

India: 2005 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with India, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 19, 2005, with the officials of India on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 22, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of February 6, 2006 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 6, 2006 discussion of the staff report that concluded the Article IV consultation.

The document listed below has been or will be separately released.

Selected Issues

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

INDIA

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation with India

Approved by Wanda Tseng and Matthew Fisher

December 22, 2005

- A staff team visited India from October 4–19 and met with Reserve Bank of India Governor Reddy, Deputy Governor Mohan, Chairman, Prime Minister’s Economic Advisory Council Rangarajan, Ministry of Finance Secretary Jha and other senior officials as well as representatives from the private sector.
- The team comprised Ms. Tseng (Head), Messrs. Schiff and Fernandez, Mmes. Purfield and Poirson (all APD), and Messrs. Flanagan (FAD), Rozhkov (MFD), and Wattleworth (Senior Resident Representative). Messrs. Misra, Executive Director, and Prasad, Advisor, also participated in the discussions.
- The last Article IV consultation was concluded on January 24, 2005 and the staff report published as IMF Country Report No. 05/86. Since then, India has conducted monetary policy prudently and met fiscal targets in the first year of the fiscal responsibility law, in line with Board recommendations. Tariff reductions and capital account liberalization continued, and a state VAT and other reforms were introduced to reduce states’ deficits. These have also been the Fund’s consistent advice. However, while India remains committed to medium-term fiscal consolidation, tax base broadening and subsidy reform have not proceeded as fast as planned. Moreover, oil price pass-through has remained partial, although plans for an automatic pricing mechanism are under consideration. Some structural reforms advocated by the Fund, including liberalization of labor laws and privatization, have stalled, and further opening of the banking sector to private and foreign participation has been delayed.
- India has accepted the obligations of Article VIII Sections 2, 3, and 4. One restriction subject to Article VIII provisions was removed, but others remain in place. India’s exchange rate regime is a managed float.
- India subscribes to, and is currently in observance of, the Special Data Dissemination Standard. India has undertaken an FSAP and a fiscal ROSC in the context of the 2001 Article IV consultation, and is participating in the coordinated compilation of financial sector indicators. A Data ROSC was published in April 2004.

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EXECUTIVE SUMMARY

- **India's economic performance continues to be impressive for the third year running.** Real GDP growth exceeded 8 percent y/y in the first half of 2005/06, led by strong domestic demand. Inflation remained low through August 2005, but has risen in recent months reflecting higher pass-through of world oil price increases and robust demand. Real GDP growth should moderate to 6¾ percent in 2006/07 as the economy adjusts to high oil prices and rising domestic and global interest rates. Stronger-than-expected domestic demand supported by fast credit growth poses key upside risks to growth and inflation.
- **Macroeconomic policies in the near term need to remain focused on warding off inflationary pressures.** Overperformance on the budget would help address demand pressures and also strengthen the credibility of the Fiscal Responsibility Law (FRBMA). The October hike in interest rates was appropriate, and staff encouraged the Reserve Bank of India (RBI) to remain vigilant in view of upside risks. Staff also welcomed the RBI's commitment to increased exchange rate flexibility.
- **The government's medium-term fiscal strategy is broadly appropriate and faster implementation is key.** There was agreement on the need for tax base broadening. However, staff noted that implementation of the government's 2004 roadmap to increase tax revenue had fallen behind schedule, and reiterated the need to broaden the revenue base by quickly removing exemptions and introducing a goods and services tax. To help create fiscal space for infrastructure and priority social spending, the authorities should also implement subsidy reform and address fast-rising pension outlays through parametric changes. Recent changes in center-state relations should support state-level adjustment. There was agreement that strengthened conditionality and tighter global borrowing limits may be required if all states are to achieve the fiscal consolidation targets.
- **India's growth spurt provides a golden opportunity to fast-forward the government's structural reform agenda.** The government is rightly focused on improving infrastructure, opening and liberalizing further the Indian economy, and alleviating poverty. Tariff reduction and liberalization of foreign investment could be further accelerated. Steps to improve the business climate and regulatory environment, and reform of restrictive labor laws could have large pay-offs in terms of foreign investment and job creation. Such reforms will require building political consensus but are key for India to fully utilize its positive demographics.
- **Banking sector health continues to improve, but rapid credit growth present a new challenge.** The credit boom is a welcome sign of financial deepening, although regulations could be further tightened, in line with best international practices, to prevent a possible deterioration in credit quality.

I. INTRODUCTION

1. **India’s economic performance continues to be impressive.** For the third year running, growing openness and rising consumer and investor confidence are helping sustain rapid growth, buoying foreign investor interest. Real per capita incomes have risen by over 50 percent over the past decade, igniting consumer expenditure, and firms are investing in new capacity to tap growing internal and external markets. India’s growth spurt has been accompanied by a marked opening to the regional and global economy. Import and export growth (including services) exceeded 33 percent per year in 2003–04, and the share of exports to Asia in India’s total exports rose to about one-third, up from less than one-fourth in 2000.

India's Consumption Boom					
	1995	2000	2003 Est.	2004 Est.	Percent Since 2000
(Per 1,000 people)					
Internet users	0.3	5.4	17.5	..	221.9
Mobile phones	0.1	3.5	24.7	41.2	1,067.1
Passenger cars	4.1	6.0	7.8	9.6	58.5
Telephone mainlines	12.9	32.0	46.3	54.6	70.3
Two-wheelers	22.4	35.4	50.4	58.2	64.2
Vehicles	6.5	9.3	12.8	14.9	61.4

Sources: World Bank, *World Development Indicators*; CMIE; and staff estimates.

2. **However, the evolving macroeconomic situation is presenting policy challenges.** Rapidly rising domestic demand, a widening trade and current account deficit, and inflationary pressures are key risks to the near-term outlook. The Reserve Bank of India (RBI) has recently raised interest rates, but fiscal policy is adding to demand pressures, reflecting higher outlays on priority infrastructure and social programs and higher transfers to the states.

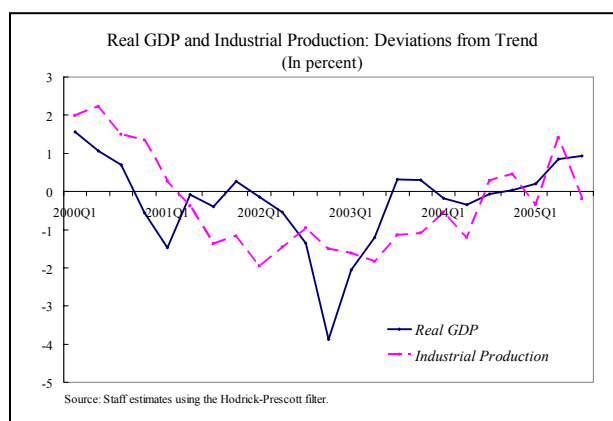
3. **In the medium term, bridging the income and poverty gap will require India to sustain and improve on current growth rates by forcefully addressing its entrenched structural problems.** Poverty remains high and concentrated in the rural areas, with 35 percent of the population living on less than a dollar a day in 2000. India’s social indicators continue to lag those of many East Asian countries a quarter of a century ago (India Planning Commission, Mid-Term Appraisal of the Tenth Five Year Plan (2002–2007)), and achieving the Millennium Development Goals will be difficult (Table 1). Despite facing some of the region’s lowest labor costs, inadequate infrastructure and power, and burdensome red tape have hampered competitiveness. The structural reform agenda is well-known to the authorities. Continued priorities of the Congress-led coalition government include further opening and liberalizing the Indian economy, addressing infrastructure weaknesses, and alleviating rural poverty.

4. **Building political consensus for major reforms remains a challenge.** After a promising start under the Congress-led government—including the introduction of VAT, the lifting of several FDI restrictions, and continued tariff reductions over the past year—reforms have slowed. Opposition from several political parties that support the governing coalition from outside have halted privatization, slowed liberalization of foreign investment and power

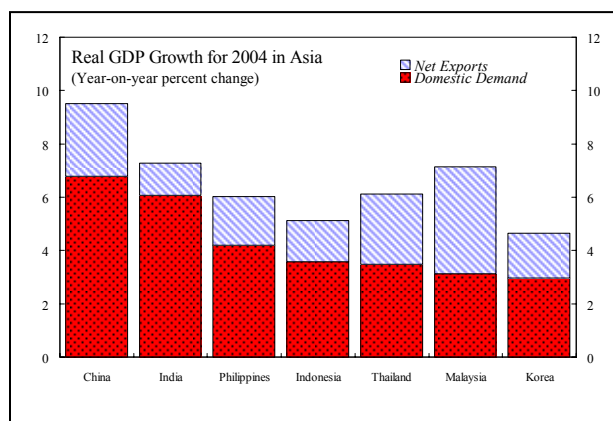
sector reform, and stalled labor and agricultural reform. With the opposition winning an absolute majority in recent state assembly elections in Bihar, and elections forthcoming in the Left Front strongholds of Kerala and West Bengal, the near-term prospects for moving ahead with broader reforms are uncertain.

II. RECENT DEVELOPMENTS AND OUTLOOK

5. **India's growth is robust and becoming more broad-based.** GDP growth in 2004/05, at nearly 7 percent, was again above trend, as rapid growth in services broadened to encompass industry.¹ The contribution to growth of domestic demand has been larger than in most emerging markets in Asia. Strong momentum in manufacturing and services continued in the first half of 2005/06 and GDP growth accelerated to over 8 percent y/y (Table 2). Capacity utilization has risen, and business confidence has soared to a 10-year high (Figure 1). Growth is set to exceed 7½ percent in 2005/06, led by private investment and household demand, and supported by fast credit growth, a normal monsoon, and accommodative monetary and fiscal policies.



6. **The external current account has shifted into deficit reflecting strong domestic demand and high oil prices.**



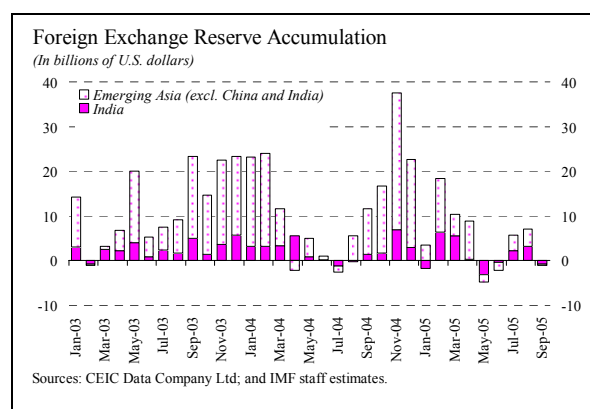
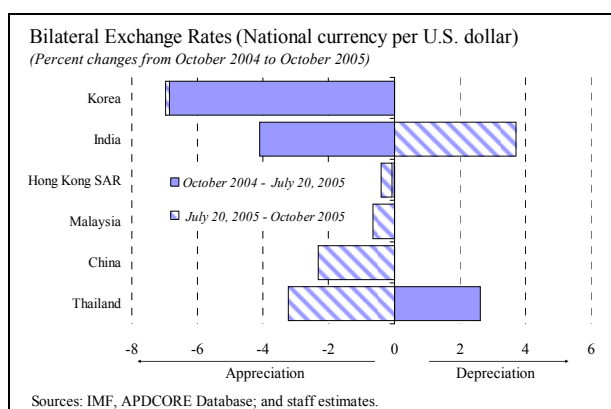
The trade deficit widened to over 5¼ percent of GDP in 2004/05 and the current account reverted into deficit for the first time in three years notwithstanding high growth in exports of goods and services (Figure 2 and Table 3). In the first quarter of 2005/06, goods exports continued to grow robustly—up 22 percent y/y led by engineering and chemicals—but a large increase in both oil and non-oil imports caused the trade deficit to reach 2 percent of projected annual GDP.² Since then, exports and imports have remained buoyant, growing by 21 percent and 30 percent y/y, respectively, in July-October.

¹ Fiscal year April-March.

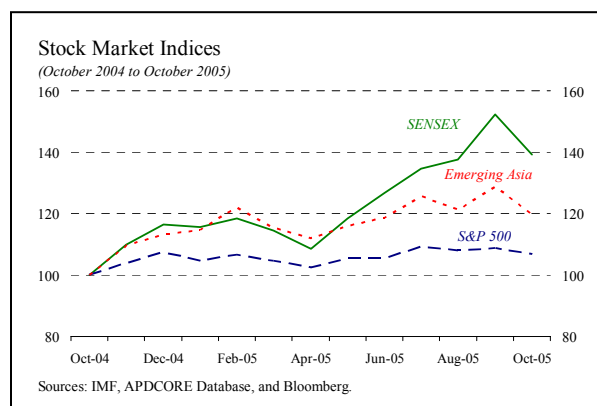
² Non-customs imports—in part, defense-related—rose sharply, accounting for about two-thirds of the widening in the trade deficit q/q.

7. **Continued strong capital inflows have offset the impact of the widening external deficit on the balance of payments.** In 2004/05, almost one-half of inflows were debt-creating as Indian corporates took advantage of favorable global interest rates, an appreciating rupee, and the liberalization of restrictions on external commercial borrowings to borrow abroad. FDI inflows remained weak, but portfolio inflows have gained importance since late 2003. Capital inflows remained strong and reserves rose modestly so far this fiscal year (\$1.6 billion) despite the widening current account deficit. Although growing reliance on more volatile debt-creating and portfolio inflows has increased India’s susceptibility to changes in investor sentiment, ample reserve coverage and remaining capital controls mitigate the impact of potential reversals (Box 1 and Table 4).

8. **The RBI has allowed increased two-way flexibility in the exchange rate.** In the eight months to June 2005, the RBI scaled back intervention in foreign exchange markets, and the rupee appreciated by 4 percent against the dollar (6½ percent in real effective terms). Since then—with the exception of a six-week period following China’s July 21 revaluation, when the RBI intervened in response to a pickup in capital inflows—the rupee has depreciated, reflecting pressures from the growing current account deficit and renewed U.S. dollar strength, and the RBI has largely refrained from intervening.



9. **Asset prices have surged.** Net foreign institutional investor (FII) inflows (whose holdings account for 13 percent of market capitalization), accelerated from the second quarter of 2005. FII inflows, supported by strong domestic institutional investment, contributed to soaring equity prices. Notwithstanding a correction in October, equity prices are up 43 percent from end-April, leaving the average price-earnings ratio of 18.4 at mid-November high by emerging market standards. Ample liquidity and historically low interest rates have also helped fuel property prices, which have risen in some major cities by over 20 percent annually over the past two years. While there is no

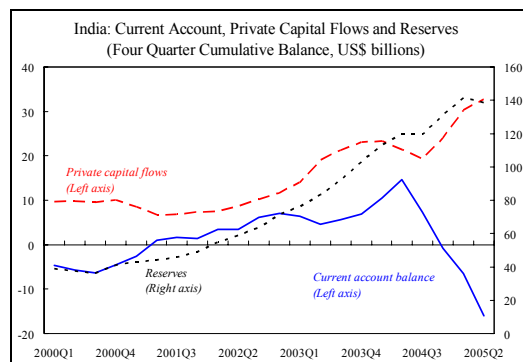


Box 1. How Vulnerable is India to a Change in Investor Sentiment?

Capital flows into India have surged in recent years tripling to about \$32 billion per annum. These inflows had contributed to the accumulation of international reserves, but with rising world oil prices and the pickup in domestic demand, capital inflows are now financing a growing current account deficit.

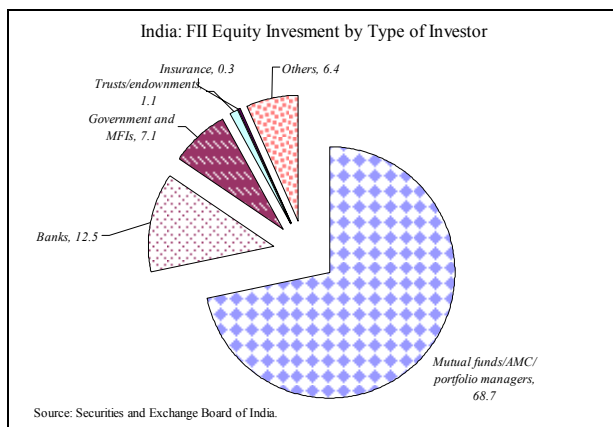
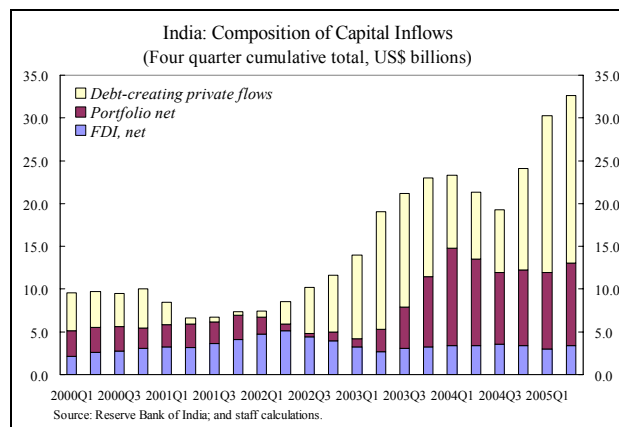
Debt-creating flows dominate private capital inflows.

