	2.7
Industry (% change)	9.8	9.6	10.9	10.0	9.5	9.3	9.2	9.0	8.8
Services (% change)	9.6	9.8	11.0	10.0	9.5	9.3	9.2	9.0	8.8
WPI (% change)	6.5	4.4	5.5	3.8	3.9	3.9	3.9	3.9	3.9
CPI (% change)	3.8	4.4	6.7	5.6	4.2	3.9	3.9	3.9	3.9
				(In percent of GDP)					
Central government balance 1/	-4.2	-4.1	-3.5	-3.5	-3.2	-3.0	-3.0	-3.0	-3.0
General government balance 1/	-7.3	-6.8	-5.9	-5.8	-5.3	-4.9	-4.7	-4.5	-4.3
General government debt (gross)	85.7	82.9	79.0	75.3	72.2	68.8	66.0	63.3	60.9
Current account balance	-0.4	-1.1	-1.1	-2.4	-2.6	-2.5	-2.4	-2.4	-2.4
Trade balance	-4.8	-6.4	-7.1	-7.9	-8.5	-8.6	-8.7	-8.7	-8.7
Capital account balance	4.1	3.0	5.1	5.7	4.7	4.2	3.9	3.6	3.4
FDI (net)	0.5	0.6	0.9	1.1	1.1	1.1	1.1	1.0	1.0
Portfolio flows (net)	1.3	1.6	0.8	2.3	1.6	1.2	1.0	0.9	0.8
ECB (net)	0.7	0.3	1.8	1.0	0.9	0.9	0.9	0.8	0.8
Memodandum items:									
External debt stock (In billions of USD)	123	126	155	181	208	236	268	300	335
External debt stock (In percent of GDP)	17.7	15.7	17.0	15.6	16.2	16.6	17.0	17.4	17.6

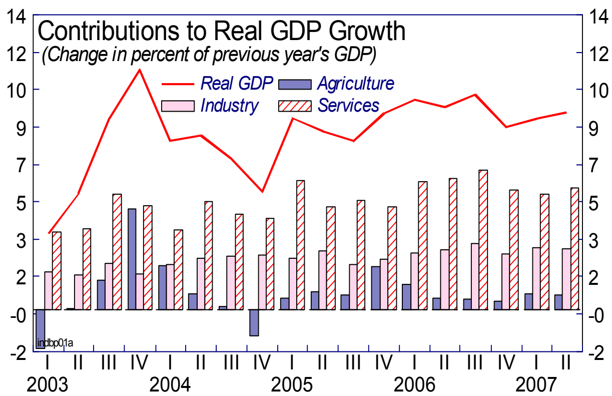
1/ Divestment is treated as financing; excludes off budget bond issuance.

9. **Medium-term prospects are for sustained growth, contained inflation, and continued external stability.** GDP growth would moderate to 8 percent, staff's estimate for potential growth.[5] Inflation should range around 4 percent. The current account deficit would remain around 2½ percent of GDP, comfortably financed by private capital inflows. Capital inflows will likely remain sizeable. Strong growth would help reduce the general government deficit to about 4¼ percent of GDP. The key medium-term risk is slow progress in reforms to deal with financial globalization and supply constraints to growth.

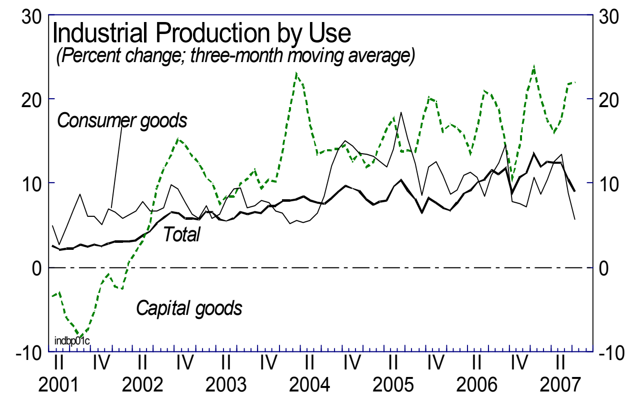
[5] See Oura, *Wild or Tamed? India's Potential Growth*, IMF Working Paper 07/224.

Figure 1. India: Growth

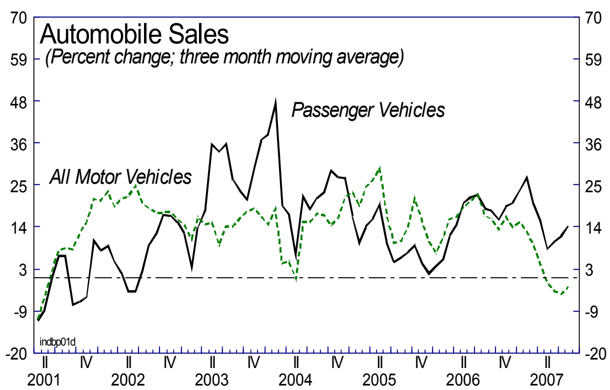
Growth has been robust…



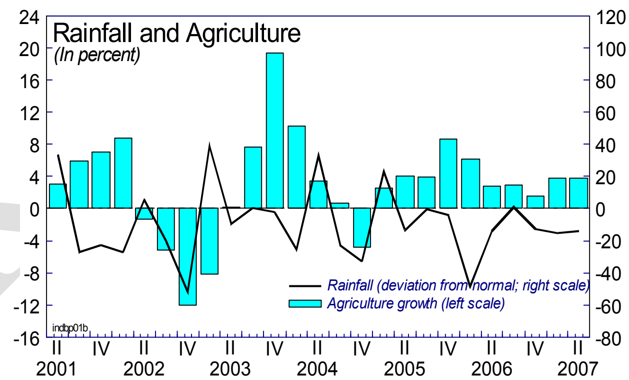
…helped by strong industrial production indicating buoyant investment,…



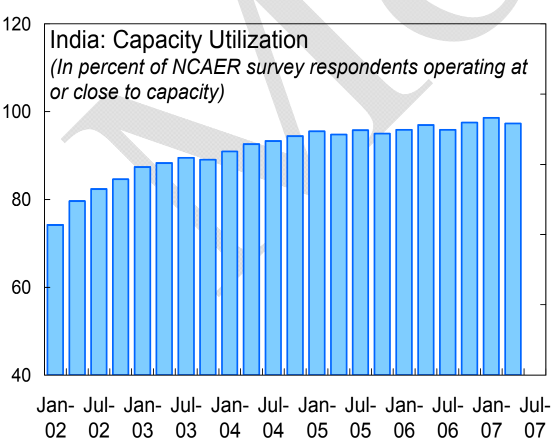
…solid household spending,…



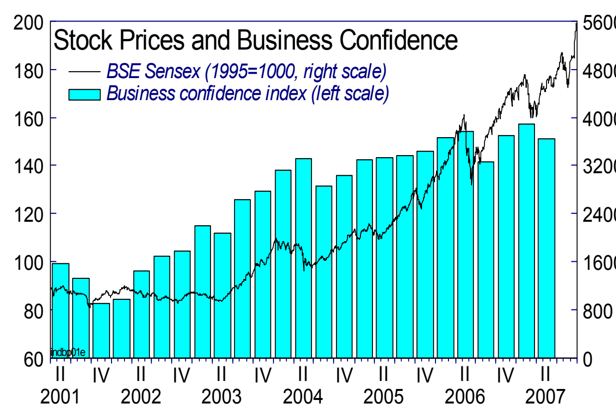
…a normal monsoon,…



…reflected in higher capacity utilization,…



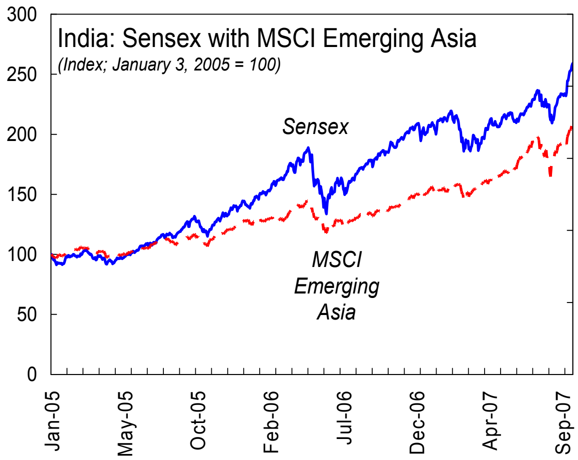
…and increasing stock prices. However, lower business co signals easing momentum.



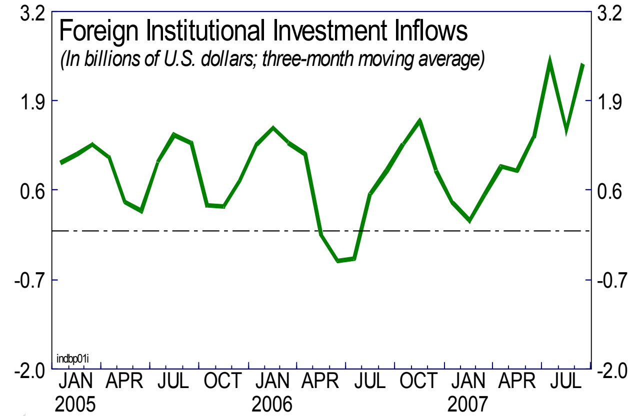
Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; NCAER; and IMF staff projections.

Figure 2. India: Asset Market

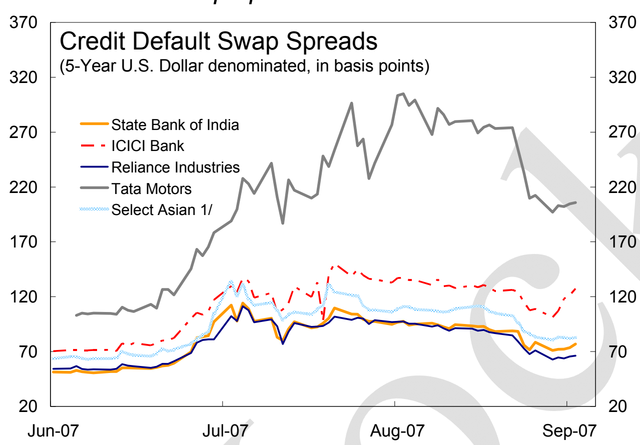
Stock prices have recovered from summer turbulence...



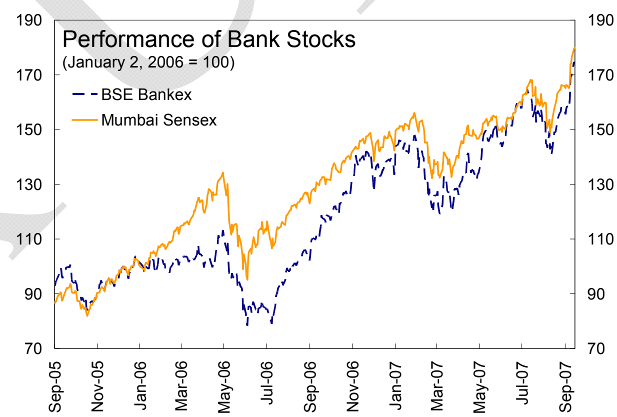
... as have inflows.



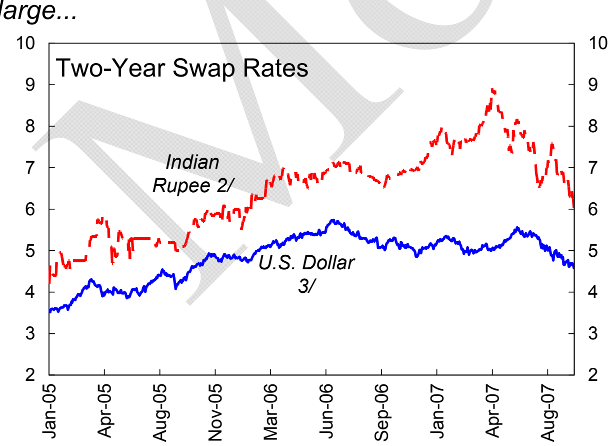
Credit default swap spreads have started to ease...



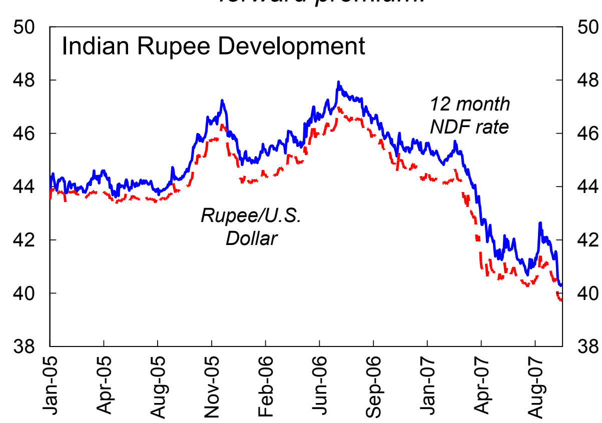
...and banks stocks are recovering.



The spread versus U.S. dollar interest rates remains large...



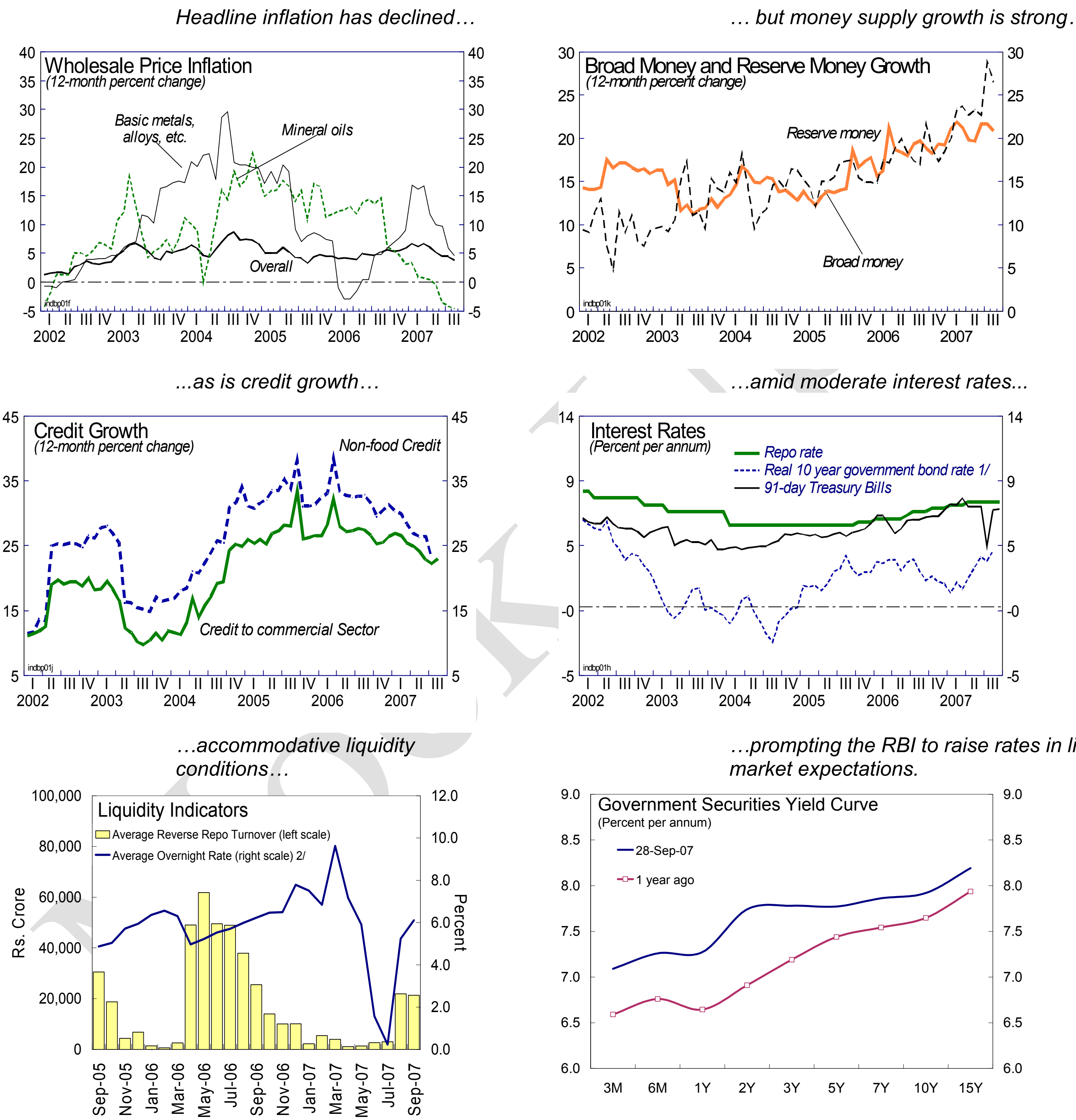
... as reflected in a significant forward premium.



Sources: Data provided by the Indian authorities; and Bloomberg LP.

1/ Average spread of Indonesia, Korea, Malaysia, Philippines and Thailand.
2/ Non deliverable forwards.
3/ Semi-annually fixed rate versus 3 month U.S. Dollar LIBIOR.

Figure 3. India: Money and Inflation

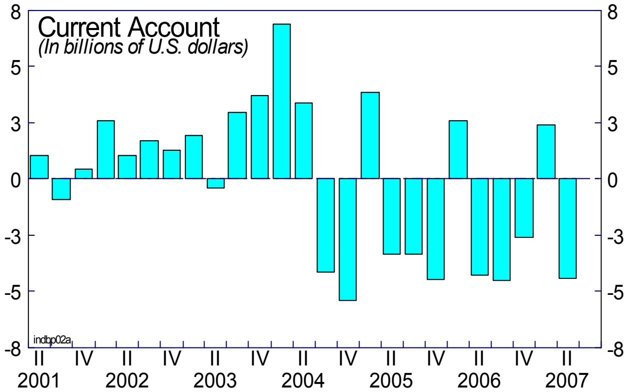


Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; and IMF staff projections.

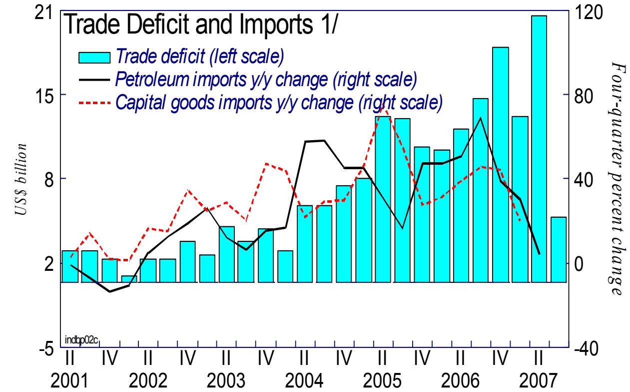
1/ Deflated by the WPI.
2/ Average of daily weighted call money borrowing rates.

Figure 4. India: External Sector

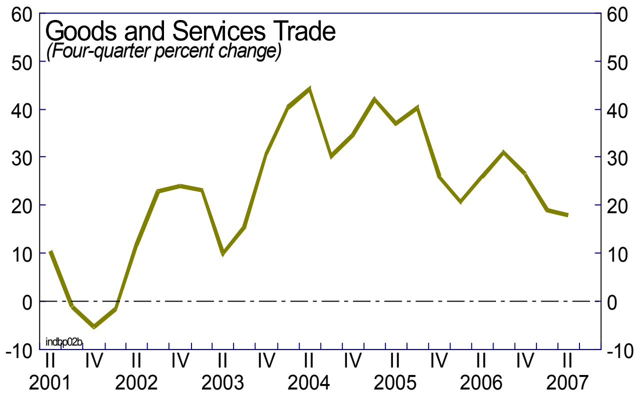
The current account is in deficit…



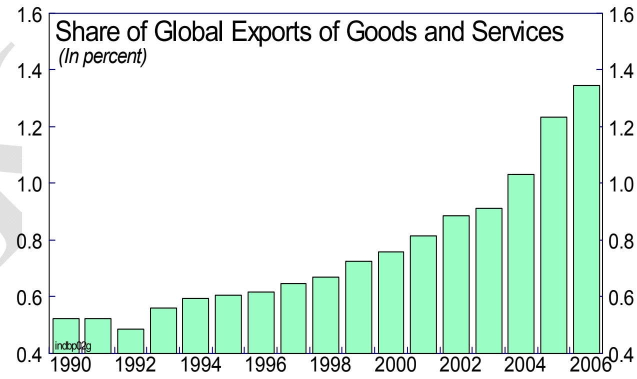
…on the back of a rising trade deficit, reflecting strong domestic demand.



