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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 86/71

10:00 a.m., April 28, 1986

J. de Larosière, Chairman
R. D. Erb, Deputy Managing Director

Executive Director	Alternate Executive Director
	Mawakani Samba
	M. K. Bush
	H. G. Schneider
M. Finaish	
H. Fujino	M. Sugita
	B. Goos
Huang F.	
J. E. Ismael	
	J. R. N. Almeida, Temporary
T. P. Lankester	
H. Lundstrom	
M. Massé	L. Leonard
	J. M. Jones, Temporary
	M. A. Weitz, Temporary
	J. E. Suraisry
	J. E. Rodríguez, Temporary
H. Ploix	
	J. de Beaufort Wijnholds
	A. V. Romuáldez
G. Salehkhou	
A. K. Sengupta	A. S. Jayawardena
S. Zecchini	N. Coumbis

L. Van Houtven, Secretary
L. Collier, Assistant

Also Present

IBRD: C. L. Robless, South Asia Regional Office. Asian Department: P. R. Narvekar, Deputy Director; H. Neiss, Deputy Director; C. M. Browne, S. Tiwari. European Department: H. B. Junz. Exchange and Trade Relations Department: E. H. Brau. External Relations Department: M. Goldstein, H. O. Hartmann. Fiscal Affairs Department: R. Hemming. Legal Department: P. R. Francotte. Treasurer's Department: A. G. Chandavarkar. Personal Assistant to the Managing Director: R. M. G. Brown. Advisors to Executive Directors: S. Ganjarerndee, G. D. Hodgson, J. Hospedales, G. Nguyen, A. Ouanes, P. Pêterfalvy, A. Vasudevan. Assistants to Executive Directors: M. Arif, A. Bertuch-Samuels, B. Bogdanovic, F. Di Mauro, W. N. Engert, V. Govindarajan, S. King, Z. b. Ismail, R. Msadek, D. Saha, S. Simonsen.

1. REPORT BY MANAGING DIRECTOR

The Managing Director reported that he had attended the ministerial meeting of the Organization for Economic Cooperation and Development (OECD) in Paris on April 17 and 18, 1986. The text of his statement had been circulated to Executive Directors as had the communiqué of the Ministers (EBD/86/121, 4/22/86). At the beginning of the meeting, the Chairmen of the two Advisory Committees to the OECD, one relating to business and industry and the other to trade unions, had distributed an unprecedented joint statement. Interestingly, their conclusions converged with those of the Fund; they had observed that the problem of unemployment could only be fought with sustained growth, labor flexibility, structural reforms, and a higher rate of growth in capital stock to allow expanded investment by enterprises.

The meeting had then focused on the economic policies to be pursued in the OECD countries, the comments made having been similar to those heard during the Interim Committee meeting and the Executive Board's discussion of the world economic outlook, the Managing Director remarked. A number of speakers had commented that current account imbalances would remain excessively high, given present policies and exchange rates, and some had called for further adjustments in the exchange rate system. But the thrust of the discussion had been on the need to narrow the gap between the rate of growth in the United States and that in countries like Germany or Japan, which had almost eliminated inflation but had not placed emphasis on regaining momentum in domestic demand. A common theme of the discussion had been the expectation that interest rates should decline further, to the extent that inflation, inflationary expectations, and monetary conditions permitted.

The discussion of structural policies had been especially interesting, with a number of Ministers having stressed agricultural policy in that context, the Managing Director added. Several speakers had stressed that developing countries were not in a position to compete with developed countries that had built up large surpluses as a result of their subsidization of agriculture: those subsidies amounted to $20 billion in both the United States and in Europe, and one third of the value added in agriculture in Japan was subsidized. In addition, some speakers had set forth in detail their views on the need to reduce the role of government in the economy. Finally, Mr. Dunkel, Director-General of the GATT, had explained the procedures for moving forward with the multilateral trade negotiations, which should be launched by mid-September; the OECD communiqué indicated that in terms of the monitoring of protectionist measures, a standstill was quite viable, although it was of course necessary to act to roll back with respect to measures that would dovetail into the negotiations.

In Geneva, where he had answered questions at a luncheon for some 20 ambassadors representing developing countries, the launching of those trade negotiations had also been of great interest, the Managing Director noted. The debt strategy had also been a matter of interest.

His address on April 22 to the Swiss Institute of International Studies in Zurich on the role of commercial banks in the debt strategy, the text of which had been circulated, had been followed by an informal dinner session, at which he had explained the Fund's current activities to Swiss bankers, the Managing Director concluded. They had shown special interest in the more practical aspects of the Fund's role, including the debt strategy.

2. INDIA - 1986 ARTICLE IV CONSULTATION

The Executive Directors considered the staff report for the 1986 Article IV consultation with India (SM/86/54, 3/6/86; Cor. 1, 4/16/86; and Sup. 1, 4/18/86). They also had before them a report on recent economic developments in India (SM/86/56, 3/14/86; and Sup. 1, 3/14/86) and an information notice on the real effective exchange rate of the Indian rupee (EBS/86/90, 4/23/86).

Mr. Sengupta made the following statement:

The Indian economy has been growing steadily over the last 10 years or so at an annual average rate of over 5 percent. During the Fifth Plan period (1974/75-1978/79), India's GNP grew at 5.2 percent. During the Sixth Plan (1980/81-1984/85), the annual average growth of GNP was 5.3 percent. The expected rate of growth for the Seventh Five-Year Plan (1985/86-1989/90) is also 5.2 percent. The annual growth of GNP during this period has made a sharp break from its historical trend of about 3.5 percent, reflecting a basic change in the structure of the Indian economy. Substantial progress was made in increasing agricultural and industrial production, the expansion of exports, and import substitution. Several structural reforms were undertaken to improve the overall efficiency of the economy. Financial policies succeeded in ensuring high rates of domestic savings and in containing inflation, as reflected in the decline in the wholesale price index from 21.4 percent in 1979/80 to 7.6 percent in 1984/85. The inflation rate further decelerated to only 3.6 percent in 1985/86.

The year 1985/86 has been a successful start to the Seventh Five-Year Plan. A number of policy initiatives were undertaken during this year to boost economic growth, reinforce antipoverty programs, revitalize industry, and provide a new direction in major policy areas. Several economic indicators showed significant improvement. GNP growth is expected to be about 4.5-5 percent as against an estimated 3.7 percent in the previous year. Growth in agricultural production is estimated at about 3 percent, despite drought in several regions of the country. Industrial output is estimated to have increased by as much as 6.6 percent. Close monitoring of prices, coupled with effective supply and demand management--including regulated imports and releases of sugar and edible oils, a strengthened public distribution system, and a cut in the Central Goverment's non-Plan expenditure--has helped to moderate inflationary pressures in the economy.

The year 1985/86 was also characterized by major policy initiatives in the fiscal area. In the 1985/86 budget the structure of direct taxes was rationalized with the aim of increasing revenues by combining reasonable rates with improved compliance. The personal income tax exemption was increased, the rate structure was simplified, and both personal income and corporate tax rates were reduced. Steps were taken to improve tax collection and compliance, and as a result revenues were expected to increase substantially. The revised estimates show that the performance was in fact better than envisaged at the beginning of the year. The revenues collected were 21 percent higher than last year and 10 percent higher than the budget estimates for 1985/86. Income tax collections, in particular, are estimated to be as much as 36 percent higher. This order of increase in direct tax collections is unprecedented. In addition, small savings collections were 23 percent higher than budget estimates and 32 percent more than in the previous year.

Taking advantage of buoyancy in tax revenues and the satisfactory behavior of other economic indicators, including the high level of food stocks, the Government decided to step up the Central Plan during the year by Rs 15.94 billion. The budget deficit as a result would be higher than budget estimates. However, the rate of growth of money supply has been contained and is, in fact, lower than in the previous year. The deficit has been absorbed by the economy without unduly affecting inflationary expectations.

The current year's budget estimates for total receipts are of the order of Rs 487.67 billion and for expenditures Rs 528.62 billion. Of this expenditure, Rs 223.00 billion would be for Plan outlay, which is a 20.5 percent increase over last year's budget estimates for the Plan. Net additional resource mobilization, including customs duties and other measures, would yield Rs 4.77 billion. This would leave an uncovered deficit of Rs 36.50 billion, which is significantly less than the deficit of Rs 44.90 billion for the previous year. In relation to the size of our economy and the stock of money, the deficit is considered by my authorities reasonable and noninflationary.

In the budget speech for 1985/86 a commitment was given by the Finance Minister of India to move toward a long-term fiscal policy (LTFP):

> The formulation of a budget is an annual exercise, but to be meaningful, it has to be set in a longer time frame. Our fiscal system has served us well. However,

> over the years, objective conditions have changed calling for new responses. I am quite aware that it is not possible to usher in all the changes at one stroke, yet we have to initiate a process of reform which can be completed in a phased manner in a time-bound frame. We will be moving toward the formulation of a long-term fiscal policy coterminous with the [Seventh Five-Year] Plan.

Accordingly, the long-term fiscal policy was announced in December 1985. The LTFP provides a long-term perspective to the formulation of fiscal policy and adds direction and coherence to the annual budgets. It accords a greater role for rule-based fiscal and financial policies and less reliance on discretionary, case-by-case administration of physical controls, and it emphasizes the importance of increasing public sector surpluses to finance the Seventh Plan thus reducing the need for domestic borrowing.

The primary thrust of the current year's budget (1986/87) has been to implement some of the elements of the LTFP. While last year's budget focused on the reform of direct taxes, the present budget contains a proposal for the overhaul of the system of excise taxation by introducing a modified value-added tax (MODVAT) to reduce the cascading effect of multipoint excise levies. In addition to MODVAT, a number of measures have been introduced in the budget in line with the LTFP to rationalize the tax structure further. These include the placement of investment allowance by an appropriate funding scheme, more liberal provisions for depreciation, elimination of surtax on corporate incomes, relaxation of capital gains tax, and gift tax exemptions. There has also been a rationalization of customs duties. Similarly, measures were taken to improve the surpluses of the public sector, in particular through substantial increases in the prices of their products. These included increases in the prices of petroleum products, which are expected to yield Rs 5.3 billion; coal prices were raised by about 14 percent, fertilizer prices by about 10 percent, and issue prices of wheat and rice to the public distribution system by 10.5 percent and 6.5 percent, respectively. Increases in the prices of fertilizers and foodgrains would contribute to a reduction of subsidies.

The Government's commitment to controlling expenditure is also demonstrated by the successful control of the States' overdrafts. In addition, acceptance by the Government of the principle of monetary targeting would help contain expenditures by bringing about a better coordination between fiscal and monetary policies.

A noteworthy development in the monetary field in 1985/86 has been the low growth rate in money supply compared with 1984/85 or any of the preceding three years. Expansion of

M3 stood at 14.9 percent compared with 18.7 percent in the previous year. The growth of narrow money--M1--has been markedly subdued at 8.1 percent as against 19.9 percent in the previous year. This deceleration in monetary expansion has been brought about by a monetary policy that included the raising of the statutory liquidity ratio, and appropriate credit planning. My authorities intend to continue the cautious monetary policy in the coming months so as not to generate any inflationary pressures.