Debt-creating-non-portfolio flows primarily reflect banking capital and external commercial borrowings (ECBs), and to a much smaller extent, trade-related credits. India attracts relatively little FDI, and as Indian firms invest abroad, the share of net FDI in total private capital inflows has fallen to about 10 percent. However, portfolio investments are becoming increasingly important and they now account for about one-third of total private capital inflows. These flows mainly enter the equity market—capital controls limit foreign investors access to debt markets—where they account for about 6 percent of market turnover and about 13 percent of market capitalization.^{1/} As debt-creating and portfolio inflows are more volatile than FDI, growing reliance on such flows to finance the current account deficit leaves India more susceptible to reversals.



	1996Q2-1999Q4	2000Q1-2005Q2	1996Q2-2005Q2
	(Coefficient of variation in percent of GDP)		
Total private capital flow (net)	1.1	0.6	0.8
FDI (net)	0.6	0.3	0.5
Portfolio (net)	1.5	1.1	1.2
ECB (net)	1.7	6.9	2.7
Short-term credit (net)	5.4	2.3	3.0
NRI deposits (net)	1.6	1.0	1.4
Other capital (net)	-22.3	1.8	2.9
Memorandum items:	FDI/GDP	Portfolio/GDP	Loans/GDP
India	0.5	1.2	1.2
Indonesia	0.8	1.7	1.7
Korea	0.6	1.3	1.3
Malaysia	0.5	3.5	3.5
Mexico	0.5	2.1	2.1
Philippines	0.9	2.0	2.0
Thailand	0.6	1.1	1.1
Less financially integrated economies	1.3	2.5	2.5
More financially integrated economies	0.7	1.8	1.8

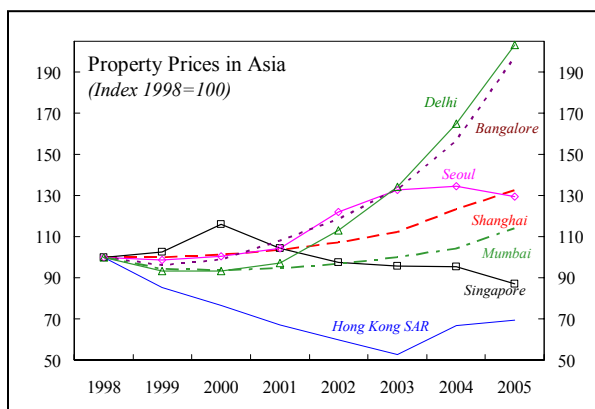
Sources: Reserve Bank of India; Prasad et al (2003); and staff calculations.



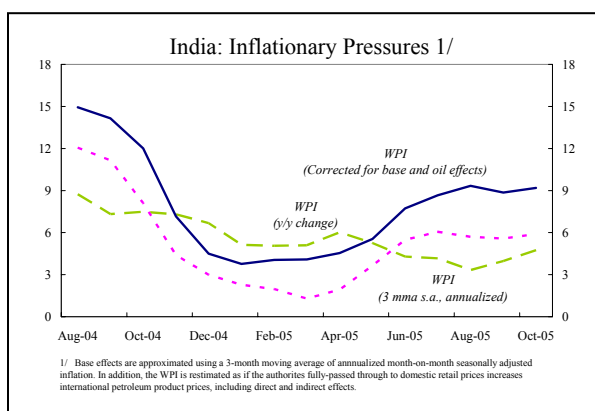
Large international reserves and capital controls provide a buffer against reversals. Reserves exceed the stock of portfolio investments, NRI deposits, and short-term residual maturity external debt by about \$50 billion. In addition, capital controls, particularly on volatile inflows like ECBs, remain in place. ECB approvals are capped at \$9 billion per annum, and are subject to end-use, term, and prepayment restrictions that help limit vulnerability. Foreign investment in debt is capped at \$2.25 billion. Nonetheless, while reserves provide a cushion, especially in the context of a system of capital controls, the growing reliance on capital inflows further underscores the need for sound macroeconomic policies.

^{1/} Of total trading in other Asian stock markets, foreign shareholders account for 2.7 percent in China, 22½ percent in Korea, 29 percent in Thailand, and 36 percent in Taiwan. In Korea, foreign investors account for 40 percent of domestic market capitalization.

evidence of a nationwide housing boom, with much more modest price increases in other major cities, some indicators—including high vacancy rates in new shopping malls— suggest overinvestment in selected sectors. Concerned with speculative pressures, the RBI has raised risk-weights on housing and real estate loans, and imposed controls on real estate investments aimed at curbing speculative FDI inflows (see paragraph 33).

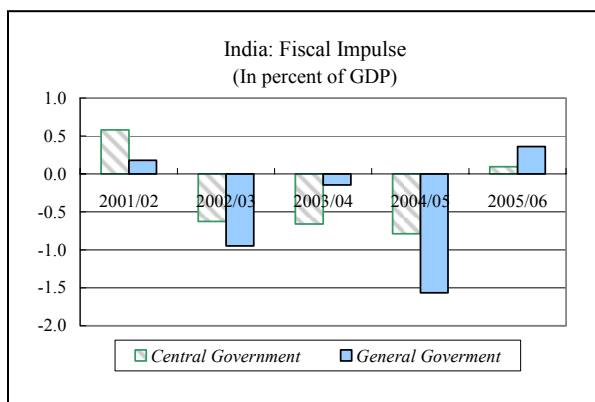


10. **Headline inflation has remained moderate, but inflationary pressures are building.** In 2004/05, the RBI took several steps to tighten liquidity, including raising reserve requirements and policy interest rates. This, together with the incomplete pass-through of higher oil prices (Box 2), helped to moderate inflation. More recently, however, inflation has risen, reaching 4¾ percent in October (Figure 3) and indicators of broad and reserve money growth have picked up (Table 5).



Furthermore, a number of indicators, including capacity utilization, peak electricity shortages, and average turnaround time in ports suggest that supply-side constraints are tightening (Figure 4).

11. **Following three years of declining fiscal deficits, a “pause” in deficit reduction was announced for 2005/06.** The central government fiscal deficit came in below target in 2004/05 for the second consecutive year, helped by a cyclical rebound in revenue and expenditure compression, but also reflecting greater recourse to off-budget petroleum subsidies (Table 6).³ The current deficit was reduced by 1 percentage point, twice the minimum



³ Staff estimates that the overall cost of oil subsidies increased by 0.2 percent of GDP to 0.7 percent of GDP in 2004/05. Meanwhile, subsidies borne off-budget doubled from 0.3 percent of GDP to 0.6 percent of GDP.

Box 2. The Impact of Higher Oil Prices

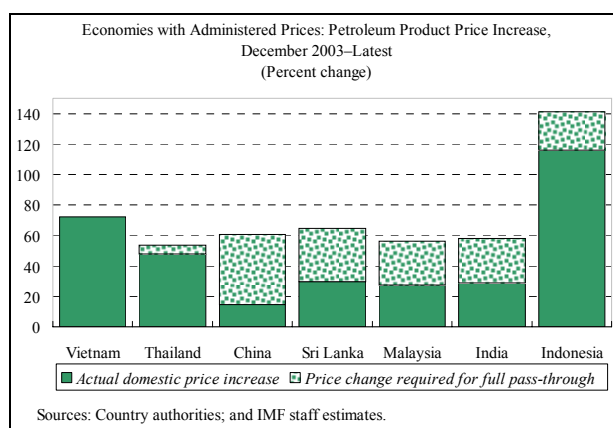
Despite recent price increases, the pass-through of international prices remains incomplete. After an increase of about 7 percent in September, domestic gasoline and diesel prices remain around 10 percent below import parity levels (nevertheless, at \$0.96 and \$0.67 per liter respectively, they are relatively high because of taxes). Prices of kerosene and LPG, however, require much larger increases. To limit price increases, the government has also lowered oil taxes and partly replaced ad valorem with specific excises. The average price adjustment required in India to achieve full pass-through is similar to that in other countries in Asia.

Price controls are imposing quasi-fiscal costs. Costs amounted to $\frac{3}{4}$ percent of GDP in 2004/05 and $\frac{1}{2}$ percent of annual GDP in the first half of 2005/06. The bulk has been borne by state petroleum companies with explicit budget subsidies only amounting to 0.1 percent of GDP per year. While these subsidies (especially those for kerosene) have shielded some poor households from the impact of higher oil prices, there is substantial leakage of benefits to higher income households (almost 40 percent in the case of kerosene).

Thus far, the impact of high oil prices on growth has been limited. In addition to the incomplete pass-through of international prices, other factors have contributed to this: the rapid growth in exports of refined products; robust growth of other exports, as global demand has remained strong; the strong underlying productivity growth of India's economy—which allows for a smoother reallocation of resources in the face of a shock; and a supportive monetary policy, made possible by well-anchored inflation expectations.

	Gasoline	Diesel	Kerosene	LPG
Price changes since December 2003 (in percent)	29	40	0	22
Further adjustment required (in percent; staff estimates)	15	8	154	56

Source: IMF staff estimates.



	2002/03	2003/04	2004/05	2005/06 Proj.
Net oil imports (in billions of U.S. dollars)	15.5	17.0	22.3	32.4
Imports	18.1	20.6	29.1	42.3
Exports	2.6	3.6	6.8	9.9
Net oil imports (in percent of GDP)	3.1	2.8	3.2	4.2
Oil price (Indian basket; U.S. dollars)	26.2	27.8	38.9	54.9
Percent change	19.3	6.1	39.9	41.2

Sources: Reserve Bank of India; *Basic Petroleum Statistics*, Ministry of Petroleum and Natural Gas; and staff projections.

required under the Fiscal Responsibility and Budget Management Act (FRBMA).⁴ With higher revenue and expenditure compression also helping states reduce their deficits, staff estimates that the general government actual and structural deficit fell below 7½ percent of GDP, enough to stabilize public debt at around 86 percent of GDP (Table 7).⁵ In 2005/06, the central government overall and current deficit targets of 4.3 percent of GDP and 2.7 percent of GDP, respectively, fall short of the minimum reductions required by the FRBMA. This reflects increased social and infrastructure outlays and higher transfers to states recommended by the Twelfth Finance Commission (TFC)⁶ (Box 3 and Figure 5). The budget implies a rise in the general government actual and structural deficit to 7¾ percent of GDP, imparting a pro-cyclical impulse to the economy. The higher deficit has been comfortably financed—largely domestically—so far, with nearly 70 percent of government market borrowings completed by end-October. Reflecting easy liquidity conditions, yields on the 10-year benchmark bond have softened by 13 basis points since end-April.

12. **The banking sector continues to strengthen but risks remain.** Commercial banks have continued to reduce NPAs, largely reflecting the pickup in credit but also gains in NPL recovery⁷ and favorable economic conditions, and aggregate capital adequacy remains high (Table 8 and Figure 6). Banks have reduced their exposure to interest rate risk, decreasing their holdings of government paper and shortening maturity. Declining profitability due to rising interest rates has been in part offset by higher credit growth. However, interest rate risk remains a concern with bank holdings of government paper (at 38 percent of assets) still in excess of statutory requirements; rapid credit growth raises concerns about credit quality (Box 4); and cooperative banks (accounting for about 6 percent of banking system assets) remain in poor health.

13. **Looking ahead, staff expects economic activity to moderate and inflation to rise in the near-term.** Real GDP growth is projected at 7½ percent in 2005/06, and is expected to decline slightly to below 7 percent in 2006/07, reflecting further pass-through of higher oil prices and rising global and domestic interest rates (Table 9). Inflation should rise from 5¼ percent in 2005/06 to 6¾ percent in 2006/07, reflecting the expected upward adjustment

⁴ The FRBMA is summarized in India Staff Report for the 2003 Article IV Consultation (unpublished).

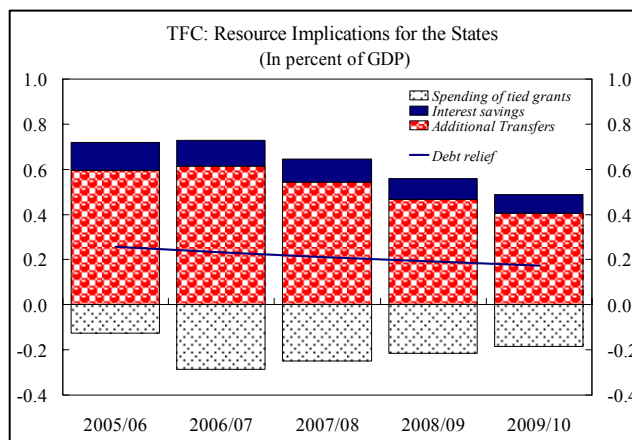
⁵ Public debt estimates include market stabilization bonds used for monetary policy operations of Rs. 655 billion (2.1 percent of GDP) in 2004/05.

⁶ Finance Commissions are constitutional bodies appointed at least every five years to mediate the sharing of resources between the center and states. The terms of reference for the TFC included measures to restructure public finances and achieve debt reduction.

⁷ Banks' recovery of bad loans via the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, debt recovery tribunals, and asset reconstruction companies increased six-fold in 2004/05.

Box 3. Implications of the Twelfth Finance Commission (TFC) for the States

The recommendations of the TFC, which have been implemented by the government, could provide a significant boost to state fiscal adjustment. States will benefit from a higher revenue share and higher grants, and from debt restructuring and relief. The latter is conditional upon passage and implementation of fiscal responsibility legislation targeting current balance by 2008/09 and a 3 percent of GDP overall deficit by 2009/10. Some grants are tied to higher annual expenditure on social priorities (0.2–0.3 percent of GDP). The net benefit for state finances approaches 0.6 percent of GDP in 2005/06, falling to 0.3 percent of GDP by end-period, as grants do not to grow in line with nominal GDP.



The incentive to take part in the TFC’s debt relief may be too small for some states. The combined incentive for all states is larger than that in previous finance commissions, but it varies state by state. Some states will receive comparatively little debt relief in relation to the primary adjustment they need to achieve. The center will ensure that all states adhere to their fiscal adjustment paths by enforcing a tighter state borrowing regime, involving global ceilings and increased market discipline. The center in particular will only lend to fiscally weak states.

India: Sustainability of State Debts Post-TFC 1/
(In percent of GSDP)

	Debt Post-Relief	Debt Relief	Required Prim. Adj.	Primary Gap 2/ 3/	Debt/Revs. (ratio) 4/	Int./Revs. (ratio) 4/
Andhra Pradesh	30.9	2.5	-0.1	0.4	1.9	0.2
Bihar	49.1	6.9	0.5	1.0	1.8	0.2
Gujarat	35.3	2.0	2.0	0.1	2.6	0.2
Haryana	26.4	0.8	-1.9	0.3	2.3	0.2
Karnataka	30.3	2.3	-0.3	-0.5	1.5	0.1
Kerala	37.7	3.1	1.8	0.7	2.3	0.2
Madhya Pradesh	40.7	2.8	4.2	-0.4	2.0	0.1
Maharashtra	29.7	1.3	2.2	-0.5	2.2	0.2
Orissa	64.3	4.7	2.4	1.7	2.7	0.2
Punjab	51.8	2.1	2.5	0.7	2.4	0.2
Rajasthan	57.0	1.9	4.3	1.2	2.8	0.2
Tamil Nadu	26.2	1.7	-0.3	-0.5	1.9	0.2
Uttar Pradesh	48.2	3.1	2.1	0.8	2.7	0.2
West Bengal	42.7	1.8	2.5	2.3	3.6	0.4

Sources: World Bank; IMF staff estimates.
 1/ Assumes all debt relief and fiscal adjustment are realized up-front.
 2/ Assumes an overall deficit of 3 percent of GSDP.
 3/ When a positive gap exists, the debt level would decline.
 4/ Assumes three-quarters of the fiscal adjustment is via revenues.