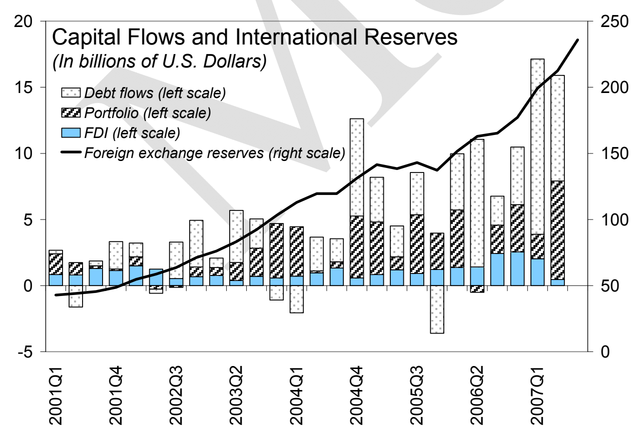
Export growth is easing from recent highs, but remains strong…



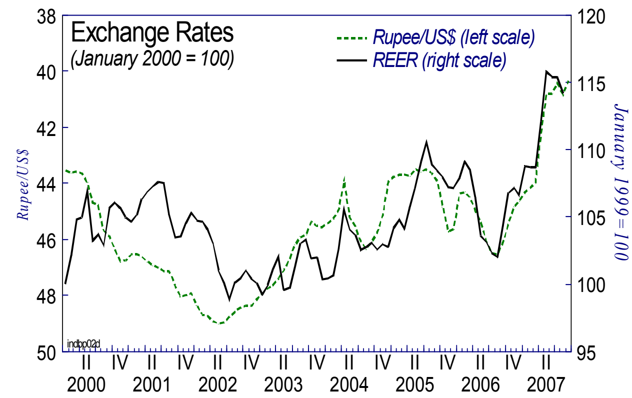
…expanding gains in world market share.



Reserves continue to rise…



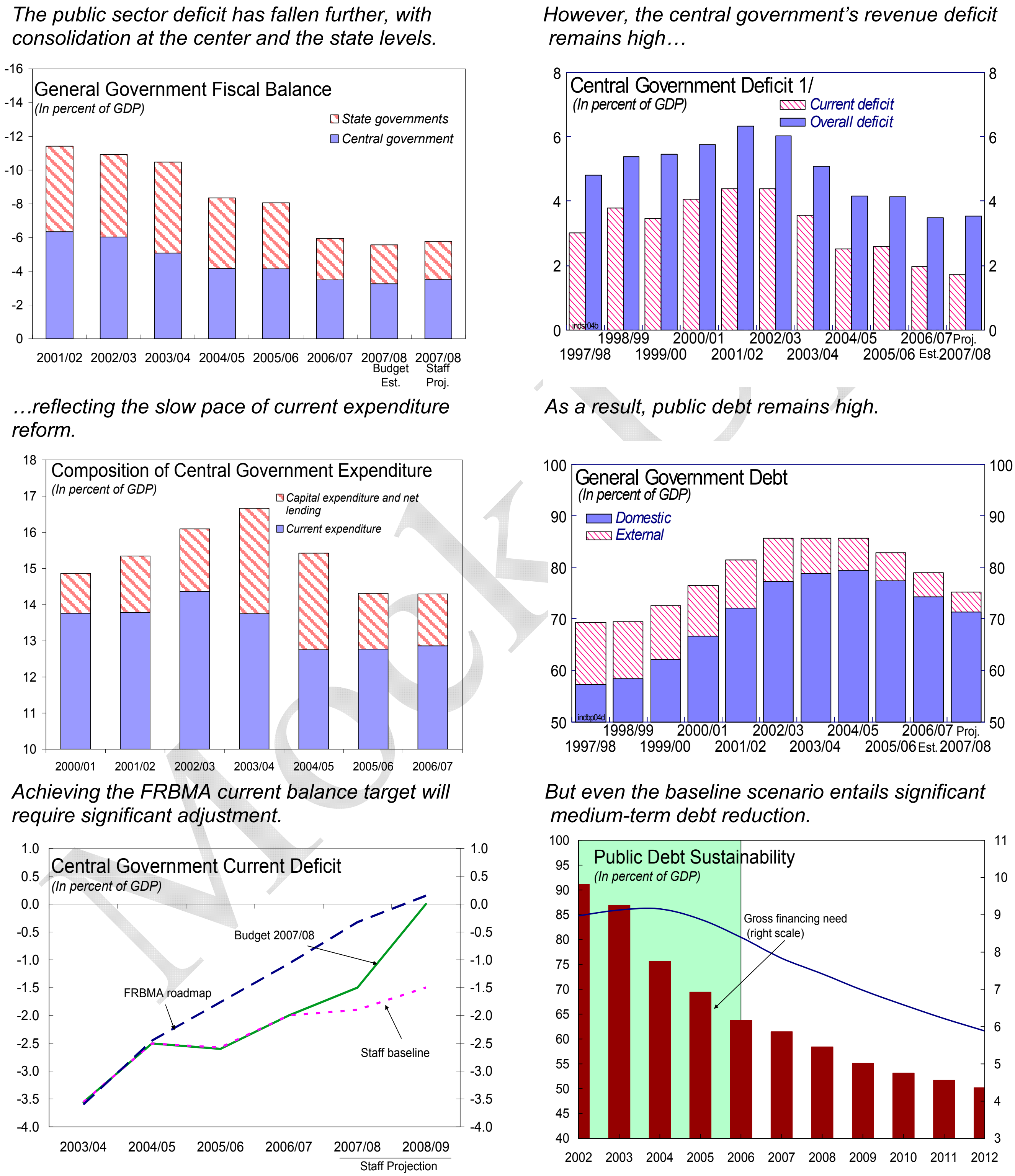
…yet the exchange rate has appreciated s



Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; and IMF, *WEO*.

1/ Customs data; based on U.S. dollar values, up to July 2007.

Figure 5. India: Fiscal Trends



Sources: Data provided by the Indian authorities; and staff projections.

1/ Excluding privatization receipts.

Table 1. India: Millennium Development Goals, 1990–2006 1/

	1990	1995	2001	2004	2006
Eradicate extreme poverty and hunger 2/					
Income share held by lowest 20 percent	...	...	...	8.1	...
Malnutrition prevalence, weight for age (percent of children under 5)	63.9	...	...	...	...
Poverty gap at $1 a day (PPP) (percent)	...	10.7	...	7.9	...
Poverty headcount ratio at $1 a day (PPP) (percent of population)	...	41.8	...	34.3	...
Poverty headcount ratio at national poverty line (percent of population)	...	36.0	28.6	...	...
Prevalence of undernourishment (percent of population)	...	25.0	...	20.0	...
Achieve universal primary education 3/					
Literacy rate, youth total (percent of people ages 15–24)	64.3	...	...	...	76.4
Persistence to grade 5, total (percent of cohort)	...	...	61.4	78.9	...
Primary completion rate, total (percent of relevant age group)	68.2	77.1	75.8	88.5	...
School enrollment, primary (percent net)	...	...	81.4	89.7	...
Promote gender equality 4/					
Proportion of seats held by women in national parliament (percent)	5.0	...	9.0	9.0	8.3
Ratio of girls to boys in primary and secondary education (percent)	69.5	...	77.5	86.9	...
Ratio of young literate females to males (percent ages 15–24)	73.9	...	...	...	80.5
Women employed in the nonagricultural sector (percent of total nonagricultural employment)	12.7	14.4	16.8	17.3	...
Reduce child mortality 5/					
Immunization, measles (percent of children ages 12–23 months)	56.0	72.0	58.0	58.0	58.0
Mortality rate, infant (per 1,000 live births)	80.0	74.0	66.0	61.6	56.0
Mortality rate, under-5 (per 1,000)	123.0	104.0	94.0	...	74.0
Improved maternal health 6/					
Births attended by skilled health staff (percent of total)	...	34.2	42.5	...	...
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	...	...
Combat HIV/AIDS, malaria, and other diseases 7/					
Children orphaned by HIV/AIDS	...	...	...	...	...
Contraceptive prevalence (percent of women ages 15–49)	44.9	...	47.0	...	...
Incidence of tuberculosis (per 100,000 people)	167.8	...	...	...	...
Prevalence of HIV, female (percent ages 15–24)	...	...	...	...	...
Prevalence of HIV, total (percent of population ages 15–49)	...	...	...	0.9	0.9
Tuberculosis cases detected under DOTS (percent)	...	0.3	23.8	57.1	61.3
Ensure environmental sustainability 8/					
CO2 emissions (metric tons per capita)	0.8	1.0	1.1	1.2	...
Forest area (percent of land area)	21.5	...	22.7	...	22.8
GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent)	4.0	4.3	5.0	5.5	...
Improved sanitation facilities (percent of population with access)	14.0	...	...	33.0	...
Improved water source (percent of population with access)	70.0	...	...	86.0	...
Nationally protected areas (percent of total land area)	...	...	...	...	...
Develop a global partnership for development 9/					
Aid per capita (current US$)	1.6	1.9	1.6	0.6	1.6
Debt service (PPG and IMF only, percent of exports of G&S, excl. workers' remittances)	...	...	...	...	...
Fixed line and mobile phone subscribers (per 1,000 people)	6.0	12.9	43.6	84.5	127.7
Internet users (per 1,000 people)	0.0	0.3	6.8	32.4	54.8
Personal computers (per 1,000 people)	0.3	1.3	5.8	12.1	15.5
Total debt service (percent of exports of goods, services and income)	31.9	29.7	14.7	19.1	...
Unemployment, youth female (percent of female labor force ages 15–24)	...	8.0	10.2	10.8	...
Unemployment, youth male (percent of male labor force ages 15–24)	...	8.4	10.1	10.4	...
Unemployment, youth total (percent of total labor force ages 15–24)	...	8.3	10.1	10.5	...
General indicators					
Fertility rate, total (births per woman)	3.8	3.4	3.1	2.9	2.8
GNI per capita, Atlas method (current US$)	390.0	380.0	460.0	630.0	730.0
GNI, Atlas method (current US$) (billions)	330.6	349.6	478.7	680.4	804.1
Gross capital formation (percent of GDP)	24.1	26.5	24.5	31.0	33.4
Life expectancy at birth, total (years)	59.1	61.4	62.9	63.4	63.5
Literacy rate, adult total (percent of people ages 15 and above)	49.3	...	...	...	61.0
Population, total (millions)	849.5	932.2	1,032.5	1,079.7	1,094.6
Trade (percent of GDP)	15.7	23.2	27.6	40.1	44.7

Source: *World Development Indicators* , April 2007.

1/ In some cases the data are for earlier or later years than those stated.
2/ Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day.
3/ Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.
4/ Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.
5/ Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.
6/ Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.
7/ Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and other major diseases.
8/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum dwellers.
9/ Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries. Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

Table 2. India: Selected Economic Indicators, 2003/04–2007/08 1/

Nominal GDP (2006/07): US$912 billion
Population (2006/07): 1.13 billion
GDP per capita (2006/07): US$809
Quota: SDR 4,158.2 million

	2003/04	2004/05	2005/06	2006/07	2007/08 2/	2007/08							
				Prov.	Proj.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov. 3/
Growth (y/y percent change)													
Real GDP (at factor cost)	8.5	7.5	9.0	9.4	8.7	...	...	...	...	...	...	...	...
Industrial production	7.0	8.4	8.2	11.3	...	11.3	10.6	8.9	8.3	10.7	6.8	11.8	...
Prices (y/y percent change, period average for annual data)													
Wholesale prices (1993/94 weights)	5.4	6.5	4.4	5.5	3.6	6.0	5.2	4.5	4.7	3.9	3.4	3.0	3.7
Consumer prices - industrial workers (2001 weights)	3.9	3.8	4.4	6.7	5.9	6.7	6.6	5.7	6.5	7.3	6.4	5.5	...
Saving and investment (percent of GDP)													
Gross saving 4/	30.4	31.2	32.6	34.2	35.6	...	...	...	...	...	...	...	...
Gross investment	28.0	31.5	33.8	35.3	37.0	...	...	...	...	...	...	...	...
Fiscal position (percent of GDP)													
Central government balance - authorities 5/	-4.5	-4.0	-4.1	-3.5	-3.3	-0.6	-1.4	-1.7	-2.0	-1.5	-1.0	-1.1	...
Central government balance - staff 6/	-5.1	-4.2	-4.4	-4.4	-4.5								
General government balance - staff 6/	-9.1	-7.3	-7.1	-7.2	-6.8	...	...	...	...	...	...	...	...
General government debt	85.7	85.7	82.9	79.0	75.2	...	...	...	...	...	...	...	...
Money and credit (y/y percent change, end-period)													
Broad money	16.7	12.3	21.2	21.3	…	19.8	19.7	21.6	21.8	20.7	21.0	22.5	22.8
Credit to commercial sector	13.0	26.0	32.2	25.4	…	24.9	23.6	22.5	21.9	22.7	20.5	21.2	21.7
Financial indicators (percent, end-period)													
91-day treasury bill yield	4.2	5.3	6.1	8.0	...	7.4	7.1	7.2	6.2	6.9	7.1	7.2	7.5
10-year government bond yield	5.1	6.7	7.5	8.0	...	8.2	8.1	8.2	7.8	7.9	7.9	7.8	7.9
Stock market (y/y percent change, end-period)	83.4	16.1	73.7	15.9	…	15.2	39.9	38.1	44.7	30.9	38.8	53.0	41.4
External trade 7/													
Exports of goods (US$ billions)	66.3	85.2	105.2	127.1	154.4	11.0	12.2	11.9	12.5	12.7	12.8	13.3	...
y/y percent change	23.3	28.5	23.4	20.9	21.5	28.1	21.9	14.1	18.5	18.9	19.3	35.6	...
Imports of goods (US$ billions)	80.0	118.9	157.0	192.0	241.9	17.8	19.2	19.2	17.5	19.6	17.2	20.8	...
y/y percent change	24.1	48.6	32.0	22.3	26.0	41.8	34.4	36.7	20.4	32.6	2.3	24.3	...
Net oil imports (US$ billions)	17.0	22.9	32.3	41.3	50.3	2.3	2.5	3.6	5.0	6.0	5.5	6.1	...
Balance of payments (US$ billions)													
Current account balance	14.1	-2.5	-9.2	-9.6	-17.4	...	...	...	...	...	...	...	...
(in percent of GDP)	2.3	-0.4	-1.1	-1.1	-1.5	...	...	...	...	...	...	...	...
Foreign direct investment, net	2.4	3.7	4.7	8.4	23.5	1.6	2.1	1.2	0.7	0.8	...	...	...
Portfolio investment, net (equity and debt)	11.4	9.3	12.5	7.1	30.6	1.8	1.3	0.3	5.5	-1.8	4.6	5.7	-1.5
Overall balance	31.4	26.2	15.1	36.6	93.9	...	...	...	...	...	...	...	...
External indicators													
Gross reserves (US$ billions end-period)	113.0	141.5	151.6	199.2	296.1	204.1	208.4	213.5	227.1	228.9	247.3	262.5	273.5
(In months of imports) 8/	9.2	8.7	7.6	7.8	9.8	6.5	6.7	7.0	7.6	7.8	8.7	9.4	9.9
External debt (percent of GDP, end-period) 9/	18.5	17.8	15.8	17.1	17.9	...	...	...	...	...	...	...	...
Of which : short-term debt 10/	1.8	3.1	2.0	2.1	2.9	...	...	...	...	...	...	...	...
Ratio of gross reserves to short-term debt (end-period)	10.7	6.5	9.5	10.5	12.2	8.4	8.6	8.8	9.3	9.4	10.2	10.8	11.2
Gross reserves to broad money (percent; end-period)	24.6	27.5	24.8	26.3	...	25.3	25.4	25.7	26.6	27.0	27.5	28.6	29.5
Debt service ratio 11/	16.0	6.0	9.7	5.1	5.5	...	...	...	...	...	...	...	...
Real effective exchange rate													
(y/y percent change, period average for annual data)	1.0	2.2	4.4	-2.2	…	5.3	11.7	12.0	12.9	12.0	9.7	7.9	6.3
Exchange rate (rupee/US$, end-period)	43.6	43.7	44.6	43.5	...	41.2	40.6	40.7	40.4	40.9	39.8	39.3	39.6
Memorandum items (in percent of GDP):													
Off-budget subsidy related bonds 12/	0.0	0.0	0.3	1.0	1.2	…	…	…	…	…	…	…	…

Sources: Data provided by the Indian authorities; CEIC Data Company Ltd.; and Fund staff estimates and projections.

1/ Data are for April-March fiscal years.
2/ Current staff projections.
3/ Latest available figures.
4/ Differ from official data due to revisions in the current account.
5/ Divestment proceeds are treated as revenue until 2005/06 (included); excludes off-budget bond issuance.
6/ Divestment is treated as financing; includes off-budget bond issuance.
7/ Monthly data are on a customs basis; annual data are on a projected balance of payments basis.
8/ Imports of goods and services projected over the following twelve months.
9/ Data are reported relative to staff's estimated annual GDP.
10/ Residual maturity basis, except contracted maturity basis for medium and long-term non-resident Indian accounts.
11/ In percent of current account receipts excluding grants.
12/ Issued by the central government to FCI, the state-owned oil refining/distribution companies, and fertilizer companies as compensation for losses incurred from the provision of price subsidies.

Table 3. India: Balance of Payments, 2003/04–2007/08 1/

(In billions of U.S. dollars)

	2003/04	2004/05	2005/06	2006/07 Prov.	2007/08 Proj.
Current account balance	14.1	-2.5	-9.2	-9.6	-17.4
Merchandise trade balance	-13.7	-33.7	-51.8	-64.9	-87.5
Merchandise exports	66.3	85.2	105.2	127.1	154.4
Merchandise imports	80.0	118.9	157.0	192.0	241.9
Oil	20.6	29.9	44.0	57.3	71.0
Non-oil	59.4	89.0	113.0	134.7	170.9
Of which: customs based 2/	57.7	76.8	105.2	124.1	…
Non-factor services balance	10.1	15.4	23.9	32.7	40.0
Receipts	26.9	43.2	61.4	81.3	103.3
Of which: software services	12.8	17.2	23.6	13.0	...
Payments	16.7	27.8	37.5	48.6	63.2
Income, net	-4.5	-5.0	-5.5	-4.8	-5.4
Transfers, net	22.2	20.8	24.3	27.4	35.4
Capital account balance	16.7	28.0	23.4	44.9	110.7
Direct investment, net	2.4	3.7	4.7	8.4	23.5
Of which: direct investment in India	4.3	6.0	7.7	19.4	35.3
Portfolio investment, net	11.4	9.3	12.5	7.1	30.6
Government borrowing, net	-2.9	1.9	1.7	1.8	2.6
Commercial borrowing, net	-2.9	5.2	2.7	16.1	16.5
Short-term credit, net	1.4	3.8	1.7	3.3	12.1
NRI deposits, net	3.6	-1.0	2.8	3.9	10.6
Rupee debt	-0.4	-0.4	-0.6	-0.2	-0.2
Other capital, net 3/	4.1	5.5	-2.2	4.6	15.0
Errors and omissions	0.6	0.6	0.8	1.3	0.6
Overall balance	31.4	26.2	15.1	36.6	93.9
Valuation change	5.4	2.4	-5.0	11.0	3.0
Increase in gross reserves (-)	-36.9	-28.5	-10.1	-47.6	-96.9
Memorandum items:					
Change in forex reserves (includes valuation)	36.9	28.5	10.1	47.6	96.9
Foreign exchange reserves	113.0	141.5	151.6	199.2	296.1
In months of next year's imports (goods and servic	9.2	8.7	7.6	7.8	9.8
Current account balance (percent of GDP)	2.3	-0.4	-1.1	-1.1	-1.5
Merchandise trade balance (percent of GDP)	-2.3	-4.8	-6.4	-7.1	-7.4
Overall balance (percent of GDP)	5.2	3.8	1.9	4.0	8.0

Sources: CEIC Data Company Ltd.; and Fund staff estimates and projections.

1/ Data are for April-March fiscal years. Indian authorities' presentation, including new methodology to estimate direct investment.

2/ Noncustoms imports include defense related items.

3/ Net other capital is sum of net banking capital (RBI format) and net other capital (RBI format) less net NRI deposits.