Turning to the external sector, during 1985/86 the foreign exchange reserves excluding gold and SDRs rose by about Rs 5.7 billion. However, developments in external trade during the year have not been particularly satisfactory. Imports, based on the first eight months' data, grew substantially at 22 percent--though at a rate less than that in the corresponding period of the previous year--while exports net of crude oil rose at about 9 percent, with a pickup in recent months. My authorities are aware that it is essential to improve export performance for the financing of necessary imports to ensure the targeted economic growth in the Seventh Plan while maintaining a prudent level of external borrowing. The Government has accepted and implemented most of the major recommendations of the high-powered Trade Policy Committee to which I referred in my statement last year (EBM/85/27, 2/22/85). These include the announcement of a three-year import-export policy rather than an annual policy as was the earlier practice, exemption from income tax of 50 percent of profits earned from exports, decanalization of over 50 items, merging of the automatic permissible list of imports with the open general license list, introduction of a new import-export passbook for manufacture exporters to provide duty-free access to imported inputs for export production, transition from quantitative restrictions to import tariffs wherever possible, as well as reduction of customs tariffs on imported capital goods in which there is no indigenous production. In the budget for 1986/87 several incentives for export promotion were announced, including fiscal concessions to several items--ranging from the removal of export duty and the reduction in import tariffs to raising the rates of duty drawback and excise relief. One of the recommendations of the Trade Policy Committee was that the real effective exchange rate should not be allowed to appreciate and should be maintained at a level considered appropriate for ensuring competitiveness of exports. My authorities consider that the exchange rate is only one of the variables for bringing about medium-term balance of payments equilibrium. They intend to pursue the realistic exchange rate policy which they have been implementing in the past, and in this context it is noteworthy that the rupee depreciated in real effective terms by about 11 percent in the period February 1985-February 1986.

The year 1985/86 has witnessed a number of industrial policy initiatives that reflect a continuation of the trend in rationalizing industrial policies under way since the beginning of the decade. In March 1985, the Government announced the delicensing of 25 broad categories of industries. For some industries still subject to industrial licensing, the facility of "broad-banding" was accorded to allow them to make rapid changes in their product mix. Broad-banding was extended in stages and by the end of January 1986 covered some 28 industry groups. Toward the end of 1985, the Government also announced a scheme of automatic capacity re-endorsement to all licensed units that had achieved 80 percent of their capacity. Substantial relaxation was introduced in the operation of the Monopolies and Restrictive Trade Practices Act (MRTP) by exempting several industries from its purview. The asset threshold for a unit to be treated as an MRTP company was also increased fivefold in 1985.

My authorities feel that the liberalization effected in the last year or so in industrial licensing and regulation and in trade policy and the initiatives taken in fiscal and monetary policies have been substantial. They have helped to create a favorable economic climate, as evidenced by the remarkable buoyancy exhibited in the stockmarkets and by the increases in the granting of letters of intent for setting up industries, in the approval of foreign collaboration, and in the disbursement of term loans by financial institutions. There has also been considerable improvement in industrial relations. My authorities intend to consolidate the gains of all these efforts.

The medium-term scenarios developed in the staff paper indicate a possibility that the debt service ratios may rise beyond 20 percent in the next few years, given the need for external resources to maintain a minimum level of per capita income growth. My authorities intend to keep the debt service burden within manageable limits. India will need continued inflows of external resources for quite some time to come, and a quick switchover from being a recipient of substantial concessional assistance to a borrower of high-cost resources would be a matter of serious concern. India has reached a stage where persistent efforts to ameliorate poverty have begun to show positive results. The percentage of the population below the poverty line is estimated to have come down from 48 percent in 1976/77 to 37 percent in 1984/85. A major objective of the Seventh Five-Year Plan is to bring down the proportion of the poor to 26 percent by 1989/90. However, India will still have more people in absolute poverty--about 200 million in 1990--than in all of sub-Saharan Africa. The World Bank's Task Force on Concessional Assistance has reaffirmed that poverty should continue to be a primary criterion for allocating concessional development assistance. We would consider, therefore, expansion of concessional assistance from bilateral donors and multilateral institutions as most essential for India to achieve adequate growth to ensure poverty alleviation, while maintaining its traditionally prudent economic policies.

Extending his remarks, Mr. Sengupta noted that the most recent data indicated that foreign exchange reserves had stood at Rs 73.84 billion at the end of 1985, amounting to more than five months' imports. The liberalization measures implemented by the Government had been reflected in the buoyancy of the private sector: there had been a 57 percent increase in the equity price index from March 27, 1984 to April 11, 1985. Letters of intent, which were granted to industry when it wished to establish new units, had increased by 43 percent; similarly, approvals of foreign collaboration had also increased by 36 percent in one year. There had also been a substantial increase in capital issues and disbursements of term loans by financial institutions to the private sector.

Mr. Ismael observed that the Indian economy in 1985/86 had been satisfactory in many respects, despite unfavorable external circumstances. Growth was estimated to have been significantly higher than in the previous year, while inflation had experienced a downward trend. To a large extent, those developments demonstrated the crucial role of the authorities in bringing about much needed policy adjustments. He commended the Indian authorities for their political courage in instituting a number of reforms in many areas, particularly taxation, industry, and finance.

Nevertheless, an element of uncertainty concerning the objectives of the Seventh Plan remained, Mr. Ismael continued. In essence, the Plan aimed at an average growth rate of 5.2 percent a year for 1985/86-1989/90. Achievement of that target would presumably be supported by annual export growth of 6.8 percent in real terms, while investment and savings were targeted to increase substantially compared with the actual results of the Sixth Plan. As a consequence, the current account deficit in relation to GDP was expected to remain unchanged from the level realized in the previous Plan. That perspective, however, implied a sizable foreign borrowing requirement, resulting in an increased debt service burden toward the end of the Seventh Plan period and beyond.

The consistent framework in which the Seventh Plan had been formulated and the broad outline of the policy stance that had been adopted to achieve the stipulated targets were impressive, Mr. Ismael commented. However, the Plan's growth target, which was expected to be achieved by an export-led growth strategy, might be somewhat optimistic in view of current volatile global developments. Although some of the necessary structural adjustments had already been implemented in support of a sustainable growth strategy, the impact of continued stagnation in the commodity markets and of unresolved protectionist measures could not be underestimated. In the event that export earnings should fall short of the targets, the authorities, to be on the safe side, should be ready to revise the Plan's objectives, and the early preparation of such a contingency plan could be useful. Furthermore, he wondered whether a critical look at India's future debt profile--especially in relation to the commercial borrowing component--together with the objective of improving the debt structure, might not be the proper course for the formulation of the overall external debt management policy.

Exports played a dominant role in the Seventh Plan, despite the unfavorable experiences of the previous Plan, Mr. Ismael remarked. Notwithstanding the authorities' commendable achievement in containing the current account deficit to 1.6 percent on average during the Sixth Plan and to 1.5 percent of GDP in 1985/86, the substantial slowdown in the volume of exports and the ensuing decline in the share of exports in world trade were causes for concern. Since export competitiveness would inevitably be the main policy thrust of the Plan, he welcomed the satisfactory progress made in that respect during the past year, including the alleviation of bottlenecks in inputs through a more liberal attitude toward imports, a progressive reduction of administrative obstacles, and an improvement in the quality of traded goods. His chair hoped that the authorities would be encouraged to pursue their present policy of perseverance and, concurrently, to exert more effort on market diversification. The authorities' willingness to pursue a flexible exchange rate policy was also welcomed.

The realization of the Plan's growth target required a major upswing in investment and domestic savings, Mr. Ismael said. With respect to the savings of the central government budget, the positive response to the initial reform of direct taxes in 1985/86 was praiseworthy. The revenue effect was more favorable than anticipated in spite of across-the-board reductions in statutory tax rates and more liberal exemption limits. His chair also fully supported the recent reform of excise and customs duties; in particular, the restructuring of customs duties, accompanied by a steady reduction in quantitative restrictions, should eventually result in more efficient production through a lower degree of protection.

There had been a substantial slippage in central government expenditures in 1985/86 as a result of the July, December, and March supplementary budgets and the rising level of food and fertilizer subsidies, Mr. Ismael noted. In an attempt to reverse that trend, the authorities had adopted a somewhat tighter budget for 1986/87, which envisaged a cut in expenditures on subsidies, grants, and loans. That fiscal stance--together with the continued restrictions on the states' access to the Reserve Bank's overdraft facilities and the preclusions of use of the supplementary budget--was crucial for the successful generation of budgetary savings. There was considerable scope for dealing with the financial problems of the public enterprises, particularly the non-oil enterprises. Indeed, past experiences with the oil sector should guide the authorities in the implementation and design of corrective measures.

With respect to the mobilization of private savings and the role of the financial system, past adjustments of interest rates had achieved the desired results, Mr. Ismael commented; he therefore urged the authorities to explore further means to reduce rigidities in the rate structure. Because of the limited market for financial instruments and the sizable budget deficit to be financed, his chair recognized the difficulty of complete liberalization of interest rates. Nevertheless, the appointment of a committee to study the working of the financial system was, in itself, valuable.

The pace and design of the industrial restructuring that had taken place thus far were impressive, Mr. Ismael observed. The consistency between tax reforms and the objectives of industrial structural adjustments could perhaps be maintained in order to ensure proper incentives for the transfer of technology, the efficient utilization of resources, and the maintenance of the competitive stance of industry. In conclusion, he supported the proposed decision.

Mr. Suraisry said that he was in broad agreement with the staff assessment and endorsed the proposed decision. Over the past few years, India had been successful in achieving high rates of economic growth and lower inflation while maintaining a viable balance of payments position. In the past year, the Indian authorities had intensified their efforts in support of the policy direction initiated during 1981-84 under an extended arrangement with the Fund. That continued commitment to carry forward the process of economic liberalization and to maintain the momentum of growth beyond the Fund program period was exemplary. As he had indicated on previous occasions, it was important to sustain adjustment efforts beyond program periods, so as to consolidate achievements, increase confidence in the economy, and create an environment conducive to sustained growth.

Recent experience in India underscored that important point, Mr. Suraisry continued. In 1985/86, for example, inflation had been further reduced and real GDP growth had continued and accelerated. In addition, the prospects for 1986/87 were for continued satisfactory growth and lower inflation. He commended the authorities for those achievements; however, more remained to be done. In particular, further efforts were needed to address the remaining structural weaknesses, the large budgetary deficit, and the weak export performance.

Administrative controls, including heavy reliance on industrial regulation and import control, had prevented Indian industry from reaching its full potential, Mr. Suraisry commented. The authorities were aware of those weaknesses. The recent introduction of structural reforms in the areas of industrial licensing and import liberalization, together with tax and financial reforms, were indeed impressive. However, further efforts were needed, particularly to achieve the growth and export objectives of the current Plan. As suggested by the World Bank, improved access to technology, greater reliance on the private sector in investment efforts, and a higher degree of liberalization were key elements of the success of the Indian industrial development strategy.

The central government budgetary deficit in 1985/86 had been high, Mr. Suraisry noted. While private sector savings had grown strongly, public savings had declined in relation to GDP, and the public sector savings-investment gap had widened. As a result, the public sector had not only claimed all private sector excess savings but had also in effect increasingly absorbed foreign savings. That trend must be reversed, particularly in view of the increased emphasis on private sector participation in the investment effort. He therefore welcomed the commitment to reduce the budget deficit to 8.7 percent of GDP in 1986/87. It was also encouraging that those efforts were being supplemented by a major tax reform. He commended the authorities' decision to restructure direct taxes, decrease reliance on indirect taxes, and overhaul administrative procedures. Such measures would help to create an environment that would foster private sector growth and reduce tax evasion.

Improvement in the public sector financial position would be enhanced by the strengthening of the performance of public enterprises, Mr. Suraisry observed. Since the growth in the savings of the oil sector enterprises was likely to be smaller than in the recent past, improving the financial discipline of non-oil enterprises was all the more important. A flexible pricing policy and cost-saving measures--including high rates of capacity utilization and improved labor productivity--were essential. The Government was aware of the need to strengthen the financial position of the public enterprises and, had taken commendable measures, including flexible pricing and the establishment of a monitoring system.

The new shift in the direction of fiscal policy toward a long-term approach was impressive and should ensure policy continuity and facilitate the achievement of the authorities' medium-term objectives, Mr. Suraisry said. It would also foster an environment of stable expectations conducive to enhanced private sector development.