Stronger adjustment may be required for some states. Under the staff’s baseline scenario, the targeted adjustment does not ensure sustainability for four states, and in five others debt would remain over 250 percent of revenue. In 11 states, interest payments would exceed 18 percent of revenue (the norm suggested by the 11th Finance Commission).^{1/} Expenditure reforms, including power sector, wage and pension, and subsidy reforms, and revenue measures, including higher user charges and tax base broadening, would be needed to put these states finances on a stronger footing.

^{1/} For details, see *Selected Issues*.

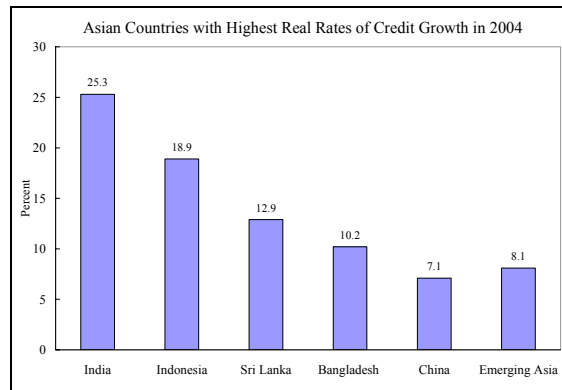
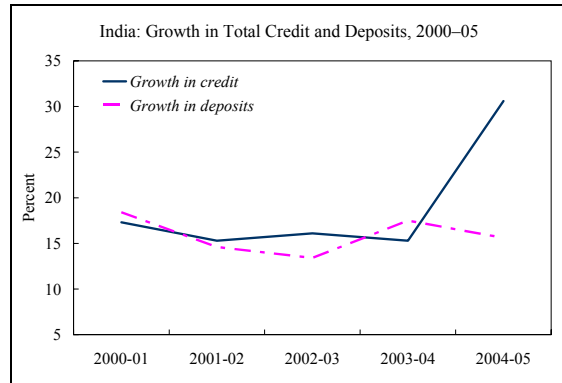
Box 4. Credit Growth

India had the fastest rate of credit growth in Asia in 2004/05. In the year ending in March 2005, bank credit grew by over 30 percent, the ratio of private sector credit to GDP grew to around 40 percent, and the aggregate credit-to-deposit ratio exceeded 60 percent. However, credit remains low compared to GDP (around 40 percent), reflecting a low level of financial intermediation compared to other countries.

Rising incomes and consumption amid falling borrowing costs have fueled credit demand. Retail banking, particularly for housing and credit cards, is a new growth area for banks.

While credit growth is broad based, it rose fastest in public sector banks and priority sectors. Priority sectors (such as agriculture and small industry) accounted for 40 percent of total nonfood credit growth. Housing credit has grown rapidly, accompanied by an exuberant real estate market.

Rapid credit growth raises concerns given some banks' weak risk assessment systems. The overall NPA ratio is low, and stress tests show that the banking system is resilient to the deterioration in credit quality that typically accompanies periods of rapid credit growth. However, NPAs are highest in public banks and in some priority sectors, and rapid credit growth is putting pressure on the capital adequacy of some banks. In addition, while credit card debt is still small, the rapid rise in such debt (36 percent in 2004/05), as well as the already sizable share of nonperforming loans (8 percent on average) and reports of unfair market practices, point to the possibility of future problems.^{1/}



^{1/} *Selected Issues* examines recent credit growth and related risks in more detail.

in fuel prices.⁸ The possibility of an acceleration in domestic demand supported by credit growth poses a key upside risk to growth and inflation. A more rapid than expected rise in world interest rates, either because of a disorderly global rebalancing or inflationary pressures in the United States, would hit India's exports, but the impact would likely be more modest than elsewhere in Asia, as India is still relatively closed.

14. **India's medium-term prospects are bright provided that key fiscal and structural reforms are implemented.** Staff projects growth at 6½ percent annually in the medium-term, but agreed with the authorities that growth could reach their objective of 8 percent in a reform scenario where successful fiscal adjustment creates space for needed infrastructure and social spending and structural reforms accelerate. Long-term growth prospects are aided by favorable demographics, which has the potential to raise savings and employment substantially over the next several decades. However, job creation and commensurate investments in human capital and infrastructure are key to realize this potential, especially as 60 percent of the increase in working age population over the next 40 years is projected to occur in the four slowest growing states. Slow reforms would leave growth closer to its recent historical average of 6 percent. The fiscal outlook would worsen in such a scenario, with the general government deficit rising, and the positive growth-interest differential fading by 2010/11. The resulting rise in debt from already high levels would increase vulnerabilities, and continued high deficits could stunt financial sector reform and capital account liberalization, and crowd-out private investment.

III. POLICY DISCUSSIONS

15. **Discussions focused on the policies needed to address inflationary pressures and to achieve India's medium-term growth potential.** Staff noted that, while short-term prospects are favorable, risks have increased since the last Article IV consultation, with higher oil prices, rising inflation and current account deficits, and fast credit growth. In this light, macroeconomic policy in the near term needed to be geared toward keeping inflationary pressures in check. The authorities were in broad agreement regarding the economic outlook, but were somewhat less concerned about domestic demand pressures, arguing that India's potential growth had increased in the last several years. Over the medium term, far-reaching structural reforms would also be needed to address long-standing constraints on growth and absorptive capacity. Acknowledging political constraints, the staff sought to focus on issues where near-term progress is most likely, and to bring value added by presenting international experience in specific areas, including tax base broadening, energy policy, and dealing with risks from rapid credit growth.

⁸ See Chapter I of the *Selected Issues*.

A. How Can India Deal with Short-Term Risks?

Fiscal Policy

16. **Overperformance on the 2005/06 budget would be appropriate.** Staff stressed that this would not only counter demand pressures and help achieve a more balanced policy mix to address inflationary risks, but also allow the authorities to meet targets envisaged by the FRBMA and strengthen its credibility. The authorities noted that they were seeking to do so, pointing to the potential for revenue overperformance and limited expenditure savings. In particular, VAT introduction on April 1 in 20 states has proceeded well so far, and compensation needs are expected to be less-than-budgeted.⁹ However, they noted that expenditure pressures, including higher social and infrastructure outlays and transfers to states mandated by the TFC, would likely limit the reduction in the overall deficit to about 0.2 percentage points of GDP, maintaining a downward trend in the deficit as a percent of GDP, but not sufficient to meet FRBMA targets.

17. **Staff argued that incomplete oil price pass-through was adding to budgetary pressures and preventing adjustment of demand to permanent price changes.** With high oil prices likely to be permanent, a move to full pass-through with adequate compensation mechanisms for the poor would serve India well by curbing rising quasi-fiscal costs,¹⁰ and encouraging improvements in energy efficiency, which would also help preserve India's competitiveness over time. Staff supported the recommendations of the government's 2004 report on central subsidies to phase-out LPG subsidies, which are regressive, and to improve the targeting of kerosene subsidies, given large leakages. In the short run, the latter could be achieved by restricting subsidies to below-poverty-line (BPL) households under the existing ration card system. Over time, staff encouraged the authorities to replace subsidies with targeted support, such as cash transfers to the poor. Together with the reintroduction of an automatic pricing mechanism (APM) for petroleum products, these steps would pave the way to eventual full price liberalization. To avoid high ad valorem taxes amplifying price shocks, staff advised a switch to specific petroleum taxation, in a revenue neutral manner and with annual automatic inflation indexation.

18. **The authorities recognized that high oil prices were likely to last, something to which policies had to adjust.** A committee headed by the chairman of the Prime Minister's Economic Council is looking into the issue of petroleum pricing and taxation. However, such measures faced political obstacles in the near-term, and compensating the poor could be technically difficult. In the interim, ad hoc and partial adjustments were likely to continue

⁹ VAT receipts rose 14 percent y/y in the first half of 2005/06. These preliminary estimates may overstate revenues as some states' VAT laws delay provision of refunds by up to a year.

¹⁰ Oil companies have suffered ½ percentage points of GDP in revenue losses due to the lack of pass-through in the first half of 2005/06.

and the central government was considering compensating oil companies for part of their losses by issuing them bonds. The authorities also called for more transparency in world oil markets. Over time, acquisition of oil assets abroad by state-owned oil companies and efforts to develop alternative energy sources would help India bolster energy security. Staff cautioned against quasi-fiscal risks arising from asset acquisitions and pressed the need to record the oil bond transaction transparently as a budgetary subsidy.

Monetary and Exchange Rate Policy

19. **A monetary policy response was needed to ward off inflationary pressures.** Staff suggested that a modest interest rate hike would help keep inflation expectations in check, and allow India to adjust to an environment of rising global interest rates. The RBI acknowledged that the oil price rise made it difficult to contain inflation in the range of 5-5½ percent projected earlier without an appropriate policy response, and stood ready to respond to evolving circumstances as warranted. In the event, RBI raised the reverse repo rate, its key policy rate, to 5¼ percent at its mid-term October policy review, pointing to upside inflationary pressures from oil prices in the context of incomplete pass-through, and also noting higher world interest rates. With risks to demand and inflation still on the upside, the RBI needs to monitor conditions closely and stand ready to tighten further if needed.

20. **There was agreement that appreciation of the rupee over the past year had not undermined competitiveness.** In particular, staff estimates of the real equilibrium exchange rate derived using an extended PPP approach suggest that the exchange rate was fairly valued at end-2004 and India's rising share in global export markets suggests that competitiveness is not a problem.¹¹ Staff welcomed the RBI's commitment to two-way flexibility in the exchange rate—as demonstrated by its absence from foreign exchange markets for much of 2005—which should boost incentives for corporates to hedge foreign exchange exposures. The large stock of reserves had enabled India to weather successfully a number of exogenous shocks and the RBI did not see the current level of reserves as excessive. Given increased reliance on more volatile capital inflows and a widening current account deficit, staff agreed that the current level of reserves provided a useful buffer shock against potential reversals, but underscored that given increased openness continued progress in structural reforms and supporting macroeconomic policies were also needed to underpin investor confidence.

B. How Will the Targeted Fiscal Adjustment Be Achieved?

21. **The authorities' medium-term fiscal roadmap provides a good framework for reform, but accelerated implementation is key to achieve FRBMA targets.** The authorities envisage a revenue-led adjustment, as large spending needs—in particular for infrastructure and priority social spending—limit the scope for closing the fiscal gap by compressing outlays. On the spending side, the emphasis would be on improving efficiency, including via the publication of an outcomes budget. Staff supported the revenue-led

¹¹ See Box 5.

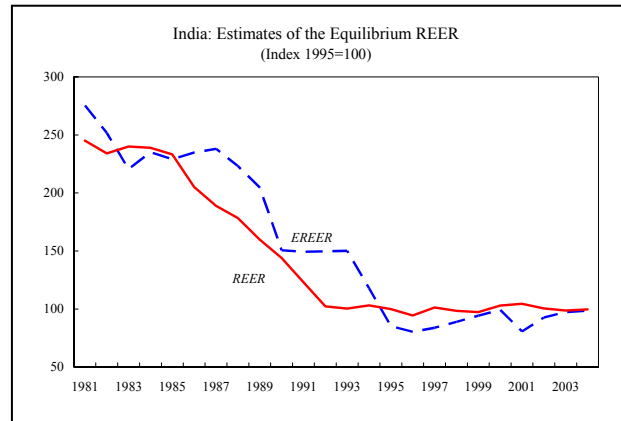
Box 5. Real Effective Exchange Rate

India’s real effective exchange rate (REER) has been rising, prompting some analysts to argue that the rupee is overvalued. The RBI’s new REER index, which was revised in December to reflect changes in goods trade patterns, has risen by 7.6 percent since 2003-04, and by 6.4 percent since 1993-94. Staff’s own broader based measure of the REER that, in addition to changes in goods trade also reflects trade in services and the competition Indian goods face from its trading partners in its export markets, has appreciated by 7 percent since 1993.

	RBI 6 Country	IMF Broad 43 Country
(In percent of total)		
Euro Area	35.1	34.6
United States	28.2	18.8
Japan	7.2	7.1
United Kingdom	10.1	6.2
China	12.0	3.8
Other emerging Asia	7.5	13.5
<i>Of which: Hong Kong SAR</i>	7.5	1.1
Other countries	...	16.1

Source: RBI December Bulletin, Bayoumi, Lee and Jayanthi (2005).

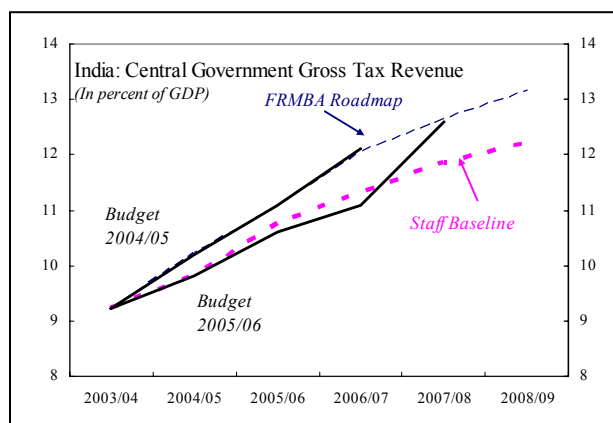
Existing methodologies yield a wide range of estimates of the “equilibrium” level of the rupee, with large uncertainties associated with each of these estimates. Determining the equilibrium exchange rate is a daunting task particularly for an economy like India that is undergoing structural change. Staff investigations using vector-error-correction models are a case in point. A specification that incorporates trends in relative productivity, openness, and net foreign assets suggests that at end-2004 the rupee was undervalued by about 15 percent. However, a similar specification that includes a control for the 1991 balance of payments crises finds the rupee fairly valued at end-2004 (the latter specification is shown in the chart below). In sum, the small sample size and the instability of the results to changes in specification suggest these estimates should be treated with a great degree of caution. The estimates are lower than those from other studies that use a panel-based extended PPP approach. Davoodi (2005) found the rupee to be 40 percent undervalued at end-2000; Benassy-Quere et al (2005) 16 percent undervalued at end-2001; and Milesi-Ferretti, Ricci, Lee and Jayanthi (2005) 30 percent undervalued at end-2004.



In sum, empirical investigations find little evidence of overvaluation. Moreover, India’s export performance in goods and services suggests that the exchange rate has not undermined competitiveness.^{1/}

1/ See Chapter 2 in the *Selected Issues*.

adjustment, but noted that implementation of the 2004 FRBMA roadmap for raising tax revenue had fallen behind schedule and that subsidy reform, as envisaged in a 2004 government report on subsidies, was stalled.¹² Full implementation of these reforms in the 2006/07 budget would be critical to prevent a deteriorating fiscal outlook. With only gradual tax base broadening, staff baseline projections suggest that the medium-term rise in tax revenue would be more modest than targeted by the authorities.



As a result, an additional $\frac{3}{4}$ percent of GDP in non-interest current expenditure savings would be required to meet FRBM targets.

22. **The authorities agreed that expanding India’s narrow tax base was a key priority of their medium-term fiscal strategy.** While the 2004 roadmap envisaged front-loaded measures—including the quick removal of exemptions and early introduction of a national goods and services tax (GST)—the authorities have adopted a more gradual approach. They would allow existing exemptions to lapse over the next four years, while taking steps to track and publish tax expenditure estimates. In addition, ongoing expansion of the services tax base and efforts at strengthening compliance via IT enhancements for tax administration were already boosting revenue. The introduction of GST remained a medium-term objective, which would require bringing remaining states into the VAT. Noting that exemptions were pervasive,¹³ staff underscored that their removal—with grandfathering if needed—and limits on the scope of tax incentives under the Special Economic Zones Act 2005 were key to meet revenue needs. Given the necessary lead time, preparations for the introduction of a GST with few exemptions should be accelerated, including by phasing-out as planned the inter-state sales tax (CST) and by reaching agreement with states on sharing of GST revenues. In the medium-run, staff advised a lowering of the personal income tax exemption threshold, which is high compared to higher-income emerging markets.

¹² See *Report of the Taskforce on Implementing the Fiscal Responsibility and Budget Management Act, 2003*, July 2004, Ministry of Finance, India; and *Central Government Subsidies in India*, December 2004, Ministry of Finance, India.

¹³ A recent study by the National Institute of Public Finance and Policy commissioned by the Finance Ministry estimates that the annual cost of key tax exemptions, including for small-scale enterprises, exports, underdeveloped regions, housing, and agriculture, exceeds $1\frac{1}{2}$ percent of GDP. See also Chapter III of the *Selected Issues*.