Table 4. India: Reserve Money and Monetary Survey, 2003/04–2007/08 1/

	2003/04	2004/05	2005/06	2006/07	2007/08						
					Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.
Reserve money					(In billions of rupees, end-period)						
Reserve money	4,365	4,891	5,731	7,090	7,305	7,260	7,207	7,520	7,463	7,812	7,699
Net domestic assets of RBI	-479	-1,237	-999	-1,571	-1,076	-1,046	-1,427	-1,418	-1,891	-2,016	-2,130
Claims on government (net)	449	-180	81	58	185	63	-197	219	-629	-744	-1,371
Center	369	-233	52	21	180	55	-197	210	-643	-643	-643
States	80	53	30	36	6	8	0	9	13	-102	-728
Claims on commercial sector	21	14	14	15	14	14	14	14	14	14	14
Claims on banks	54	53	58	76	53	44	13	0	1	1	…
Other items (net)	-1,003	-1,123	-1,152	-1,721	-1,328	-1,167	-1,256	-1,651	-1,277	-1,287	…
Net foreign assets of RBI	4,844	6,128	6,730	8,662	8,381	8,306	8,634	8,939	9,355	9,828	9,828
					(Contribution to reserve money growth)						
Reserve money	18.3	12.1	17.2	23.7	22.7	23.3	22.9	29.0	26.4	29.1	26.9
Net domestic assets of RBI	-15.9	-17.4	4.9	-10.0	2.7	8.2	2.7	6.2	-2.4	-8.4	-11.0
Claims on government (net)	-20.5	-14.4	5.3	-0.4	0.1	-0.2	-4.8	4.0	-10.5	-14.1	-24.4
Net foreign assets of RBI	34.2	29.4	12.3	33.7	20.0	15.2	20.2	22.8	28.9	37.4	37.9
Monetary survey					(In billions of rupees,end-period)						
Broad money (M3)	20,057	22,514	27,295	33,103	33,218	33,274	33,865	34,539	34,756	35,744	36,082
Currency with public	3,150	3,559	4,131	4,835	5,034	5,041	5,010	4,957	4,869	4,871	5,065
Deposits	16,856	18,891	23,096	28,193	28,114	28,179	28,784	29,458	29,836	30,818	30,968
Non-bank deposits at RBI	51	65	69	75	70	54	71	123	50	56	48
Net domestic assets	14,791	16,022	20,034	23,971	24,366	24,497	24,912	25,282	25,340	26,273	26,184
Domestic credit	17,591	20,370	24,596	29,615	29,542	29,383	29,545	30,288	30,417	31,046	30,851
Net credit to government	7,429	7,568	7,666	8,382	8,649	8,621	8,630	9,169	8,786	8,727	8,528
Of which: RBI	449	-180	81	58	185	63	-197	219	-629	-744	-1,371
Credit to commercial sector 2/	10,162	12,802	16,930	21,234	20,893	20,762	20,915	21,119	21,631	22,319	22,323
Of which: commercial bank len	8,408	11,004	15,071	19,289	18,878	18,837	19,175	19,145	19,601	19,601	19,601
Nonfood	8,048	10,593	14,664	18,824	18,380	18,389	18,747	18,735	19,216	19,216	19,216
Other items (net)	-2,800	-4,348	-4,562	-5,644	-5,176	-4,885	-4,633	-5,007	-5,077	-4,772	-4,667
Net foreign assets	5,266	6,493	7,262	9,132	8,852	8,777	8,952	9,257	9,416	9,471	9,898
					(Twelve-month percent change)						
Broad money (M3)	16.7	12.3	21.2	21.3	19.8	19.7	21.6	21.8	20.7	21.0	22.5
Net domestic assets	11.7	8.3	25.0	19.7	21.8	23.4	24.5	24.2	20.2	20.6	22.5
Domestic credit	11.7	15.8	20.7	20.4	19.3	18.8	18.3	19.3	18.7	16.9	16.3
Net credit to government	9.8	1.9	1.3	9.3	7.4	8.5	9.2	13.6	9.9	8.5	5.1
Credit to commercial sector 2/	13.0	26.0	32.2	25.4	24.9	23.6	22.5	21.9	22.7	20.5	21.2
Of which: commercial bank len	15.3	30.9	37.0	28.0	27.1	26.1	26.1	23.0	24.2	18.0	18.5
Nonfood	18.4	31.6	38.4	28.4	26.9	26.4	26.7	23.2	24.6	18.0	18.8
Net foreign assets	33.7	23.3	11.9	25.7	14.6	10.5	14.1	15.7	22.1	22.1	22.6
					(Contribution to broad money growth)						
Net domestic assets	9.0	6.1	17.8	14.4	15.7	16.7	17.6	17.4	14.5	15.0	16.4
Net credit to government	3.9	0.7	0.4	2.6	2.2	2.4	2.6	3.9	2.8	2.3	1.4
Of which: RBI	-4.4	-3.1	1.2	-0.1	0.0	-0.1	-1.0	0.8	-2.1	-2.9	-5.0
Credit to commercial sector 2/	6.8	13.2	18.3	15.8	15.0	14.3	13.8	13.4	13.9	12.9	13.3
Net foreign assets	7.7	6.1	3.4	6.9	4.1	3.0	4.0	4.4	6.2	6.0	6.2

Sources: Reserve Bank of India; and Fund staff estimates.

1/ Data are for April - March fiscal years.
2/ Starting in May 2002, figures include ICICI, formerly a large development finance institution, which merged with ICICI Bank Ltd. to form a new commercial bank.

Table 5. India: Central Government Operations, 2003/04–2007/08

	2003/04	2004/05	2005/06	2006/07		2007/08	
				Budget	Est.	Budget	Staff proj.
				(In billions of rupees)			
Total revenue and grants	2,818	3,204	3,636	4,196	4,499	5,424	5,622
Net tax revenue	1,886	2,264	2,721	3,287	3,531	4,057	4,312
Gross tax revenue	2,543	3,050	3,662	4,422	4,734	5,481	5,826
Of which: corporate tax	636	827	1,013	1,330	1,433	1,684	1,909
income tax	414	493	636	774	865	988	1,148
excise taxes	908	991	1,112	1,190	1,177	1,302	1,220
customs duties	486	576	651	771	863	988	1,010
other taxes	100	163	250	357	396	520	539
Less: States' share	658	786	940	1,134	1,203	1,425	1,514
Nontax revenue 1/	911	910	884	882	943	1,346	1,289
Grants	22	31	30	26	25	21	21
Total expenditure and net lending	4,222	4,506	5,113	5,683	5,930	6,934	7,181
Current expenditure 2/	3,802	3,987	4,555	5,043	5,301	5,739	6,004
Of which: interest payments	1,241	1,269	1,326	1,398	1,496	1,590	1,695
wages and salaries	322	352	373	398	400	448	448
subsidies 3/	443	437	475	462	535	543	609
Capital expenditure and net lending 4/ 5/	420	519	557	640	629	1,195	1,177
Overall balance	-1,404	-1,302	-1,477	-1,487	-1,431	-1,509	-1,558
Overall balance (authorities' definition) 6/	-1,234	-1,258	-1,461	-1,487	-1,431	-1,509	-1,558
Overall balance (augmented) 7/	...	...	-1,576	-1,890	-1,834	-1,913	-2,126
Financing	1,404	1,302	1,477	1,487	1,431	1,509	1,558
External (net)	-135	148	75	83	85	91	91
Domestic (net)	1,539	1,154	1,402	1,404	1,346	1,418	1,467
				(In percent of GDP)			
Total revenue and grants	10.2	10.2	10.2	10.5	10.9	11.7	11.9
Net tax revenue	6.8	7.2	7.6	8.2	8.6	8.8	9.1
Gross tax revenue	9.2	9.8	10.3	11.1	11.5	11.8	12.3
Of which: corporate tax	2.3	2.6	2.8	3.3	3.5	3.6	4.0
income tax	1.5	1.6	1.8	1.9	2.1	2.1	2.4
excise taxes	3.3	3.2	3.1	3.0	2.9	2.8	2.6
customs duties	1.8	1.8	1.8	1.9	2.1	2.1	2.1
other taxes	0.4	0.5	0.7	0.9	1.0	1.1	1.1
Less: States' share	2.4	2.5	2.6	2.8	2.9	3.1	3.2
Nontax revenue 1/	3.3	2.9	2.5	2.2	2.3	2.9	2.7
Grants	0.1	0.1	0.1	0.1	0.1	0.0	0.0
Total expenditure and net lending	15.3	14.4	14.3	14.2	14.4	15.0	15.2
Current expenditure 2/	13.7	12.8	12.8	12.6	12.8	12.4	12.7
Of which: interest payments	4.5	4.1	3.7	3.5	3.6	3.4	3.6
wages and salaries	1.2	1.1	1.0	1.0	1.0	1.0	0.9
subsidies 3/	1.6	1.4	1.3	1.2	1.3	1.2	1.3
Capital expenditure and net lending 4/ 5/	1.5	1.7	1.6	1.6	1.5	2.6	2.5
Overall balance	-5.1	-4.2	-4.1	-3.7	-3.5	-3.3	-3.3
Overall balance (authorities' definition) 6/	-4.5	-4.0	-4.1	-3.7	-3.5	-3.3	-3.3
Overall balance (augmented) 7/	...	...	-4.4	-4.7	-4.4	-3.3	-4.5
Financing	5.1	4.2	4.1	3.7	3.5	3.3	3.3
External (net)	-0.5	0.5	0.2	0.2	0.2	0.2	0.2
Domestic (net)	5.6	3.7	3.9	3.5	3.3	3.1	3.1
Of which: market borrowing	3.2	1.5	2.7	2.8	3.1	2.4	2.3
small savings (net of states' share)	0.2	0.1	0.2	0.2	0.1	0.3	0.3
divestment receipts	0.6	0.1	0.0	0.1	0.0	0.0	0.0
Memorandum items:							
Military expenditure	2.2	2.4	2.3	2.2	2.1	2.1	2.0
Primary balance	-0.6	-0.1	-0.4	-0.2	0.1	0.2	0.3
Current balance 6/ 8/	-3.6	-2.5	-2.6	-2.1	-2.0	-0.7	-0.7
Current balance (augmented) 7/ 8/	...	...	-2.9	-3.1	-2.9	-0.7	-2.0
Central government debt 9/	62.8	63.8	63.4	61.9	61.5	59.3	60.4
Food Corporation of India bonds 10/	...	...	...	0.4	0.4	0.0	0.1
Oil bonds 10/	...	...	0.3	0.6	0.6	0.0	0.8
Fertilizer bonds 10/				...	...	...	0.3
Nominal GDP (in Rs. billion)	27,655	31,266	35,672	39,952	41,257	46,317	47,193

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

1/ In 2007/08, includes a special dividend payment from the RBI amounting to 0.7 percent of GDP. The authorities include this item under "other capital receipts" rather than non-tax revenue.
2/ Includes the surcharge on Union duties transferred to the National Calamity Contingency Fund.
3/ Excludes off-budget subsidy-related bond issuance.
4/ Authorities' treatment of state debt swap scheme (DSS) in 2002-05 shows the prepayment by States of on-lent funds to the center as net lending. The Center's prepayment of its debt to the National Small Savings Fund (NSSF) is treated as a capital expenditure.
5/ In 2007/08, includes roughly 0.7 percent of GDP for the government's purchase of SBI shares from the RBI.
6/ Authorities' definition treats divestment as a revenue item until 2005/06 (included); excludes off-budget subsidy related bond issuance.
7/ Staff's definition treats divestment receipts as a below-the-line financing item and includes off-budget subsidy-related bond issuance.
8/ In 2007/08, the authorities' definition of the current deficit (which classifies the special dividend from the RBI as "other capital receipts"), the budget target for the current deficit is 1.5 percent of GDP. Staff includes this item under non-tax revenue.
9/ External debt measured at historical exchange rates.
10/ Issued by the central government to FCI, fertilizer producers, and the state-owned oil refining/distribution companies as compensation for losses incurred from the subsidized provision of commodities.

Table 6. India: General Government Operations, 2003/04–2007/08 1/

	2003/04	2004/05	2005/06	2006/07		2007/08	
				Staff proj.	Est. 2/	Budget	Staff proj. 3/
				(In billions of rupees)			
Total revenue and grants	5,171	6,127	7,189	8,648	8,702	10,365	10,652
Tax revenue 4/	4,143	4,941	5,910	7,298	7,304	8,543	8,888
Nontax revenue 5/ 6/	1,006	1,156	1,250	1,326	1,373	1,800	1,743
Grants	22	31	30	25	25	21	21
Total expenditure and net lending 7/ 8/	7,683	8,410	9,600	11,214	11,251	12,942	13,289
General government balance	-2,512	-2,283	-2,411	-2,566	-2,549	-2,577	-2,636
Financing	2,512	2,283	2,411	2,566	2,549	2,577	2,636
External (net)	-135	148	75	79	85	91	91
Domestic (net)	2,647	2,136	2,336	2,487	2,464	2,486	2,545
Disinvestment receipts	170	44	0	0	0	0	0
				(In percent of GDP)			
Total revenue and grants	18.7	19.6	20.2	21.0	21.1	22.4	22.6
Tax revenue 4/	15.0	15.8	16.6	17.7	17.7	18.4	18.8
Nontax revenue 5/ 6/	3.6	3.7	3.5	3.2	3.3	3.9	3.7
Grants							
Total expenditure and net lending 7/ 8/	27.8	26.9	26.9	27.2	27.3	27.9	28.2
General government balance	-9.1	-7.3	-6.8	-6.2	-6.2	-5.6	-5.6
(including disinvestment receipts)	-8.5	-7.2	-6.8	-6.2	-6.2	-5.6	-5.6
(augmented with off-budget bonds)	...	...	-7.1	-7.2	-7.2	-5.6	-6.8
Domestic financing (net)	9.6	6.8	6.5	6.0	6.0	5.4	5.4
Memorandum items:							
Primary balance	-2.7	-1.2	-1.0	-0.6	-0.4	-0.1	0.0
Nondefense capital expenditure	3.1	2.9	2.7	0.8	3.1	4.2	3.7
Net interest payments	6.4	6.1	5.8	5.6	5.8	5.5	5.6
General government balance	-9.1	-7.3	-6.8	-6.2	-6.2	-5.6	-5.6
Central government	-5.1	-4.2	-4.1	-3.6	-3.5	-3.3	-3.3
State and union territory governments	-4.5	-3.5	-2.5	-2.7	-2.7	-2.4	-2.4
Consolidation items 9/	0.4	0.4	-0.1	0.1	0.0	0.1	0.1
Off-budget subsidy-related bond issuance	...	...	0.3	1.0	1.0	0.0	1.2
General government debt	85.7	85.7	82.9	79.3	79.0	76.6	75.2

Sources: Data provided by the Indian authorities; state level data from the *RBI State Finance Bulletin.* Fund staff amalgamate and prepare projections.

1/ The consolidated general government comprises the central government (CG) and state governments.

2/ Based on RBI's estimate of provisional outturn for state finances.

3/ Based on staff's projection of state finances.

4/ Tax revenue = Tax revenue of central government (CG), including NCCF and states' share, plus state tax revenue.

5/ Nontax revenue = Nontax revenue of CG, less interest payments by states on CG loans, plus nontax revenue of states.

6/ In 2007/08, includes a special dividend payment from the RBI amounting to roughly 0.7 percent of GDP. The authorities include this item under "other capital receipts".

7/ Expenditure and net lending = Total expenditure and net lending of CG (authorities' definition excluding off-bduget bonds), less net loans and grants to states and union territories, plus total expenditure of states (excluding interest payments on CG loans).

8/ In 2007/08, includes 0.7 percent of GDP for the government's purchase of SBI shares from the RBI.

9/ Above-the-line items in the CGA, which cancel out in the consolidation (e.g., loans to states).

Table 7. India: Indicators of External Vulnerability, 2003/04-2007/08 1/

	2003/04	2004/05	2005/06	2006/07	2007/08 2/	
Financial indicators						
General govenment debt (percent of GDP)	85.7	85.7	82.9	79.0	75.2	(Projection)
Broad money (percent change, 12-month basis)	16.7	12.3	21.2	20.8	22.8	As on 11/23/07
Private sector credit (percent change, 12-month basis)	13.0	26.0	32.2	25.4	21.7	As on 11/23/07
91 day T-bill yield (percent; end period)	4.2	5.3	6.1	8.0	7.4	As on 12/18/2007
91 day T-bill yield (real, percent; end period) 3/	-1.1	-1.1	1.6	2.4	3.6	As on 12/18/2007
External indicators						
Exports (percent change, 12-month basis in US$) 4/ 5/	23.3	28.5	23.4	20.9	35.6	(October 2007)
Export volume (percent change, 12-month basis) 5/	10.7	11.7	15.5	16.5	15.3	(Projection)
Imports (percent change, 12-month basis in US$) 4/ 5/	24.1	48.6	32.0	22.3	24.3	(October 2007)
Import volume (percent change, 12-month basis) 5/	8.8	28.0	20.0	13.5	13.2	(Projection)
Terms of trade (percent change, 12 month basis) 5/	-1.6	-2.9	-4.2	-1.2	-1.3	(Projection)
Current account balance (percent of GDP)	2.3	-0.4	-1.1	-1.1	-1.5	(Projection)
Capital and financial account balance (percent of GDP)	2.8	4.0	2.9	4.9	9.4	(Projection)
Of which: net portfolio investment (debt and equity)	1.9	1.3	1.6	0.8	2.6	(Projection)
Other investment (loans, trade credits, etc.)	2.1	1.2	3.5	5.2	2.8	(Projection)
Net foreign direct investment	0.4	0.5	0.6	0.9	2.0	(Projection)
Foreign currency reserves (billions of US$)	113.0	141.5	151.6	199.2	273.5	(November 2007)
RBI forward liabilities (billions of US$)	1.4	0.0	0.0	0.0	0.0	(October 2007)
Official reserves in months of imports (of goods and services)	9.2	8.7	7.6	7.8	9.8	(Projection)
Ratio of foreign currency reserves to broad money (percent)	24.6	27.5	24.8	26.3	28.8	(October 2007)
Total short-term external debt to reserves (percent)	9.3	15.5	10.6	9.5	8.2	(Projection)
Total external debt (percent of GDP)	18.5	17.7	15.7	17.1	17.9	(Projection)
Of which: public sector debt	8.3	7.5	6.7	6.1	4.9	(Projection)
Total external debt to exports of goods and services (percent)	119.9	95.9	75.9	75.0	81.5	(Projection)
External interest payments to exports of goods and services (percent)	4.7	3.7	3.1	3.1	3.1	(Projection)
External amortization payments to exports of goods and services (percent)	15.7	4.8	8.3	2.9	3.4	(Projection)
Exchange rate (per US$, period average)	45.9	44.9	44.3	45.2	40.5	As on 12/18/2007
REER (y/y change in percent; end period)	1.5	1.5	4.2	0.2	6.3	(November 2007)
Financial market indicators						
Stock market index (end period)	5,591	6,493	11,280	13,072	19,080	As on 12/18/2007
Foreign currency debt rating						
Moody's Investor Services	Baa3	Baa3	Baa3	Baa3	Baa2	(November 2007)
Standard and Poor's	BB	BB+	BB+	BBB-	BBB-	(November 2007)
Fitch Ratings	BB	BB+	BB+	BBB-	BBB-	(November 2007)

Sources: Data provided by the Indian authorities; Bloomberg LP; IMF, *Information Notice System*; and Fund staff estimates and projections.

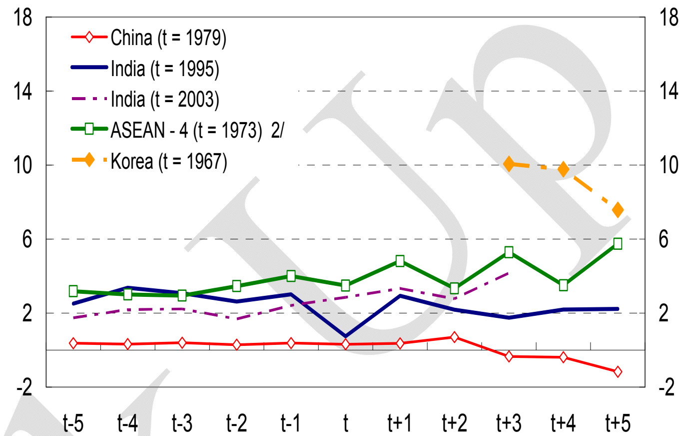
1/ April-March fiscal year.
2/ Latest date available or staff estimate, as noted.
3/ Nominal yield is less than actual WPI inflation, when negative.
4/ Data on BOP basis.
5/ Merchandise trade only; volumes are derived from partner country trade price deflators from the WEO database.

II. Staff Assessment

10. Staff believes that India's strong macroeconomic performance, the long-awaited pick-up in investment demand, and very favorable demographic trends have generated a structural rise in capital inflows. Investor interest—especially since 2006/07—has been driven by the emergent "India story" of strong, stable growth. In turn, inflows have helped to finance the ongoing investment boom, as evident in buoyant ECBs and FDI. With India's bright economic outlook and sizeable capital expenditure needs, capital inflows will likely remain strong, consistent with the experience in a number of other Asian countries around their growth takeoffs. Of course—as in other financially integrated emerging market economies—a more open capital account raises the probability of occasionally volatile capital flows. In this context, the challenge is to upgrade the policy framework so as to maximize the benefits of a more globally integrated economy—with the twin objectives of absorbing capital flows to raise investment and growth, while safeguarding the economy and financial sector from the adverse effects of global financial shocks.