The export performance continued to be weak, resulting in a sizable loss of market share, Mr. Suraisry stated. Priority should be accorded to improving export performance so as to achieve faster growth and avoid external debt problems. As shown in the staff's medium-term scenarios, even under fairly optimistic assumptions, the achievement of the Plan's objectives would require high levels of commercial borrowing with an adverse impact on the debt-servicing ratio, although the authorities, as stated by Mr. Sengupta, were committed to keeping commercial borrowing at manageable levels. A number of measures recently introduced and the efforts under way to improve the efficiency of the economy and to liberalize the trade system should stimulate exports. Furthermore, the recent depreciation in the real effective exchange rate and the declared policy of exchange rate flexibility should safeguard India's competitive position. But for those efforts to succeed, India's trading partners must lower their trade barriers to the country's exports.

In the monetary area, Mr. Suraisry continued, the financial system had traditionally been directed toward meeting the financing needs of the Government. Enhanced control over central government expenditure and improved financial management of public sector enterprises should facilitate the task of conducting monetary policy and keeping inflation under control. The replacement of selective credit controls by general controls would improve the allocation of credit and increase the effectiveness of monetary policy. Overall, monetary policy had been managed skillfully and had achieved the twin objectives of controlling inflation and generating savings.

The Indian authorities had once again demonstrated their commitment to adjustment with growth, Mr. Suraisry said. In the process they had achieved remarkable success in redressing some of the economic problems they had faced; the remaining problems were being actively monitored. He commended the authorities for those achievements.

Ms. Bush remarked that the staff report described the basic economic strategy of the Indian authorities as one that emphasized prudent financial policies, complemented by structural reforms. The authorities correctly characterized the implementation of the strategy as a "continuing process." Prudence in financial policies must be a constant in the management of all economies. Structural change, particularly in the context of India's history of heavy administrative involvement in the economy, was crucial to success. There might be a resistance to change and, therefore, persistence was required to bring about the successful structural adjustment that was needed for continued improvement in the Indian economy. There had been progress: prudent financial management had contributed to a high rate of real economic growth; the rate of inflation had been brought down substantially; employment growth in the organized sector had been fairly substantial; and the current account deficit of the balance of payments had been kept to about 1 1/2 percent of GDP in each of the past six years. Indeed, the staff had cited the commendable degree of financial stability as providing a favorable environment for the desired acceleration of structural change; she concurred with that view, but remained concerned about the fiscal situation.

Some advances had been made in the structural area, including tax reform, industrial deregulation, and import liberalization, Ms. Bush continued. Yet the staff's analysis of the extent of liberalization and deregulation--and of their effects--was subject to many caveats and qualifications about progress to date. For example, the staff reported that shortages still existed in some industrial sectors, that imports of most consumer goods were banned, and that the banks were faced with a portfolio investment requirement equal to 37 percent of their deposits. Obviously, the Indian economy remained subject to administrative controls that could not help but reduce the responsiveness of the economy to future economic opportunities. She welcomed Mr. Sengupta's statement that letters of intent had increased by 43 percent, but she regretted the administrative complexity associated with their issuance.

Over the medium term, the achievement of adequate economic growth with a sustainable balance of payments and external debt situation was not assured, Ms. Bush observed. A continued adequate growth rate would depend on two factors: the savings/investment balance and reforms in the industrial sector. Recent data showed a rather high level of domestic savings and investment in India, but with a tendency for the public investment ratio to rise while the public savings ratio fell; in the private sector, the pattern was reversed. It would be interesting to know what those shifts in the public and private savings/investment patterns portended, in terms of the need to stimulate economic diversification, technological change, and export growth. Exports had increased significantly--9 percent--in the past eight months, and she wondered what factors were responsible. Continued industrialization and diversification of the economy would also require a further substantial dismantling of administrative controls, such as industrial licensing, some elements of the antimonopoly regime, and the exclusive production rights given to small businesses in some areas. There was also room for improvement in the climate for foreign investment and significant scope for further import liberalization; she would be interested in hearing Mr. Sengupta's views about actions that might be planned in those areas. She welcomed the 36 percent rise in approvals of foreign collaboration, although she continued to regret the controls on foreign direct investment. The increase in approvals could be an indicator of improvement in the investment climate, but administrative complexities were still a hindrance to increased foreign direct investment.

A reduction in the fiscal deficit and reforms in the public sector would continue to be important, both for maintaining an environment of financial stability and for favoring greater efficiency in business enterprises, both public and private, Ms. Bush commented. The continuation of large deficits in the central government and consolidated central and local government accounts, as well as on the books of many public enterprises, limited the financial resources available in the public sector for future investment and tended to pre-empt resources that might otherwise be employed productively in the private sector. The deficit in the consolidated budget accounts had tended to creep up from about 9 percent of GDP in 1980-82 to about 11 percent in 1984-86. Both the revenue and expenditure ratios to GDP had trended upward in recent years, increasing the relative size of the public sector. Similarly, in the public enterprise sector, the excess of investment over savings had fluctuated around a high range of 6 1/2-7 1/2 percent of GDP. Progress had been made on the revenue side of the fiscal accounts, both in collecting taxes and in reducing the disincentive effects of the tax system. Positive steps had been taken in the 1985/86 and 1986/87 budgets to cut high corporate and personal income tax rates, reduce wealth and capital gains tax rates, eliminate the corporate surcharge and surtax, broaden the tax base by reducing deductions, provide tax relief to low-income groups by raising tax exemptions, and simplify the personal income tax by reducing the number of tax brackets. The authorities had also begun the simplification of excise taxes and customs duties. In addition, the Government's December 1985 statement on its long-term tax policy stance should help households and businesses to plan for the future with a greater degree of assurance. Those measures would have a stimulative effect on the economy and would contribute to the buoyancy of the private sector.

The rise in interest payments on the public debt and in subsidies--especially for food and fertilizers--had accounted for a substantial part of the growth of expenditures, Ms. Bush noted. She concurred with the staff's suggestion that a reversal in the growth of subsidies and the avoidance of supplemental budgets would help considerably to limit and reduce the deficit. Cost reduction, greater managerial efficiency, and realistic pricing policies would also help to strengthen the financial position of the public enterprises.

Less progress seemed to have been made in the reform of the financial system, Ms. Bush remarked. Monetary policy continued to be constrained by the need to help finance large public sector deficits. Although interest rates and financial instruments seemed to have become more attractive for savers, interest rate inflexibility could still impede the mobilization of savings and efficient investment. A substantial degree of monetary rigidity continued in the form of direct controls over banks' investment portfolios. The staff had noted that a report on the operations of the Indian monetary system had been completed, including recommendations for change, and that the matter was to have been discussed early in 1986. She wondered whether those discussions had been held and what had been the outcome.

The staff had calculated medium-term projections of the external accounts under different scenarios, Ms. Bush said. The Seventh Five-Year Plan (1985/86-1989/90) called for a GDP growth rate of 5.3 percent and growth of export volume averaging 6.8 percent over the period. The export volume assumption would represent a substantial rise above the 1.3 percent growth rate during the Sixth Plan and could constitute a weak link in the Plan's assumptions, although there was some recent short-term evidence to the contrary. In fact, improvement in the disappointing performance of exports under the Sixth Plan was correctly described by the staff as an "urgent task." Exchange rate flexibility, import liberalization, and containment of excess demand--especially by limiting the fiscal deficit--were important factors in reaching an acceptable export outcome. She wondered whether the export growth mentioned by Mr. Sengupta was sustainable. Perhaps growth of foreign direct investment might also play an important role. Admittedly, external factors, to which the Indian balance of payments was sensitive, would also be important--as shown in Table 7 of the staff report--but some of those variables could be positive. In fact, the reduction in interest rates and the recent decline in the world price of oil were important examples. Nonetheless, Scenario IV, which showed the effects of a decline to $15 per barrel in the oil price in 1986/87, was revealing; that scenario suggested that even with a correspondingly higher level of non-oil imports and a higher rate of growth of GDP by perhaps 1/2 percent, India would still fall short of its economic growth target during the Seventh Plan by about 3/4 percent each year if export growth was only 4 percent, instead of the 6.8 percent assumed in the Plan.

Another important assumption in the Seventh Plan was a substantial rate of foreign commercial borrowing, Ms. Bush observed. Her chair had believed for some time that India could take advantage of its good foreign credit rating to obtain capital from private markets to help finance trade and investment. The authorities had increasingly done so. Although it was essential that the economy significantly increase its export base on a more lasting basis, that had not been the case in recent years, so that the debt service ratio had doubled from about 9 percent of exports in 1980/81 to more than 18 percent in 1985/86. The Indian authorities seemed to recognize that the planned economic growth rate could not be achieved in the absence of better export performance. She hoped that recent developments were indicative of a trend of improved export performance and at the same time that import liberalization would proceed so that economic growth could be maintained in the context of an open and competitive environment.

Mr. Fujino commented that during the 1980s, significant progress had been made in several important areas in the Indian economy. Increased agricultural production, particularly in foodgrains, had added to the stocks of rice and wheat and had substantially reduced susceptibility to supply variations. Rapid growth of crude oil production had raised the rate of self-sufficiency in oil and petroleum products to about 70 percent. Such improved productivity in key sectors of the economy would provide a more solid basis for future economic growth. Liberalization and deregulation in industrial and trade policy pursued under the extended arrangement with the Fund during the period 1981-84 had also created a favorable environment for higher productivity in industry. From a somewhat shorter perspective, economic growth had continued in 1985/86, the rate of inflation had remained under control, and the growth of money supply had slowed.

However, weaknesses remained in various aspects of the economy, Mr. Fujino noted. Resource mobilization in the public sector remained inadequate because of the narrow tax base, insufficient expenditure control, and poor financial performance of public enterprises. Export growth had been sluggish, and a recent increase in the debt service ratio and in external commercial borrowing posed a potentially serious challenge to the authorities in debt management. The supplement to the report on recent economic developments showed that India's share of world exports had declined from 2 percent in 1950 to 0.5 percent in 1984, manifesting a long and deep-rooted inefficiency in the economy, although the 9 percent growth rate of exports in the past eight months was reassuring. Nevertheless, that inefficiency was also reflected in the extremely low capacity utilization of basic industries, with that of electricity remaining at about 50 percent. Severe poverty and a large and growing population underscored the need for accelerated economic growth, which could not be brought about without properly addressing the economy's structural problems. Great strides had been made in key sectors--food and energy--and policy adjustments were in progress toward more market-oriented economic management. The reinforcement and acceleration of policy efforts in that direction were crucial to the realization of the high growth potential of the Indian economy.

The central government deficit in 1985/86 had been large and indeed much higher than that of the previous fiscal year, Mr. Fujino remarked. As implied in the supplement to the staff report, that result might have been expected; however, to the extent that it had been caused by expenditure slippages, much stronger expenditure control--particularly with regard to food and fertilizer subsidies--seemed to be needed. Expenditure control in coming years would become more important, given the high resource mobilization of the public sector that was envisaged for the Seventh Five-Year Plan. A commitment to a long-term fiscal policy, as mentioned by Mr. Sengupta, rightly emphasized the importance of increasing the public sector surplus. Curtailment of overdraft facilities to the state governments was a step in the right direction, but much more would be needed. On the revenue side, tax reforms implemented in the previous year had helped to streamline the tax structure and widen the tax base. The authorities' December 1985 statement on long-term fiscal policy should help to create a more stable climate for long-term business planning. Nevertheless, much stronger and stricter tax administration would be required to prevent pervasive tax evasion and to realize higher tax elasticity. Although some of the administered prices had been raised during the past year, state enterprises that had long been afflicted with overstaffing, improper pricing, and other inefficiencies needed further streamlining.