23. **Expenditure restructuring would be needed to create fiscal space for priority social and infrastructure spending.** The government recently approved a rural employment program (REGS) guaranteeing 100 days of public works employment per year per family head.¹⁴ In addition, the 2005/06 budget provides for continued increases in education and health spending, and a four-year program to provide basic infrastructure for the poor. The staff pointed out that to make room for these priority expenditures, more progress was needed in reforming subsidies, as recommended in the government's 2004 report.¹⁵ The authorities explained that these reforms face strong public resistance, and that they intended to keep a lid on subsidies through efficiency improvements. They also remained committed to containing the wage bill, although wage pressures were increasing, with the last civil service pay awards in 1998. Although the REGS was not explicitly targeted to the poor, the authorities' plan to start the program on a pilot basis and ensure self-targeting through low wages and strict work requirements. Over time, the staff suggested that consideration be given to replacing the large number of welfare programs and implicit and explicit subsidies—many of which are not well targeted—with a more formal social safety net.

24. **Center–state fiscal relations are being reformed to strengthen states finances.** The authorities expected that new debt relief incentives would induce states to pass and implement fiscal responsibility laws targeting current balance by 2009, consistent with the center's own law. In addition, the center intended to enforce a global borrowing constraint and promote greater reliance on market borrowing. While welcoming these measures, staff noted that some states would remain under fiscal stress even after reaching deficit reduction targets, while others would have difficulty achieving the targets.¹⁶ Addressing this would require stronger adjustment paths for some states and tighter borrowing caps, supported by better fiscal reporting by the states and a tighter link between grants and fiscal performance. Recent steps to curb the growth of small savings deposits—against which states can borrow without restrictions—are welcome.¹⁷ The staff also advised linking administered interest rates on these savings schemes to market rates—something advocated by a series of government reports—as a move toward their eventual elimination. The authorities agreed that incentives were only part of the solution to state fiscal problems, in particular as conditional grants were limited under India's federal system. Nevertheless, harder budget constraints would force states to undertake adjustment.

¹⁴ The annual cost of the program is estimated at about 1 percentage point of GDP once implemented in all states, 90 percent of which would be borne by the central government.

¹⁵ The government's 2004 subsidy report noted that the major subsidies are costly and not well targeted, and advocated fundamental reforms to food and fertilizer subsidies.

¹⁶ See Box 3 and Chapter IV of the *Selected Issues*.

¹⁷ See IMF Country Report No. 01/181 for background on the small savings system in India.

25. **The pending passage of a Pension Bill will help improve long-term fiscal sustainability and contribute to the development of the financial sector.** In January 2004, a mandatory defined contribution scheme for newly–recruited central government civil servants was introduced, which 15 state governments have joined so far. The Pension Bill would set up a new pensions regulator, and set guidelines for pension fund managers, prudential norms, investments, and capital requirements. Pension coverage is expected to increase over time as the system is extended on a voluntary basis to all states and parts of the private sector. While welcoming these measures, staff pointed out that parametric changes to the existing defined benefit pension system for civil servants—recommended in earlier government reports—are also needed to ease the fiscal burden of budgetary pension outlays and to control the size of unfunded pension liabilities.¹⁸ The authorities acknowledged the fast growth of pension payments, and noted that some states had already undertaken parametric reforms; but the central government favored waiting until the NPS was well established before making changes.

C. How Can the Government Ease Infrastructure Bottlenecks?

26. **The government is attempting to close part of India’s infrastructure gap through public-private partnerships (PPPs).** The pace of infrastructure development has recently increased in some sectors—including telecommunications, ports, and roads in and around major cities. To encourage further private sector involvement, the authorities have issued new sectoral guidelines, including model concessionary agreements for roads and ports; and set up a special purpose vehicle (SPV) to help address the lack of long–term infrastructure financing. The SPV would borrow domestically with government guarantee to finance commercially viable projects with private participation.¹⁹ Staff welcomed these measures, while emphasizing that better and more consistent regulatory practices, including independent regulators in all sectors, would be key to increase private participation. While the SPV provides a partial solution, it should be accompanied by financial reforms to expand the investor base. In this context, key steps to develop long-term corporate debt markets would include greater transparency in the issuance process, streamlining of registration procedures and tax provisions, lower barriers to domestic and foreign institutional participation, and development of derivatives trading.²⁰ Staff also underscored the need to reflect in the fiscal accounts all future fiscal risks, including those related to guarantees.

¹⁸ Following the 1990s civil service pay awards, pension outlays have risen to 2¼ percentage points of GDP in 2004/05. The World Bank estimates that the unfunded pension liability of central and state governments exceeds one–third of GDP.

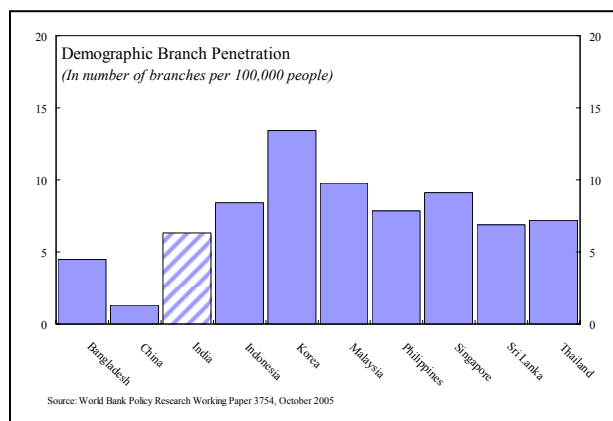
¹⁹ The SPV borrowing limit for 2005/06 is set at Rs. 100 billion (\$2.2 billion). The lead banker will be responsible for project appraisal.

²⁰ See also IMF Board paper on *Public Investment and Fiscal Policy—Summary of the Pilot Country Studies* (www.imf.org).

27. **Power bottlenecks remain a key constraint on growth.** Technical and commercial losses remain high, electricity shortages widespread, and tariff rates for industrial users are not internationally competitive. Losses of state utilities, although diminishing, remain a large drain on state finances. The government has continued implementation of the 2003 Electricity Act, which would allow for private operators in the sector but reforms have been uneven at state-level, with a few states recently reintroducing free power for farmers. The staff pressed the need for faster implementation of the Act—including the introduction of regulatory guidelines to catalyze the restructuring of State Electricity Boards and increase private participation. Although investor interest appears to be increasing recently, especially in generation, regulatory uncertainties and doubts about the independence of state regulators remain important constraints. The authorities were confident that the introduction of the National Electricity Tariff Policy—which will set pricing rules and provide guidelines on phasing out cross-subsidy surcharges—would help clarify the regulatory environment, and that good outcomes in reforming states would put pressure on other states to enact reforms.

D. How Can India Develop a World Class Banking System?

28. **Enhancing financial intermediation and ensuring broader access to financial services are key to promoting growth and poverty reduction in India.** The health of the banking system has improved dramatically in recent years. However, private credit at under 40 percent of GDP remains low, compared to over 100 percent for countries such as Korea and Malaysia. Moreover, while a large branch network ensures an overall level of access to banking services comparable with other developing countries in the region, large segments of the population lack any such access.²¹ Indian banks continue to have one of the largest exposures to government securities in the world, and the banking sector is dominated by public sector banks (PSBs) whose prudential indicators, despite recent improvements, remain less favorable than those of new private and foreign banks.



29. **While the pickup in credit growth is a welcome sign of financial deepening, it also raises concerns about credit quality.** The authorities were well aware of risks from rapid credit growth, and had taken steps to tighten prudential regulations. They noted that banks have continued to show strong profitability and low impaired loans, the latter reflecting improvements in risk management. The risks for banks' asset quality from surging

²¹ See *India: Scaling-Up Access to Finance for India's Rural Poor*, World Bank Report No. 30740-IN.

asset prices were being handled with prudential measures, notably by tightening capital market exposure limits and prudential norms on housing loans. Staff advised additional prudential measures in selected sectors to bring regulations in line with best international practices and raising risk weights on “priority sector” lending where NPLs were higher than the average.²² Staff also expressed concern about fast-rising credit card debt and the high delinquency rates in the sector. While welcoming the RBI’s close monitoring and steps to curb unfair lending practices, staff stressed the need for greater consumer education. Following the mission, the RBI announced an increase in general provisioning (with an exemption for agricultural and SME sectors) and tighter supervision on lending to real estate and other high risk sectors. The RBI is also considering the scope for additional steps, including the tightening of loan classification norms and for introducing “special mention” loans that would require provisions.

30. **The authorities plan to commence implementation of Basel II in 2007.** Banks are required to adopt the Standardized Approach for credit risk and Basic Indicator Approach for operational risk by end-March 2007. In preparation for this move, the RBI is taking steps to train supervisors, enhance monitoring of banks’ risk management systems, and improve market discipline and disclosure practices of banks. In particular, the RBI plans to extend the pilot project for risk-based supervision—currently covering 23 banks—to more banks. The RBI also indicated that many banks would need to raise additional capital to satisfy the new capital requirements.²³ Staff emphasized that this was a more ambitious schedule than in most other emerging market economies and noted that meeting the 2007 deadline would require a rapid pace of skill advancement in the RBI and commercial banks.

31. **Cooperative banks do not present a systemic risk but the failure of a number of such banks could affect confidence in the banking system.** Staff urged the authorities to align prudential regulations of urban cooperative banks with those of scheduled commercial banks, which was in line with the RBI’s longer-run objective. Meanwhile, the RBI was negotiating with key states to resolve the problem of dual oversight and developing a supervisory framework for urban coops. Rural cooperative banks also remain in financial distress, with NPAs reaching 35 percent in some banks, more than a third of rural coops under-capitalized, and about a quarter unprofitable. Staff advised quick implementation of recent recommendations to bring such institutions under RBI supervision with the regulatory norms on par with those of scheduled commercial banks.

32. **The improving financial soundness of the banking sector provides an opportunity to accelerate banking reforms.** To encourage financial development, the RBI

²² See Chapter V in the *Selected Issues*.

²³ Discussions with private sector banks suggest that implementation of Basel II norms would reduce their CAR by 1–2 percentage points, requiring a commensurate increase in their capital.

has recently initiated banking reforms aimed at increasing public sector banks (PSBs)’ autonomy and gradually lifting restrictions on foreign competition (Box 6). While acknowledging the authorities’ concerns regarding PSBs’ capacity to withstand increased foreign competition in the near term, staff observed that international experience has shown that increased foreign presence can be effective in improving banks’ performance by increasing technical know-how and efficiency. Bringing forward the 2009 target date for expanding FDI in domestic banks to include non-distressed banks and lifting the 10 percent cap on voting rights—the latter contemplated under amendments to the Banking Act currently in Parliament—would help accelerate foreign participation.. More generally, increasing private involvement could spur efficiency gains. In the short run, allowing some PSBs to raise additional capital by reducing their government share below the 51 percent requirement would further this objective.²⁴

33. Greater emphasis should be given to addressing other impediments to the development of the financial system. Staff advised the authorities to shift from a heavy reliance on priority lending to removing roadblocks to lending such as remaining difficulties in recovering assets, lack of well-developed credit registries, and weak accounting practices in SMEs. The Securitization and Debt Recovery Act and the new credit registry were positive developments but collateral requirements and limits on microfinance continue to constrain potential. Measures considered by the RBI to develop the government securities market via primary dealers and introduction of short selling are welcome. However, it will be important to ensure that interest rates are market-determined—the government currently retains the right to determine cut-off rates—and that steps are taken to deepen the market, including expanding the institutional investor base and accelerating the use of derivatives. Recent proposals to permit limited investment by domestic pension funds in local equity markets would also help deepen India’s financial markets.

E. How Can India Benefit More from Globalization?

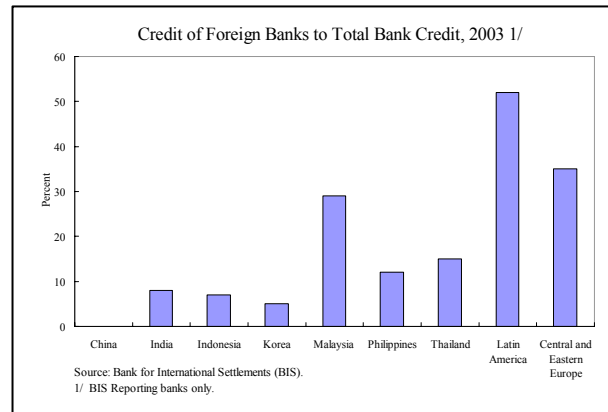
34. The authorities were committed to decreasing customs duties to ASEAN levels (9 percent) by 2009. Tariff reductions have continued in 2004/05, with the peak non-agricultural tariff rate declining from 20 percent to 15 percent, and average tariffs falling by 5 percentage points to 17 percent. Staff welcomed these developments and encouraged faster liberalization. More rapid convergence to ASEAN levels would enhance competitiveness and help the authorities reach their objective of doubling India’s share in world trade.²⁵ Efforts to streamline customs procedures—notably, through pilot projects to

²⁴ With rapid credit growth and the need to meet Basel II capital norms, a number of public banks with government ownership close to the 51 percent floor would need additional capital.

²⁵ Despite robust export growth in the last several years, India still only accounts for 2½ percent of the global trade in goods and services.

Box 6. Foreign Banks in India

In early 2005, the RBI announced a series of banking reforms, designed to give public banks greater autonomy and to provide guidelines for foreign bank expansion. The authorities see it as a new step in the continuing process of financial market liberalization. The intention of the reforms is to increase public banks' efficiency, while providing them breathing space by keeping some restrictions on foreign competition until 2009. From 2005, foreign banks are allowed to establish wholly-owned subsidiaries (previously only branches were allowed). In addition, the RBI plans to amend legislation to eliminate the 10 percent cap on the voting rights of foreign banks. However, any acquisition of 5 percent or more by a foreign bank will still require RBI approval, and FDI is limited to private banks identified for restructuring, with a limit of 74 percent. Full national treatment for wholly-owned subsidiaries of foreign banks and the expansion of FDI to non-distressed banks is not envisaged until 2009.



Foreign banks currently account for about 7 percent of total assets of the banking system, and 5 percent of deposits. Although foreign banks can engage in all financial sector activities, foreign presence in the Indian banking system (as captured by balance sheet data) is lower than in some other emerging Asian countries, and significantly lower than in Latin America and Eastern Europe. In contrast, foreign shareholders account for 21 percent of total trading in the Indian stock market—a level similar to other Asian countries.

Empirical studies show that larger foreign bank presence can enhance the competitiveness of the banking sector, and widen access of qualified borrowers to financing.¹

Foreign bank entry may also lower risks through improved risk management techniques and more realistic provisioning against bad loans, and may contribute to making more capital or liquidity available when needed.

	All Banks	Domestic		Foreign Banks
		State Banks	Private Banks	
	(In percent)			
Market share (in assets)	100.0	74.4	18.8	6.8
Capital to risk weighted assets	12.8	12.9	12.2	14.0
Tier I capital to risk weighted assets	8.4	8.0	8.5	11.2
Gross NPLs to gross loans	5.2	5.5	4.4	2.8
Net NPLs to capital	11.7	13.6	9.5	4.5
Personnel expenses to total income	15.3	17.2	9.0	10.3
Return on assets	0.9	0.9	0.8	1.3
Return on equity	13.6	14.7	11.7	10.8

The key financial soundness indicators of foreign banks in India are somewhat better than for public or domestic private banks.

¹ See e.g., Chapter 6, “The Role of Foreign Banks in Emerging Markets,” in *IMF World Economic and Financial Surveys, International Capital Markets, Developments, Prospects, and Key Policy Issues, 2000*, eds. by D. Mathieson, G. Schinasi, and S. Claessens.

improve risk-based assessments and reduce costly inspections—are also important, and should be expanded together with reduction of nontariff barriers. The authorities supported the Doha Round as the best forum for addressing agricultural issues and expanding market access. However, they noted that the developed countries’ reluctance to reduce farm support in exchange for market access undermined the reaching of an agreement. The authorities saw the South Asian Free Trade Agreement and other regional and bilateral agreements as an important aspect of trade policy, noting that such initiatives enhanced economic cooperation and helped build support for multilateral liberalization. Staff supported efforts to enhance intra-regional trade, but emphasized the need for further MFN-based tariff reductions to minimize the potential for trade diversion associated with preferential trade agreements (PTAs). Staff also cautioned against a potentially complex web of tariff schedules and regulations arising from multiple PTAs, which would be difficult to administer and possibly hinder trade.