Capital Flows in Select Asian Countries 1/

Net flows in U.S. Dollars expressed as percent of current GDP in U.S. Dollars



1/ Countries or country-groups are assumed to have taken off in period "t".
2/ Average of Indonesia, Malaysia, Philippines and Thailand.
Source: IMF, *World Economic Outlook and staff calculations*.

11. **Thus far, the policy response to capital inflows has been flexible and responsive to a dynamic environment**. The authorities have used a range of tools to preserve stability and growth, including intervention in the foreign exchange market, sterilization, monetary tightening (including by allowing a significant exchange rate appreciation earlier this year), and measures on the capital account, both for inflows and outflows.

12. **However, continued capital inflows are likely to exacerbate the tensions in this approach.** India's increased global financial integration has brought into sharp relief the "impossible trinity" of a managed exchange rate, monetary independence, and financial openness. Tensions among the three objectives have already started to emerge. For example, exchange rate appreciation earlier this year has raised concerns about competitiveness. But intervention by the RBI aimed at moderating the pace of appreciation has boosted domestic liquidity, fanning inflation pressures. The monetary tightening to absorb liquidity (e.g., CRR hikes) has maintained the interest rate differential, drawing in further inflows. At the same time, capital controls have not kept out inflows, but forced them to come in through the few available channels, which could risk financial instability through asset price bubbles. Additional controls—if they are effective—could limit funds needed for productive investment, such as infrastructure.

13. **Taken together, costs of the present strategy are rising**. The annualized sum of sterilization costs in the MSS and LAF, the tax on the banking system from the CRR, and the implicit tax on corporations from recent ECB controls presently amount to Rs. 13,000 crore. These costs will rise further if sterilization continues. And unlike temporary subsidies, they will need to be paid "forever."

14. **Looking ahead, the key question is how might the policy framework evolve to maintain—and even improve upon—India's impressive macroeconomic performance, in the face of sustained inflows.** We see four key ingredients to such an evolution:

- Monetary and exchange rate policy calibrated to an environment of increasing financial openness;
- Deepening and broadening capital markets—while maintaining financial stability—to better intermediate capital inflows and finance infrastructure;
- Fiscal consolidation aimed at facilitating inclusive growth and coping with appreciation pressures; and
- Structural reforms to enhance economic flexibility and productivity, key to both inclusiveness and competitiveness.

Monetary and exchange rate policies[6]

15. **Monetary policy has been successful in maintaining price stability.** However, assessing the current monetary stance is complicated, as indicators other than the WPI send conflicting signals. While credit is decelerating, monetary aggregates have accelerated, capacity is tight, and CPI inflation is ranging well above WPI inflation. In light of these uncertainties and underlying pressures, we support the RBI's cautious approach to adjusting monetary settings. Looking ahead, while policy makers would still need to look at a variety of indicators in assessing the inflation outlook, focusing policy on a broad-based CPI with updated weights would be timely as it could improve the public understanding of inflation performance and the outlook, and would orient policy around a clearer measure of the actual cost of living.

16. **Monetary operations and strategy are adapting to financial globalization, and this process can usefully be stepped up.** During 2007, the RBI has managed liquidity more actively, improved communication, and allowed increased exchange rate volatility. On monetary operations, greater use of open market operations, with a broader range of maturities, would enhance the flexibility and effectiveness of monetary policy, as well as decrease reliance on the CRR as a liquidity management tool. In addition, more frequent policy meetings would reduce the need to react to circumstances with inter-meeting policy decisions. On the communications front, greater elaboration on the inflation outlook in the

[6] See Annex I (Monetary and Exchange Rate Policy).

monetary policy reviews, including through eventual publication of the inflation expectations survey, would help inform and guide the public and financial market participants.

17. **By our judgment, rupee appreciation is largely an equilibrium phenomenon, reflecting India's strong economic fundamentals**. Our research suggests that the rupee is appropriately valued from a medium-term perspective. Available data seem to confirm these calculations: export growth and profitability remain strong. While it may be too early to gauge the full impact of the recent rupee appreciation, certain industries are clearly suffering from the appreciation, and targeted, time-bound support could be made available to them to facilitate adjustment. However, most export industries should be able to adjust by reducing costs, modernizing operations and structures, and diversifying to new markets. We agree that exchange rate policy should not try to target a level or path for the currency and that the exchange rate should be determined by market forces; thus, the stated policy of a managed float with some intervention to curb volatility, but with no target or preannounced path, remains appropriate.

18. **Increasing the tolerance for rupee flexibility will improve the independence of monetary policy and reduce the costs of exchange rate management.** A further increase in exchange rate flexibility would reduce the need for intervention and sterilization, which would allow monetary policy greater room to focus on containing inflation.[7] It would also help to contain the aforementioned costs of sterilization. Moreover, a more flexible rupee, in combination with better-developed derivatives markets, would encourage private entities to hedge and avoid the risk that the rupee is perceived as a "one way bet" both by domestic corporates and foreign investors.

19. **We would caution against using capital controls for macroeconomic management, as they have the potential to affect investment and growth adversely.** These risks are demonstrated by the recent experience with tightening controls on ECBs, which have not curbed overall flows but have raised concerns about financing for infrastructure projects. Moreover, while we understand that the government remains committed to moving toward fuller capital account convertibility, imposing new controls may give rise to confusion about that commitment and about the "exit strategy" from the newly imposed controls.

20. **A preferable strategy would be to make capital account liberalization part of a deliberate process.** The temporary space provided by existing controls should be used to prepare for a more open capital account by upgrading the monetary framework and strengthening the financial system on a realistic but preannounced timetable. Welcome steps were steps taken to liberalize capital outflows in 2006 and 2007, and the authorities should continue to liberalize outflows—including by large domestic institutional investors—would signal the commitment to fuller capital account convertibility. While local investors may not

[7] The limited effectiveness of sterilization operations is discussed in the October *World Economic Outlook* and the *Asia-Pacific Regional Economic Outlook.*

take full advantage of broadened opportunities to invest overseas right away, over time outflows will rise as part of portfolio diversification, relieving pressure from inflows.

Financial development and stability[8]

21. **Broader and deeper financial markets could better intermediate capital inflows, accommodate adjustments in the exchange rate, and finance India's large investment requirements.** Developing the corporate bond and derivatives markets onshore will be crucial to funding the massive infrastructure investment needs and providing corporations with the tools they need to manage the risks associated with India's financial globalization.[9] Indeed, a rupee-denominated domestic corporate bond market would both allow companies to avoid taking currency risk and provide a natural venue for infrastructure finance.[10] Specific steps would include opening up the market to participation by both foreign and domestic institutional investors, with domestic institutions permitted to invest based on ratings; streamlining the stamp duty as well as registration and disclosure requirements; and developing a more liquid government securities market. On the latter, further liberalizing short-selling rules (particularly reducing the penalty for fails) and promoting a liquid short-term interest rate swap and futures market, while further opening up to foreign participation, and reducing the SLR (sterilizing the liquidity implications), would move the process in the desired direction. Another priority is developing exchange-traded currency and interest rate derivatives markets, to complement the growing OTC markets, through centralized risk management, improved market transparency, and lower barriers to entry for small investors.

22. **An important issue is enhancing the efficiency of financial institutions**. Key steps would include opening up further to foreign banks, phasing out directed lending requirements, further loosening interest rate restrictions (which, as Governor Reddy noted recently, distort the interest rate structure and blunt the transmission channel of monetary policy), encouraging consolidation, and reducing the CRR. In addition, further liberalizing FDI in financial services would spur competition and bring innovation and advanced financial technologies.

23. **The RBI appropriately continues to keep a strong focus on preserving financial stability.** In particular, the continued emphasis in policy statements on ensuring credit quality, the RBI's ongoing close scrutiny of banks' retail credit portfolios and market risk exposures, and its initiatives to improve bank risk management and enhance stress testing will help to preserve financial stability in the context of the credit boom. The RBI indicates that no significant problems have appeared in banks' credit portfolios so far, and that the risks posed by a turn in the credit cycle are likely to be manageable. The close surveillance of

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[8] See Annex I (Financial Development and Stability).

[9] As a side benefit, better-developed financial markets would strengthen the monetary policy transmission mechanism.

[10] Attempting to finance massive, long-term infrastructure projects through the banking system would open up asset-liability mismatches. More broadly, it is unclear whether the banks have the balance-sheet capacity to finance a significant part of the needed almost $500 billion in infrastructure investment.

wholesale exposures in OTC derivatives markets through the CCIL is also welcome. The ongoing review of financial stability and development appropriately emphasizes macro-prudential surveillance, including system-level stress testing, and we look forward to the publication of the report in March 2008. In addition, the pending adoption of Basel II is providing an opportunity to further strengthen bank risk management.

Fiscal policy[11]

24. **Revenues remain buoyant but expenditure pressures pose risks to fiscal consolidation.** Tax performance has been underpinned by the strong economy and high corporate profitability, and also by the introduction of the VAT, base broadening, and better administration. However, in 2006/07 current expenditure exceeded the budget target, and off-budget issuance of subsidy-related bonds totaled 1 percent of GDP. For 2007/08, we project a central government deficit of about 4¼ percent of GDP (including off-budget bond issuance of almost 1 percent of GDP), only ¼ percentage point of GDP lower than last fiscal year.[12]

25. **Further fiscal consolidation is essential to sustain inclusive growth and also to cope with financial globalization.** High public debt causes interest costs to absorb fiscal space; that space is needed for priority social and infrastructure spending, to improve inclusiveness and competitiveness. Consolidation would also reduce the risks of crowding out (which grow as firms' borrowing needs rise), and set the stage for further financial openness. Finally, a tight fiscal stance can shoulder some of the burden of adjusting to the inflationary impact of capital inflows; this burden presently falls on monetary policy alone.

26. **Achieving the FRBM target of revenue balance by March 2009, however, will be challenging.** We expect tax revenue to continue to perform well given India's favorable economic outlook, although some slowdown is likely as the profitability cycle turns and tax losses from SEZs increase. But there are significant expenditure risks. The subsidy bill looms large, given soaring commodity prices, while interest payments are likely to remain elevated (in part reflecting the rising MSS costs of monetary sterilization). In addition, spending on wages, salaries, and pensions will rise with the Sixth Pay Commission award. This suggests that reaching revenue balance next fiscal year—entailing an adjustment of 1.5 percentage points of GDP—will require bold measures.

27. **Revamping India's subsidy framework would be a key priority.** With oil prices approaching $100 per barrel and at risk of going higher, the authorities are rightly concerned about the growing subsidy burden. Accordingly, the time is right to implement a phased reduction in subsidies and a gradual alignment of domestic prices to international levels. Going forward, a more rule-based pricing and burden sharing mechanism for petrol and diesel (which account for about one-third of the total oil subsidy bill) is warranted to reduce

[11] See Annex I (Fiscal policy).

[12] Accounting for the government's purchase of SBI shares from the RBI according to Government Finance Statistics standards would reduce the deficit by 0.7 percent of GDP.

the fiscal burden and improve transparency. Regarding food and fertilizer subsidies, the favorable economic conjuncture provides an opportune moment to introduce pilot programs that aim to reduce costs and improve effectiveness through better targeting.

28. **Revenue reforms could also yield further gains.** Cutting exemptions would substantially boost the tax take; in 2006/07, foregone revenue amounted to an estimated 5.7 percent of GDP (roughly half of actual tax collections). We strongly endorse the government's plans to introduce the GST; the ongoing phase-out of the central sales tax is an important preparatory step. Early announcement of a roadmap for GST adoption (planned for April 2010) would help taxpayers to prepare; it could include a timetable for merging the central VAT-like taxes and widening the scope of the services tax. Regarding the GST's structure, international experience suggests that a single point of collection (as in most federal OECD countries) would likely be easier to administer than a decentralized model. On non-tax revenue, there is considerable potential to raise collections from user fees. However, this will require a significant improvement in service delivery.

29. **The fiscal performance of India's states in aggregate remains impressive, and provides fiscal space for greater social spending.** Adoption of fiscal responsibility laws, large central government transfers, and introduction of the VAT have spurred rapid deficit reduction, to an estimated 2.7 percent of GDP (or even lower) in 2006/07, with further consolidation likely this fiscal year. Liquidity management could be improved further; some cash-rich states could use excess revenue to reduce high-cost debt. Looking ahead, with the states bearing the primary responsibility for achieving inclusive growth, a priority should be to improve the quantity and quality of state spending on education and health.

30. **An important medium-term question is whether the FRBMA could be augmented to provide an explicit framework for future debt reduction.** While the Act implicitly targets further debt reduction beyond March 2009, adoption of an explicit, ambitious medium-term debt reduction target, encompassing the consolidated government (including public enterprises), could bolster the government's commitment to further debt reduction, and guide public expectations regarding future fiscal policy.

Structural reforms[13]

31. **Structural reforms to make the economy more flexible will be key to productivity and competitiveness, as well as to inclusive growth.** To be sure, India is chalking up a remarkable productivity performance—by our estimates, the best in Asia, outside China. In addition, rapid growth has fostered substantial poverty reduction. However, during the past decade, growth in the consumption by the bottom 30 percentile by expenditures has not kept pace with that of the top 30 percentile. Widening disparities—especially in urban areas—may reflect the rapid growth in skilled wages owing to skills shortages, which in turn reflects gaps in the provision of education. In addition, infrastructure

[13] See Annex I (Structural Reforms).

gaps and labor market rigidities will pose increasing constraints to overall growth as the expansion continues.

32. **The priorities for structural reform are well known**. Investment is needed in essential public goods like power and transportation infrastructure to lower the cost of doing business. In light of the government's ambitious agenda for private sector investment, a more predictable regulatory environment in the power sector (particularly as regards pricing and reliable payment and collections mechanisms) is warranted. Higher—and more effective—public spending on education is also essential, to enhance the pool of skilled labor and keep skills shortages from widening income disparities. FDI in education could play a supportive role, and therefore greater clarity about the regulatory regime would be helpful. More flexible labor regulations can facilitate the reallocation of labor from weaker to stronger sectors of the economy.

33. **Further trade liberalization can facilitate growth.** Tariff reductions have reduced the costs of key capital goods and raw materials, and in tandem with complementary structural reforms, have spurred domestic competition and pushed firms in India to align their cost structures with firms globally. In this connection, we support the aim to reduce tariffs to ASEAN levels.

III. Summary of the Authorities' Views

34. **The authorities saw the current conjuncture and outlook as favorable**. Demand remains strong but supply responses had allayed overheating, while credit growth had moderated partly owing to prudential measures taken in 2006/07. However, they remain vigilant, given abundant liquidity and high international commodities prices.

Monetary and Exchange Rate Policy

35. **With the conjuncture and outlook favorable, monetary policy remains unchanged but vigilant for inflation.** Demand remains strong but supply responses had allayed overheating, while credit growth had moderated thanks to past measures. However, abundant liquidity and high international commodities prices posed risks. The RBI is withdrawing liquidity, using varied instruments to distribute costs among the RBI, banks and the budget. Lowering the reverse repo rate could moderate capital inflows, but with inflation signals mixed, cutting policy rates would be premature. Overall, the RBI viewed its approach as well understood in markets, and took efforts to increase transparency.

36. **Foreign exchange intervention aims solely to maintain orderly conditions in the U.S. dollar/rupee market, particularly amid externally-induced volatility.** Recent intervention had been one-way (foreign exchange purchases) because there had been no net outflows since May 2006. With capital flows risks on both upside and downsides, the rupee could weaken as well as strengthen. Over time, higher exchange rate volatility could help India adjust to financial globalization.

37. **The authorities considered that the exchange rate reflects medium-term fundamentals, but saw it as too early to assess the effects of recent appreciation.** Notably, the sizable trade deficit may signal loss of competitiveness from appreciation. However, the authorities have publicly stressed that companies should adapt by boosting productivity.

38. **Formulating a response to rapid capital inflows is difficult given the present global environment.** Excessive inflows had resulted from the "unusual heightened global uncertainties" from the disruption in global credit markets, interest differentials, and in particular, the policy response by major-country central banks. Massive capital inflows—far in excess of the economy's absorptive capacity—were overwhelming conventional monetary policy instruments, and if continued could create financial vulnerabilities. Thus, all options for maintaining stability were open, including capital controls.

39. **In the medium term, the government's intent remains to gradually increase capital account convertibility,** with a hierarchy of preferences according to stability of flows, and some role for existing controls to preserve financial stability. At the same time, the authorities shared staff's doubts about the long-term effectiveness of controls and concerns about the impact of ECB restrictions on investment. On outflows, they noted that ceilings on overseas investments of corporates, mutual funds, and individuals had been increased, but so far, related outflows were insignificant., and further liberalizing would only attract net inflows.

Financial market development

40. **The authorities agree on the need for a more liquid government securities yield curve and a better developed corporate bond market.** They have been gradually consolidating benchmark issues to reduce fragmentation, and taken steps toward allowing strips. On corporate bond markets, a trade-reporting platform had been developed, corporate bond repos would be introduced once an efficient and safe settlement system is implemented, and the Securities and Exchange Board of India has reduced lot sizes and ratings requirements.

41. **On derivatives markets, the RBI has clarified the regulatory environment through comprehensive guidelines on derivatives (April 2007) and draft guidelines on credit default swaps (May 2007).** It has also proposed to permit authorized dealers to run options books and allow corporates to buy and write covered options. A November 2007 report of the RBI's Internal Working Group on Currency Futures recommended a dedicated exchange, and a sub-group of the RBI Technical Advisory Committee on Markets is considering how to reactivate the interest rate futures market.

42. **Banking system efficiency has improved**, including for public banks**.** Going forward, banks would need to raise capital for Basel II (for foreign banks and Indian banks with foreign activities from March 2008) of about one percent of risk-weighted assets. Foreign ownership of banks would be reviewed in 2009 as planned. Priority-sector lending requirements promoted financial inclusion.

43. **The RBI is carefully monitoring bank risk exposures**, frequently inspecting banks (cognizant that banks have not experienced a full retail credit cycle) and has found no basis for concern, meanwhile and working to improve banks' risk management. The pending move to Basel II will further strengthen risk management and supervisory review.

44. **A Committee on Financial Sector Assessment is assessing financial stability and development.** Advisory panels are addressing financial stability and stress testing; financial regulation and supervision; institutions and market structure; and transparency standards. The Committee is expected to complete its work by March 2008.

Fiscal policy

45. **The authorities remain committed to FRBMA targets.** This year, significant revenue overperformance was expected to offset higher-than-budgeted interest payments and subsidies, thus allowing the central government deficit target to be met.[14] Achieving revenue balance by March 2009 would be challenging, given persistent expenditure pressures.

46. **At the same time, the government plans to ramp up priority spending significantly in coming years.** The 11th Plan (2007–2012) envisions spending (mostly public) on education and health tripling to 6 percent and 9 percent of GDP, respectively,. Infrastructure investment would nearly double to 9 percent of GDP, with an increased private-sector share. To avoid undermining fiscal consolidation, the government would contain non-priority spending growth. Relatedly, Planning Commission officials expressed concern that pushing for revenue balance by March 2009 would constrain priority spending and jeopardize inclusive growth objectives.

47. **The Ministry of Finance agreed that reforms are needed to secure lasting fiscal consolidation.** Steps to cut the subsidy bill were under consideration but the timing of these politically-difficult reforms is unclear. Tax buoyancy would moderate as growth eased, but ongoing compliance improvements and base-broadening would help.

48. **The authorities were cautiously optimistic about the outlook for state finances.** States needed to strengthen their revenue-raising capabilities to rely less on central government transfers. Some states may have consolidated expenditure too quickly, with hiring freezes causing labor shortages in education. Improving service delivery will be key for inclusive growth.

On medium-term fiscal issues:

- The 13th Finance Commission will prepare a road map for GST introduction and make recommendations for medium-term fiscal policy.

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[14] In this connection, they acknowledged that the official deficit was understated, though they noted that subsidy-related bonds are considered extra-budgetary because India's fiscal accounts are on a cash basis.

- The authorities downplayed concerns about SPC expenditure risks, noting that the award was unlikely to be as high as in 1997 because of recent cost-of-living hikes. Increases would likely be phased in, and states' improved fiscal positions would help them absorb costs.

- On financing infrastructure, the government plans to increase significantly the role of public-private partnerships.

Structural reform

49. **"Faster and more inclusive growth" is the guiding objective of the 11th Plan.** Priorities include enhancing social services, physical infrastructure, and competition to support private investment and job creation.