On monetary policy, Mr. Fujino continued, several steps had been taken during 1985/86 to reduce rigidities in the interest rate structure. In addition, the committee on the working of the monetary system, appointed by the Reserve Bank, had produced a report on the measures that could be taken to rationalize monetary control and to enhance the effectiveness of monetary policy. The recommendations should be implemented as fully and as early as possible; one complicating factor would be the implication on public financing. Although there might be a short-run adverse effect, in the longer run the effects would be beneficial not only on the effectiveness of monetary policy but also on public finance itself, as the improved efficiency of the economy stemming from flexible interest rates would strengthen the tax base and as the flexible and higher interest rates would divert funds from the unofficial economy. In other words, flexible interest rates were a prerequisite for the effective mobilization of resources for higher growth in the long run.

Indian industries were subject to wide-ranging and detailed regulations and interventions by the authorities, Mr. Fujino noted. Progress had been made toward liberalization under the extended arrangement with the Fund during 1981-84, and he welcomed the fact that the authorities had continued their efforts in that respect even after the termination of the Fund-supported program. But the question arose regarding the need for basic philosophical change toward a system of "free as a rule, and regulations only under exceptional circumstances" in future rather than piecemeal liberalization. He would welcome any comments from Mr. Sengupta on that point.

Ongoing deregulation in industry licensing and import restrictions was expected to have favorable effects on export growth through the enhanced efficiency of the economy, Mr. Fujino observed. However, such effects had not manifested themselves despite continuous efforts for some years by the authorities. Stronger efforts would be needed to improve quality control, product design, and delivery and to adopt modern technology for higher export growth. The more active presence of foreign enterprises and factories on the domestic scene might serve as a showcase for future development. Flexible management of exchange rate policy would also be important.

The Seventh Five-Year Plan envisaged a high growth rate on the assumption of increased public sector resource mobilization and a higher growth rate of export volume, Mr. Fujino said. While public sector resource mobilization might be achievable if proper policies were put in place with strong determination, there was considerable uncertainty as to whether the assumed export growth could be realized. In the second scenario by the staff, which assumed a more realistic rate of export growth and aid flows, the debt service ratio would rise to an unsustainable level, even if the oil prices envisaged were lower than the authorities' assumptions. Moreover, remittances from the Middle East might fall short of staff projections. Under the circumstances, it seemed advisable for the authorities to try to work within the maximum ceiling of $2 billion for commercial borrowing and aim at a higher growth rate only when increased exports and higher aid flows created room for additional growth. Indeed, for 1985/86 the authorities were taking a cautious approach by limiting the gross amount of commercial bank lending to $1.4 billion. The authorities should expedite structural reforms in industrial, trade, tax, and financial policies in order to achieve the badly needed high rate of growth.

He commended the Indian authorities' decision not to avail themselves of the use of the structural adjustment facility of the Fund, thereby allowing less endowed countries to utilize such resources, Mr. Fujino remarked. Finally, he supported the proposed decision.

Mr. Schneider said that the recently approved Seventh Plan represented an ambitious attempt by the Indian authorities to address deep-seated structural problems and to modernize the economy. Indeed, the goals of the far-reaching Plan could only be achieved if the authorities closely monitored developments in the economy over the years to come and continued to react flexibly in implementing the envisaged measures, together with those additional measures described by the staff.

The timing of the launching of the ambitious new strategy seemed to be appropriate, Mr. Schneider commented. By and large, recent economic developments had been satisfactory; progress had been made in the areas of economic growth, inflation, and the balance of payments. India had also succeeded in establishing a better balance between investment and domestic savings that compared favorably with levels in a number of other developing countries. Nevertheless, given the favorable external environment and the ongoing structural reforms to promote efficiency and reduce distortions in resource allocation, there remained room for a further increase in the level of investment and domestic savings.

There were, however, areas that gave cause for concern because they could endanger the goals of the Seventh Plan, Mr. Schneider continued. The poor export performance could lead to a serious weakening of the balance of payments and the public sector finances. The export sector's performance had been inadequate, although the overall external situation had been relatively comfortable. Under those circumstances, an increase of India's export earnings, particularly for nontraditional goods, would require the continuation of a flexible exchange rate policy as well as other factors--such as the use of modern technology, economies of scale, and quality control--which could increase the profitability of the export sector. He welcomed the recent pickup in exports.

The level and trend of the central government budget deficit was a matter of concern, Mr. Schneider remarked; the latest estimate for 1985/86--10.3 percent of GDP--was disappointing. Despite new tax measures and revenue collection procedures, and a wide range of administrative price increases, slippages in expenditures had resulted in the highest deficit in the past five years. He therefore welcomed the intention to reduce the budget deficit for 1986/87 to 8.7 percent of GDP. Long-standing structural problems in the public sector were the main cause of the deficit, but there was still some room for maneuver in controlling expenditures and increasing revenue collection, even if one agreed with the authorities' interpretation that the economic impact of the increased budget deficit had not been inflationary as it had been financed through both small private savings funds and the issuance of small savings bonds.

Nevertheless, Mr. Schneider continued, a deficit of such magnitude contradicted the general framework of the economic stance of the Government, and crowded out private sector activities. The solution to the deep-rooted problem lay on the revenue side rather than the expenditure side. While the expenditure/GDP ratio--about 20 percent--was average compared with other developing countries, total revenues were far below average and warranted the authorities' efforts. The ongoing and proposed reforms of the tax system were most welcome because, if effectively implemented, they would help to increase revenues in the medium term.

India's new economic strategy, together with better external conditions could considerably reduce the long-standing weaknesses in the economy, Mr. Schneider concluded. Moreover, the authorities' efforts would contribute to a viable balance of payments situation, a sustainable growth rate, and an improvement in the living conditions of the Indian people.

Mr. Goos said that he welcomed India's medium-term reform program, which as part of the Seventh Five-Year Plan aimed at tackling deep-seated structural problems and modernizing the economy through intensified liberalization efforts. While a number of important and commendable measures--such as the major tax reform--had already been taken, much remained to be done, and he encouraged the authorities to adhere firmly to the chosen path in the coming years. In particular, the growth potential would greatly benefit from further liberalization of industrial and trade policies and of the financial system, including more extensive liberalization of interest rates and the abolition of selective credit controls. The fact that the recent restructuring of customs duties had led to an increased level of protection in the domestic capital goods industry gave cause for concern and seemed inconsistent with the thrust of the reform strategy.

The key medium-term issue was the mobilization of domestic savings and the generation of adequate export earnings while maintaining a prudent external borrowing policy, Mr. Goos remarked. Finding the appropriate policy response to that issue was certainly not facilitated by the ambitious economic growth target of 5.3 percent a year pursued by the authorities. The information provided by the staff clearly indicated that the efforts to generate higher savings must concentrate on the public sector. While that assessment appeared to be shared by the authorities, he was concerned about recent fiscal developments that showed a historically high central government deficit for 1985/86. It was worth noting, however, that the increase in the deficit did not reflect the impact of the reform policies introduced the previous year; on the contrary, as Mr. Sengupta stated, fiscal revenues had responded favorably to the policy initiatives of 1985/86. Accordingly, apart from the deliberate increases in fiscal expenditures, the widening in the Central Government's budget deficit could be largely attributed to weaknesses in expenditure control and in export performance rather than to recent reforms. Therefore, the authorities should address those weaknesses as a matter of priority, and, rather than slowing down the pace of reform, that process should focus increasingly on those areas where progress had been lagging thus far.

The swing from a positive to a negative contribution by the Central Government to plan financing that appeared to be projected for the next four years was surprising, Mr. Goos commented. Continued and determined efforts to reduce current expenditure should free additional resources from the central budget as well. It was noteworthy that some current expenditure items still showed substantial above-average increases in the budget proposal for 1986/87. He welcomed the latest information that the authorities intended to reduce the growth in total expenditure--plus net lending of the Central Government--to only 4 percent in 1986/87, compared with 22 percent in 1985/86. Experience proved that achievement of that goal would also require close monitoring and continued efforts to improve the financial position of state governments--a task that should be considerably facilitated by the recent decision to limit their recourse to overdrafts with the Reserve Bank. Of course, state budgets could hardly be seen in isolation from the performance of public enterprises. The Government's plan to cut costs and raise income through a flexible pricing policy, increased efficiency, and higher labor productivity and capital utilization--including the closure of unprofitable units--was a step in the right direction and deserved full support.

He welcomed the adoption of a long-term fiscal policy approach, which, by providing a stable and predictable framework for the conduct of economic policies, should considerably improve the climate for domestic savings and investment, Mr. Goos stated. That beneficial effect would be enhanced by the implementation of monetary targeting, which seemed to be under active consideration by the Government. His own Government had achieved impressive results through such policies, and he encouraged the Indian authorities to vigorously pursue the long-term policy approach upon which they had embarked.

With regard to the external sector and the medium-term balance of payments projections, Scenario I--which was consistent with the current Five-Year Plan--assumed an optimistic rate of growth for export volume and foreign aid receipts, Mr. Goos noted. Notwithstanding the encouraging information provided by Mr. Sengupta on the recent export performance, during the first year of the Plan the export target had been missed by a wide margin. In comparison, Scenario IV appeared to be more realistic, and it would also conform with India's traditionally prudent external borrowing policy. It would, however, imply a downward revision of the ambitious output growth target even under the revised assumptions on oil prices. Of course, actual developments could turn out to be more favorable, but since many of the underlying assumptions were beyond the authorities' control, it became even more important that cautious policies that aimed at strengthening India's export performance be pursued as a matter of priority, thereby increasing the scope for higher imports and growth without recourse to higher commercial borrowing.

He agreed with the staff's specific recommendations regarding exchange rate policy, import liberalization, and the domestic liberalization efforts required to increase efficiency and enhance competition in India's industrial and trading sectors, Mr. Goos observed. It was particularly important to achieve the speedy reduction and eventual elimination of widespread and numerous impediments to a more competitive private sector, notably a further reduction in the administrative regulations and controls that had in the past seriously hampered the utilization of productive capacity and created inefficiencies in resource allocation. It was reassuring to note from the staff report and Mr. Sengupta's statement that the authorities themselves were in broad agreement on the need for such policies and had in fact already begun their implementation. However, the time required until such reforms would yield lasting results should not be underestimated. He encouraged the authorities to resist the pressures of vested interests hostile to reforms and to press ahead with economic liberalization.

Mr. Massé remarked that in recent years, India had sought to increase economic growth while decreasing inflation and avoiding a deterioration in the external accounts; the results for the most part had been encouraging. During the past year, the Indian authorities had also undertaken a number of initiatives through the long-term financial plan and the Seventh Five-Year Plan to increase the efficiency and competitiveness of the economy. The realization of those reforms was crucial to reach the goal of noninflationary growth with balance of payments viability. Those initiatives had focused on the liberalization of markets and the reform of the tax system, and he endorsed the staff's recommendation that efforts in those areas should be continued. He was encouraged that the Indian authorities also regarded liberalization and reform as a continuous process.

Unfortunately, financial reform had lagged behind reform in other sectors, Mr. Massé observed. A viable and efficient financial market was indispensable for a well-functioning economy; it was essential for the effective mobilization and distribution of scarce credit and capital resources, and it played a valuable role in improving the scope and effectiveness of monetary policy. The Indian authorities had particular problems in that area, given their public sector financing requirement. However, those problems could be tackled through greater reliance on a flexible interest rate policy, a reduction in quantitative lending controls, and the use of market-related yields on government securities.