India: Recent Regional Trade Agreements and Agreements Under Negotiation (Partners, nature of agreement, date)
I. Concluded
* Singapore, Comprehensive Economic Cooperation Agreement, August 2005
* South Asia (Bangladesh, Bhutan, Maldives, Nepal, Pakistan, Sri Lanka) Free Trade Agreement, January 2006
* Mercosur, Preferential Trade Agreement, January 2004
II. Under Negotiation
* ASEAN, Comprehensive Economic Cooperation Agreement
* Bay of Bengal Initiative for Multi-Sector Technical and Economic Cooperation (BIMST-EC), Free Trade Agreement Goods, Services, and Investments
* Chile, Preferential Trade Agreement
* Mauritius, Comprehensive Economic Cooperation Partnership Agreement
* Southern African Customs Union, Preferential Trade Agreement
* Sri Lanka, Comprehensive Economic Partnership Agreement
* Thailand, Free Trade Agreement
Source: Government of India, Ministry of Commerce and Industry.

35. **The authorities aim to continue the gradual liberalization of capital flows.** In addition to further liberalization of the FDI regime, proposals are under consideration to progressively ease quantitative limits on foreign investors’ access to domestic equity and debt markets. However, there remains a range of views among the authorities regarding the scope and pace at which such liberalization should take place, reflecting concerns about the origin of the inflows and their potential impact on macroeconomic volatility.²⁶ Liberalization of outflows has been proceeding and further liberalization would be achieved through gradually lifting remaining restrictions.²⁷ While pension funds are not allowed to invest abroad under the draft Pension Bill, the authorities indicated this provision could be

²⁶ See *Report of the Expert Group on Encouraging FII Inflows and Checking the Vulnerability of Capital Markets to Speculative Flows*, Ministry of Finance, India, November 2005.

²⁷ Recent measures included liberalizing corporate overseas investment, and raising limits on domestic mutual funds and individual investments abroad.

reconsidered once the system is well established. Staff underlined the potential benefits from further capital liberalization—including more rapid financial sector development and enhanced risk diversification—but generally supported the authorities’ gradual approach, in particular in view of still-large fiscal imbalances.

36. Progress has been made toward liberalizing FDI. Interest in India among investors remains very high—India rates among the top three

potential destinations for FDI in a number of surveys—but actual FDI raised remains low relative to many other emerging market economies. In this context, staff welcomed the raising of FDI limits in some sectors, and urged other such increases, including for insurance and retail. Even more important, a continued improvement in the overall business climate could have a large pay-off.²⁸ The authorities are pinning their hopes in the near term on the expansion of Special Economic Zones (SEZs) to spur FDI, pointing that in addition to tax incentives and good infrastructure, businesses in SEZs will have access to a single window clearance office.

37. Less restrictive labor laws would enhance prospects for much needed employment gains. Despite rapid economic growth in recent years, employment has remained flat, and with some 100 million new labor market entrants expected in the next decade, the expansion of labor-intensive manufacturing is critical. However, India’s labor laws are widely perceived as more rigid than in other countries in the region, stalling the development of large-scale manufacturing.²⁹ The authorities acknowledged that restrictive labor laws impeded FDI in manufacturing, but did not see them as the key constraint for most Indian corporates. A move toward “hire and fire” flexibility would face stiff political

India: Selected Capital Account Liberalization Measures, 2005	
I. Inflows	
* FDI up to 100 percent permitted under the automatic route in townships, housing, built-up infrastructure and construction but is subject to minimum capital requirements, lock-in and size requirements.	March
* NGOs engaged in microfinance permitted to use external commercial borrowings up to US\$5 million, subject to "fit and proper" safeguards.	April
* External commercial borrowing for real sector activity, including investment in infrastructure, no longer to requires RBI approval. Nonbank financial corporations also permitted to borrow externally without RBI approval provided borrowing is for a minimum average maturity of 5 years.	June
II. Outflows	
* The ceiling of overseas investment by Indian companies under the automatic route was doubled to 200 percent of a companies net worth.	April
* FDI cap on investments in non-news publishing eliminated.	June
* FDI cap on investments in private radio eliminated.	July
* Ceiling for automatic prepayment of external commercial borrowing doubled to US\$200 million.	August
* FDI cap on investments in the telecom sector raised to 74 percent.	October
Source: Reserve Bank of India.	

²⁸ India ranks 116 on the overall ease of doing business among 155 countries (World Bank *Doing Business in 2006—Creating Jobs*), with enforcing contracts, trading across borders, and dealing with licenses highlighted as particular problems.

²⁹ India ranks 116 on the ease of hiring and firing, with indices of employment rigidity, hiring costs, and firing costs all higher than the regional average (World Bank *Doing Business in 2006—Creating Jobs*).

opposition, in particular in light of the lack of an adequate social safety net. However, the authorities were considering some reforms supported by the staff, including amending the contract labor law to expand the number of industries that can hire contract workers, streamlining labor regulations, and raising the cutoff size for firms exempt from certain labor laws, inspections, and reporting requirements.

38. **Staff pointed to the post–MFA performance of the Indian textile sector as evidence both of the potential of Indian manufacturing as well as the need for further reforms.** While recent performance is encouraging—textile and clothing production has grown by over 11 percent y/y in January-October, and exports to U.S. markets have grown by 23 percent y/y according to U.S. Bureau of Census data—important roadblocks remain. The private sector points to labor market rigidities—which limit the ability of Indian firms to respond nimbly to rapid changes in demand—as a key issue. In addition, poor infrastructure raises the cost of manufacturing and exporting, while the legacy of small–scale industry reservation has meant that firms typically do not benefit from economies of scale.

F. Other Issues

39. **India eliminated a restriction on payments for current account transactions subject to approval under Article VIII (Annex II, Section VII).** However, other restrictions remain in place and the staff encouraged their removal.

40. **Staff welcomed progress made in improving economic statistics.** In particular, the staff looked forward to the planned publication of a CPI with a 2000 base year and a new producer price index.³⁰ Staff also welcomed the planned creation of a National Statistical Office in 2006, merging the Central Statistical Office with the National Sample Survey Organization. While India’s statistics are adequate for surveillance purposes, weaknesses remain in timeliness and coverage of statistical series (Annex V). The authorities were encouraged to address the main issues identified by the 2004 data ROSC and a recent follow–up technical assistance mission. In light of the significant financial sector reforms that have been implemented in recent years and rapid growth in the insurance sector, an FSAP update would also be welcome. The authorities indicated that for now, they were focused on their self-assessment, on which they welcomed staff comments.

IV. STAFF APPRAISAL

41. **The Indian economy is reaping the rewards of the structural reforms introduced since the early 1990s.** The economy showed remarkable resilience in 2004/05, with growth nearing 7 percent and becoming increasingly broad–based. Thus far in 2005/06, these trends have continued and, with a near normal monsoon, growth should exceed 7½ percent.

³⁰ See Chapter VI in the *Selected Issues*.

42. **Favorable conditions provide an opportunity to fast-forward the government’s structural agenda, allowing it to achieve its own ambitious growth and poverty-reduction targets.** The government is rightly placing emphasis on addressing infrastructure bottlenecks, deepening global integration, and accelerating annual growth to 8–10 percent to create jobs and improve the living standards of the rural poor. Steps to improve the business climate and regulatory environment, and reform of restrictive labor laws would potentially have large pay-offs by encouraging needed domestic and foreign private participation and fostering job creation, allowing India to fully benefit from demographic advantages.

43. **Macroeconomic policies should remain vigilant in 2005/06, in view of the evolving macroeconomic and financial situation.** Strong domestic demand and high world oil prices are contributing to rising inflation and a widening current account deficit.

44. **In this context, fiscal policy should counter demand pressures.** The authorities should strive to meet the minimum adjustment required under the FRBMA, which would not only be an appropriate macroeconomic policy response, but would also help maintain the credibility of the FRBMA and allow the center to lead by example in efforts to encourage adjustment by the states. In this light, the authorities should direct any revenue overperformance to deficit reduction and work to identify potential expenditure savings.

45. **The authorities have understandably sought to share the burden of higher world oil prices, but the Indian economy must now adapt to a higher oil price environment.** Together with a move to full pass-through, the government could replace special price subsidies by a system of targeted support for the poor. It would also be desirable to reinstate an APM and shift petroleum taxation further toward a specific basis, in a revenue-neutral manner and with automatic inflation adjustments to protect the real value of collections. The government should consider full liberalization of oil prices in the medium run.

46. **Monetary policy needs to remain focused on keeping inflation expectations in check.** The recent increase in the reverse repo rate was appropriate, signaling the RBI’s commitment to price stability and helping India adjust to an environment of rising global rates. With indicators suggesting tightening supply-side constraints, and upside risks to domestic demand growth, further interest rate increases may be needed.

47. **The RBI should continue its two-way flexibility in exchange rate management.** Despite a recent real effective appreciation, competitiveness appears adequate and staff analysis finds that the exchange rate is close to fair value. In this context, two-way exchange rate flexibility will help facilitate economic adjustment and encourage hedging of foreign exchange risk.

48. **Despite fiscal adjustment efforts since 2001/02, public debt remains high and the medium-term fiscal environment has turned more challenging.** The central government fiscal deficit reached an eight-year low in 2004/05. Notwithstanding this progress, the debt burden remains high. Moreover, the improvement in recent years reflects in part a cyclical

upturn and a low interest rate environment, while the impact of high oil prices has been shifted off-budget, and neither tax nor expenditure reform has moved as fast as initially envisaged. Large planned increases in infrastructure and social spending also complicate the center's efforts to meet its fiscal targets.

49. Further tax base broadening is needed to generate the needed adjustment.

Important progress has been made, including the introduction of a VAT in most states and the expansion of the services tax base. In addition, ongoing modernization of tax administration will help bring more taxpayers into the tax net. The central government can broaden further its tax base by trimming exemptions and continuing expansion of the service tax base. The development of tax expenditure estimates would also provide a valuable tool for resisting attempts to introduce inefficient exemptions. Regarding the VAT, initial gains should be consolidated by bringing in remaining states, phasing-out the CST, and agreeing with states on revenue-sharing to lay the ground for introduction of a GST.

50. Sustainable fiscal adjustment will also require greater spending efficiency, in particular improved targeting of support to the needy. Subsidy reform is needed to free resources for infrastructure and social spending as well as deficit reduction. The rural employment program also represents a potentially large expenditure commitment and the government should proceed cautiously while providing appropriate incentives for self-targeting. The center should also consider replacing, over time, the large number of welfare programs and subsidies with a better-targeted social safety net.

51. The pending passage of the Pension Bill would be a welcome step toward broader pension reform. The introduction of fully-funded defined contribution pensions will help provide a secure and sustainable source of retirement income and aid in the development of capital markets. However, the unfunded pension liabilities of existing defined benefit schemes for civil servants require parametric revisions to ease the fiscal burden and make these liabilities manageable.

52. The authorities should build on the important steps taken in recent years to improve states' fiscal health.

- **States have, in the aggregate, succeeded in reducing their overall and current deficits.** But deeper reforms—including tax base broadening and pension, subsidy and power reforms—are needed to sustain and extend these gains. The introduction of a VAT in most states is an important step in this regard.
- **Implementation of TFC recommendations will provide states with greater resources as well as incentives to undertake fiscal reform.** However, incentives provided may be too small to ensure that some states with large deficits adjust, and in other states, TFC targets are not sufficiently ambitious. Harder budget constraints—via tight global borrowing ceilings, reform of small savings, and greater reliance on market borrowing—will be key to enhance the effectiveness of the TFC.

53. **Ensuring that regulatory and other policies support private investment and productivity growth remains a key challenge.** The emphasis on PPPs to ensure greater private participation in infrastructure is welcome, but an improved regulatory framework is also needed. Moreover, the government should evaluate and account for all contingent liabilities associated with infrastructure projects. The SPV for infrastructure should be accompanied by financial reforms to broaden the long-term investor base. In the power sector, the 2003 Electricity Act provides a solid framework for reform and implementation should be accelerated.

54. **The Indian financial system has remained resilient.** Both the underlying strength of financial regulation and an effective response to recent fast credit growth have contributed to this. However, with a large and growing share of credit directed to higher-risk “priority sectors,” prudential standards may need to be strengthened further and reliance on priority sector lending reduced by addressing impediments to lending. The RBI also needs to monitor carefully credit card debt. While still in its infancy in India, the rapid rise in such debt, as well as the already sizable share of nonperforming loans, point to the need for close supervision and consumer education. The RBI should also continue its efforts to strengthen the regulation of UCBs, which remain in poor health. Finally, the RBI should continue efforts to ensure readiness for the planned move to Basel II, by enhancing relevant skills for bank supervisors, monitoring improvements in commercial banks’ risk management systems, and improving disclosure practices of banks.

55. **With financial soundness improving, the authorities should use this opportunity to emphasize underlying financial sector development.** In particular, the authorities should consider encouraging more foreign participation in the banking system, which would provide banks the tools and incentives to increase their efficiency. In this context, the RBI should consider accelerating implementation of its banking reforms. Steps to develop the government and corporate securities market are welcome, but certain aspects, such as the introduction of short-selling, could be accelerated.

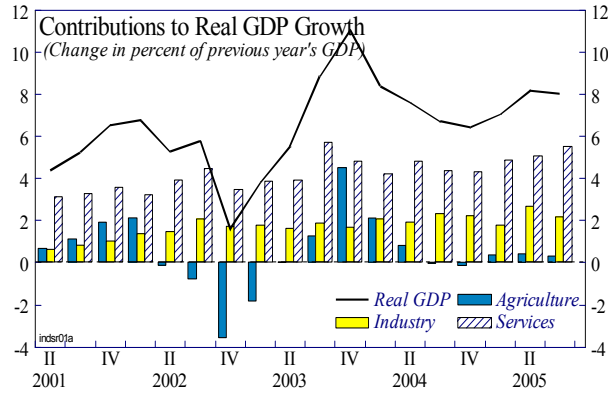
56. **India is already benefiting from its increased integration into the global economy but further opening would allow the country to reach its full growth potential.**

- **Given excellent progress already made in reducing tariffs, faster convergence to ASEAN levels should be achievable.** The authorities’ pursuit of preferential trade agreements (PTAs) bolsters the case for MFN-based tariff reductions so as to reduce the trade diversion potentially associated with PTAs.
- **Continued loosening of FDI limits, together with efforts to improve the business climate and liberalize labor laws would have a major payoff.** Increased FDI would bring technological and managerial know-how to India, while reducing reliance on shorter-term capital flows. Although liberalizing labor laws are a complex and socially contentious issue, some key steps short of fully flexible hiring and firing would seem feasible in the near term.

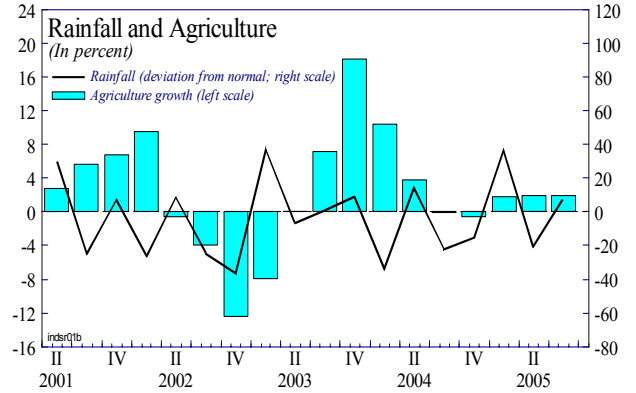
57. It is recommended that the next Article IV consultation take place within the standard 12-month cycle.

Figure 1. India: Growth

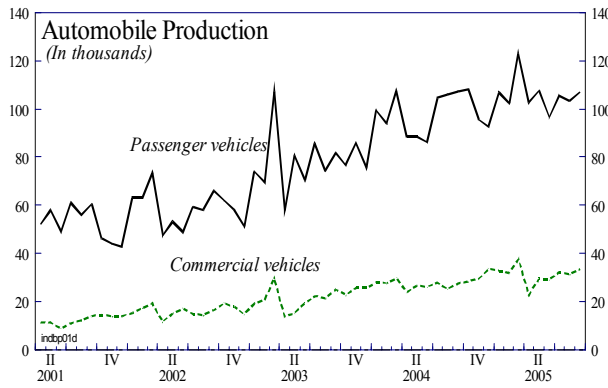
Growth has been robust...



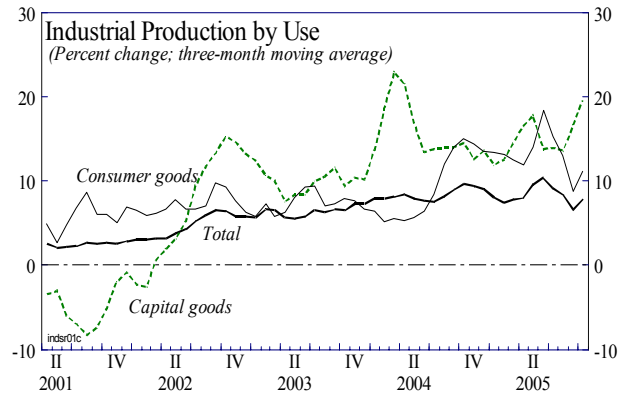
...helped by a normal monsoon,...



