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SM/85/27
Correction 1

CONTAINS CONFIDENTIAL INFORMATION

March 1, 1985

To: Members of the Executive Board

From: The Secretary

Subject: India - Staff Report for the 1985 Article IV Consultation

The following corrections have been made in SM/85/27 (1/25/85):

Page 4, Table 1, line 23: add footnote 4/
subsequent footnotes renumbered

line 27, column 7: for "7.5" read "7.6"

column 10: for "7.1" read "7.5"

line 30, column 1: for "23.7" read "25.5"

line 31, column 1: for "23.9" read "23.7"

Page 27, Table 8, line 4, column 2: for "-43" read "-431"

Page 29, 1st full para., line 6: for "14 percent" read "10 percent"

Corrected pages are attached.

Att: (3)

Other Distribution:
Department Heads

I. Introduction

A staff mission visited New Delhi and Bombay during the period November 2-17, 1984 to hold the 1985 Article IV consultation discussions and in this connection to review developments under the extended arrangement. The principal Indian officials participating in the discussions were Messrs. P.K. Kaul, Finance Secretary, Bimal Jalan, Special Secretary and Chief Economic Advisor, Montek Singh Ahluwalia, Economic Advisor, all of the Department of Economic Affairs; and Manmohan Singh, Governor, Reserve Bank of India. Meetings were held in New Delhi with officials from the Ministries of Finance, Agriculture, Commerce, Industry, Petroleum, and from the Planning Commission; and in Bombay with the Reserve Bank of India and specialized development finance institutions. The staff representatives were Mr. Scott (Head, ASD), Ms. Ripley (ASD), Ms. Kelly (ETR), Messrs. Choudhry and Hides (ASD) and Ms. Job (ASD). Messrs. Grawe and Hansen (IBRD, New Delhi) participated in some of the discussions. Mr. Malhotra, Executive Director for India, attended the meetings as an observer.

The Executive Board approved an extended arrangement for India (EBS/81/198) on November 9, 1981 in an amount of SDR 5 billion (291 percent of old quota). Programs were negotiated covering the three fiscal years (ending March 31) 1981/82 to 1983/84. All performance criteria were observed and scheduled purchases, totaling SDR 3.9 billion, were made. In January 1984, the Indian authorities announced their intention to cancel the extended arrangement, effective May 1, 1984. This released committed resources amounting to SDR 1.1 billion.

India continues to avail itself of transitional arrangements under provisions of Article XIV and maintains a bilateral payments agreement with a Fund member (Romania) that is subject to approval under Article VIII.

II. A Retrospective and Economic Background to the Extended Arrangement

Indian economic performance during the 1970s was characterized by modest economic growth, moderate inflation, and a sustainable external position. Development plans aimed at a reduction in the number of families below the poverty level, but performance in this regard was disappointing. Between 1970/71 and 1980/81, real GDP rose at an annual rate of 3.2 percent; in per capita terms the increase was only 1 percent (Chart 1). 1/ Despite the rise in gross domestic savings from 17 to 23 percent of GDP, with a commensurate rise in gross investment, there

1/ All macroeconomic statistics are reported on a fiscal-year basis (April-March) unless otherwise noted.