The eventual success of the Government's economic plan rested on effective resource mobilization and increased exports in the medium term, Mr. Massé remarked. With respect to public sector resource mobilization, it would be necessary to reduce expenditure as well as to increase revenue in eliminating the budgetary deficits. In particular, the authorities should reverse the trend in the growth of subsidies and prevent expenditure increases through supplementary budgets. The greatest scope for reducing expenditure lay in improving the financial performance of the non-oil enterprises. He encouraged the authorities to act resolutely in pursuit of their goals--which would also call for flexibility in pricing policies--and the states to make a greater effort at cost recovery by adjusting charges.

The alternative medium-term scenarios presented by the staff demonstrated the importance of increased exports for the success of the Seventh Plan and for improving the performance of the economy, Mr. Massé noted. The determinants of a successful export performance would be a flexible exchange rate policy, the implementation of thorough, effective liberalization and reform measures, and financial restraint in the public sector.

If the desired level of exports could not be achieved--and there was some reason to doubt that it would be possible to do so before the later years of the Plan--the Government would be well advised not to resort to import controls to achieve the desired balance, Mr. Massé stated. To do so would contradict the trend toward the liberalization of economic activity that was under way and that held out the promise of a higher growth path for the future. Instead of moving back to controls, the Government should lower its growth targets until such time as the structural changes on which higher exports depended had been effected. That temporary sacrifice would permit a higher average growth path for the medium and long term. Finally, he agreed with the proposed decision.

Mr. Lankester remarked that India's economic performance continued to be favorable by the standards of many other countries. Growth had been relatively high--about 5 percent a year--and steady when other countries had been experiencing wide fluctuations in their growth rates. The deceleration of inflation to only 3 1/2 percent over the past year was exceptionally impressive, especially as India had many of the structural and supply problems to which other developing countries ascribed their high inflation rate. India's good performance had been assisted by prudent economic management. Monetary expansion had moderated in 1985/86, and, by its cautious external borrowing policy, India had been able to avoid the debt-servicing difficulties and economic retrenchment experienced elsewhere. He commended the authorities for their continuing efforts.

But India remained an extremely poor country, and it was important--particularly for the sake of the over 200 million people who were still below the poverty line--that the Seventh Plan's growth objectives were achieved, Mr. Lankester continued. India's prospects seemed reasonably good. Over the past year or so, the Government had embarked on a new and encouraging phase of economic policy. The various reforms they had announced were welcome, but the Seventh Plan's objectives had the best chance of being achieved if the pace of reform could be speeded up.

The staff's description of the liberalization measures affecting industries and foreign trade indicated that the measures were not as far reaching as appeared at first, Mr. Lankester commented. Despite the impressive figures mentioned by Mr. Sengupta for the granting of letters of intent and approvals of foreign collaboration over recent months, the reform seemed to be implemented halfheartedly. A more efficient, faster growing industrial sector required further freeing up of the rules and regulations. At present, industry was still subject to a panoply of controls which, at best, caused delays and too often created supply bottlenecks, stifled enterprise, and rewarded inefficiency. The control system was also one of the main causes of India's large black economy, although he realized that some of the controls--such as those limiting the expansion of the largest companies and those designed to help the small-scale sector--existed partly for social reasons. Vested interests made it hard to move too fast, and in addition, over many years India had experienced constraints in freeing up its import regime because of concerns about the lack of foreign exchange. But the economic case for further liberalization on the industrial and trade front was incontrovertible, and he urged the authorities to move forward.

Despite the progress that had been made, there seemed to be a philosophical reluctance to reform the basis on which imports were controlled, Mr. Lankester remarked. Piecemeal changes, although on a fairly wide scale, had been designed to deal with particular problems such as exports and high-technology industries. Meanwhile, the basic concept of banning all imports of items that were supposed to be in adequate supply domestically remained intact. That system created high levels of protection, and the time had come for India to start moving to a more purely based tariff system.

The control system had been one of the factors holding back the growth of nontraditional exports and had thus contributed to the difficulties of export firms in the past few years, Mr. Lankester observed. He welcomed the information that exports had performed well in the first ten months of 1985/86; that development contrasted with the slow growth experienced over the preceding five years. It remained to be seen whether the Seventh Plan objective of an annual growth rate of 7 percent in volume terms could be achieved, although the authorities seemed to recognize the importance of reaching that goal. They accepted the need for a competitive exchange rate, undoubtedly noting that exports had grown rapidly in the 1970s in the wake of the depreciation of the real exchange rate in that period. Measures had been taken to provide exporters with better access to imported inputs, but he wondered whether they had gone far enough if India was to compete with Japan, Taiwan, and other Southeast Asian exporters. A franker discussion by the staff of the control system, as it affected exports and industry more generally, would have been helpful.

The authorities had taken the view that they should not try to make up for a shortfall of exports through higher commercial borrowing, Mr. Lankester said. In other words, they would accept lower growth rates; and although he agreed that that would be the right choice, it would be preferable not to have to make that decision. Incidentally, the staff's alternative debt scenarios were extremely helpful.

His authorities commended India for its decision not to avail itself of the resources of the structural adjustment facility, Mr. Lankester stated, but it was clear that India would continue to need large amounts of external assistance. The authorities had ambitious plans for domestic resource mobilization. In that context, it was disappointing that the central government budget deficit for 1985/86 was 10.3 percent of GDP--rather higher than expected a few months earlier. The authorities' view was that the adverse monetary effects of that deficit would be reduced to the extent that much of the increase in the deficit in recent years had been financed by private sector savings. That argument was not particularly compelling, as those private savings could have been used to finance higher private sector investment, which had been more profitable than public sector investment.

A reduction in the central government budget deficit was projected for the current fiscal year, and steps had been taken, through limiting their resort to the Reserve Bank, to ensure that the states' finances were brought under better control, Mr. Lankester commented. In seeking further reductions in the budget deficit, continued revenue-enhancement efforts would be required. The major tax reform introduced in the 1985/86 budget appeared to have been very successful in raising revenues; nevertheless, further measures to widen the tax base seemed to be needed. The indirect tax system was confusing and provided too many opportunities for evasion. The authorities' proposals to simplify customs and excise duties by consolidating the multitude of rates and exemptions were particularly welcome. He also commended the authorities for the longer-term approach to fiscal policy that they had announced in December 1985--a policy that would be helpful for private sector confidence.

On financial policies, the Chakravarty Committee proposals were still under consideration, Mr. Lankester noted. The large government deficit was undoubtedly one of the reasons why reform had been slower in that area than in others. A more market-oriented monetary system would certainly be consonant with the more market-oriented industrial and agricultural economy to which India was moving. He hoped that the authorities would be able to move toward greater emphasis on flexible interest rates rather than quantitative controls on the regulation of credit.

The staff had correctly emphasized the crucial importance of the performance of the public enterprise sector in improving resource mobilization, Mr. Lankester considered. Public enterprise savings were projected to rise to nearly 5 percent of GDP--twice the level achieved during the Sixth Plan--over the coming five years. In the recent past, the performance of the non-oil public enterprise sector had been generally weak. For example, the staff had stated that the resource generation of public enterprises had relied heavily on the oil sector, particularly the national oil company; elsewhere, profitability had been weak. There had been some improvement in the performance of the non-oil sector in 1984/85 and in 1985/86, but it was clear that there was considerable room for the progress that would allow the Government to achieve its resource mobilization objectives. He invited the staff or Mr. Sengupta to comment on the measures that the Government proposed in the area and on whether any consideration had been given to increasing the role of the private sector in public enterprises.

The authorities were to be commended for the steady growth that they had fostered without excessive resort to international borrowing, Mr. Lankester commented. The fall in oil prices and in interest rates should provide a favorable external background over the next few years. Nonetheless, the authorities would need to continue resolutely their program of structural reform if the Seventh Plan growth targets were to be achieved.

Mr. Romuâldez said that overall the Indian authorities deserved commendation; they had managed the economy effectively, although not always with the policies and institutional structures most conducive to efficiency but in a manner consistent with, and adequate to, the requirements of their strategies and targets. Economic growth had been maintained at 4.5-5 percent in 1985/86, and agricultural output had been raised close to record levels. Industrial output, although constrained by considerable regulation, had accelerated somewhat with some further progress in liberalization. In spite of a larger than targeted budget deficit and a too accommodative credit policy, the rate of inflation had been kept below 4 percent.

The authorities seemed well aware of what was required to achieve the accelerated growth rate envisaged in the Seventh Plan, and they broadly agreed with the staff, Mr. Romuâldez commented. They differed, however, with regard to the pace and timing of certain liberalization measures in various sectors of the economy. Given the authorities' relative effectiveness in the past, he tended to allow them the pace they had plotted out for themselves. As the latest information indicated, external developments--particularly in the oil market--had also been favorable.

Moreover, except perhaps on the issue of the budget deficit, the authorities had shown themselves generally willing and able to adjust quickly to contingencies.

Nevertheless, the staff's recommendations deserved serious consideration, particularly on matters pertaining to the development of the export sector and the management of external debt, Mr. Romuâldez continued. Furthermore, although past management had been relatively effective, the high degree of regulation of India's economy had allowed rigidities to set in that could create obstacles to the achievement of the Seventh Plan's accelerated growth targets. In particular, the unfavorable impact of the historically high--10.3 percent of GDP in 1985/86--budget deficit on the credit needs of the private sector could affect that sector's participation in bringing about growth. The effect would certainly compound a situation already rendered difficult by overregulation. He welcomed Mr. Sengupta's statement concerning data that indicated significant increases in private sector activity. The authorities' expressed intention to curb food and fertilizer subsidies, which had been increasing rapidly in the past two years, was commendable, as was their determination to exercise firmer control over non-oil public enterprises. He was also encouraged to learn of the plan to further relax industrial and import regulations as well as to include major reforms in the structure of direct taxation in the 1985/86 budget. Also significant--in the context of the goals of the Seventh Plan--were the staff recommendations concerning the reform of the financial system, which the authorities viewed as a necessary complement to their recent liberalization measures.

Performance in 1986/87 would bear careful watching, Mr. Romuâldez remarked. The ambitious targets incorporated in the Seventh Plan called for more heroic efforts in deregulation, resource mobilization and allocation, export development and diversification, and fiscal control. Without those, the economy's medium-term prospects could take a turn for the worse. The impact on the external accounts and on India's foreign debt position would be unfortunate. However, he was confident that the authorities would continue to manage the economy effectively. All the ingredients for success were present; the authorities were fully aware of both the appropriate courses of action that they must take, the constraints on the potential of their institutional structures and stood ready to make adjustments--temporary and ad hoc as well as more lasting--as required. He agreed with the staff's analysis and recommendations, although he could accept the Indian authorities' decisions on timing and pacing, without detracting from the urgent need for those reforms. He supported the proposed decision.

Mr. Finaish observed that for well over three decades, India had been pursuing the path of planned economic development in order to alleviate the extreme poverty of its large population and gradually provide for the private and public basic needs of its people. Traditionally, the growth process had been sustained to a great extent through national resources. The strategy employed had not only strengthened and expanded the economy's infrastructural and productive base through emphasis on medium and heavy industries, but had also given high priority to agricultural production, which should form the cornerstone of any poverty-oriented growth program. The three successive record levels of foodgrain harvest achieved in the recent past and the continued low rate of inflation--3.7 percent in 1985/86--had significantly facilitated the pursuit of the authorities' socioeconomic objectives.

However, with the backlog of poverty in the country and the present rate of growth of the population, the growth rate of the economy in 1984/85, as well as its historic trend, had been rather low; hence, the authorities intended to accelerate the growth process during the current Seventh Plan period, Mr. Finaish continued. The achievement of that objective would depend on the full utilization of the productive potential of the economy through further liberalization and reform, as well as the mobilization of additional national resources. To not tap fully national resources and to resort to large-scale commercial borrowing abroad would not only strain the external balance of the economy through increasing the debt service burden but would also mark a departure from India's commendable traditional policy of self-reliance. Therefore, it was important to emphasize issues of economic reforms and national savings in the context of the objectives of a high growth rate for poverty alleviation and a sustainable external balance.