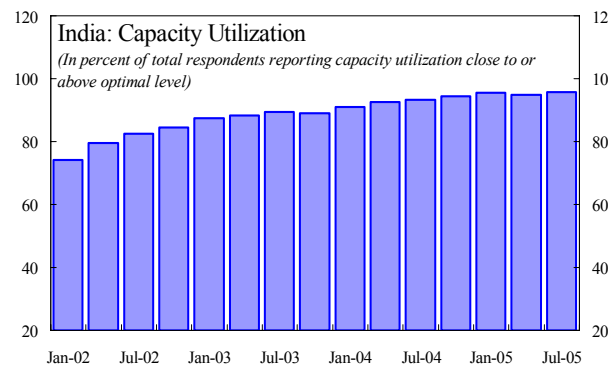
...buoyant consumption demand,...



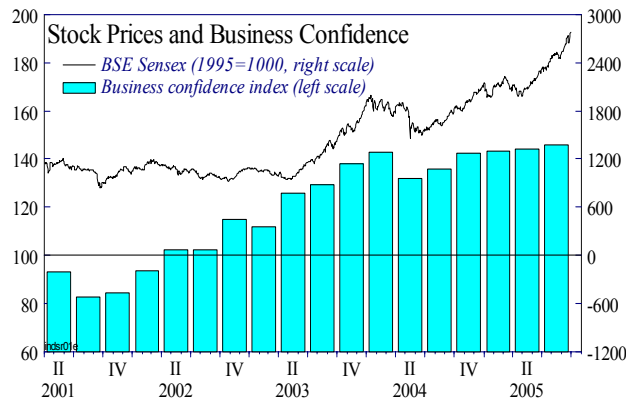
...strong industrial production,...



...higher capacity utilization...



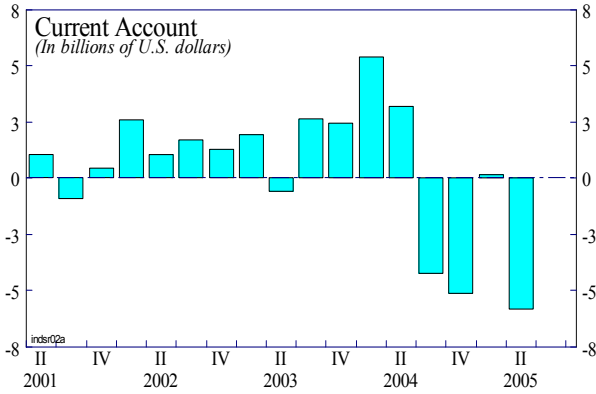
...and increasing stock prices and business confidence.



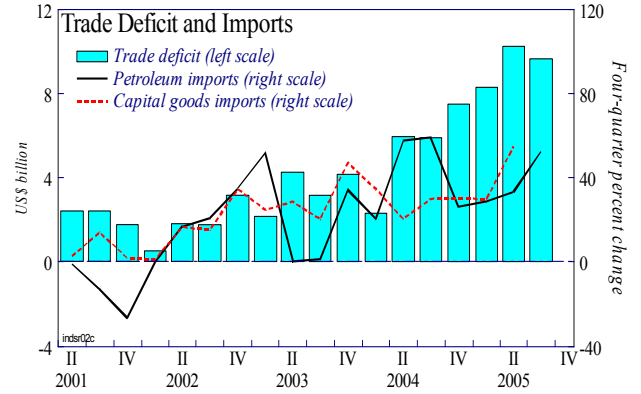
Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; NCAER; and IMF staff projections.

Figure 2. India: External Sector

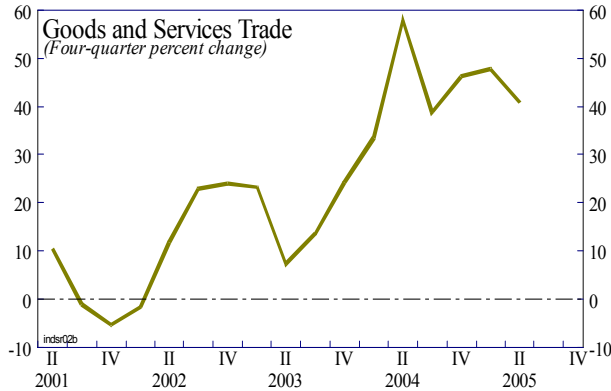
The current account moved into deficit...



...as the trade deficit rose on high oil prices and strong domestic demand.



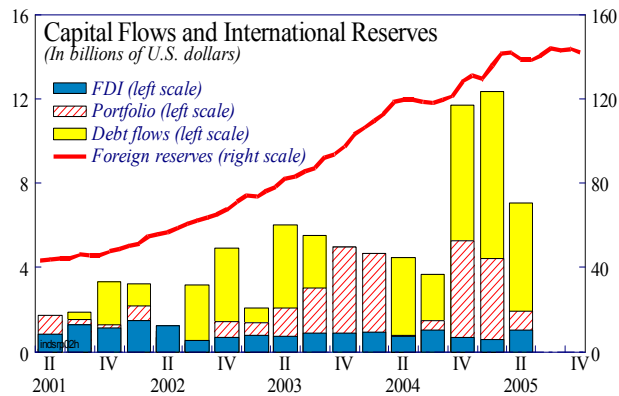
However, export growth remained strong...



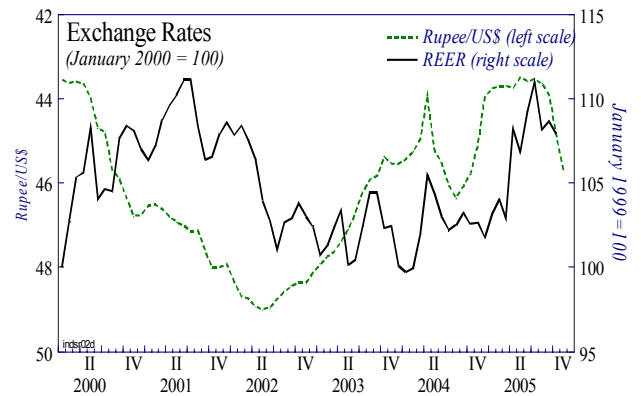
...and India gained market share.



More recently, the reserve build-up has slowed...



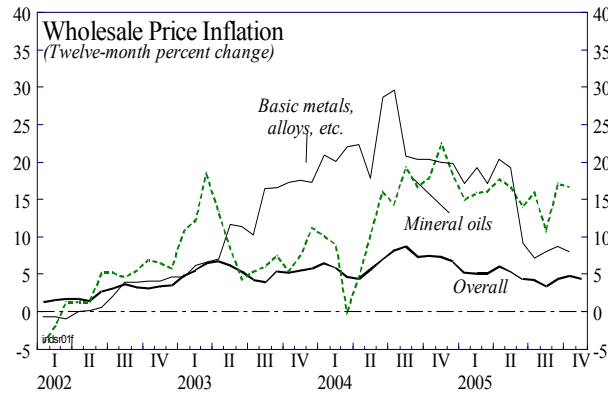
...and the exchange rate has depreciated.



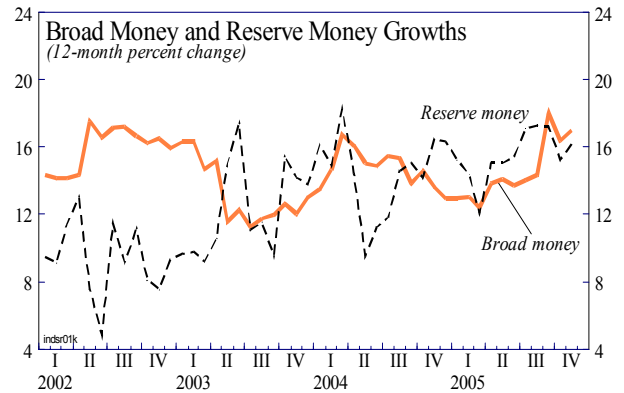
Sources: Data provided by the Indian authorities; and CEIC Data Company Ltd.
1/ Customs data; based on U.S. dollar values.

Figure 3. India: Money and Inflation

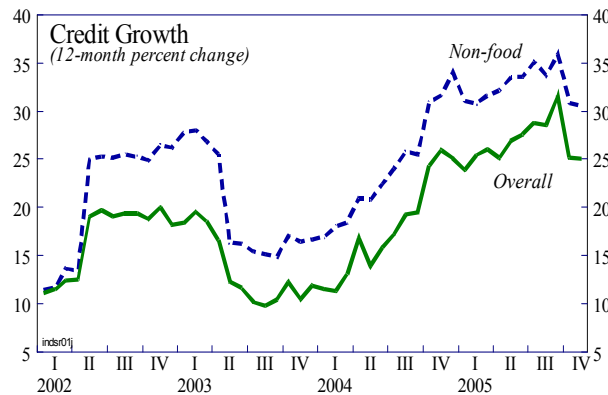
Headline inflation is beginning to rise...



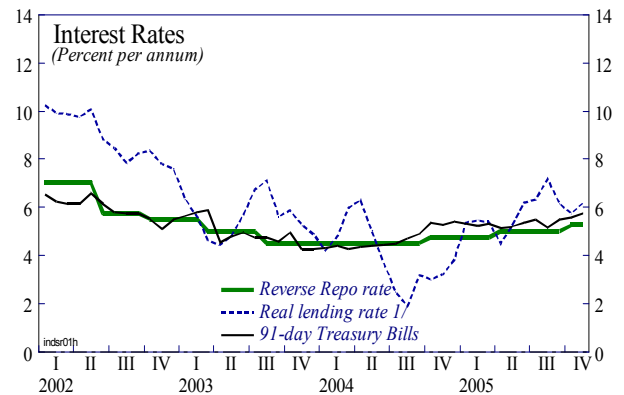
...reflecting high money supply growth...



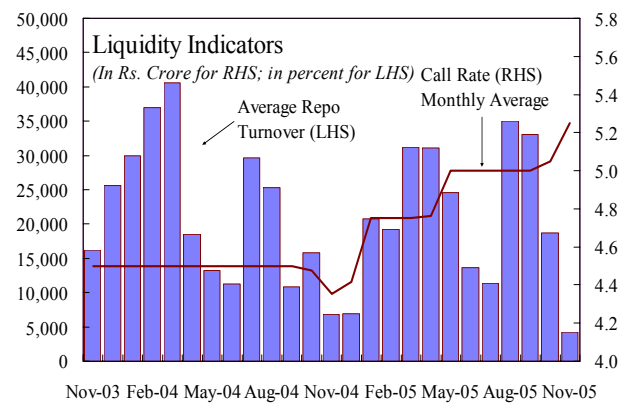
...and strong credit growth...



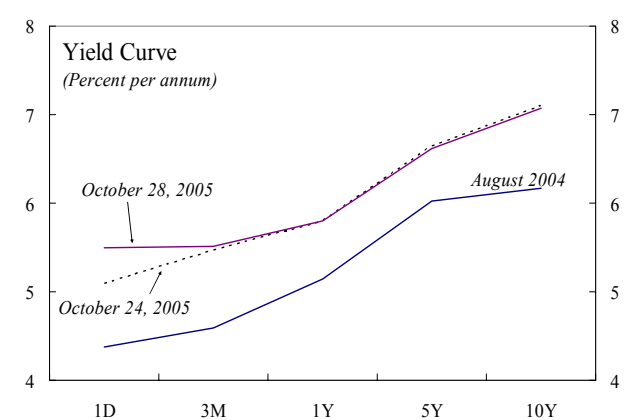
...amid low interest rates...



...and accommodative liquidity conditions...



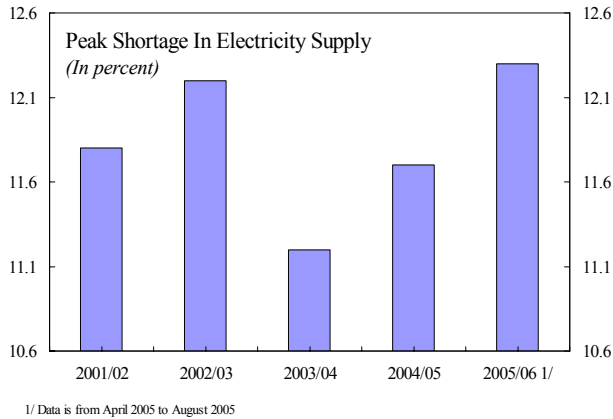
...prompting the RBI to raise reverse repo rates in line with market expectations.



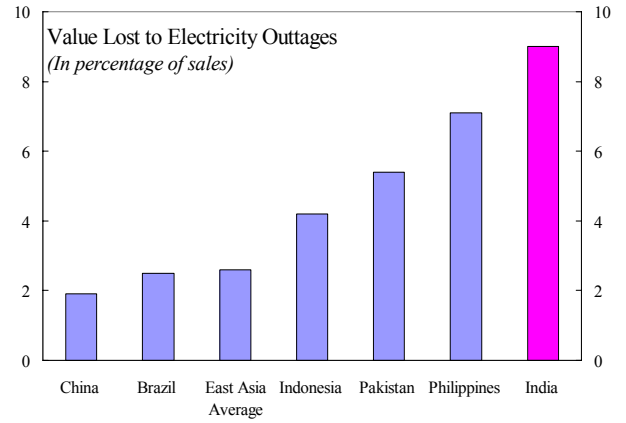
Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; and IMF staff projections.
1/ Prime lending rate deflated by the WPI.

Figure 4. India: Infrastructure Indicators

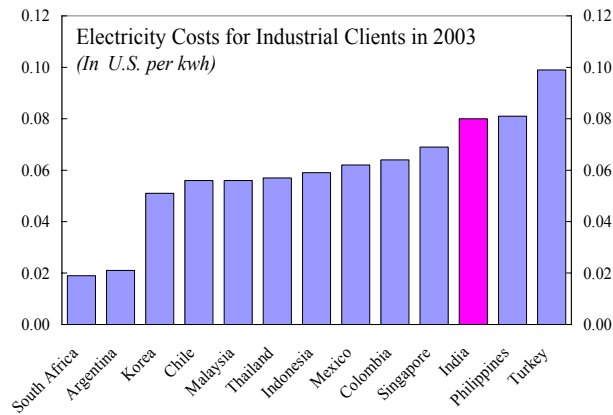
Electricity demand continues to outstrip increases in supply ...



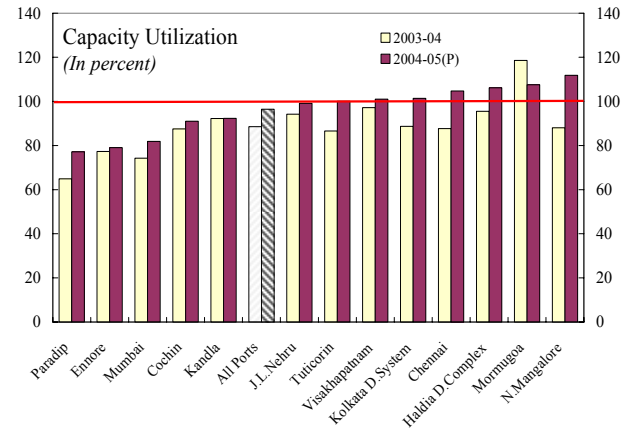
...causing large losses for Indian firms ...



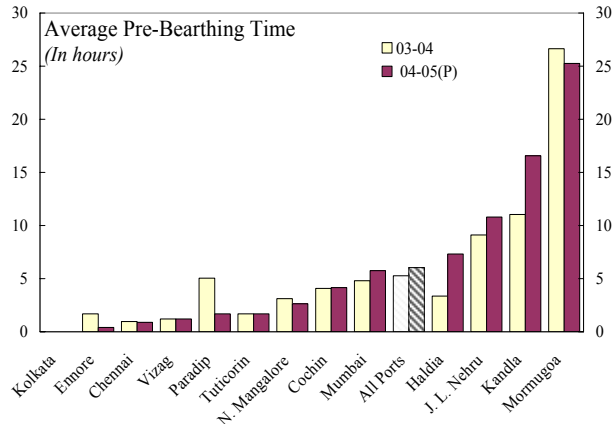
... and higher costs relative to competitors.