50. **The Plan envisions enhanced education and labor market flexibility.** Improved education would better align the skills of graduates with market needs, and limit widening income disparities. Quality services provision will be key, with enhanced monitoring, evaluation and accountability. Rigid labor regulations stifle organized-sector employment, and the 11th Plan includes, for the first time, recommendations to ease labor regulations, though political feasibility remains unclear.

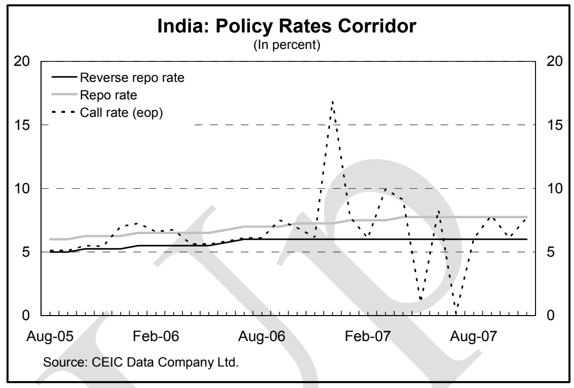
51. **The government is relying on public-private partnerships (PPPs) in infrastructure.** Progress has varied across sectors: in the power sector, regulatory hurdles regarding payment mechanisms remain the biggest obstacle. Model concession agreements in key infrastructure sectors are moving towards allocating a greater share of the risk to the public sector. The authorities also plan to increase public investment significantly.

52. **The authorities remain committed to multilateral trade liberalization.** Tariff cuts have lowered the costs of imported capital and materials and spurred domestic competition. While the government plans to reduce tariffs to ASEAN levels by 2009, domestic concerns and corresponding tariffs and non-tariff barriers of major trading partners may influence the degree of reductions. The authorities were hopeful for progress in the Doha Development round, though they expressed concern that the focus on development was fading. In the meantime, India is pursuing further trade liberalization through FTAs with key nations.

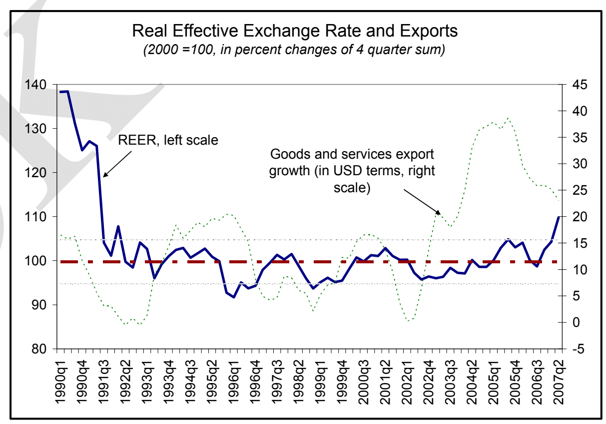
ANNEX I ANALYTICAL BACKGROUND NOTES

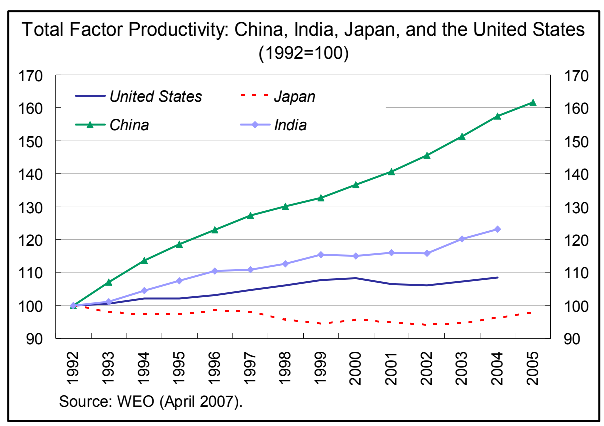
Monetary and Exchange Rate Policy

1. **With the balance of inflation risks tilted to the upside, vigilance is warranted.** WPI inflation—the RBI's preferred measure—is set to remain below the RBI's end-year forecast of 5 percent this fiscal year. In this context, it is appropriate to leave policy rates unchanged for now, in view of conflicting signals about prices (from the CPI) and demand growth. If money and economic activity does not slow as expected, there is a case for further rate hikes to moderate credit expansion and anchor inflation expectations.



2. **The rupee is assessed by staff as in line with fundamentals.** So far, the rupee's rise has not broadly hampered competitiveness, with the level of the rupee appropriate from a medium-term perspective, and exports and profits remaining strong. During January-November 2007, the rupee rose over 11 percent against the U.S. dollar. On a REER basis, the rupee is now outside of the ±5 percent range maintained since the early 1990s. Sharp appreciation has led to strong calls to support the export sector. At the same time, the September 2007 CGER exercise puts the rupee "close to equilibrium." India's cyclically adjusted medium-term current account deficit is close to its fundamental level (3 percent of GDP), as downward pressure on the deficit from favorable demographic trends are broadly offset by fiscal deficits and strong growth. Strong growth also supports a sustainable net foreign liabilities position, allowing India to comfortably run current account deficits.

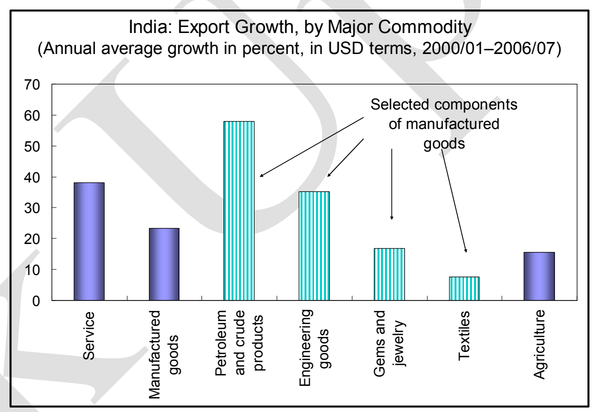




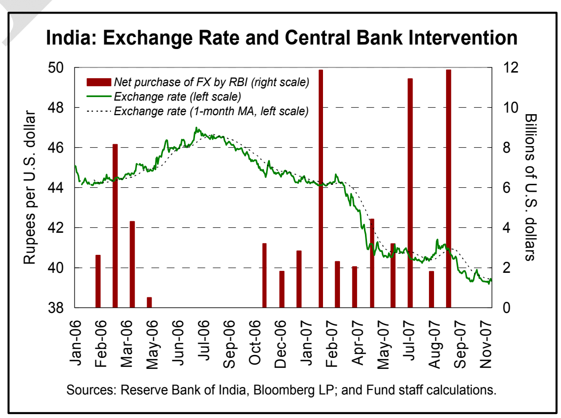
3. **Equilibrium rupee appreciation is also supported by rapid productivity growth.** India's total factor productivity (TFP) growth averaged about 3⅓ percent in recent

years, compared with peak decade averages of 2⅓ percent for Japan or newly industrialized countries in the past four decades.[1] Consistent with buoyant productivity, India's share in world exports of goods and services has risen about ½ percentage point since 2000.

4. **However, some industries are clearly making losses and have led the public call for action by the authorities to stem exchange rate appreciation or to offer some form of protection.** While selected industries are affected, the appropriate response could be targeted, time-bound support—e.g., offering affected workers training and temporary financial assistance—to facilitate adjustment. In general, industries experiencing the lowest export growth are those with low import content, and high labor intensity (and thus covered by the rigid labor laws or by small scale industry reservations). These industries have had significant protection over the years and have faced little incentive to become efficient and to raise productivity. In contrast, services exports and more capital intensive manufacturing exports have been expanding more briskly, and gaining market share globally. In addition, enhanced labor market flexibility, improvements in power and transport infrastructure, and removal of small scale reservations would reduce business costs and increase economic flexibility. Benefits of appreciation (e.g., lower inflation and cheaper imports) also need to be better communicated.



5. **Large capital inflows are complicating the conduct of monetary policy,** creating excess liquidity and pressuring the rupee. Intervention to smooth volatility coupled with the need to maintain relatively high interest rates is aggravating inflows by giving rise to one-way bets. More generally, inflows are exacerbating tensions in the policy framework among exchange rate stability, monetary independence, and financial openness—the "impossible trinity."



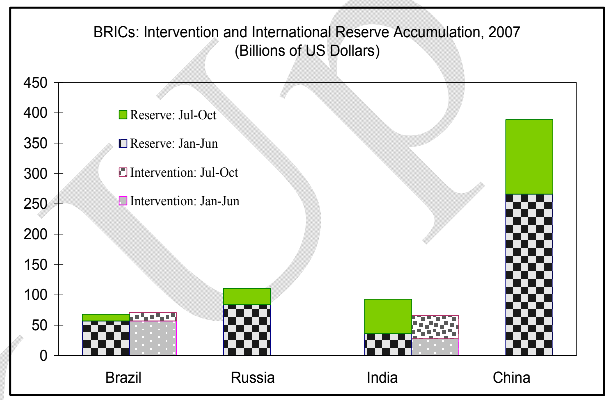
6. **Further rupee flexibility would be the most effective way to address the "trinity."** The stated policy of a managed but market determined exchange rate with no target path, and intervention only to curb short-term volatility remains appropriate. Within this framework and in light of the large net inflows faced by India and other large emerging markets, avoiding large and prolonged foreign currency purchases would reduce the risk that

[1] World Economic Outlook, September 2006, "Asia Rising."

the rupee is perceived as a "one way bet" and the need for costly sterilization.[2] Moreover, a more flexible rupee, along with better-developed derivatives markets, would encourage private entities to hedge.[3]

7. **Welcome steps were taken to liberalize capital outflows in 2006 and 2007**. Continuing to liberalize outflows—including by large domestic institutional investors—would signal the commitment to fuller capital account convertibility. While local investors may not initially take full advantage of broader opportunities to invest overseas, over time outflows will rise as part of portfolio diversification, reducing net inflows.

8. **India is not unique with respect to the size of inflows over the past two years,** but stands out as the only one in the BRICs (Brazil, Russia, India, and China) with a current account deficit. Since the start of 2007, all BRICs have had rising balance of payment inflows and experienced significant REER appreciation. For India and Brazil, it has been mostly from capital inflows, and for China and Russia, mostly from the current account surplus (Table). High commodity prices supported inflows through the trade balance in Russia and Brazil. Brazil experienced the largest increase in portfolio inflows in percent of GDP, followed by India. Net portfolio inflows were smaller in both China and Russia, partly reflecting outward investment. The Indian corporate sector and Russian banks increased overseas borrowing. In the second half of 2007, the pace of capital inflows appears to have picked up more in India than the in other countries, as suggested by the more rapid reserve accumulation (chart).



BRICs: Exchange Rate Appreciation

	Dec. 2006–Aug. 2007			Average y/y Change 2005–2006	
	LC/USD	REER	NEER	REER	NEER
	(In percent change)				
India	-8.6	7.1	7.5	1.4	-0.7
Brazil	-8.5	9.0	8.3	17.5	14.9
China	-3.2	5.3	2.2	0.9	1.4
Russia	-2.5	4.9	0.3	9.1	1.7

Source: INS

9. The BRICs' policy responses put different emphases on inflation, exchange rates, and the capital account.

- *Intervention*: Regardless of their exchange rate regimes, all of the BRICs intervened heavily in foreign exchange markets: Brazil

[2] Staff estimates annualized sterilization costs and the tax on the banking system from higher reserve requirements at about $3 billion (0.2 percent of GDP).

[3] Evidence consistent with this notion is presented in Patnaik and Shah, "Does the Currency Regime Shape Unhedged Currency Exposure" (NIPFP Working Paper, 2007).

is an independent floater, India and Russia are managed floaters with no predetermined path, and China maintains a crawling peg.

- *Sterilization*: Both India and China partially sterilize their foreign exchange intervention, but India does so at a higher rate than China. In Brazil, intervention is fully sterilized consistent with its inflation target. In Russia, sterilization is limited to the oil-fund related inflows.

10. **For India, using capital controls for macroeconomic management could affect investment and growth adversely**. These risks were demonstrated by the recent experience with tightening controls on external commercial borrowings, which have not curbed overall flows, but have raised concerns about investment financing. Such controls are likely to be effective only temporarily. Moreover, new controls could foster uncertainty about the government's commitment to fuller capital account convertibility and about the "exit strategy" from new controls.

11. **The temporary space provided by existing controls should be used to prepare for a more open capital account**. In particular, the flexibility and effectiveness of monetary policy would be enhanced by strengthening the monetary framework.

- On *monetary operations*, the heightened use of market sterilization instruments in 2007 is welcome. Further reliance on open market operations (OMOs), with a broad range of maturities, would be warranted, rather than relying on the CRR—which taxes banks.

- On *communications,* welcome improvements have been made—such as the 2005 shift from annual to quarterly reviews and the increasingly forward-looking analysis in policy documents. Further increasing the frequency of policy meetings would reduce the need for inter-meeting measures. Monetary policy reviews could elaborate further on the inflation and demand-supply outlook, including through eventual publication of the inflation expectations survey, to guide expectations. In addition, focusing policy on a broad-based CPI would orient policy around a clearer measure of the cost of living.

Financial development and stability

12. **India's financial globalization necessitates development of broader and deeper financial markets,** as well as increased efficiency and continued stability in the financial system. Better developed financial markets would help to intermediate capital inflows, expand risk management toolkits, and finance India's large investment needs. In the financial system, continued deregulation, with appropriate strengthening of prudential rules, can improve the efficiency of intermediation while preserving stability.

Financial markets

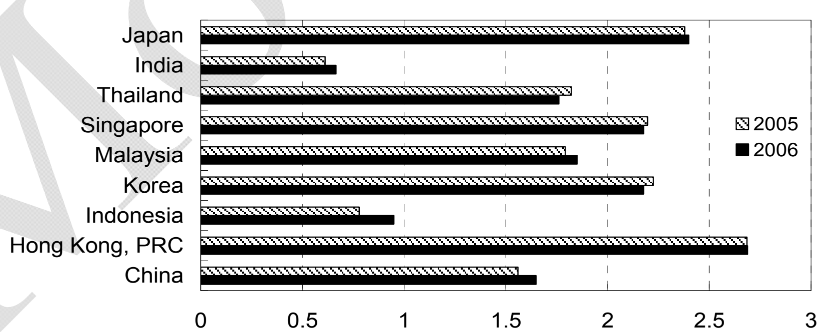
13. **The priorities are developing India's government debt, corporate bond, and derivatives markets.** A liquid government debt market is needed as a foundation for pricing

financial instruments (and would strengthen the monetary transmission mechanism). A robust, rupee-denominated corporate debt market would allow corporations to avoid currency mismatches while providing a venue for infrastructure finance (the banking system lacks the balance-sheet capacity to provide it). Well-developed derivatives markets would provide financial institutions and corporations with tools needed to manage risks accompanying financial globalization.

14. **The government yield curve is illiquid, undercutting its role as a pricing benchmark.** The turnover ratio of government debt is about 70 percent—lower than in Indonesia and Vietnam, and about half that in countries such as Thailand and Malaysia. Only four issues are traded more than four times a week. Reasons include (i) stringent short selling rules (positions may remain open for no more than five days, for only two preannounced issues per month; failure to deliver faces harsh penalties, including banning from trading); and (ii) the Statutory Liquidity Ratio (SLR) requires banks to maintain in cash, gold, or government and other approved securities at least 25 percent of demand and time deposits.[4]

15. **The corporate debt market is underdeveloped,** amounting to less than 5 percent of GDP, compared with over 20 percent of GDP in Thailand, Chile and Mexico, and 50-100 percent of GDP in more advanced economies. Impediments to a vibrant market include quantitative limits on institutional investors such as pension funds and FIIs;[5] restrictive issuance procedures (including a requirement for two investment-grade ratings); tax deduction at source and stamp duties; the lack of a repo market; and low price transparency (with most trading OTC).

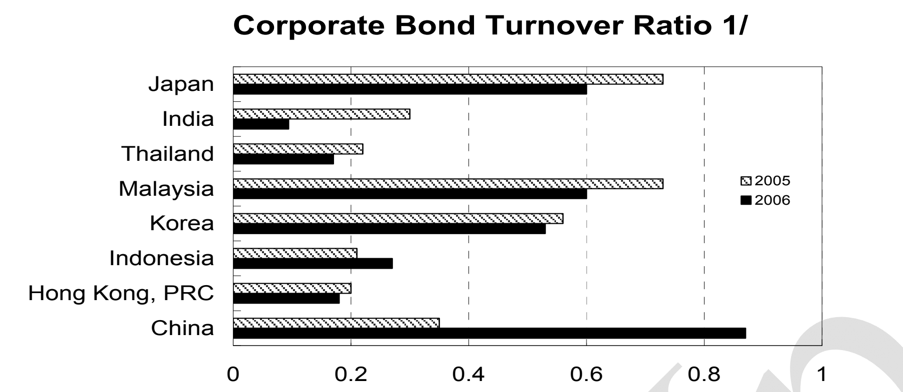
Government Bond Turnover Ratio 1/



Sources: Country authorities and Bond Market Assocations, Bank for International Settlements, World Federation of Exchanges, AsianBondsOnline, Bloomberg LP.; and Fund staff estimates.
1/ Based on a scaled measure of trading volume (sales in local currency units) divided by year-end local currency value of outstanding bonds.

[4] Lowering the SLR would require offsetting monetary operations to avoid a sharp rise in liquidity.

[5] Pension funds are allowed to invest up to ten percent of annual acccruals in corporate bonds, while total FII investment is capped at $1.5 billion.



Sources: Country authorities and Bond Market Associations, Bank for International Settlements, World Federation of Exchanges, AsianBondsOnline, Bloomberg LP.; and Fund staff estimates.
1/ Based on annual trading volume (sales amount in local currency) divided by year-end local currency value of outstanding bonds.

16. **Augmented exchange-traded interest-rate and foreign-exchange derivatives would complement growing OTC markets.** While OTC markets turnover has risen threefold during 2004–2007 to over $8 billion per day, OTC markets lack the centralized risk management and inherent transparency of exchanges. In addition, legal uncertainty exists about settlement in OTC markets, particularly closeout netting (which limits the risk that a defaulting counterparty will demand payment on contracts that are in his favor while refusing to pay those on which he owes money). However, attempts to introduce exchange-traded interest-rate contracts had limited success, partly due to imperfect contract design and restricted participation, while currency futures are presently disallowed.

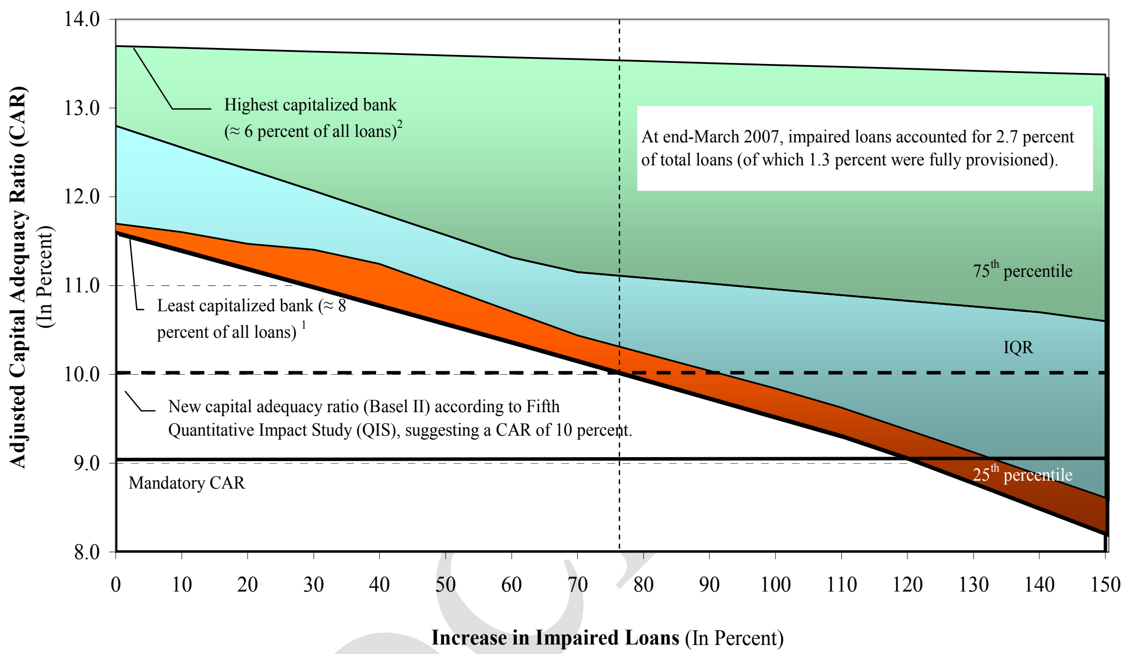
Financial efficiency and stability

17. **The main risks to financial stability—rapid growth in credit and strong capital inflows—appear to be manageable at present, but warrant close monitoring.** Financial soundness indicators are in prudent ranges, and overall credit growth is decelerating. However, growth in credit to real estate remains elevated, at almost 70 percent y/y, and is concentrated in new private sector banks (accounting for more than 30 percent of their loan books). Also, the rapidly growing retail segment is relatively new to Indian banks. In addition, Indian corporates' foreign currency borrowing has risen, and data on the extent of hedging are unavailable but anecdotes suggest that it is far from complete. In this environment, close supervisory attention would be needed to banks' careful management of retail credit portfolios, and to their exposure to corporates that have unhedged foreign exchange exposures.[6] Going forward, stress tests of banks' exposures, and strengthened supervision under Basel II, will help to maintain the stability of the banking system.