The substantial role played by government in the economy over the years inevitably had led to, inter alia, a proliferation of regulations which the authorities had lately come to view as increasingly obstructive in their drive to enhance efficiency, production, and exports, Mr. Finaish remarked. The emphasis on regulatory management of the economy was believed to have hindered capacity utilization in the industrial sector and had contributed to keeping the growth rate of exports at less than 2 percent a year during the Sixth Plan period. Accordingly, the launching of the Seventh Plan in 1985/86 had been accompanied by a comprehensive package of deregulatory and incentive measures, which were deemed to have already contributed to increased capacity utilization in the industrial sector. The target of 7 percent annual growth in export volume during the Seventh Five-Year Plan period was an ambitious one, and would require the achievement of sustained implementation of appropriate export promotion measures. At a time when the market for traditional exports had slackened, encouragement of nontraditional exports would be of particular importance. Adequate export growth would be necessary for maintaining imports at a level consistent with a reasonably high growth rate of the economy and for minimizing foreign commercial borrowing. The continuation of an appropriately flexible exchange rate policy could facilitate that task. The authorities' efforts to promote exports would also be helped by a reduction in barriers against their exports in industrial country markets.

India deserved commendation for sustaining a high rate of national saving, which averaged 22.3 percent during the Sixth Plan period, restricting the external financing of investment to 1.6 percent of GDP, Mr. Finaish noted. That outcome was despite the low level of per capita income and the less than satisfactory performance of the public sector mainly due to subsidies and transfers to public enterprises. The authorities had been able to mobilize new resources through high real rates of interest from noninstitutional national sources, domestic as well as foreign, which would otherwise have remained untapped. He hoped that as a result of the implementation of the recommendations of the committee appointed by the Reserve Bank of India, the contribution of such resources to the country's growth effort would be further enhanced. The authorities rightly regarded that to be a noninflationary mechanism.

In the public sector, a major effort would be needed to generate the additional resources necessary for sustaining an accelerated growth process, containing the fiscal deficit, and restraining domestic demand pressures in order to minimize the external imbalance and commercial borrowing, Mr. Finaish commented. The three main areas for policy action were taxation, subsidies, and non-oil public enterprises. As regards taxation, the authorities had already initiated a far-reaching and long-term simplification and streamlining program through the measures announced in March and December 1985. That policy action had already had a salutary impact, and it was encouraging to note that the authorities intended to take further necessary action along those lines. Subsidies on food and fertilizer, which had formed 7 percent of total expenditures during the past fiscal year, posed a difficult problem in view of their bearing on the agricultural and social objectives of the Government. Hence, the authorities might wish to follow a cautious path and explore the advisability of confining the benefits of food subsidies to selected income groups only, although that policy would have some administrative implications. As regards public enterprises, the authorities had underlined their seriousness by targeting more than a doubling of the savings of that sector during the current Plan period and setting up a monitoring system to watch the progress of necessary measures in the areas of price adjustment, inventory management, and capacity utilization. That policy needed to be pursued vigorously and consistently. Finally, as pointed out by Mr. Sengupta, India continued to need an inflow of external resources, including concessional assistance, to sustain the process of poverty elimination and development.

Mr. Zecchini remarked that the discussion of recent economic trends and policies in India took place at an interesting time: the end of the Sixth Plan and the beginning of the new five-year plan. The Board had the opportunity to assess the achievements and weaknesses of the Indian economy in the past five years and on that basis to appraise India's chances of reaching the economic targets that it had set for the next five years. By looking at the record of the economy in the light of the Sixth Plan targets, it was apparent that India had succeeded in broadly achieving its goals in spite of a rather unfavorable external economic environment. In a period when the growth of the world economy had been disappointing, India had succeeded in attaining an annual rate of growth of real GDP of 4-5.5 percent, with agricultural production rising more than programmed and fixed investment expanding at a rate close to the target. At the same time, inflation had been halved compared with the rate prevailing at the beginning of the period.

The only major weakness in performance pertained to the external account, which showed a virtual stagnation of export volume, Mr. Zecchini continued. However, that had been matched by a scaling down of imports from the high planned target, indicating a model of economic development that relied basically on domestic incentives to growth and tended to shelter the economy from external depressing factors. There were signs of an increasing openness of the economy to the rest of the world in the next five years, which could help India to reach the target rates of output growth and fixed capital accumulation. In fact, in spite of the impact the declining commodity prices might have on the evolution of the terms of trade, the resulting lively expansion that was expected for the world economy might offer India unprecedented opportunities for surpassing the programmed goals.

In general, those goals did not appear overambitious, Mr. Zecchini considered. They took account of the new orientation of the planning authorities, who had followed the recommendations of the Fund Executive Board for continuous progress toward market and production liberalization, deregulation, and structural reform. Nonetheless, the achievement of the stated goals also depended to a large extent on the degree of caution that the authorities would apply in their conduct of budgetary, external trade, financial, and monetary policies.

Undoubtedly, fiscal policy was the area where substantial adjustments were needed that had the most far-reaching implications, as they might affect not only the level of aggregate demand but also industrial policy, price policy, fixed investment, and income distribution, Mr. Zecchini said. The fiscal deficit--both central government and general government --had steadily increased from 1981/82 to 1985/86, reaching a level that was, in terms of GDP, 1 percentage point higher than planned. For a country like India that had a compelling need to grow, even in the face of a stagnating world economy, the rise in the public deficit was not a negative sign by itself. That trend must instead be assessed in the light of the role of that deficit in stabilizing the business cycle and the contribution of expenditure and revenue policies to enhancing the development of the economy.

With regard to the evolution of the business cycle, he expected that in the coming year, once the level of economic activity had recovered, the authorities would aim at reducing the budget deficit, for example, by making appropriate use of supplementary budgets, Mr. Zecchini commented.

Major efforts had to be made to contain the relative expansion of expenditure devoted to mere assistance, while widening the portion directed toward fostering fixed capital formation, Mr. Zecchini stated. That applied particularly to public enterprises where reductions in subsidies and improvements in management must be sought. In that respect, however, an additional burden might derive from the oil industries. In the past, those industries had made an important contribution to the formation of savings in the public sector, while many non-oil industries had often recorded pretax earnings close to zero, such as the case of 179 state controlled non-oil enterprises in 1984/85. The recent weakening of oil prices in world markets might affect the profitability of the oil industry, thereby raising doubts about the expectation contained in the Seventh Plan that those enterprises would double their contribution--compared with the Sixth Plan--to gross public savings.

The need to contain expenditure and to increase its effectiveness would become even stronger if the recent tax reform should fail to ensure an adequate expansion of the tax base, Mr. Zecchini observed. He agreed with the principles underlying the recent tax reform, which would allow a less unbalanced revenue structure, reduce the area of tax evasion, and lower the degree of effective protection. However, it was not certain whether the recent buoyancy of tax revenue was bound to last if further progress in fiscal reform did not follow. There was a need for further rationalization of direct taxes, restructuring of indirect taxes, adjustments in the system of incentives, and a transition from quantitative controls on imports to tariffs.

Another example of needed reform was the cascade effect induced by the present tax on inputs for production, leading to a gap between nominal and effective tax rates on production, which differed between sectors and thereby created uneven incentives for import substitution and vertical integration in production, Mr. Zecchini continued. Those implications were not necessarily in line with the objective to promote efficiency and production. Therefore, the introduction of some form of value-added tax might improve the present situation, but it was not clear whether the proposed tax on a modified basis would prove to be at least revenue neutral, as it should be.

The development of the Indian economy would require an excess of imports over exports of goods and services and a reduced degree of protection of the domestic market, Mr. Zecchini stated. If that was the natural consequence of an accelerated approach to economic development, the external deficit might correspond to various levels of imports and exports. In that respect, it was important that during the period of the Seventh Plan, such a deficit should stem from much higher levels of exports and imports compared with the Sixth Plan period. The promotion of external competitiveness and exports might derive from the recent depreciation of the real effective exchange rate, the deregulation in industry, and the new deductions of indirect taxes. Further significant improvements in export performance would result mainly from increased diversification of export composition, which could be brought about by a more effective and innovative management of manufacturing enterprises. At the same time, import liberalization appeared to be an additional prerequisite for the stimulation of competition and efficiency at home. He encouraged the Indian authorities to pursue that course of action in light of those consequences, and moreover in the context of the forthcoming multilateral trade negotiations.

Liquidity had built up in the first part of 1985/86 and the monetary authorities had recently attempted to bring money supply in line with demand, Mr. Zecchini said. Besides supporting that less accommodative monetary stance for the current year, he invoked a bolder approach to reform of the monetary and financial structures and instruments, in parallel with fiscal reform. The gradual shift from selective credit control to "general" monetary instruments might reduce the inevitable inefficiencies in credit allocation that were embedded in the former system of control. Of course, that would involve greater interest rate flexibility, which could be confined to the shorter end of the financial markets as it would be used for better management of liquidity conditions. Moreover, it would be appropriate to reconsider the system of statutory liquidity requirements on bank deposits for the purpose of strengthening control over liquidity. For example, a reserve requirement in the form of monetary-based deposits with the central bank would make monetary management more effective and add more transparency to the financing of the Treasury's borrowing needs and to its financial implications.

He fully agreed with Mr. Sengupta's analysis of the consequences of India's economic development for the buildup of external debt, Mr. Zecchini concluded. He also agreed that in spite of some improvement in the general standard of living, poverty remained a widespread social condition that had to be relieved through inter alia external resources of concessional nature. India still needed large inflows of concessional assistance, and the transition to costly borrowed resources should be very gradual.

Mr. Wijnholds remarked that the Indian economy had performed well in recent years, and the basic aims of the Sixth Five-Year Plan had been attained. Growth had been satisfactory at 4 1/2-5 percent of GDP, the rate of inflation was under 6 percent, and a viable external position had been maintained. A particularly satisfactory development over the past years had been the vastly improved food situation, which could be attributed both to technical improvements--such as greater use of fertilizer and of high-yielding seeds--and to economic factors--such as higher procurement and support prices. Despite that good news and the steady rise in the standard of living of the Indian population in recent years, he wondered whether enough progress had been made. For example, he wondered why growth rates had been higher in neighboring countries, some of which faced similar problems relating to a huge population and the administration of a vast territory. No doubt, the authorities had also asked themselves that question. It was encouraging to see that they had embarked upon a course of more structurally oriented policies, which should improve the efficiency of the economy. Under the Seventh Five-Year Plan, the average annual growth rate was to increase to 5.3 percent, which would have substantial implications for living standards. He welcomed that aim and the increased emphasis on structural elements in Indian economic policy, and it was to be hoped that the new policies would be implemented fully and without much delay.

The greater emphasis being placed on the private sector was a positive development in the Indian economy, Mr. Wijnholds noted. The administrative deregulation and tax reform under way should encourage greater susceptibility to changes in supply and demand and promote the modernization of production. The authorities' more forthcoming attitude with respect to foreign direct investment was also commendable. The access to new technology thus provided, as well as the nondebt-creating nature of direct investment, should prove very helpful to India. The low inflation and relatively stable yet sufficiently flexible exchange rate should help to offer an attractive environment to foreign investors. Administrative complications and delays would of course work in the opposite direction, and more would have to be done in terms of deregulation to effectively remove that obstacle.

The results of macroeconomic policies were mixed, Mr. Wijnholds commented. The budget deficit had increased in relation to GDP. On the basis of the new higher figures for the central government deficit, the overall government deficit might exceed 11 percent of GDP for the current fiscal year. He agreed with the staff that the deficit for 1986/87 would need to be constrained, both through expenditure control and revenue enhancement. In addition, the rate of increase of net credit to the Government was on the high side. Nevertheless, there had been a deceleration of the rate of monetary expansion in recent months. To improve the effectiveness of monetary policy and promote the mobilization and efficient allocation of savings, financial reform was needed, as recognized by the authorities; he urged them to address that matter without delay, as liberalization of the financial sector was a necessary adjunct to the other reforms that had been set in motion.