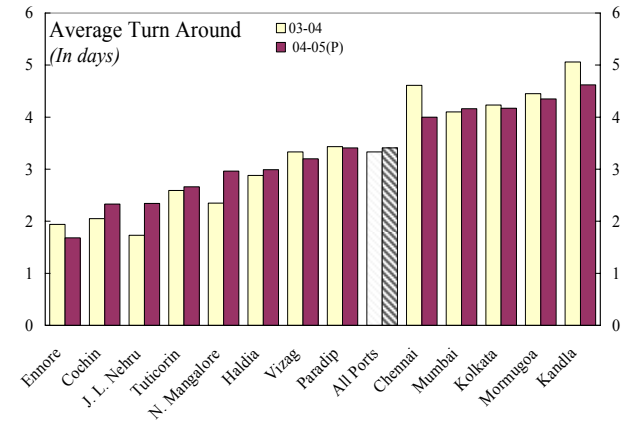
Many ports are operating close to capacity ...



... causing delays entering ports ...



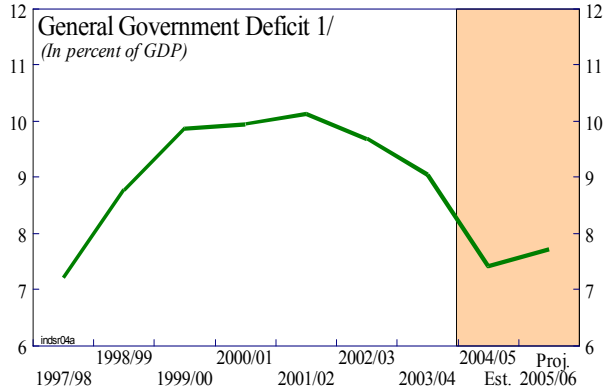
... and slow processing times.



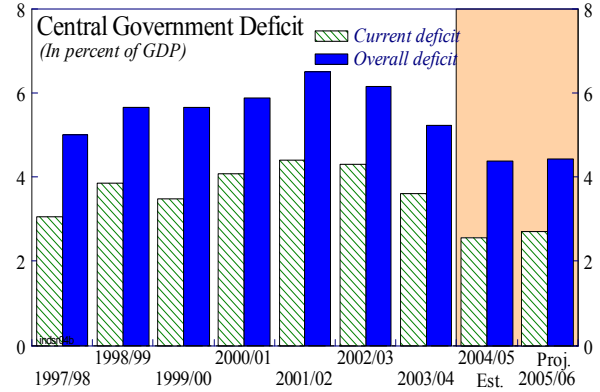
Sources: IMD World Competitiveness Yearbook, Indian authorities; World Bank Investment Climate Survey, and staff estimates.

Figure 5. India: Fiscal Trends

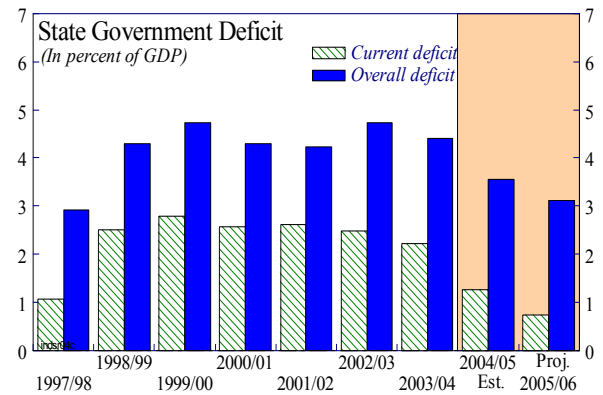
The public sector deficit has fallen...



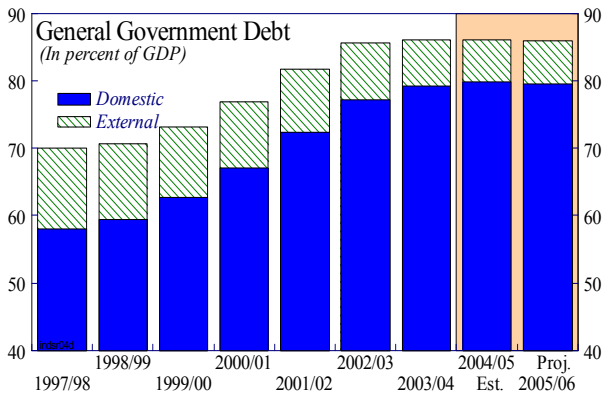
... but the central government is pausing adjustment ...



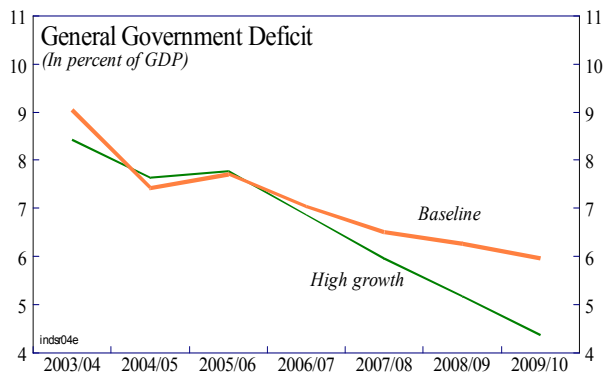
...to facilitate greater transfers to states.



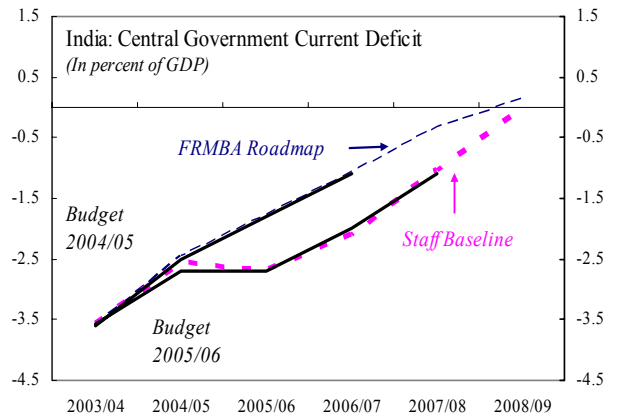
As a result, the debt ratio remains unchanged.



The Fiscal Responsibility Act should engineer a consolidation of public finances...



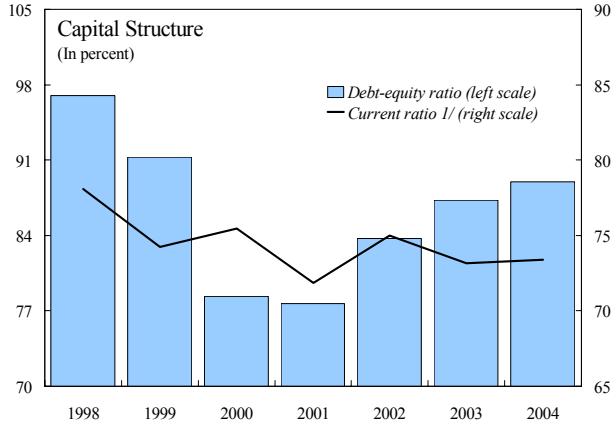
...but FRBMA targets are difficult to achieve.



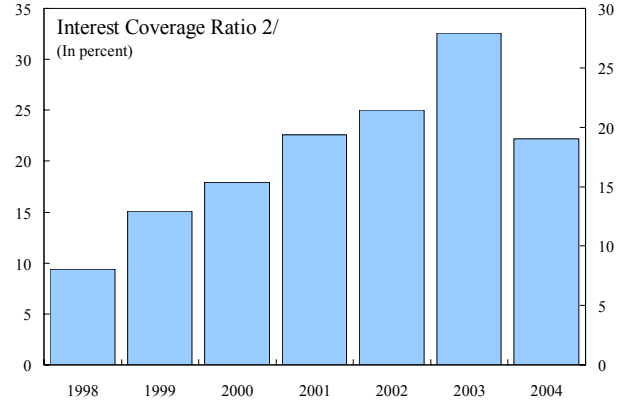
Sources: Data provided by the Indian authorities; and staff projections.
1/ Excluding privatization receipts.

Figure 6. India: Corporate and Financial Sector Soundness

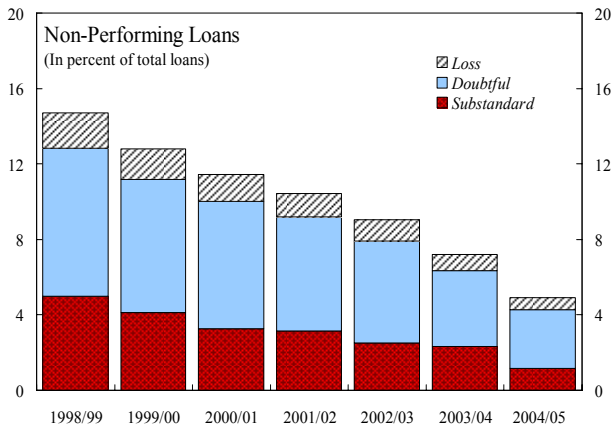
Corporates are borrowing more...



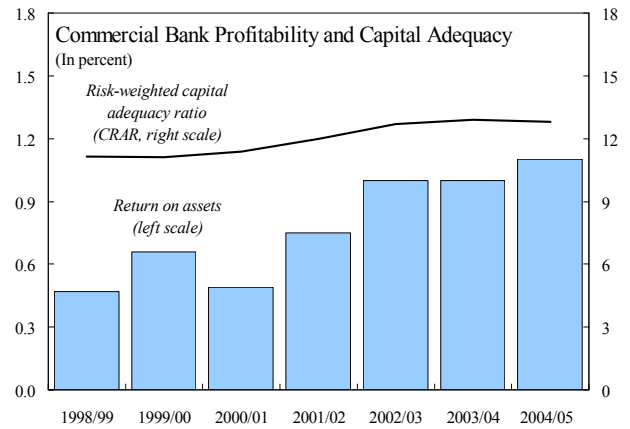
.... and rising interest costs are cutting profits.



Bank's NPLs continue to fall...



... and profitability remains comfortable.

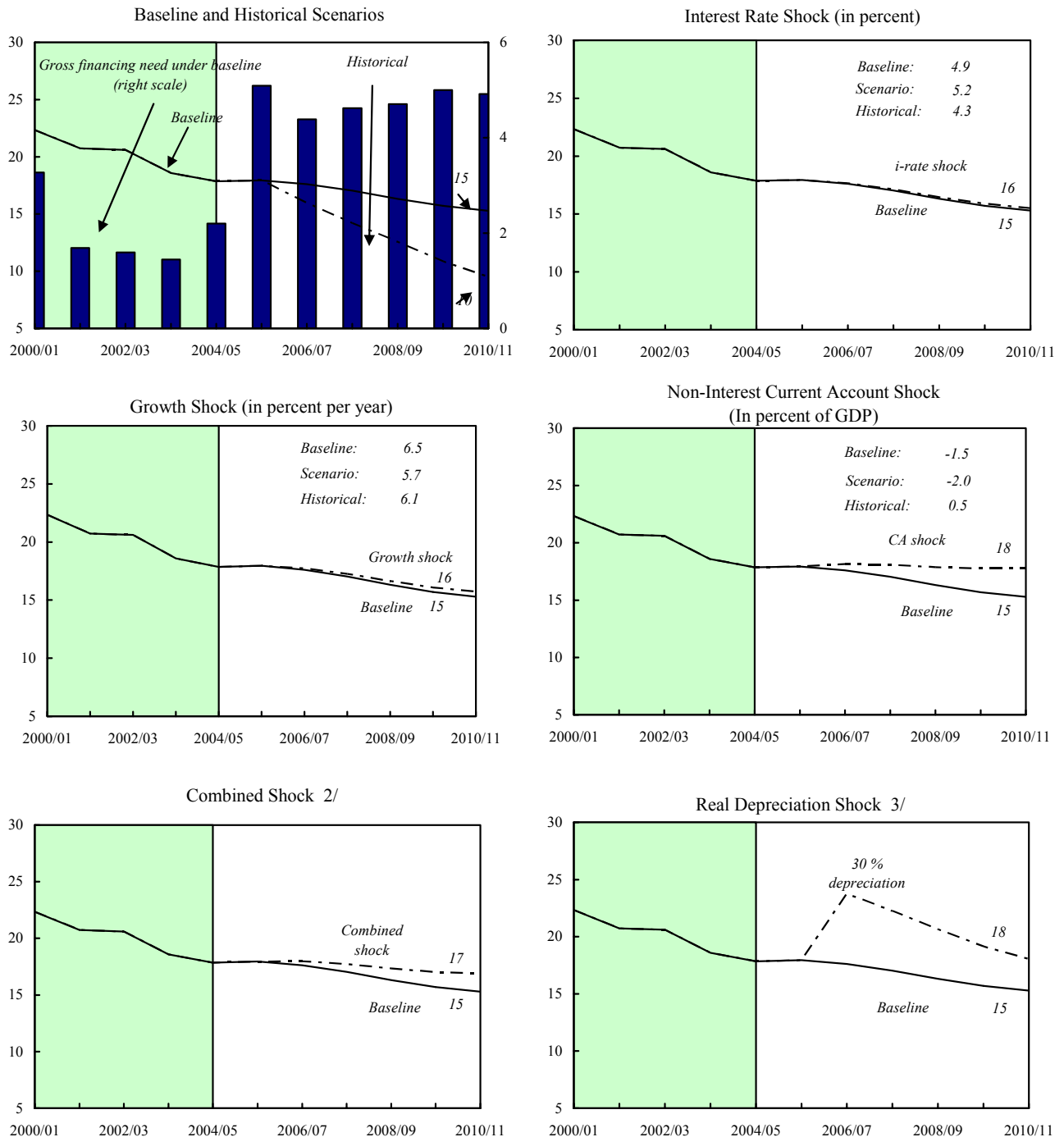


Sources: Reserve Bank of India; CEIC Data Company Ltd; and IMF Corporate Vulnerability Utility.

1/ Current assets to current liabilities.

2/ Operating profits to interest payments.

Figure 7. India: External Debt Sustainability: Bound Tests 1/
(External debt, in percent of GDP)



Sources: International Monetary Fund; country desk data; and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.

3/ One-time real depreciation of 30 percent occurs in 2006.

Table 1. India: Millennium Development Goals, 1990–2003 1/

	1990	1994	1997	2000	2003
Eradicate extreme poverty and hunger 2/					
Percentage share of income or consumption held by poorest 20 percent	...	...	...	8.9	...
Population below \$1 a day (in percent)	...	42.3	...	35.3	...
Population below minimum level of dietary energy consumption (in percent)	...	...	21.0	...	21.0
Poverty gap ratio at \$1 a day (incidence x depth of poverty)	...	10.9	...	7.2	...
Poverty headcount, national (in percent of population)	...	36.0	...	28.6	...
Prevalence of underweight in children (under five years of age)	63.9	53.2	...	46.7	...
Achieve universal primary education 3/					
Net primary enrollment ratio (in percent of relevant age group)	...	...	...	83.3	...
Primary completion rate, total (in percent of relevant age group)	...	78.0	74.0	77.0	81.0
Proportion of pupils starting grade 1 who reach grade 5	...	...	62.0	61.4	...
Youth literacy rate (in percent ages 15-24)	64.3	67.6	70.1	72.6	...
Promote gender equality 4/					
Proportion of seats held by women in national parliament (in percent)	5.0	...	7.0	9.0	9.0
Ratio of girls to boys in primary and secondary education (in percent)	70.1	...	77.7	78.6	...
Ratio of young literate females to males (in percent ages 15-24)	73.9	76.9	79.2	81.3	...
Share of women employed in the nonagricultural sector (in percent)	12.7	14.1	15.5	16.6	17.5
Reduce child mortality 5/					
Immunization, measles (in percent of children ages 12-23 months)	56.0	67.0	55.0	56.0	67.0
Infant mortality rate (per 1,000 live births)	84.0	74.0	...	68.0	63.0
Under 5 mortality rate (per 1,000)	123.0	104.0	...	94.0	87.0
Improved maternal health 6/					
Births attended by skilled health staff (in percent of total)	...	34.2	...	42.5	...
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	540.0	...
Combat HIV/AIDS, malaria, and other diseases 7/					
Contraceptive prevalence rate (in percent of women ages 15-49)	...	40.7	...	47.0	...
Incidence of tuberculosis (per 100,000 people)	167.8	167.8	167.8	167.8	167.8
Number of children orphaned by HIV/AIDS	...	...	...	..	...
Prevalence of HIV, total (in percent of population aged 15-49)	...	...	...	0.8	0.9
Tuberculosis cases detected under DOTS (in percent)	...	0.3	1.1	12.5	46.6
Ensure environmental sustainability 8/					
Access to an improved water source (in percent of population)	68.0	...	...	...	86.0
Access to improved sanitation (in percent of population)	12.0	...	...	...	30.0
Access to secure tenure (in percent of population)	...	...	...	...	...
CO2 emissions (metric tons per capita)	0.8	0.9	1.1	1.1	...
Forest area (in percent of total land area)	21.4	..	..	21.6	...
GDP per unit of energy use (2000 PPP \$ per kg oil equivalent)	4.0	4.1	4.4	4.7	5.0
Nationally protected areas (in percent of total land area)	...	...	...	...	5.2
Develop a global partnership for development 9/					
Aid per capita (current US\$)	1.7	2.5	1.7	1.5	0.9
Debt service (in percent of exports)	29.0	31.0	25.0	15.0	18.0
Fixed line and mobile phone subscribers (per 1,000 people)	6.0	10.7	19.6	35.6	71.0
Internet users (per 1,000 people)	...	0.0	0.7	5.4	17.5
Personal computers (per 1,000 people)	0.3	0.9	2.1	4.5	7.2
Unemployment, youth female (in percent of female labor force ages 15-24)	...	...	...	...	...
Unemployment, youth male (in percent of male labor force ages 15-24)	...	...	...	...	...
Unemployment, youth total (in percent of total labor force ages 15-24)	...	...	...	...	...
General indicators					
Fertility rate, total (births per woman)	3.8	...	3.3	...	2.9
GNI per capita, Atlas method (current US\$)	390.0	330.0	420.0	450.0	540.0
GNI, Atlas method (current US\$) (billions)	330.6	303.7	404.2	455.6	570.8
Gross capital formation (in percent of GDP)	24.1	23.4	22.6	22.7	23.8
Life expectancy at birth, total (years)	59.1	...	62.2	...	63.4
Literacy rate, adult total (in percent of people ages 15 and above)	49.3	52.5	54.9	57.2	...
Population, total (millions)	849.5	915.7	965.4	1,015.9	1,064.4
Trade (in percent of GDP) 10/	15.7	20.4	23.0	28.5	30.5

Source: *World Development Indicators* database, April 2005.