[6] Banks face regulatory limits on their own foreign exchange exposure.

18. **Sensitivity analysis of the ten largest banks reveals modest credit risk exposure at current capital levels.** The impact of higher default rates on capital adequacy ratios (CAR) is estimated by assuming that impaired loans are fully provisioned, and reducing risk-weighted assets and capital at a rate equivalent to the increase of the NPL ratio. The effects of various increases in NPLs are assessed.

India: CAR Adjusted for an Increase in Impaired Loans, 10 Largest Commercial Banks (end-June 2007)



Source: BankScope, Bloomberg, Moody's KMV, unconsolidated financial statements as of June 30, 2007.
1/ with a 100 percent provisioning for impaired loans.
2/ with a 20 percent provisioning for impaired loans. Note: 20 percent provisioning is required for uncollateralized loans classified as substandard.

19. **Market data indicate that bank risk has declined and the largest banks have a low implied probability of default.** That said, the range has increased in recent months, and India's bank risk is at the higher end of the range for Asian markets.

20. **A sizeable increase in NPLs would be needed to reduce the weakest bank's capital adequacy below the regulatory threshold** (figure below). The capitalization of the lowest quartile of banks drops below the regulatory CAR threshold of nine percent (the solid black line) if impaired loans rise to more than twice the current gross NPL ratio. Thus the least capitalized bank, representing eight percent of total loans, can withstand more than a doubling of current NPLs before breaching statutory capital requirements. Similarly, the average and median capitalization of the banking system remains well above the existing CAR even if NPLs double in magnitude. However, once Basel II takes effect, the regulatory

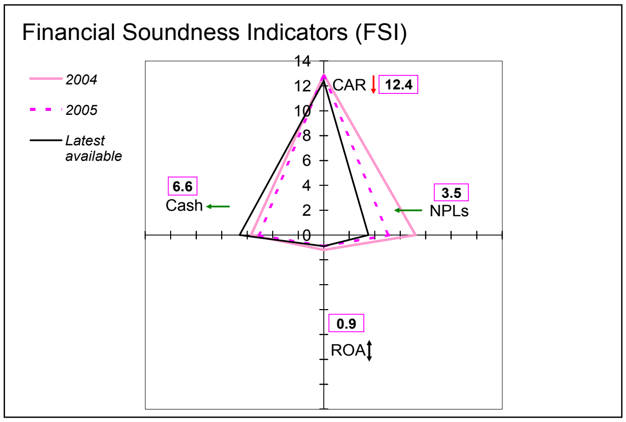
threshold for capital would rise to 10 percent, and a 75 percent increase in NPLs would push the weakest bank below that threshold.

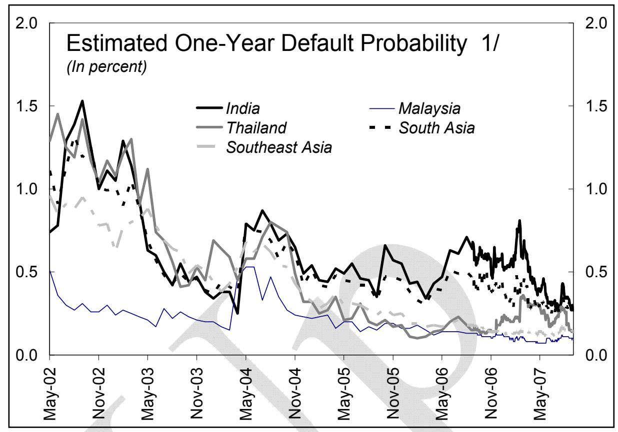
21. **There is also scope to improve the efficiency of the banking system.** Public ownership accounts for some 72 percent of banking system assets. The banking system is fragmented, including 82 commercial banks. Return on assets of domestic banks is low compared with other emerging and developed markets. Impediments to greater efficiency include credit targets to "priority sectors" (including agriculture, small scale industries, self employed); these loans tend to be small (thus costly to administer), with higher default rates than other loans.[7] Rates on savings deposits and small loans, short-term agricultural loans, and export credits are regulated. In addition, the CRR taxes banks. Foreign ownership, which could boost competition and introduce new products and technologies, is subject to limits (to be reviewed in 2009).

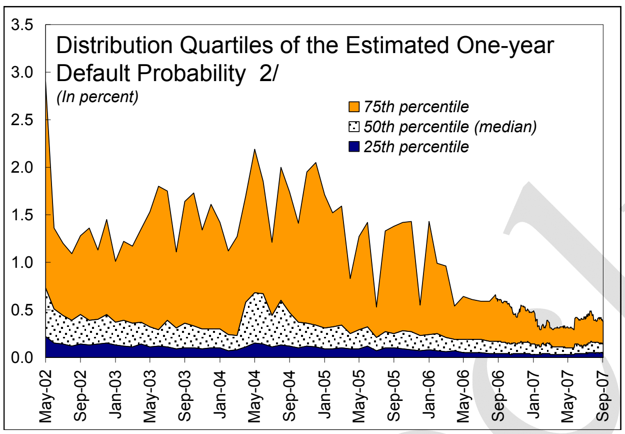
Fiscal policy

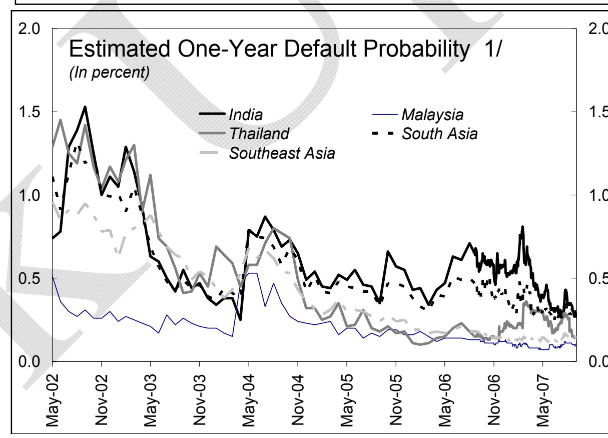
22. **Progress in consolidation has been mixed, with significant revenue gains eroded by expenditure overruns.** Tax performance has been underpinned by rapid economic growth, high corporate profits, base broadening, and improved administration. States' VATs (now in all states but Uttar Pradesh) have bolstered revenues, supplemented by higher central government transfers. But revenue gains have been offset by sharp increases in subsidies and higher-than-budgeted interest payments, reflecting soaring commodity prices and rising sterilization costs respectively. Overall fiscal consolidation has therefore stalled; on staff's definition (including off-budget bond issuance), the general government deficit has hovered at just over 7 percent of GDP since 2004/05.

[7] McKinsey Global Institute, 2006, "Accelerating India's Growth Through Financial System Reform."





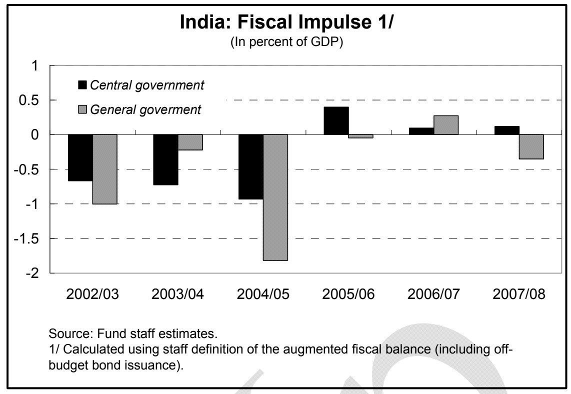


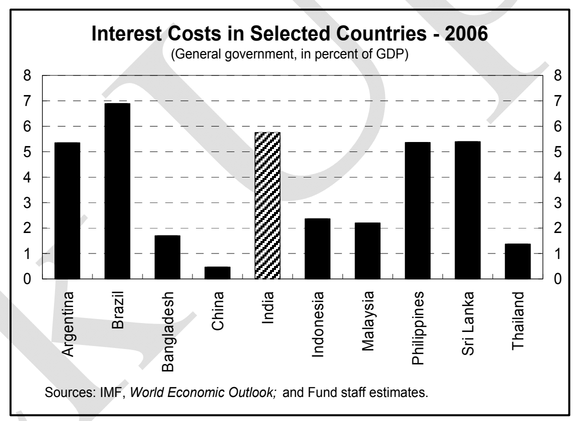


Sources: Data provided by Indian authorities, Moody's KMV CreditEdge Plus; and Fund staff estimates.

1/ Estimates show the implied risk-neutral default probability based on the adapted Black-Scholes-Merton (BSM) framework.
2/ Estimates show the implied risk-neutral default probability (by quartile) based on the adapted Black-Scholes-Merton (BSM) framework.
3/ The chart shows the cumulative, one-year implied probability of default (PD) of all 70 publicly listed banks. Banks are ordered by market share. For example, 98 percent of all banks (total bank assets) have a probability of less than five percent to default within the next year.

23. **The central government's deficit target for this year—3.3 percent of GDP—is likely to be met.** Tax revenue is likely to overperform the budget target by a wide margin, but expenditure is also expected to overshoot due to above-budget subsidy and interest costs. Including off-budget quasi-fiscal expenditure, staff projects the augmented deficit at 4½ percent of GDP, about the same as last year.[8] Looking to 2008/09, the FRBMA sets the challenging objective of revenue balance (and reduction of the overall deficit to 3 percent of GDP). Based on the staff's augmented definition of the budget deficit, achieving this target would require consolidation of 2¾ percentage points of GDP (and about 1½ percentage points of GDP to achieve the overall deficit target).[9] The staff baseline assumes that off-budget subsidy-related bond issuance will be phased out gradually, suggesting that achievement of current balance will be delayed by a few years.





24. **Given the rapid growth in revenue, fiscal consolidation could have been more ambitious.** This would not only have accelerated debt reduction, but also increased the contribution of fiscal policy to absorbing the inflationary impact of capital inflows, a burden which has been borne disproportionately by monetary policy (given the positive fiscal impulse).[10]

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[8] Bond issuance (in compensation for losses related to commodity subsidies) is expected to reach 1.2 percent of GDP this year, primarily to oil producers (0.8 percent of GDP) and fertilizer producers (0.3 percent of GDP).

[9] Staff projects this year's revenue deficit at 0.8 percent of GDP. However, this includes a one-off special dividend payment from the RBI amounting to 0.7 percent of GDP.

[10] See WP/07/268.

25. **There are risks to this baseline.** Spending risks include the persistence of high fertilizer and fuel subsidy costs (given the global commodity price outlook) and increased government wages and pensions from the Sixth Pay Commission (SPC) award.[11] Recent wage hikes and past cost of living increases would limit the rise in salary costs and phasing in pay increases would ease the fiscal burden. On revenues, rapid growth since 2004/05 (averaging 23 percent annually) largely reflects corporate profits, which are already slowing. Moreover, tax losses from Special Economic Zones, which grant full income tax exemption for five years (and 50 percent exemption for the following five years), could rise to 1½ percent of GDP per year.

26. **On a longer view, fiscal consolidation remains important for achieving India's inclusive growth objectives and coping with financial globalization.** Debt servicing costs (nearly 6 percent of GDP) absorb fiscal space needed for priority social and infrastructure projects. Consolidation would also reduce the risks of crowding out and set the stage for further financial openness.

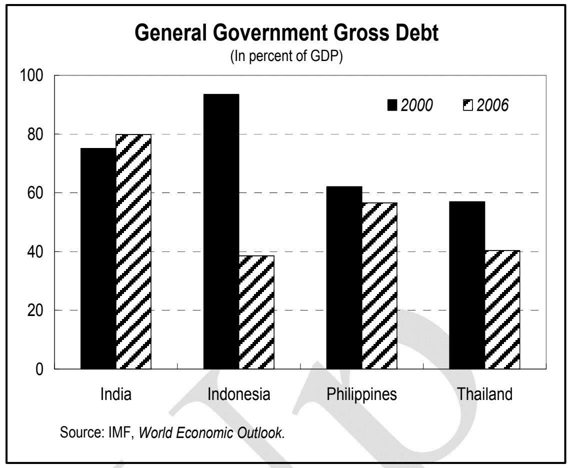
27. **Bold expenditure reforms are needed to make space for social spending.** Revamping subsidies is a key priority: they are expensive and poorly targeted.[12] A phased re-alignment of domestic fuel prices to international levels, paired with a shift to a rule-based pricing and burden-sharing mechanism for petrol and diesel, would reduce the fiscal burden and improve transparency. The government's plans to improve targeting and reduce diversion of food and fuel subsidies and other social assistance are welcome, as are efforts to broaden the social safety net (including extending social insurance to informal-sector workers and old-age pensions to the poor).

28. **Revenue reforms are needed as well.** In 2006/07, foregone revenue from exemptions amounted to 5.7 percent of GDP (roughly half of actual tax collections). The authorities' GST (planned for April 2010) would streamline the tax structure and bolster revenue in the medium term. Early announcement of a roadmap—including a timetable for merging VAT-like taxes and broadening the services tax—would help taxpayers prepare. A single point of collection (as in most federal OECD countries) would be easier to administer than a dual-tier system. On non-tax revenue, there is considerable potential to raise collections from user fees, but this will require significantly improved service delivery.

[11] Pay Commissions make recommendations on government pay scales every ten years. The SPC's recommendation is expected by April 2008.

[12] Government studies find that 58 percent of subsidized food goes to non-poor families and that subsidized liquefied petroleum gas is widely used by middle-class households.

29. **The FRBMA should be supplemented by an explicit framework for medium-term debt reduction.** The Act implicitly targets further debt reduction beyond March 2009, which staff sees as achievable (staff projects general government debt to fall to 62 percent of GDP by 2012, a decline of almost 20 percentage points (see Annex I)). Adoption of an explicit, ambitious medium-term debt reduction target could bolster the government's commitment to debt reduction, guide public expectations about fiscal policy, and relieve appreciation pressures.[13] The target should encompass the consolidated government, including non-financial public enterprises.



Source: IMF, *World Economic Outlook*.

30. **Aggregate state finances are sound.**[14] Thanks to fiscal responsibility legislation (adopted in all but two states), as well as high transfers and debt forgiveness by the central government, fiscal consolidation targets set out under the 12th Finance Commission are likely to be met ahead of schedule. Going forward, however, several risks exist:

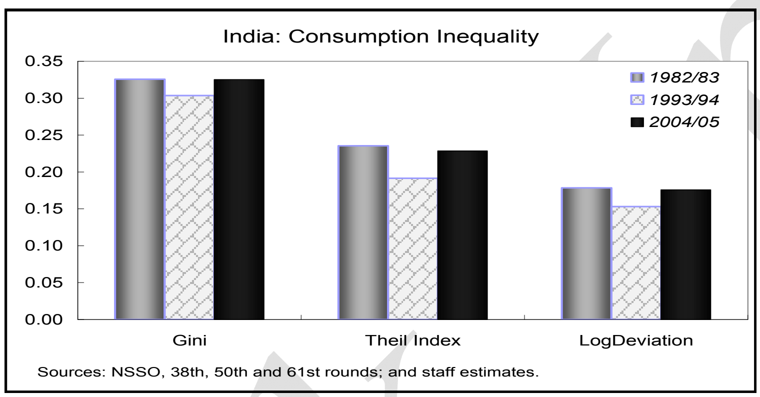
- The anticipated slowdown in central government tax collections (which are shared with the states) requires states to enhance revenues, particularly given potential SPC costs.
- With education and health spending (primarily a state responsibility) expected to rise, constraints on implementation and ensuring the quality of spending could become more acute. Monitoring and evaluation need improvement.
- State liquidity management could be improved further; cash-rich states could use excess revenue to consolidate debt more quickly.

[13] The FRBM Rules (2004) set out annual reductions in the revenue and overall deficits. While the aim of the FRBMA is to achieve revenue balance (and an overall deficit of 3 percent of GDP) by March 2009, the annual deficit reduction targets are set in perpetuity.

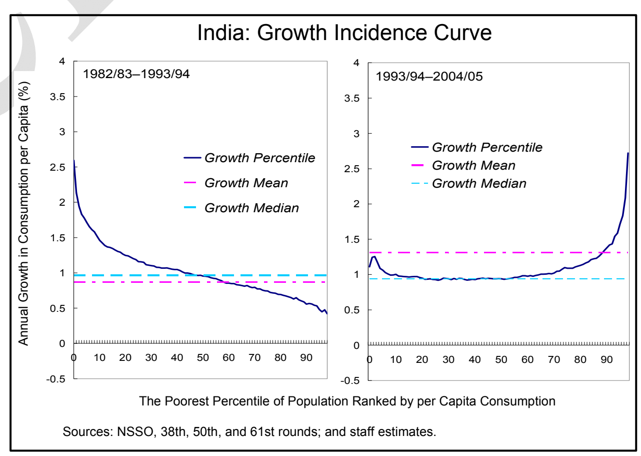
[14] The fiscal condition of some states remains worrisome, however.

Structural reforms

31. **Strong and more inclusive growth is the basis for India's economic stability,** although progress in inclusiveness has slipped during India's growth acceleration. Productivity needs to be bolstered in order to maintain competitiveness in the face of appreciation pressures. Strong growth is also needed to support fiscal sustainability, currently riding on buoyant revenues. Inclusive growth will also be essential to build political consensus for growth-oriented reforms, given growing perceptions of rising inequalities and the lack of a well-functioning social safety net.

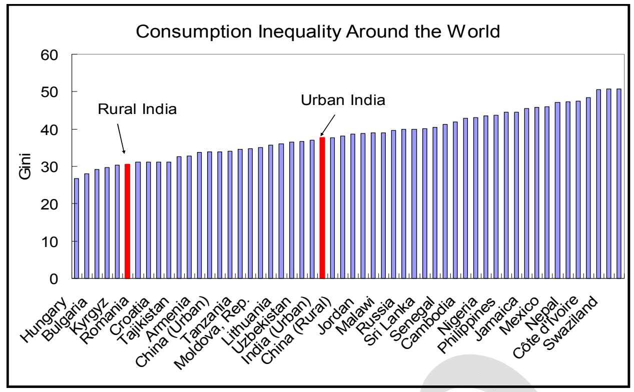


32. **Rapid growth has reduced poverty, but inequality has risen although it is still low by international standards.** The share of the population living below the poverty line fell from 45 percent in 1983, to 36 percent in 1993/94, and then to 27½ percent in 2004/05.[15] However, inequality began to rise in the 1990s. Between 1993/94 and 2004/05, the gap between average monthly per capita consumption in rural and urban India widened. The increase in income and wealth inequality is potentially much larger, as the prices of major sources of wealth, held by a small segment of the population, have risen sharply.

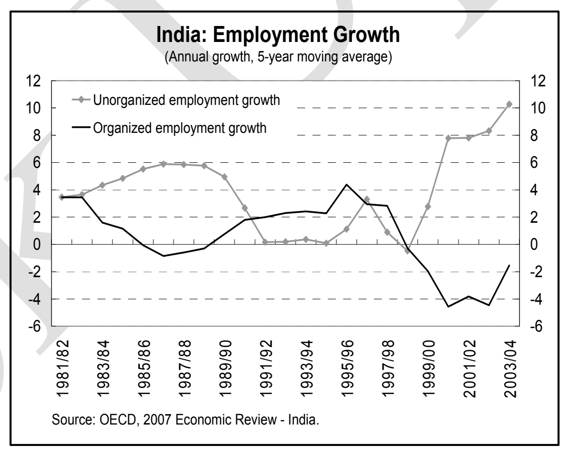


[15] An alternative measure of consumption that uses different recall periods places India's poverty rate at 21 percent in 2004/05, down from 26 percent in 1999/2000. Comparable estimates for earlier years are unavailable under this measure.

33. **The shift in consumption growth is particularly notable and suggests that growth has become less inclusive.** From 1983 to 1993/94, growth in per capita consumption at the bottom of the income distribution outpaced growth at the top. During the 1990s, the shape of the growth incidence curve reversed, with much faster growth at the top—particularly in urban India, reflecting the pickup in manufacturing and services compared with agriculture. In the 1990s, despite faster growth, the bottom 50 percent of India's population (most of whom work in agriculture), experienced slower consumption growth than in the previous decade.