The external position had remained viable, and the external debt profile was reasonably satisfactory, Mr. Wijnholds said. But as he had done the previous year, it was unfortunately necessary to again express disappointment at the performance of exports, although the figures mentioned by Mr. Sengupta for the most recent period indicated considerable improvement. Chart 2 of the staff report gave a striking illustration of that weakness; he asked the staff to explain the upsurge in the trend rate of exports during the 1970s and the subsequent fall to a trend rate of export volume growth of only 1 percent. He agreed with the staff on the need to maintain a flexible exchange rate. Import liberalization would also be helpful in that it would make domestic sales of protected goods less profitable and would reduce or eliminate the advantage over export sales; it would also help to increase the supply of some inputs needed for export activity. Export promotion and import liberalization should go hand in hand so that adverse effects on the external current account would be avoided. Improvement of export performance was of course also dependent on the success of administrative reforms, the enhancement of the quality of goods produced, and timely delivery.

The authorities should be commended for their cautious external borrowing policy, which had enabled India to maintain a viable external position, Mr. Wijnholds continued. But in spite of that cautious stance, the debt service ratio had increased from 8 percent in 1980/81 to the current level of 18 percent. However, those figures did not include private nonguaranteed debt, which although still modest was increasing rapidly according to World Bank estimates mentioned in Table 39 of the report on recent economic developments. He was also disappointed at the slow pace of aid disbursements, particularly from the World Bank group, which the staff attributed mainly to delays in project implementation; at the same time external commercial borrowing had increased, thus resulting in some hardening, on average, of the terms of capital flows into India.

The staff had provided interesting alternative scenarios for the external position in the medium term, Mr. Wijnholds noted. The outcome clearly hinged strongly on the assumptions that were made for export volume growth. While he was inclined to agree with the staff that the 7 percent increase assumed under the Seventh Plan appeared to be on the optimistic side, it should not be considered unachievable, as the experience of the 1970s showed. However, under Scenario I the debt service ratio would increase further and could reach rather high levels during the 1990s, when there might also not be offsetting effects from lower oil prices. Continued prudence with regard to commercial borrowing was therefore called for.

The authorities had embarked on the right course to bring about important improvements in the vast and complex Indian economy, Mr. Wijnholds concluded. He was confident that they would succeed in achieving those goals if they could fully implement the structural reforms under way or envisaged without undue delay.

Mrs. Ploix commented that because of India's size and role in the international arena, developments within its economy had a wide impact; the well-being of India was relevant not only to the country but to the world at large. The problems of growth and development faced by the authorities were uncommon and could not be solved overnight: long and strenuous efforts were required. Although progress might appear slow, there had been significant, positive changes as a result of the wise and constant policy pursued by the authorities. Given the scope of the issues, the medium-term strategy adopted by the authorities in the framework of the Seventh Plan seemed appropriate; its results would have to be assessed over a long period. The Sixth Plan, completed in April 1985, had been successful on the whole; the authorities should be commended for that achievement, which gave cause for confidence about the realism of the authorities' projections for the Seventh Plan.

Nevertheless, Mrs. Ploix continued, the new Plan was an ambitious one, as shown by its finalized targets. The authorities were embarked on a demanding path where reaching the fundamental growth target--5.3 percent a year--depended on the realization of several significant assumptions. The first concerned external equilibrium. Without strong export growth, estimated at 6.8 percent a year, the balance of payments could not be soundly financed. It was obvious that that performance would require a remarkable dynamism of the productive base, which needed to be stimulated. Adequate flexibility of the exchange rate, which did not mean that the necessary stability would be put into jeopardy, would be a useful incentive. Free access to the industrial countries' markets would also constitute an important condition. However, the fact that exports had constantly fallen short of expectations might cause concern, given the country's capacities. The decline in the share of world exports was worrisome and must be addressed. The importance given to that aspect by the Indian authorities was reassuring, and she commended the recent improvement in exports announced by Mr. Sengupta, and she asked him for more information on that result.

The second assumption dealt with significant aid flows expected during the period, Mrs. Ploix noted. Despite its economic size, India was a low-income country that required aid donors' efforts, especially in a multilateral framework. That consideration underlined the importance of the negotiations under way for the IDA replenishment and the preparations for the World Bank's general capital increase.

The third assumption was perhaps the most important, structurally speaking: the success of the measures aimed at infusing more flexibility and efficiency into the structure of the Indian economy, Mrs. Ploix remarked. The Government's announced objective of mobilizing public sector resources through the improved monitoring of individual public enterprises and through the liberalization of the rules and procedures applicable to that sector was an essential part of the program. It must never be lost sight of when considering the momentum the public sector could potentially provide to the Indian economy. The reform policies being implemented, especially of administrative procedures, taxes, and pricing were welcome. However, significant scope for further measures remained. The opening of the borders to imports and foreign investment was still too timid; she would appreciate Mr. Sengupta's comments on his authorities' policy on foreign investment and its place in the economy.

She was concerned about the slippages that had occurred in some areas, Mrs. Ploix commented. Even if they did not call the viability of the assumptions underlying the Plan into question, they must be corrected at an early stage. There was a clear need to strengthen fiscal policy and to curb the rise in expenditures. Despite the relief given by the drop in oil prices to the oil bill, the need to finance the current account deficit, the debt service, and investment clearly called for prudent and cautious policies. It was important to raise public and private savings levels through appropriate measures, as described by the staff.

On another matter, the presentation in an annex of the World Bank's operations in India had been most helpful; she hoped that information would be provided in future reports, Mrs. Ploix said.

There was a flaw in the present kind of exercise, as Directors often tended to focus on zones of doubt and on areas where prompt action was most needed, Mrs. Ploix observed. Nevertheless, achievements should not be overlooked, and the recent ones announced by Mr. Sengupta were welcome; she therefore commended the Indian authorities for the results achieved thus far.

Mr. Mawakani remarked that the economic performance of India had continued to be, on the whole, satisfactory in 1985. Economic expansion had picked up while inflationary pressures had subsided, and, despite the weak performance of the export sector, the external balances looked favorable. Although the Central Government's budget deficit remained large, the Indian authorities had found ways to avert inflationary financing of that deficit by calling upon the small savings funds, which seemed to be responding favorably.

Economic growth in India had been broad based, reflecting essentially the effects of the comprehensive reform program under way and the policy shift enacted in the context of the extended arrangement with the Fund and pursued thereafter, Mr. Mawakani noted. For instance, increases in producer prices combined with other factors--such as greater use of fertilizers and priority in the distribution of quality seeds--had led to a rapid expansion of agricultural output, thereby enabling India to make substantial progress in achieving the goal of self-sufficiency. The recent steps to encourage the shift in the composition of agricultural crops while increasing total output through a variety of incentives, as well as the overall progress that has been made in the agricultural sector, were all welcome. Also noteworthy were the Government's efforts to remove most of the bottlenecks--some of them of an institutional nature--hampering the performance of the industrial sector with a view to making it more efficient and internationally competitive. It was heartening to note that those efforts had yielded tangible results as evidenced by the significant and impressive improvement of the major economic indicators. Those results would have been even more impressive had shortages of imported inputs and structural inefficiencies in some of the industries not been a major constraint. He therefore urged the authorities to step up the pace of the import liberalization program to ensure the availability of needed inputs.

The fiscal position was a source of concern as the improvement in the revenue performance had not been supported by adequate expenditure control, Mr. Mawakani considered. The consolidated budget deficit as a percentage of GDP had been relatively large and was expected to rise further in 1985/86. Such developments were worrisome because of their wide-ranging effects on the economy. He welcomed the Government's intention to introduce strict expenditure control while pursuing its efforts to raise additional revenue by broadening the tax base. The arrangement to limit state governments' overdrafts from the Reserve Bank was a step in the right direction. The efforts to raise revenues should take into consideration the incidence of tax evasion on the revenue performance; the decline in the tax rate for both industries and households was welcome as it was expected to contribute to the reduction of tax evasion. Like the staff, he encouraged the authorities to adopt a simplified tax system to supplement the ongoing reform.

The financing of the government deficit had been the major source of monetary expansion, Mr. Mawakani remarked. The authorities should persevere in their efforts to contain expenditure growth, thereby lessening the financing need of the Government in general and the banking sector in particular. The introduction of higher-yield government securities with a view to attracting more nonbank financing appeared appropriate.

In sum, the commendable efforts by the Indian authorities to liberalize the industrial sector and attain a sustainable level of the fiscal deficit would undoubtedly have a favorable impact on the external sector, Mr. Mawakani concluded. Such an improvement in the overall balance of payments was all the more necessary considering, inter alia, the projected increase in the debt service obligations of the country. He supported the proposed decision.

Mr. Salehkhou noted that the overall performance of the Indian economy in 1985/86 had been largely satisfactory, with relatively high GDP growth, a lower inflation rate, and a comfortable balance of payments position. The export performance, however, remained an area of concern.

Measures implemented under the program supported by the extended arrangement with the Fund and subsequent supplementary steps taken during the past year had helped the economy to secure the high rate of output of about 5 percent in 1985/86, Mr. Salehkhou continued. The foodgrain sector had continued to receive special attention; enlargement of irrigated areas, increased use of fertilizers, and producers' remunerative prices had helped the agricultural sector to grow in line with managed domestic demand. Industrial output was also estimated to have accelerated as a result of impressive policy measures directed toward expanding capacity and diversifying production to meet domestic demand. Notwithstanding considerable efforts by the authorities to increase the production of exportable commodities, the country had been unable to regain its market share. The profitability advantage of domestic sales over exports had led producers to pay less attention to enhancing the competitiveness of their products. The increase in output had met domestic demand, however, and had helped the country to reduce the rate of inflation in spite of the relatively high pace of monetary expansion resulting from public sector financing needs.

The consolidated government deficit was estimated to have increased somewhat more than the budgeted level to about 11 percent of GDP, despite the new arrangements made to impose financial discipline on state governments, Mr. Salehkhou remarked. Taking into account the emphasis on strengthening public sector resource mobilization to help finance the higher level of public investment needed to achieve overall growth, further efforts should be made to widen the tax base in order to increase direct taxes and curb dependence on import taxes. That would also relieve the cost imposed on inputs and pave the way for a gradual elimination of supply bottlenecks. The improvement achieved in the overall financial position of public enterprises, largely as a result of the petroleum sector's performance, was encouraging. In light of the large contribution of petroleum to total profits of public enterprises and of recent developments in international oil prices, he asked the staff to comment on the attainability of the projected savings of public enterprises in the Seventh Plan, when flexible pricing policies--proposed by the staff--would apply also to those petroleum enterprises.

On the external side, commodity exports had continued their weak performance despite the implementation of supportive policies, Mr. Salehkhou observed. Apart from the adverse impact of external factors--such as low demand in India's major trade partners, increased protectionist tendencies in industrial countries, and the sharp decline in international commodity prices--the existing supply bottlenecks, high input cost, and continued deficiencies in quality control had partly weakened the competitiveness of Indian exports. Export value was estimated to have decreased by 2 percent over the previous year, while imports were estimated to have increased by 5 percent, mainly as a result of large purchases of essential commodities. With the surplus on invisibles unchanged, the current account deficit had widened to $3 billion.