Table 1. Selected Economic and Financial Indicators, 1980/81-1983/84

	1980/81		1981/82		1982/83			1983/84		
	Program base 1/	Actual	Original program 1/	Actual	Original program 1/	Revised program (EBS/82/102)	Actual	Original program 1/	Revised program (EBS/83/130)	Actual/ prov.
					(Annual percent changes)					
National income and prices										
Real GDP at factor cost	7.0	7.8	4.8	5.3	4.8	5.0	2.6	4.8	6.0-6.5	8.0
Agriculture	14.0	12.8	1.4	3.3	1.4	1.7	-3.9	1.4	5.0	10.7
Manufacturing	4.1	1.7	7.3	5.1	7.3	7.0	2.4	7.3	7.0	4.0
GDP deflator	12.0	11.4	9.0	10.2	8.5	8.5	7.8	8.0	7.0	7.0
Wholesale prices 2/	15.4	16.7	11.0	2.4	9.0	8.0	6.6	8.0	7.0	9.1
Consumer prices 3/	...	11.4	...	12.5	...	...	7.8	...	7.0	12.6
External sector										
Exports, f.o.b.	13.3	7.1	16.2	11.8	16.1	11.9	0.4	16.6	7.2	6.4
Imports, c.i.f.	41.2	41.6	12.4	5.3	12.0	3.9	-2.8	15.8	3.8	4.7
Oil	85.1	66.0	-7.9	-6.5	0.6	-8.1	-10.4	14.3	-17.7	-23.9
Non-oil	17.2	28.0	29.8	13.8	19.0	11.2	1.7	16.5	14.2	19.7
Export volume	...	-0.8	5.0	3.5	7.0	7.0	-2.9	8.0	5.0	1.9
Import volume	...	15.8	1.6	-4.9	2.7	-1.0	-5.1	...	4.0	8.5
Terms of trade deterioration -)	...	-11.7	--	-2.4	-0.6	--	1.0	-0.6	3.2	8.2
Nominal effective exchange rate 2/	...	-3.9	...	-2.9	...	...	-3.6	...	...	-6.8
Real effective exchange rate 2/	...	-3.4	...	-4.8	...	...	-1.1	...	...	-0.7
Central government budget										
Revenue and grants	18.9	13.1	16.8	21.4	...	14.5	16.2	...	15.5	14.5
Total expenditure and net lending	18.9	19.3	15.5	14.7	...	11.6	26.2	...	13.0	14.1
Money and credit										
Domestic credit	24.6	25.0	19.4	18.9	18.3	18.6	17.4	17.4	17.8	15.5
Government	34.2	28.4	20.1	19.1	17.6	17.9	14.9	16.3	17.3	14.3
Commercial sector	18.8	18.6	18.9	18.7	18.9	19.0	19.3	18.1	18.1	16.4
Money and quasi-money (M_3)	18.5	18.2	15.7	12.7	14.5	15.9	15.8	14.0	15.0	18.2
Narrow money	12.8	16.6	11.3	6.8	11.0	13.8	14.6	11.0	12.0	15.7
Interest rate (annual rate, five-year savings deposit) 4/	10.0	10.0	10.0	10.0	...	10.0	11.0	...	11.0	11.0
					(In percent of GDP)					
Public plan outlays	11.6	11.7	11.8	12.3	12.9	12.5	13.2	14.1	14.3	13.4
Public sector savings	3.6	3.6	4.4	4.3	4.8	5.0	4.9	5.2	5.4	5.0
Central government savings	2.3	2.3	3.0	2.8	3.2	3.3	3.2	3.5	3.5	3.4
Central government budget deficit	6.2	6.5	6.4	5.8	6.4	5.6	7.6	6.8	6.5	7.5
Domestic bank financing	3.4	3.1	3.1	2.6	3.0	2.8	2.2	2.9	2.9	2.4
Foreign financing	...	1.1	0.9	0.7	1.0	0.7	0.8	...	0.9	0.9
Gross capital formation	25.5	24.6	25.7	24.7	26.1	25.5	24.1	26.5	26.4	25.0
Gross domestic savings	23.7	23.0	23.7	22.6	24.1	23.4	22.4	24.3	24.3	23.6
Current account deficit	-2.1	-1.6	-2.1	-1.8	-2.0	-2.1	-1.6	-2.3	-2.1	-1.5
Overall balance of payments (SDR mn.)	-712	-774	-1,683	-2,172	-2,024	-1,683	-1,143	-2,655	-1,497	-373
External debt (including IMF)	10.9	11.6	11.2	12.2	11.7	12.0	14.2	14.5	14.4	14.7
Debt service ratio 5/6/	8.3	8.5	8.5	9.3	9.2	11.0	11.3	9.9	13.8	14.0
Interest payments 5/6/	...	2.9	3.1	3.3	4.2	4.3	5.3	5.2	7.1	7.4
Gross official reserves (months of imports)	6	6	5	4	3	4	5	3	4	5
External payments arrears	--	--	--	--	--	--	--	--	--	--
Ceilings on nonconcessional loans (in millions of SDRs)										
1-12 years	--	--	1,400	363	--	1,400	1,269	--	1,500	751
1-5 years	--	--	400	44	--	200	120	--	200	30

1/ Original program projections (November 1981). Including subsequent refinements to the statistical definition of public savings.
2/ End-year percentage change.
3/ Annual average percentage change.
4/ Until the introduction of five-year deposits at 11 percent in 1982/83, the longest term deposit was three years.
5/ In percent of total current receipts.
6/ Including IMF.