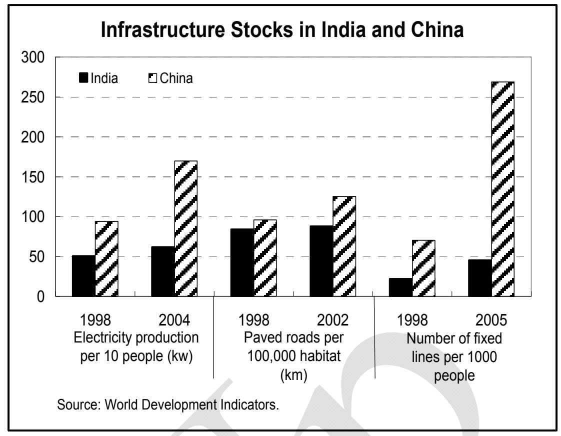


34. **Education and labor-market reforms can both accelerate growth and ensure that its benefits are distributed widely.** Skill premia, and correspondingly consumption inequality, are growing, especially in urban areas. India registered one of the highest increases in skilled wages in the world; wages of managerial and supervisory staff rose 16 percent during 2007, with a similar increase expected in 2008. Yet, unemployment rates among the young rise steeply with educational achievement, suggesting serious mismatches between education provision and market needs.[16] More flexible labor regulations could increase formal sector employment, which has stagnated even as employment in the informal sector grows. The reallocation of labor from weaker performing to stronger sectors in the economy could generate substantial productivity gains, while allowing a larger share of the population to enjoy the benefits of growth.



[16] Among 26–30 year olds, unemployment rates rise from 0.5 percent for the illiterate to 15.4 percent for those with postgraduate education and above.

35. **Major shortcomings exist in infrastructure,** which are estimated to reduce GDP growth by 1 percent per annum. Power shortages are acute and growing: the average firm reports power outages on 85 days per year, and the peak deficit reached a 10-year high of 14½ percent this year. The government estimates that some $500 billion in infrastructure investment will be needed over the medium term in power and other sectors. A prerequisite for private investment in the power sector is a more predictable and transparent regulatory framework (particularly for pricing and payment collections). Streamlining FDI regulations, developing a corporate bond market and tapping global capital markets (including by limiting restrictions on ECBs) would help mobilize the financing needed.



36. **It would be appropriate to gradual trade liberalization.** The overall average tariff has come down from 32.3 percent in 2002 to 15.8 percent in 2006, although average agricultural tariffs stand at 40.8 percent. In the 2007/08 budget, the government announced a further reduction of the peak nonagricultural rate from 12.5 percent to 10 percent (subject to certain exemptions).

MOCK-UP OF THE "CONDENSED APPROACH:"

NAMIBIA

STAFF REPORT FOR THE 2007 ARTICLE IV CONSULTATION

Contents Page

NAMIBIA

Staff Report for the
2007 Article IV Consultation

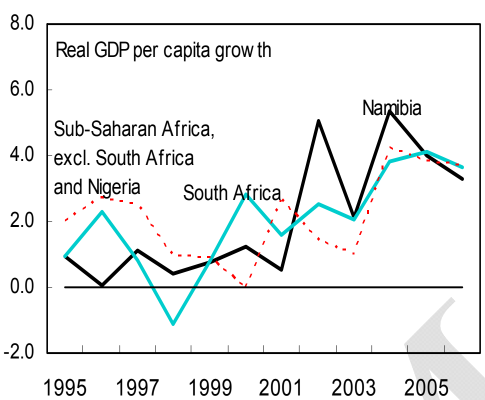
Prepared by
the Staff Representatives for
the 2007 Consultation with Namibia

Approved by
Thomas Krueger and
Anthony R. Boote

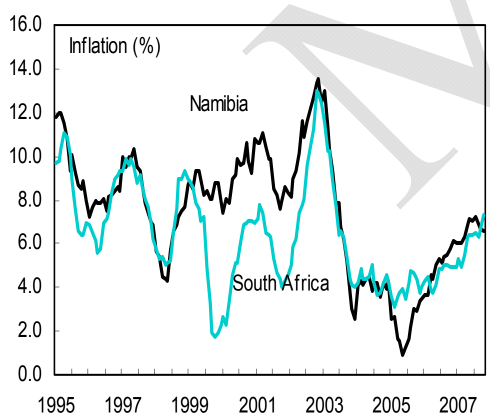
January 2, 2008

Economic position is strong for now…

Growth strengthened.



Inflation parallels South Africa's…



Overview

- The economy fared well due to favorable external conditions, but unemployment, poverty and HIV/AIDS remain difficult challenges.

- The emerging fiscal space should be used cautiously, backed by improvements in tax administration and quality of public spending.

- There is little evidence of significant currency undervaluation. Consistent with the peg to the Rand, interest rate differentials with South Africa should be limited to levels that do not destabilize capital flows or reserves.

I. Recent Economic Developments and Outlook

1. **The economy performed well in 2007**. Higher growth resulted from the strengthening of the nonmining sectors, while improvement in diamond extraction rates and favorable terms of trade contributed to the strong external position. Tighter monetary policy reduced inflation to below South Africa's rate, and the REER depreciated to its historical average of 1990-2005.

2. **High Southern Africa Customs Union (SACU) receipts**, driven by increased import growth in South Africa, not only contributed to the highest CA surplus in recent years (16-18 percent of GDP), but also boosted the fiscal position, reducing public debt to below the ceiling of 25 percent. Net international reserves have almost doubled since 2005 to $850 million, fully covering the short-term debt or three months of imports.

3. **The medium–term outlook is favorable.** Real growth per capita is expected to remain strong, and possible exploitation of the Kudu natural gas field adds further optimism with regard to growth prospect through 2012. Monetary tightening could bring down the inflation to 5.5 percent by 2009 (from 6.6 percent in October 2007 which reflects impact of increased global food prices). Continued growth in private sector credit, backed by a high private savings rate should finance rising investment. As private savings decline from peak levels, the current account surplus is projected to narrow.

4. **Nevertheless, risks remain.**

(i) The size of the mining sector implies that terms-of-trade is highly vulnerable to world mineral prices.

(ii) SACU revenue, which accounts for about one third of public spending, is vulnerable to revision of the revenue-sharing formula.

Medium-term Macroframework

	2007	2008	2009	2012
	(Percentage changes)			
Real GDP	4.4	4.8	4.5	4.8
Mining	1.4	6.8	-1.2	0.8
Nonmining	4.7	4.6	5.1	5.2
CPI (eop)	6.7	5.7	5.5	5.5
	(Percent of GDP)			
Gross Inv.	28.2	29.8	31.2	32.1
Gross natl. savings	46.7	42.4	40.9	37.5
Public	9.4	8.3	7.4	6.7
Private	37.3	34.1	33.5	30.8
External Curr.	18.5	12.6	9.7	5.4

Source: Namibian authorities; and IMF staff projections.

II. The Policy Discussions

A. Fiscal

How Should the Emerging Fiscal Space be Used?

Namibia is benefiting from windfall gains …

5. **Increased receipts from SACU and the mining sector have created fiscal space**. As a result, the 25 percent of GDP public ceiling is likely to be undershot by 2 percent in 2007/08. Provided that this ceiling is maintained, the additional fiscal space amounts to a cumulative 4.5 percent of GDP over next four years. How should this be spent?

Option 1: Keep public debt below the ceiling
Option 2: Reduce tax rates
Option 3: Accommodate new spending.

Fiscal Outlook to 2012/13
(Percent of GDP)

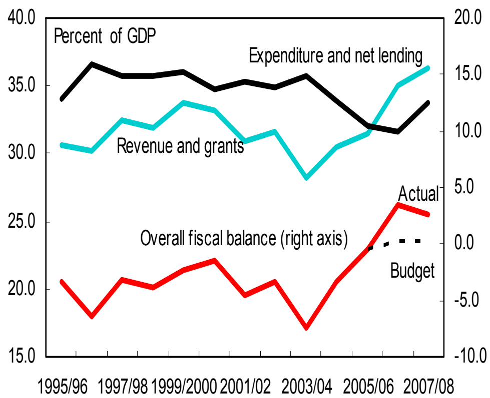
	2005/06	2006/07	2007/08	2008/09	2009/10	2012/13
Rev. & grants	31.5	35.0	36.3	34.7	33.9	33.3
SACU-transfers	9.4	13.9	14.2	12.8	12.1	11.4
Mining	1.5	2.5	2.5	2.5	2.3	2.2
Other	20.7	18.6	19.6	19.4	19.6	19.7
Expenditures	32.0	31.6	33.7	34.6	35.2	34.6
Curr. Exp.	28.0	25.9	26.8	26.8	26.7	26.6
Cap. Exp- & net lending	4.0	5.6	6.9	7.8	8.5	8.0
Overall bal.	-0.5	3.4	2.6	0.1	-1.3	-1.3
Less SACU & mineral taxes	-11.3	-12.9	-14.1	-15.2	-15.6	-14.9
Public debt	30.2	28.2	22.8	22.5	23.5	25.0

Source: Namibian authorities; and IMF staff projections.

6. **The macroframework developed with authorities opts for a modest expenditure increase, primarily to fund growth-promoting infrastructure** (notably roads, rail, and rural electrification) and sectoral programs (tourism and fisheries) (option 3). Given relatively low public debt and credible fiscal management the case for maintaining a margin below the debt ceiling (Option 1) is not persuasive.

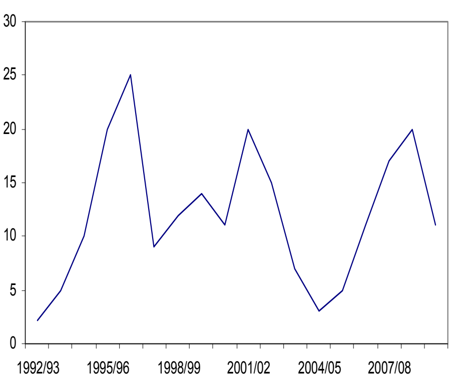
Fiscal space should continue…

Strong fiscal position reflects both the revenue growth and expenditure compression.



Namibia needs greater stability in spending…

"Stop-Go" Spending Cycles
(Annual public expenditure growth, in percent)



Efforts to Increase Revenue Collection Should Continue.

7. **Tax administration efforts must be even more ambitious. Given the uncertainties about future SACU financing**, reducing tax rates (Option 2) would not be prudent.

8. **Inland Revenue Department (IRD) should set strategic goals and work priorities---supported by stepped-up recruitment and capacity building---to resolve following constraints.**

- (i) Forensic tax audits are contracted to private accounting companies rather than the IRD staff;
- (ii) The system lacks an effective large-taxpayer unit;
- (iii) VAT refunds are audited in a comprehensive rather than risk-based manner.

9. **Authorities recognized the need to redouble efforts to strengthen tax administration and to mobilize domestic revenue**. However, they cited poor taxpayer compliance and recruitment and retention issues in IRD as factors behind the decisions to adopt intensive audits of VAT returns and to outsource forensic tax audits. They intend to seek IMF technical assistance to review the adequacy of taxation of the mining sector considering increasing rents and new investments in this area.

Expenditure Management Should Be Strengthened.

10. **On the expenditure side, staff and authorities agreed that the quality of public spending could be improved**:

- (i) *Program-based budgeting is a first priority*. Expenditure data are currently reported only by line ministry, and a modernized chart of accounts is needed to support informed discussion of spending priorities.

- (ii) *Public spending is high* by sub-Saharan African standards. Authorities indicated that they are considering the use of public-private partnerships to make public spending more effective.

- (iii) *The public wage bill in relation to GDP is one of the highest in Africa (13 percent of GDP in 2006/07),* and calls for a strategy for civil service structure, performance, and remuneration. The authorities indicated that they intend to continue to control the public wage bill.

(iv) *State-owned enterprises (SOEs) continue to jeopardize the budget.* Staff encouraged bringing the SOE Act into effect, which is stalled pending establishment of an oversight secretariat. Because of public opposition, no significant privatizations are planned.

11. **The new medium-term expenditure framework (MTEF) offers a basis for prioritizing spending, but could be more effective.** Staff noted that recent fiscal surpluses reflect shortfalls in capital spending and unexpectedly strong nominal income growth as much as fiscal discipline. Spending decision should be based on revenue outlook beyond temporary SACU, mining and other receipts, and should aim to maintain a smooth spending path.

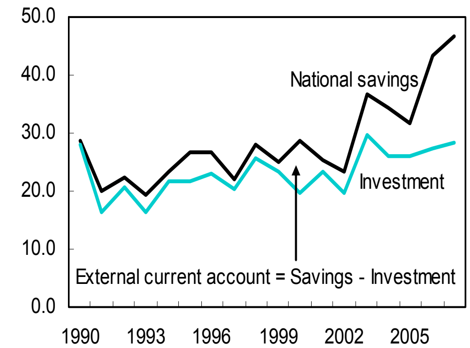
12. **Authorities confirmed the central role of MTEF in ensuring fiscal sustainability.** But they did also note the political challenges in programming fiscal surpluses when revenue is growing, given the county's unmet social and economic needs, and they continue to see the public debt limit as a central fiscal anchor.

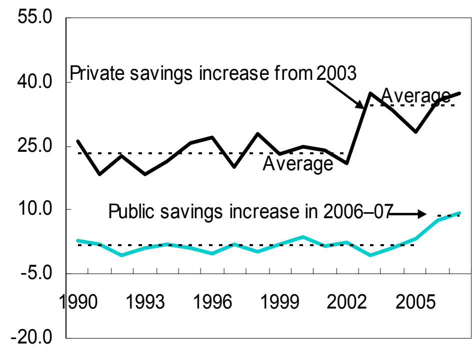
13. **Fiscal response to HIV/AIDS problem was also discussed.** Namibia's HIV/Aids program of more than 2 percent of GDP is currently donor-funded. While the program has succeeded in funding anti-retroviral therapy, staff also suggested that a progressive increase in Namibia's own contribution would help ensure sustainability.[1] The authorities responded that while the budget covered other aspects of the pandemic, provision for antiretrovirals would be increased as needed.

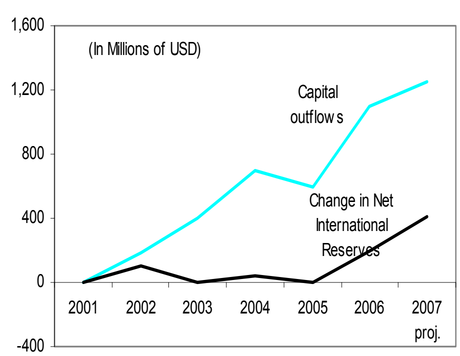
14**. The staff encouraged the authorities to consider subscription to the Extractive Industry Transparency Initiative (EITI),** a step that would be timely given the surge in new mining applications and the prospective development of the Kudu gas field.

[1] Namibia's HIV prevalence rate declined from 22 percent in 2002 to 20 percent in 2006. A program for public provision of antiretroviral drugs covers about 40,000 patients, or about 70 percent of those eligible for the benefit.

A large CA surplus reflects high savings by both the public and private sectors, but private savings are financing capital outflows rather than domestic investment.







♦ Staff Appraisal:

The emerging fiscal space and reprioritization of expenditures provide scope for modest increases for infrastructure and productive programs.

Tax administration should be improved, in particular through strengthening the strategic and operational functions of the IRD. Adoption of a program classification for budget execution and reporting should also be given a priority.

B. External

Do Large Current Account Surpluses Signal Currency Undervaluation? —Not necessarily

15. **Namibia's very large current account surpluses reflect a combination of temporary fiscal tightening and an increase in private savings**:[2]

(i) *Public savings* rose more than 6 percent in 2006, accounting for three-quarters of the rise in the current account surplus compared to the preceding three years.[3]

(ii) *Private savings* have also risen considerably since 2003. Though not well understood this trend coincides with a decline in inflation.[4]

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[2] See the selected issues paper chapter II for further details.

[3] Recent fiscal revenues from the diamond sector, Namibia's principal mineral export, have been 1–2 percent of GDP, compared to an estimated "permanent" fiscal income from diamonds of about 0.4 percent of GDP, taking into account depletion prospects. This difference is not sufficiently large to merit sustained high public savings for income smoothing purposes.

[4] There is a significant inverse relationship between private savings and inflation for 1990–2006.

Savings in 2006/07 reflect SACU and mining windfalls, as well as a decline in inflation.

Comparing 2006–07 to the previous three years:	(% of GDP)
The increased current account surplus…	10.4
largely reflects increased savings.	10.9
Public savings have risen, partly due to…	7.4
higher SACU transfers and…	4.2
increased mining taxes.	0.9
Larger private savings notably reflect…	3.5
mining windfalls.	5.7

Exchange rate does not appear undervalued.

Savings, Investment and Current Account, 1990-2012

(Percent of GDP)

	Public Savings	Public Inv.	Private Savings	Private Inv.	Current Account
1990-2002	1.5	7.7	23.1	13.8	3.1
2003-2005	1.2	7.1	33.0	20.3	6.8
2006	7.8	7.0	35.7	20.5	15.9
2012	6.7	10.1	30.8	22.0	5.4

Source: Namibian authorities; and IMF staff projections.

Indicators of Competitiveness and Currency Valuation

	1990-02	2003-05	2006	2007
	(Percent changes from precious year)			
Manufacturing sector value-added	4.2	3.4	-8.3	…
Real GDP	5.4	5.0	4.1	…
Nonmineral export values ($) 1/	-8.0	36.5	-22.0	…
Import volumes 2/	-2.7	18.2	6.3	…
		(levels)		
Inflation differential w/ South Africa 3/	1.3	1.0	0.4	-1.0
Inflation differential w/ trading partners	4.5	1.8	1.8	2.7
Government effectiveness 4/	66.0	60.5	59.2	…

1/ Excluding manufacturing, which includes a large mineral component; first column is 1999-20
2/ Staff estimates. Imports deflated by estimated partner country inflation; first column is 1991-2
3/ 2007 comparison are January-October for South Africa and January-September for other tradi
4/ World Bank calculations. Country rankings 0 to 100. The first column is 1996-2002.

(iii) *Mining sector*: The increase in private savings in 2006 may reflect increased mining incomes. Mineral exports rose by 4 percent of GDP in 2006, and although mining operations are largely foreign owned, these increased incomes may have boosted recorded savings pending payment of taxes and remittance of dividends. Absent corporate income data, this channel is difficult to quantify.

(iv) *Net foreign assets:* Much of the additional savings have been invested abroad, and the medium-term projections for the savings-investment balances are consistent with stabilization of private sector net foreign assets at a higher level.

16. **Yet there is no conclusive evidence of significant undervaluation**:

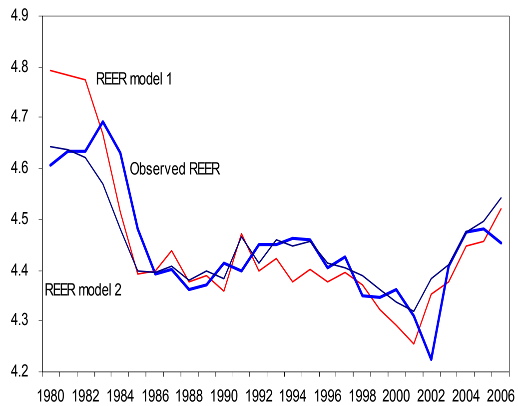
(i) *Tradables sector performance (aside from mining) is weak*, which is at odds with a possible currency undervaluation. Manufacturing growth has declined since 2003, as has real GDP growth. There is no evidence of a sustained pick-up in nonmineral exports or a slowing in import demand.

(ii) *Survey-based competitiveness indicators* have deteriorated in some measures since the 1990s; while the trend is not significant, it does not *a priori* suggest accelerated supply-side improvements that would lead to currency appreciation.

(iii) *Behavioral real exchange rate models* suggest emerging undervaluation estimated at about 7–8 percent in 2006[5] —but the models also predict that about half of this undervaluation would pass through to higher inflation differentials within a year. While inflation has picked up relative to trading partners, the increase has been modest, consistent with a small undervaluation.

[5] The model is documented in “What Do We Know About Namibia’s Competitiveness?” WP/07/191, based on data for 1980–2006.

REER Model, 1980-2006



Explanatory variables:
Model 1: Relative productivity, trade openness; investment-GDP ratio; and broad money.
Model 2: Replaces broad money with a fiscal balance term.

17. **Discussions on CMA issues focused on appropriate monetary policies**.

(i) Authorities underlined their commitment to the common monetary area (CMA).[6] They agreed that there is no clear evidence of significant currency undervaluation. Indeed, their main concern was the need to make nonmineral exports more competitive.