In the medium-term balance of payments scenario, the projected annual export volume growth of 7 percent appeared to be rather optimistic, taking into account the actual annual growth of 1.3 percent during the Sixth Plan and existing supply bottlenecks in the economy, Mr. Salehkhou commented. He agreed with the authorities that some recent external developments--such as lower interest rates--might partly offset the adverse impact of lower exports on the current account. However, further recourse to commercial borrowing to reach the projected GDP growth of 5.3 percent could cause a deterioration in the balance of payments position and raise the debt service ratio to an unsustainable level by the end of the Plan period.

The authorities' efforts to promote exports and the measures implemented in that regard were commendable, Mr. Salehkhou remarked. However, to prevent debt-servicing difficulties in the future, a continued cautious approach to commercial borrowing was advisable.

Mr. Jones said that India remained committed to the process of structural change as the key to establishing the basis for sustained economic growth. The adjustment process had already started to unleash the productive potential of the country. There was a clear connection between the broad thrust of economic policies and the objectives of growth and a viable balance of payments position, and the planning process continued to serve the useful purpose of providing a comprehensive framework to help policymakers pursue those objectives over the medium term.

The Indian economy had registered respectable growth rates in recent years, and the outlook under the Seventh Five-Year Plan was encouraging, Mr. Jones continued. Some of the statistics mentioned by Mr. Sengupta indicated that economic agents were responding to the liberalization and reform measures that had been put in place, and the absence of any major demand management problems in the short run gave the authorities some opportunity to concentrate on their medium-term development strategy with a greater degree of flexibility than would otherwise be the case.

The public sector in India had played an important role in the economy and was expected to remain a key influence on growth and development, Mr. Jones observed. Against that background, there must be some concern about the high fiscal deficit, pointing to the importance of increased efforts to mobilize resources in the public sector to help finance the high level of public investment. The Indian authorities seemed to be aware of that, and they had begun to take steps to increase revenue while containing current expenditure. Given the large number of public corporations, a major part of the resource mobilization effort would have to focus on improving their financial position. The initial steps taken by the authorities in that regard were encouraging; the mobilization of resources at the domestic level must be supported by adequate inflows of external capital, especially when an effort was being made to improve the efficiency of investment.

Whether or not India would be able to sustain the programmed rise in investment was dependent also on the extent to which the country could expand its exports, Mr. Jones considered. The staff expected slower growth in export volume and in the increase in aid disbursements during the Plan period, which could lead to higher commercial borrowing and a more rapid rise in the debt service ratio. The authorities, however, were more optimistic and deserved the benefit of the doubt. In any case, Mr. Sengupta had stated that his authorities intended to keep the debt service burden within manageable limits. If the outcome for exports and concessional financing was less favorable, growth projections for the Plan period might have to be scaled down.

In sum, the performance of the Indian economy was commendable, and the future was encouraging, Mr. Jones concluded; there was no reason to believe that the authorities would not continue along the pragmatic course they had set for themselves.

Mr. Lundstrom commented that a discussion of Indian economic developments was of particular interest and importance. Not only was India the second largest developing country, with an economy that, because of its mere size, put high demands on economic policies and administrative management, but it was also a country that had managed to avoid falling into the debt trap without sacrificing economic growth and that, generally, had performed remarkably well in many respects.

Indeed, compared with many other countries, the Indian economy had progressed relatively satisfactorily in recent years, Mr. Lundstrom continued. The strategy of securing a higher rate of economic growth while maintaining medium-term balance of payments viability had, by and large, proved successful and testified to the appropriateness of the applied five-year planning framework and to the quality of India's economic management.

Bearing in mind the ambitious targets, difficult external environment, and administrative and economic rigidities encountered, the Sixth Plan had been successful, Mr. Lundstrom stated. Real GDP growth had been satisfactory, inflation had been reduced, the current account deficit had remained relatively small, and some liberalization in the regulatory environment had been carried out. The rapid expansion under the Sixth

Plan of agricultural output, particularly in the foodgrain sector, was encouraging. However, although production had been good, investments in the agricultural sector had been seriously below expectations. Even though that development had been apparent during the midterm appraisal of the Plan, unfortunately the authorities had been unable to mobilize resources to close the emerging gap. The importance of the problem was borne out by the fact that the number of people with deficient diets was still increasing.

Another serious development under the Sixth Plan had been the low capacity utilization in industry and, in particular, the poor export performance, Mr. Lundstrom added. The Government's new pragmatic approach to industrial and trade policy had probably not yet made the environment sufficiently conducive to economic growth. Factors such as the shortage of inputs, low productivity, and bureaucratic administrative controls had been detrimental to progress in areas vitally important for the modernization of the economy. Perhaps the impact of highly variable effective rates of protection had also distorted resource allocation and weakened export growth. All in all, it seemed evident that the slow growth in industrial production and exports had had a significant negative carryover to the Seventh Plan.

The public sector had also shown less than satisfactory developments under the Sixth Plan, Mr. Lundstrom remarked. Fiscal policies had not succeeded in generating sufficient public sector savings to support the investment program of the Sixth Plan. On the contrary, the overall budget deficit had increased in relation to GDP, and substantial recourse had been made to the banking system, which had contributed to rapid monetary growth. To prevent those trends from affecting the implementation of the Seventh Plan, strong fiscal discipline would be required in the early years of the new Plan.

With the Seventh Plan currently in its initial phase, India was gearing up for a significant acceleration in the trend growth rate of the economy, Mr. Lundstrom observed. The targets might seem bold, but the early stages of the Plan benefited from the absence of major domestic demand management problems that could hinder the implementation of the planned policy measures. In addition, recent improvements in the external environment would facilitate the attainment of growth targets. Although, in general terms, the Seventh Plan was basically a continuation of the previous Plan, its very ambitious targets required substantial policy changes. As increased capital formation could play only a limited role in the planned acceleration of GDP growth, most of the impetus would have to come from more efficient resource utilization, which meant continuing the rationalization and liberalization efforts commenced in recent years.

In that context, the importance of mobilizing public sector resources could not be overestimated, Mr. Lundstrom noted. Obtaining higher financial and economic returns from public enterprises by improving their operational efficiency and by introducing more rational pricing policies was of crucial importance. There was also a need for financial liberalization through the introduction of market-related interest rates and new instruments of monetary policy. Nevertheless, the need for action in industrial and trade policy should be emphasized because it was in industry that the main acceleration in growth would have to take place. Firm action was needed in three closely interlinked areas: domestic industrial policies, import policies, and export policies.

Domestic industrial policies had to be effectively geared to reverse declining productivity trends, Mr. Lundstrom remarked. Fostering greater domestic competition was one important means to that end and implied a reduction in the numerous direct controls on private sector activity. Improved government pricing policies in key sectors should also encourage productivity growth and align domestic and border prices more closely.

While the main impact on productivity was likely to come through domestic policy measures, greater access to imports was essential to the improvement of capacity utilization and efficiency and, generally, to the planned rapid industrial growth, Mr. Lundstrom said. The authorities would be well advised to take further steps to reduce quantitative restrictions on directly competing imports. Also, a thorough review of tariffs with the dual objectives of eliminating structural anomalies and lowering their overall level seemed appropriate.

Traditionally, export performance had been the weak spot in India's medium-term plans, Mr. Lundstrom recalled, although the Indian export structure was such that many products were encountering restrictions in market access in industrial countries. Still, given the small and even declining Indian share of world exports, there seemed to be scope for an enhanced performance. To that effect, industrial policies should perhaps be more neutral in distributing incentives between exports and import substitution.

There was still no sign of the substantial breakthrough needed in exports after almost one year into the new plan period, Mr. Lundstrom observed. Unless growth in exports was accelerated, serious balance of payments difficulties might arise; as described in the staff scenarios, that could gradually lead to increased indebtedness and even to a risk of explosive time paths in debt-servicing ratios, unless the Plan targets were modified. Therefore, comprehensive measures to accelerate export growth were called for, although their success was, to a large extent, dependent upon an open trade environment.

Expansion of concessional assistance was essential for India to achieve adequate growth, Mr. Lundstrom stated. The priority given to combating poverty in the Seventh Five-Year Plan should enhance the prospects for additional assistance. As Mr. Sengupta had stated, India had more people in absolute poverty than all of sub-Saharan Africa.

Mr. Huang remarked that the Indian authorities had devoted their economic policies to achieving higher economic growth, reducing inflation, and improving their future external balance position. Generally speaking, their objectives had been largely achieved, and in particular, the economic performance in terms of growth and inflation had been remarkable. During the Sixth Plan, the annual average growth rate of real GDP had been 5.3 percent, and the inflation rate, as measured by the wholesale price index, had dropped from 18 percent in 1980/81 to 7 percent in 1984/85. In 1985/86, the growth rate of real GDP had been projected at 4.5 percent, somewhat higher than that achieved in 1984/85; and the overall rate of price increase had dropped to less than 6 percent. There had been a sustained increase in agricultural production in recent years and the growth in oil production had enabled about 7 percent of the demand for oil to be met from domestic sources in 1984/85. Those achievements were attributable to India's economic strategy emphasizing growth coupled with appropriate demand management. There was no doubt that the liberalization and reforms in a number of areas had made a considerable contribution to recent developments. The authorities' efforts and their achievements merited commendation; however, there remained a number of weaknesses and defects to be overcome in India's economic development.

One major economic problem was India's huge budget deficit--central and state government--which had amounted to 10.9 percent in 1985/86, Mr. Huang continued. Originally, a budget deficit of that size would have brought out strong inflationary pressures, but--largely due to the shortterm effects of greater supply supported by increased imports--the inflation rate had been temporarily driven downward rather than upward. However, it was evident that the persistent sizable deficit would inevitably lead to an acceleration in inflation, and thus it constituted a major threat to the economic stability of India.

He was in broad agreement with the fiscal measures to contain or reduce the budget deficit during the Seventh Plan, as indicated in the staff paper, Mr. Huang stated. In particular, since the public enterprises' savings were projected to rise to 4.7 percent of GDP--more than double the rate achieved during the Sixth Plan--it was necessary for the authorities to achieve a substantial improvement in the management and organization of the public enterprises with the aim of raising their competitiveness and profitability and bringing about rationalization, technological innovations, mergers, and, where necessary, the closure of unprofitable public enterprises. In addition, strict control on public expenditure, including public investment, was needed to prevent an increase in the budget deficit. To a considerable extent, the authorities' ambitious investment program relied on the supply effect of the tax reform, which was expected to provide greater budget savings to finance investment programs. The time lags needed for that supply effect should not be neglected; it was therefore appropriate to arrange for a lower level of public investment in the first two years of the Seventh Plan and a higher level in the remaining years.

The greatest weakness in the Indian economy was its export performance, with an annual growth rate of 1-2 percent during the Sixth Plan, Mr. Huang commented. But the Seventh Plan was based on the optimistic assumption of an annual growth of 7 percent in export volumes. There was a sharp contrast between a record that was too low and assumptions that were too optimistic. In view of the rise in protectionism and the decrease in prices of several traditional export commodities, an annual growth rate of 4 percent for export volume, as suggested by the staff, might be more realistic than the 7 percent assumption. In any case, the authorities faced the urgent task of substantially improving the export performance through enormous effort and increased competitiveness. To some extent, the depreciation of the exchange rate could contribute to the expansion of export volume, but its inflationary impact set a limited range for its implementation. Most important to India's economic development was a favorable external environment, which could be created by the international community through their concerted efforts in rolling back protectionist forces and improving the terms of trade.

India's economic performance during the Sixth Plan and in 1985/86 in terms of output and inflation had been satisfactory, and its development program, as set forth in the Seventh Plan, was ambitious, Mr. Huang observed. Obstacles remained however; besides the weaknesses he had mentioned, strict control on population growth should not be neglected. He believed that the authorities' efforts in fulfilling the Seventh Plan would be successful, and he supported the proposed decision.

The Executive Directors agreed to resume their discussion in the afternoon.

APPROVED: January 20, 1987

LEO VAN HOUTVEN
Secretary