Table 8. India: Medium-Term Debt Projections

	1985/86	1986/87	1987/88	1988/89	1989/90
		(In millions of U.S. dollars)			
Exogenous inputs: 1/					
Balance on					
Services	1,130	2,294	1,238	2,547	1,384
Transfers	2,115	2,235	2,446	2,671	2,912
Concessional loans, net	1,682	1,900	2,091	2,192	2,234
IMF transactions	-198	-431	-727	-860	-753
			(In percent)		
Export market growth	5.0	5.0	5.0	5.0	5.0
Increase in export unit values	1.4	4.9	7.5	7.5	7.5
Increase in import unit values	1.2	3.8	7.5	7.5	7.5
Scenario A:					
Export volume growth	7.0	7.0	7.0	7.0	7.0
Import volume growth	6.0	6.0	6.0	6.0	6.0
Debt service burden, including nonresident accounts	16.6	18.2	19.3	20.2	20.0
Debt service burden, excluding nonresident accounts	14.8	16.5	17.8	18.9	18.9
Reserves in months of imports	4.7	4.3	3.8	3.3	2.9
Gross borrowing on commercial terms ($ bn.)	1.4	2.2	2.9	3.9	5.0
Total external debt ($ bn.) 2/	30.8	33.9	37.7	42.3	47.8
Scenario B:					
Export volume growth	4.0	4.0	4.0	4.0	4.0
Import volume growth	6.0	6.0	6.0	6.0	6.0
Debt service ratio, including nonresident accounts	17.0	19.2	21.0	23.1	24.3
Debt service ratio, excluding nonresident accounts	15.1	17.4	19.5	21.7	23.1
Reserves in months of imports	4.7	4.3	3.8	3.3	2.9
Gross borrowing on commercial terms ($ bn.)	1.7	2.8	4.1	5.8	7.8
Total external debt ($ bn.) 2/	31.1	34.9	39.9	46.3	54.5
Scenario C:					
Export volume growth	4.0	4.0	4.0	4.0	4.0
Import volume growth	3.0	3.0	3.0	3.0	3.0
Debt service ratio, including nonresident accounts	16.9	18.8	20.0	21.1	20.8
Debt service ratio, excluding nonresident accounts	15.04	17.04	18.5	19.7	19.5
Reserves in months of imports	4.8	4.5	4.1	3.7	3.3
Gross borrowing on commercial terms ($ bn.)	1.4	1.8	2.3	3.0	3.6
Total external debt ($ bn.) 2/	30.7	33.5	36.7	40.4	44.5

Source: Staff estimates.

1/ Entries for non-interest services, transfers and concessional aid flows are invariant across the scenarios, as are the terms for commercial borrowing, and price assumptions for exports and imports. Market growth for India is based on WEO assumptions and is projected at 5 percent per annum. The interest rate for new dollar borrowings declines from 10 percent in 1985 to 8.5 percent in 1990, with a grace period of three years followed by a repayment period of seven years.

2/ Excluding nonresident deposits, which are estimated to total approximately $3.1 billion at end-March 1985; the projections allow for only a small increase in such liabilities.

one of the instruments that could be used to strengthen the external balance and should be used in a coordinated approach as other nonprice barriers to competitiveness were reduced. The staff noted the recent depreciation of the rupee in real effective terms. By October 1984 the real appreciation that had taken place in early 1983/84 had been offset, restoring the real rate to its level of November 1981. The staff noted that exchange rate policy and import liberalization should play a more central role in fostering a competitive domestic economy, a development that was seen as necessary to achieve the needed strengthening of export performance.

VI. Medium-Term Prospects and Projections

Three medium-term scenarios are presented in Table 8. These indicate the challenge facing Indian policymakers over the coming years in sustaining the satisfactory economic growth recently attained, holding debt service to below 20 percent of current receipts, and maintaining reserves at about four months of imports.

Scenario A is based on the assumption of a 2 percent per annum gain in export market shares. Thus, exports in real terms are projected to increase by 7 percent in relationship to the growth of foreign markets of 5 percent--a strengthening in the export elasticity with respect to market growth from appreciably less than 1 over the last five years to 1.4. Such an achievement is seen by the authorities as requiring a very substantial effort and is difficult to anticipate on the basis of disaggregated commodity projections. Imports in real terms are projected to grow at 6 percent per annum, one percentage point faster than the projected rate of growth of real GDP. The authorities stated that this would imply some reduction in the historical elasticity between imports and GDP. Under this scenario, with commercial borrowing determined endogenously to close the financing gap, the debt service ratio would increase to 20 percent (including servicing on nonresident Indian accounts) by 1988/89 and reserves would decline to less than 4 months of imports.

Scenario B is based on the observed historical relationship between exports and market growth, with all other assumptions the same as in scenario A. Commercial borrowing is also determined endogenously to close the financing gap. Under this scenario, gross commercial borrowing would rise to almost $8 billion by 1989/90, and the debt service ratio, including interest paid on nonresident Indian deposits, to 24 percent. Finally, scenario C is constructed so as to keep the debt service ratio from exceeding 20 percent. Import volume growth is determined endogenously and is limited to 3 percent per annum. This rate of growth is likely to prove insufficient to attain the authorities' growth objectives, unless a further reduction in oil imports could be achieved or non-oil imports could be replaced by efficiently produced domestic goods on a larger scale than in the past.

economy, but the longer-term relation between export volume and market growth has continued to decline.