(ii) While Namibia's policy interest rate decisions have matched those of South Africa since mid-2004, the authorities saw macroeconomic conditions as diverging, with more evidence in Namibia of slowing domestic demand and inflation. Accordingly, the need for continuing to align Namibia's policies with South Africa's was carefully reviewed (foreshadowing the decision not to match South Africa's 50-basis-point repo rate increase in early December).

(iii) Staff noted the need to monitor closely the impact on capital outflows and official reserves.

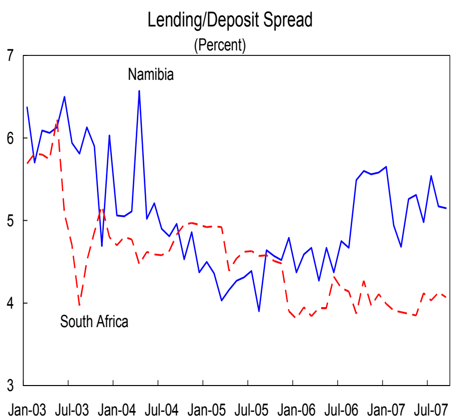
♦ Staff appraisal:

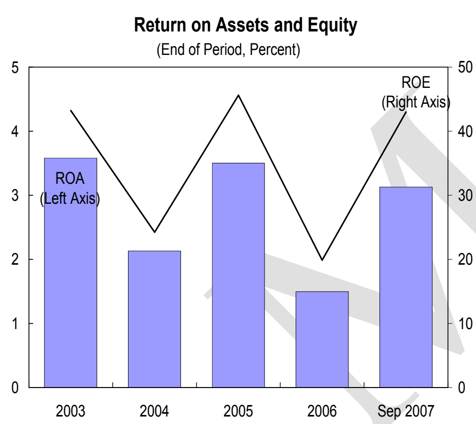
There is little evidence of any significant currency undervaluation. Consistent with the authorities' commitment to the CMA, interest rate differentials with South Africa should be limited to levels that do not destabilize capital flows or official reserves.

[6] Under the CMA, Namibia, Lesotho, and Swaziland peg their currencies to the South African rand, which is also legal tender in their territories. The CMA provides for free capital mobility. Separate central banks set interest rates and hold official reserves, which for Namibia, Lesotho, and Swaziland must equal or exceed domestic currency issue.

Namibians invest bulk of their savings abroad. Authorities are planning to impose restriction on domestic investment requirements

The lending margins are at healthy and relatively high levels.





C. Financial Sector

What Financial Sector Reforms are Needed? [7]

18. **The financial sector is strong and increasingly well regulated,** but calls for more effective intermediation of ample domestic savings to boost domestic investment and growth.

Banking sector

19. **The banking system is very profitable**, well-capitalized, with few nonperforming loans; private sector credit is relatively high by international standards, amounting to 58 percent of GDP in 2006.

20. **However, as the 2006 FSAP found, bank outreach to poorer households and small and medium-size enterprises could be better.** Banks are now extending their outreach through a range of innovative savings and credit products. A voluntary charter is also being drafted under which banks will agree to meet social and economic benchmarks for personnel management and lending.

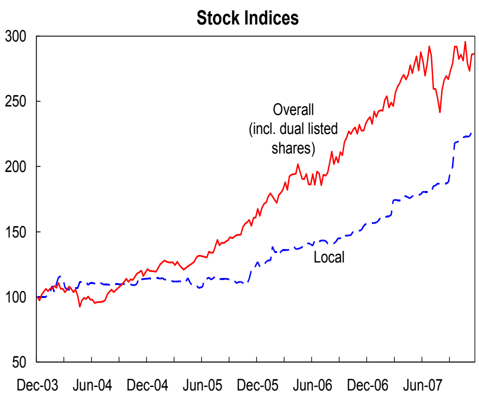
Nonbank Financial sector

21. **Namibia's well-developed life insurance and pension fund sector is required to invest 35 percent of portfolios domestically.** The industry typically invests much of the rest abroad, citing a lack of domestic investment opportunities. The capitalization of local companies on the domestic stock market is just 6 percent of GDP (only seven local companies are listed); public debt is low; and volume on the secondary corporate debt market is low. Pension savings are one factor behind Namibia's capital outflows; most middle income countries have capital inflows.

22. **The authorities are considering tighter regulation for domestic investment requirements.** Specifically, the insurance and pension funds would no longer be able to meet the current 35 percent domestic investment requirement with holdings in foreign companies dual-listed on the Namibia stock exchange, and would have to dedicate some of their portfolios to investments in domestic unlisted companies.

[7] See Selected Issues Paper Chapter III for further discussion.

Namibia's stock index has tracked South Africa's, but local companies have underperformed.



The rationale is to encourage portfolio managers of pension and insurance companies to look beyond the "easy option" of investing in South Africa's deeper markets. Any changes are to be implemented cautiously, monitoring closely the impact on the industry.

23. **Staff urged caution in tightening domestic investment requirements**.

(i) *Profitability:* International experience suggests that pension funds earn higher returns when investment is not restricted.

(ii) *Vulnerability: A* domestic development mandate leaves funds vulnerable to pressures to finance nonviable projects, especially the unlisted securities that tend to disclose less about their finances.

(iii) *Absorptive capacity*: The required repatriation of funds, which could amount to 10 percent of GDP or more, could exceed the economy's ability to absorb it.

(iv) *Enforceability*: Pension and insurance funds could side-step the regulations by investing in local banks, which would still be free to invest in South African bonds. This would result in no real increase in domestic financing while lowering returns through (a) a likely shift from equity to fixed-income returns favored by banks and (b) intermediation fees paid to banks.

24. **The authorities discounted concerns about investment opportunities**.

(i) They believe portfolio managers will find considerable unmet domestic demand for financing.

(ii) The authorities concurred, however, on the merits of broadening the range of investment options through, e.g., bond issues by solid public agencies (following the precedent of NamPower). They indicated they would look into international experience with securitization of mortgages (which make up 40 percent of banks' loan portfolios), and factoring and leasing.

Financial Sector Supervision

25. **Staff welcomed progress in strengthening the operational capacity of NAMFISA** which supervises nonbanks, as recommended in the 2006 FSAP.[8] A new CEO was appointed, and staffing and training have been increased in both NAMFISA and the Bank of Namibia, the banking regulator; risk-based supervision has been initiated; both institutions have stepped up on-site visits; NAMFISA has taken a medium-sized insurance company into curatorship; and a number of banking regulations have been issued. But collection and analysis of data from the nonbank financial sector is lagging; a full prudential picture of the sector is unlikely before mid-2008.

♦ Staff Appraisal:

Financial sector management is being enhanced consistent with the recommendations of the 2006 FSAP.

Caution is needed in modifying domestic investment requirements for pension and insurance companies—especially minimum investments in unlisted securities—to avoid raising industry risk and deteriorating returns.

D. Structural policies

Reducing Unemployment is Crucial[9]

26. **Namibia's unemployment rate is high (22 percent), even by African standards.** This is related to followings:

(i) *Education and Skills*: At independence, Namibia inherited a poor education system that did not prepare students well for the necessary skills.

Private nonfarm, nonmining employment would need to rise by almost 60 percent to absorb the 108,200 unemployed…

Participation and Unemployment Ratio

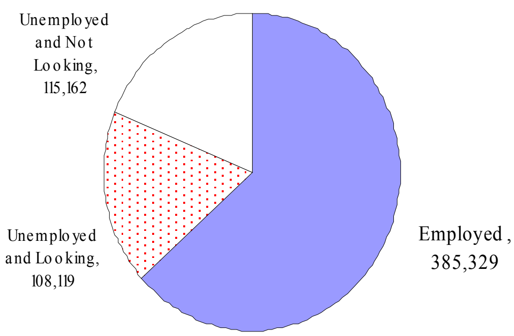
Country	Year	Labor participation	Unemployment rate 1/
Namibia	1997	53.5	19.5
Namibia	2000	54	20.2
Namibia	2004	47.9	21.9
Botswana	2006	57.2	15.3
Cameroon	2001	68.9	7.5
Egypt	2005	49.3	11.2
Lesotho	1999	64	27.3
Mauritius	2006	65.5	9.1
South Africa	2006	65.1	25.5
Tunisia	2005	54.9	14.2

Sources: Namibia Labor Force Survey; International Labor Organization, and World Bank Development Indicators.
1/ Narrow definition, excluding those not looking for work.

[8] AML policies were strengthened in 2007 with enactment of the Financial Intelligence Act and establishment of a financial intelligence center within the Bank of Namibia (BoN).

[9] See Selected Issues Paper chapter V for further discussion.

Discouraged workers and underemployment are common --almost half of unemployed are not seeking jobs.



(ii) *Economic structure:* Mining and agriculture sectors do not provide an easy solution. Mining sector is highly capital intensive. Agricultural sector has been declining over the past decade, and value-added per worker are low (as well as incomes). Manufacturing sector is a possible option, but with population of just two million, it is difficult to build a manufacturing base without developing export markets. Construction and labor-intensive service sectors such as tourism may provide some job opportunities.

(iii) *Rigidities in the labor market:* Workforce management is complicated by the lengthy process of applying for work permits for foreigners, and the contentious challenges to worker dismissals in district labor courts. The pending Labor Law would increase annual leave eligibility to 24 days (plus 5 days' compassionate leave) substantially above many middle income country peers.[10]

27. **The authorities concurred broadly on the need to improve skills and productivity, but stressed the importance of improving working conditions.**

[10] Statutory annual leave is 15 days in Botswana, Chile, and South Africa; 8-16 days in Malaysia (depending on service) and 6 days in Thailand.

Efforts to Improve Business Climate and Expand Export Opportunity Should Continue.

International Governance Indicators, 2006

(Percentile ranking, 100=strongest)

	Government Effectivenes	Regulatory Quality	Control of Corruption
Sub-Saharan Africa	27.2	27.4	30.3
Lower-middle-income countries	37.8	36.6	37.7
Namibia	59.2	57.1	61.2
Upper-middle-income countries	61.5	63	60.9
Botswana	73.9	75.6	78.2
South Africa	76.8	70.2	70.9
Namibia (1996)	73	46.8	78.2

Source: World Bank

28. **Favorable infrastructure could compensate for difficult geographic conditions.** Business access to rail, port, and air facilities viewed as superior to the average for lower-middle-income countries.

29. **Economic governance is ranked above average** but appear to have eroded over the past decade. An Anti-Corruption Commission became effective in 2006.

30. **Staff recommended continuing liberalization of the trade regime, including through broader free trade arrangements**. A wider free trade area across SADC would increase market access for Namibia but is unlikely to be achieved by the 2008 target date because non-SACU members are progressing slowly. Namibia signed an interim Economic Partnership Agreement (EPA) with the European Union in mid-December. This will preserve Namibia's access to the EU market and lower tariffs over time.

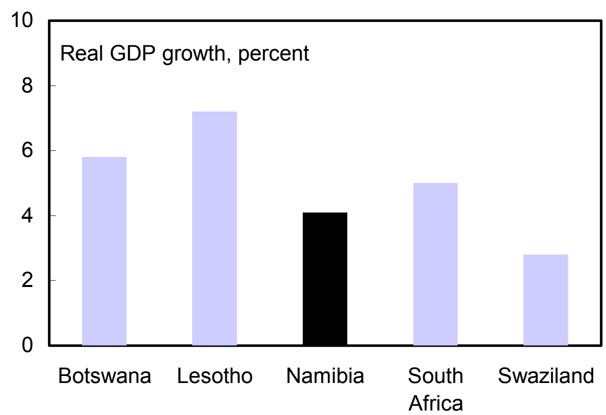
♦ Staff Appraisal:

Fostering employment growth in the nonmining economy is a central challenge. It will require forceful efforts to build skills and labor productivity, especially through greater labor market flexibility.

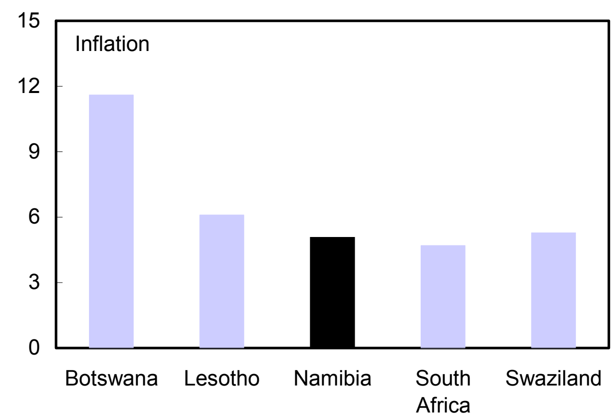
The business climate also needs to be improved. Given Namibia's daunting economic geography, it must build on its comparatively strong economic institutions and tackle bureaucratic obstacles. Further liberalization of the trade regime remains a priority.

Namibia: Regional Comparison 2006

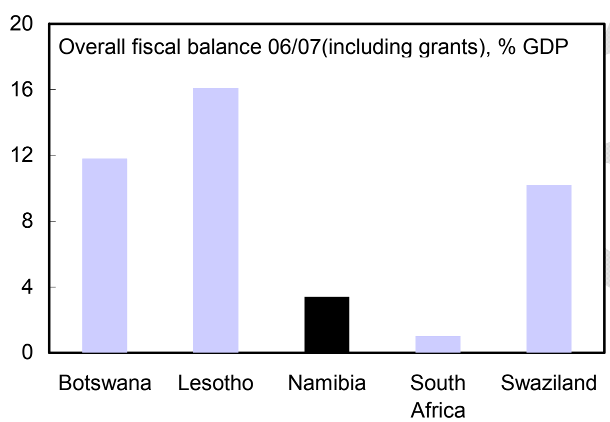
GDP growth …



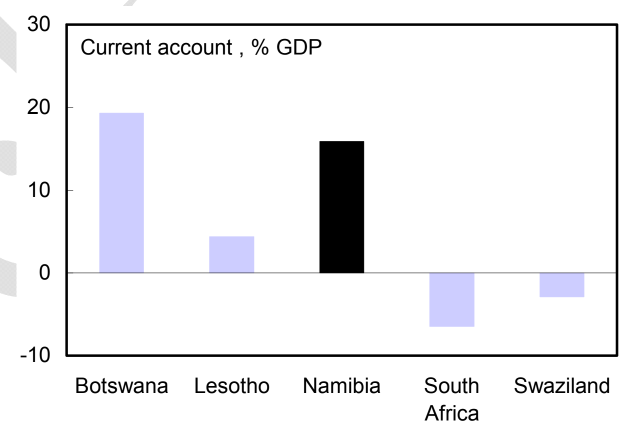
… and inflation are in line with regional peers.



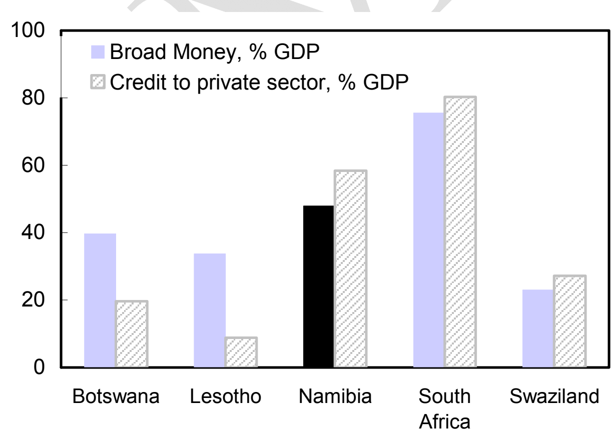
While the fiscal surplus lags due to larger SACU contributions in other countries …



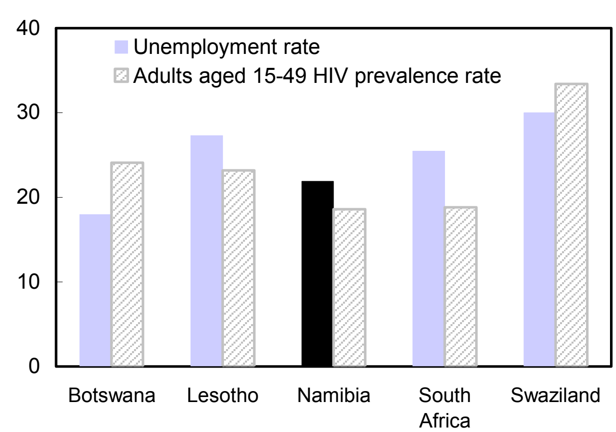
… Namibia's current account is one of the strongest.



Namibia, together with South Africa, has a relatively deep financial system.



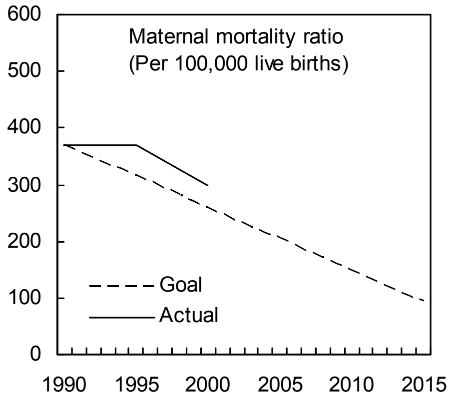
Unemployment and HIV/AIDS are regional challenges.



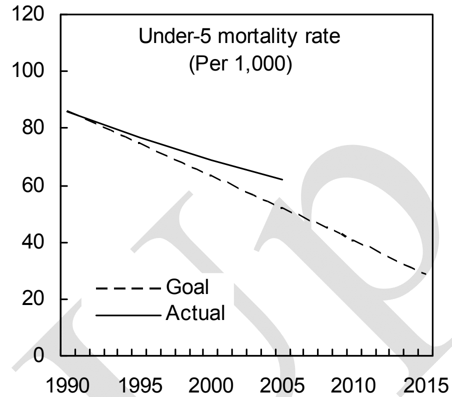
Source: IMF staff estimates.

Namibia: Progress Toward Selected Millennium Development Goals, 1990–2015 1/
(In percent, unless otherwise indicated)

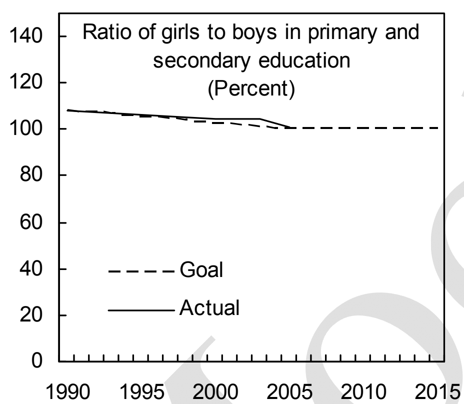
Mortality rates are falling,…



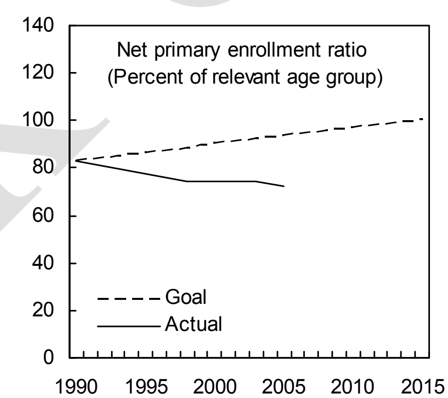
…but lag the MDG targets.



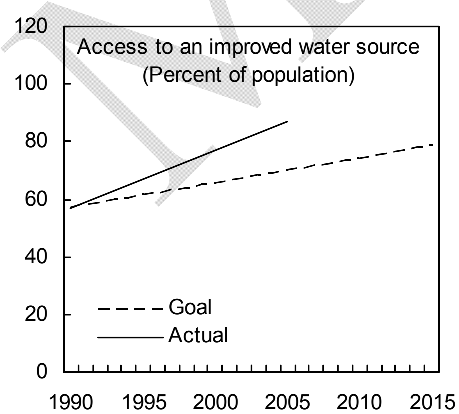
Female school enrollment is high…



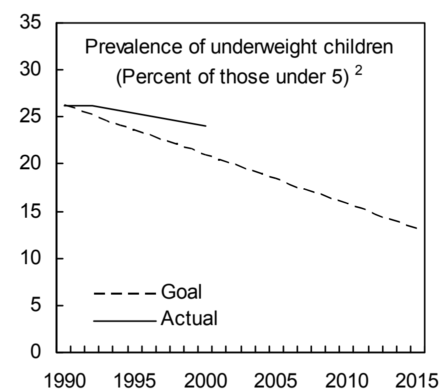
…but overall enrollment lags the MDG targets.



Access to water supplies is rising.



But nutrition performance is lagging.



Sources: World Bank, http://www.developmentgoals.org; and United Nations, http://unstats.un.org.
1/ Progress is measured compared to a linear projection between the 1990 level and the end year goal.
2/ Actual data for 1990 is assumed to be equal to 1992 level, due to lack of data.