Somewhat stronger capital inflows and diminished pressure on the current account obviated the need for use of SDR 1.1 billion of resources available under the extended arrangement while maintaining adequate gross reserves. However, by the end of 1983/84, the burden of external debt service had risen considerably above the program forecast of 10 percent of current account receipts. This reflects a combination of factors including the weaker export performance and somewhat larger capital inflows on less concessional terms. The issues underlying the unexpectedly rapid rise in the debt service burden remain to be addressed more vigorously during the remainder of the decade if India is to sustain the momentum of economic growth recently achieved.

The strong recovery of agricultural production in 1983/84 and of industrial output during the latter part of that year has contributed to sustaining momentum in the economy in 1984/85. Foodgrain production is expected to surpass the record 152 million-ton crop of 1983/84 and industrial production is rising at about 8 percent. Strong growth in electricity generation has facilitated economic growth in 1984/85. Price pressures which re-emerged in 1983/84 have abated somewhat. Nevertheless, the increase in wholesale prices is expected to be about 8 percent in the current year, a rate of increase considerably above that prevailing in India's major trading partners. Inflationary pressures pose particular problems in the Indian economy: in adjusting administered prices to maintain production incentives and profitability; in preventing industrial licensing from becoming more restrictive where size limits are expressed in nominal value terms; and in achieving the necessary strengthening of incentives for exports.

The fiscal outlook during the current year could only be assessed through developments in net bank credit to the State and Central Governments. From this perspective, the degree of expansion during the first half of 1984/85 indicates that budgetary implementation is substantially more expansionary than anticipated when the budget was approved. The staff attaches considerable importance to the fiscal review initiated in November and to the authorities' continuing commitment to cautious financial policies. In this regard, the notices to spending ministries should signal the need for avoiding excessive expenditure growth until a more comprehensive assessment of current fiscal developments is possible and appropriate supplementary measures put in place to arrest the untoward growth in bank credit to the Government.

Recent adjustments in monetary policy reflect the authorities' aim to reduce the rate of growth of monetary expansion to 15 percent by March 1985. The staff attaches considerable importance to achieving such a slowing of growth in total liquidity. The expansionary pressures emanating from fiscal operations of the States and Central Government pose the most important challenge for reducing monetary expansion. The staff notes the special role played by the banking system in mobilizing financial resources and, through the statutory liquidity ratio, allocating a large part to the Government. However, India's industrial and export growth prospects depend importantly on the performance of the private sector. Adequate access to the savings of the economy will be important for sustained growth in the private sector.

Sustaining the rate of economic growth recently achieved will require strengthening key elements of the adjustment strategy pursued in recent years. The staff believes that policies to enhance competition in the domestic economy and to raise the productivity of investment must be strengthened. This is recognized in the strategy being defined for the Seventh Plan. Further liberalization of import and industrial policy, within the framework of shifting policy instruments away from administrative controls toward macroeconomic management and financial incentives, would be appropriate.

The present medium-term outlook for the balance of payments, including developments in the capital account, the growth of external debt, and the burden of debt servicing is not to be viewed with equanimity. Export performance must be improved considerably. Resource use in the Indian economy must become more efficient. In the view of the staff, this latter goal could best be pursued through a reduction in the role of direct interventions through administrative procedures and an appropriate stance of macroeconomic policies; and much greater emphasis should be given to strengthening financial performance of public enterprises. Recognizing the important role that further import liberalization must play, a more active use of exchange rate policy for the rupee would be appropriate. Such a policy should be aimed at shifting relative prices in favor of exports and efficient import substitution so as to avoid undue pressure on the balance of payments over the medium term.

The present burden of external debt service is not excessive. However, the sharp rise in the debt service ratio since 1980/81 must be moderated. Although interest rate developments may prove more favorable in the period ahead, the effective cost to India of external resources will increase as greater recourse to foreign savings on commercial or semi-commercial terms becomes necessary. Thus, the prognosis for sustaining higher rates of economic growth will only become favorable if India's export performance is strengthened. Import substitution will also have a role to play, but historic trends do not suggest that it would be a sufficient strategy to realize higher rates of economic growth with sustained external stability.

The timeliness, and for some series, the quality of the statistical base makes it difficult to monitor current economic developments in any but the narrowest terms, namely, in terms of movements in prices, credit to the Government, and foreign exchange reserves. The strong growth in