1/ In some cases the data are for earlier or later years than those stated.

2/ Halve, between 1990 and 2015, the proportion of people whose income is less than one dollar a day.

3/ Ensure that, by 2015, children everywhere, boys and girls alike, will be able to complete a full course of primary schooling.

4/ Eliminate gender disparity in primary and secondary education preferably by 2005 and to all levels of education no later than 2015.

5/ Reduce by two-thirds, between 1990 and 2015, the under-five mortality rate.

6/ Reduce by three-quarters, between 1990 and 2015, the maternal mortality ratio.

7/ Have halted by 2015, and begun to reverse, the spread of HIV/AIDS. Have halted by 2015, and begun to reverse, the incidence of malaria and

8/ Integrate the principles of sustainable development into country policies and programs and reverse the loss of environmental resources. Halve, by 2015, the

proportion of people without sustainable access to safe drinking water. By 2020, to have achieved a significant improvement in the lives of at least 100 million slum

9/ Develop further an open, rule-based, predictable, non-discriminatory trading and financial system. Address the Special Needs of the Least Developed Countries.

Address the Special Needs of landlocked countries and small island developing states. Deal comprehensively with the debt problems of developing countries through

national and international measures in order to make debt sustainable in the long term. In cooperation with developing countries, develop and implement strategies for

decent and productive work for youth. In cooperation with pharmaceutical companies, provide access to affordable, essential drugs in developing countries. In

cooperation with the private sector, make available the benefits of new technologies, especially information and communications.

10/ Based on financial year data.

Table 2. India: Selected Economic Indicators, 2002/03–2005/06 1/

Nominal GDP (2004/05): US\$691 billion

Population (2004/05): 1.08 billion

GDP per capita (2004/05): US\$640

Quota: SDR 4,158.2 million

	2002/03	2003/04	2004/05	2005/06	2005/06						
		Prov.	Prov.	Proj. 2/	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec. 3/
Growth (y/y percent change)											
Real GDP (at factor cost)	4.0	8.5	6.9	7.6	8.1	...	...	8.0	...	...	...
Real GDP (at factor cost, calendar year basis)	4.7	7.3	7.2	7.6	...	...	...	...	...	...	...
Industrial production	5.7	7.0	8.4	...	12.2	4.7	8.2	6.9	8.5	...	...
Prices (y/y percent change, period average for annual data)											
Wholesale prices (1993/94 weights)	3.4	5.4	6.4	5.2	4.3	4.2	3.3	4.3	4.8	4.5	...
Consumer prices - industrial workers	4.0	3.9	3.8	4.4	3.3	4.1	3.4	3.6	4.2	...	...
Saving and investment (percent of GDP)											
Gross saving 4/	26.1	28.1	26.6	26.8	...	...	...	...	...	...	...
Gross investment	24.8	26.3	27.5	29.7	...	...	...	...	...	...	...
Fiscal position (percent of GDP) 5/											
Central government deficit 6/	6.0	5.1	4.3	4.3	1.6	2.2	2.5	2.4	2.7	...	...
General government deficit	9.7	9.0	7.4	7.7	...	...	...	...	...	...	...
General government debt	85.7	86.1	86.1	86.0	...	...	...	...	...	...	...
Money and credit (y/y percent change, end-period)											
Broad money	14.7	16.7	12.4	...	13.7	14.0	14.3	18.0	16.4	17.0	...
Credit to commercial sector	18.5	13.0	26.0	...	27.6	28.8	28.5	31.6	25.2	25.7	...
Financial indicators (percent, end-period)											
91-day treasury bill yield	5.9	4.2	5.3	...	5.4	5.5	5.2	5.5	5.6	5.7	5.7
10-year government bond yield	6.1	5.1	6.7	...	6.9	7.0	7.1	7.1	7.1	7.1	7.1
Stock market (y/y percent change, end-period)	-12.1	83.4	16.1	...	50.0	47.7	50.3	54.6	39.1	41.0	40.3
External trade 7/											
Exports (US\$ billions)	53.8	64.7	80.8	97.3	7.3	7.4	7.6	7.3	8.1	6.2	...
y/y percent change	20.3	20.4	24.9	20.3	22.6	29.2	28.5	7.3	27.5	-11.4	...
Imports (US\$ billions)	64.5	80.2	119.0	161.7	10.3	10.6	11.5	11.3	11.4	9.9	...
y/y percent change	14.5	24.4	48.4	35.9	21.1	42.4	45.2	26.4	31.7	8.7	...
Net oil imports (US\$ billions)	15.6	17.1	22.4	32.1	2.3	2.7	3.1	3.1	...	...	...
Balance of payments (US\$ billions)											
Current account balance	6.3	10.6	-6.4	-23.1	...	...	...	...	...	...	...
(in percent of GDP)	1.2	1.8	-0.9	-3.0	...	...	...	...	...	...	...
Foreign direct investment, net	3.2	3.4	3.0	4.6	0.3	0.3	0.4	...	...	...	...
Portfolio investment, net (equity and debt)	0.9	11.4	8.9	9.3	1.2	1.8	1.1	1.0	-1.1	0.4	0.3
Overall balance	17.0	31.4	26.2	4.5	...	...	...	...	...	...	...
External indicators											
Gross reserves (US\$ billions end-period)	76.1	113.0	141.5	146.0	138.4	140.6	143.8	143.1	143.8	142.2	143.1
(In months of imports) 8/	9.3	8.7	7.7	6.8	-6.0	-6.1	-6.1	-6.0	-6.0	-5.9	-5.9
Net of forward liabilities (US\$ billions end-period)	78.5	114.4	141.5	...	138.4	140.6	143.8	...	...	...	...
External debt (percent of GDP, end-period) 9/	20.6	18.6	17.9	17.9	15.3	...	...	...	...	...	...
Of which: short-term debt 10/	3.8	1.9	2.7	2.4	...	...	...	...	...	...	...
Ratio of gross reserves to short-term debt (end-period)	4.0	10.0	7.4	9.5	9.0	9.2	9.4	9.3	9.4	9.3	9.3
Gross reserves to broad money (percent; end-period)	21.0	24.6	27.5	...	25.5	25.7	26.4	25.5	26.1	26.1	...
Debt service ratio 11/	16.3	16.3	4.7	6.9	...	...	...	...	...	...	...
Real effective exchange rate											
(y/y percent change, period average for annual data)	-5.4	-0.9	1.3	...	6.1	8.4	5.2	4.6	5.5	...	...
Exchange rate (rupee/US\$, end-period)	47.5	43.6	43.7	...	43.5	43.5	44.1	44.0	45.1	46.0	46.1

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

1/ Data are for April-March fiscal years.

2/ Current staff projections.

3/ Latest available figures.

4/ Differs from official data due to revisions in the current account.

5/ Privatization investment proceeds treated as below-the-line financing.

6/ For central government, year-to-date deficit data is reported relative to staff's estimated annual GDP.

7/ Monthly data are on a customs basis; annual data are on a projected balance of payments basis.

8/ Imports of goods and services projected over the following twelve months.

9/ Data is reported relative to staff's estimated annual GDP.

10/ Residual maturity basis, except contracted maturity basis for medium and long-term non-resident Indian accounts.

11/ In percent of current account receipts excluding grants.

Table 3. India: Balance of Payments, 2001/02–2005/06 1/
(In billions of U.S. dollars)

	2001/02	2002/03	2003/04	2004/05 Prov.	2005/06 Proj.
Current account balance	3.4	6.3	10.6	-6.4	-23.1
Merchandise trade balance	-11.6	-10.7	-15.5	-38.1	-64.4
Merchandise exports	44.7	53.8	64.7	80.8	97.3
Merchandise imports	56.3	64.5	80.2	119.0	161.7
Oil	14.0	18.1	20.6	29.1	41.9
Non-oil	42.3	46.3	59.6	89.9	119.7
<i>Of which: customs based 2/</i>	36.7	42.5	57.7	77.0	...
Non-factor services balance	3.3	3.6	6.6	14.6	17.9
Receipts	17.1	20.8	24.9	51.3	77.8
<i>Of which: software services</i>	7.6	9.6	12.2	17.3	...
Payments	13.8	17.1	18.4	36.7	59.9
Income, net	-4.2	-3.4	-4.0	-4.0	-2.6
Transfers, net	15.9	16.8	23.4	21.0	26.0
Capital account balance	8.6	10.8	20.5	32.2	27.5
Direct investment, net 2/	4.7	3.2	3.4	3.0	4.6
Portfolio investment, net	2.0	0.9	11.4	8.9	9.3
Government borrowing, net	1.1	-3.1	-2.7	1.9	1.6
Commercial borrowing, net	-1.6	-1.7	-1.5	5.9	4.2
Short-term credit, net	-0.8	1.0	1.4	3.8	5.0
NRI deposits, net	2.8	3.0	3.6	-1.1	-0.7
Rupee debt	-0.5	-0.5	-0.4	-0.4	-0.4
Other capital, net 3/	0.9	8.0	5.3	10.1	4.0
Errors and omissions	-0.2	-0.2	0.3	0.4	0.0
Overall balance	11.8	17.0	31.4	26.2	4.5
Valuation change	0.1	5.0	5.4	2.4	0.0
Increase in gross reserves (-)	-11.8	-22.0	-36.9	-28.6	-4.5
Memorandum items:					
Foreign exchange reserves	54.1	76.1	113.0	141.5	146.0
In months of next year's imports (goods and services)	8.0	9.3	8.7	7.7	6.8
Current account balance (percent of GDP)	0.7	1.2	1.8	-0.9	-3.0
Merchandise trade balance (percent of GDP)	-2.4	-2.1	-2.6	-5.5	-8.3
Overall balance (percent of GDP)	2.5	3.3	5.2	3.8	0.6

Sources: Data provided by CEIC; and staff estimates and projections.

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

2/ Non-customs imports include defense related items.

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

Table 4. India: Indicators of External Vulnerability, 2001/02–2005/06 1/

	2001/02	2002/03	2003/04	2004/05	2005/06 2/
Financial indicators					
General government debt (percent of GDP)	81.7	85.7	86.1	86.1	86.0 (Projection)
Broad money (percent change, 12-month basis)	14.1	14.7	16.7	12.4	17.0 (25-Nov-05)
Private sector credit (percent change, 12-month basis)	12.4	18.5	13.0	26.0	25.7 (25-Nov-05)
91 day T-bill yield (percent; end period)	6.1	5.9	4.2	5.3	5.7 (13-Dec-05)
91 day T-bill yield (real, percent; end period) 3/	2.6	2.3	-1.1	-1.1	1.5 (13-Dec-05)
External indicators					
Exports (percent change, 12-month basis in US\$) 4/ 5/	-1.6	20.3	20.4	24.9	27.5 (Oct.-05)
Export volume (percent change, 12-month basis) 5/	1.7	15.2	8.1	12.4	13.8 (Projection)
Imports (percent change, 12-month basis in US\$) 4/ 5/	-2.8	14.5	24.4	48.4	31.7 (Oct.-05)
Import volume (percent change, 12-month basis) 5/	1.7	8.6	9.0	27.7	20.5 (Projection)
Terms of trade (percent change, 12 month basis) 5/	1.2	-1.0	-2.4	-4.4	-6.2 (Projection)
Current account balance (percent of GDP)	0.7	1.2	1.8	-0.9	-3.0 (Projection)
Capital and financial account balance (percent of GDP)					(Projection)
<i>Of which</i> : net portfolio investment (debt and equity)	0.4	0.2	1.9	1.3	1.2 (Projection)
Other investment (loans, trade credits, etc.)	1.0	1.0	3.0	1.8	1.5 (Projection)
Net foreign direct investment	1.0	0.6	0.6	0.4	0.6 (Projection)
Foreign currency reserves (billions of US\$)	54.1	76.1	113.0	141.5	143.1 (2-Dec-05)
RBI forward liabilities (billions of US\$)	-0.4	2.4	1.4	0.0	0.0 (Oct.-05)
Official reserves in months of imports (of goods and services)	8.0	9.3	8.7	7.7	6.8 (Projection)
Ratio of foreign currency reserves to broad money (percent)	17.6	21.0	24.6	27.5	26.1 (Nov.-05)
Total short-term external debt to reserves (percent)	26.1	25.2	10.0	13.5	10.5 (Projection)
Total external debt (percent of GDP)	20.7	20.6	18.6	17.9	17.9 (Projection)
<i>Of which</i> : public sector debt	11.6	10.9	8.5	7.4	6.8 (Projection)
Total external debt to exports of goods and services (percent)	159.5	145.8	132.5	95.5	78.9 (Projection)
External interest payments to exports of goods and services (percent)	7.1	5.4	5.0	2.3	2.9 (Projection)
External amortization payments to exports of goods and services (percent)	10.9	16.3	17.4	3.4	6.4 (Projection)
Exchange rate (per US\$, period average)	47.7	48.4	45.9	44.9	44.4 (to Dec. 13, 2005)
REER (change in percent; end period)	-1.1	-4.9	-0.3	0.9	5.5 (Oct-05)
Financial market indicators					
Stock market index (end period)	3,469	3,049	5,591	6,493	9,264 (13-Dec-05)
Foreign currency debt rating					
Moody's Investor Services	Ba2	Ba1	Baa3	Baa3	Baa3
Standard and Poor's	BB	BB	BB	BB+	BB+

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

1/ April-March fiscal year.

2/ Latest date available or staff estimate, if noted.

3/ Nominal yield is less than actual WPI inflation.

4/ Data for 2005/06 are on a customs basis, whereas data for previous years are on a BOP basis.

5/ Merchandise trade only; volumes are derived from partner country trade price deflators from the WEO database.

Table 5. India: Reserve Money and Monetary Survey, 2001/02–2005/06 1/

	2001/02	2002/03	2003/04	2004/05	2005/06							
					Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.
Reserve money												
	(In billions of rupees; end-period)											
Reserve money	3,380	3,691	4,365	4,891	5,007	4,907	4,960	4,968	5,040	4,962	5,097	5,225
Net domestic assets of RBI	740	108	-479	-1,237	-1,124	-1,116	-1,022	-932	-1,138	-1,269	-1,316	-1,220
Claims on government (net)	1,522	1,207	449	-180	-12	-161	-87	-75	-255	-340	-198	-79
Center	1,464	1,171	369	-233	-59	-169	-87	-79	-257	-339	-199	-81
States	58	35	80	53	47	9	0	4	1	0	0	2
Claims on commercial sector	46	-46	21	14	14	14	14	14	14	14	14	14
Claims on banks	107	72	54	53	52	71	64	34	34	45	36	41
Other items (net)	-935	-1,124	-1,003	-1,123	-1,178	-1,040	-1,013	-905	-931	-989	-1,167	-1,197
Net foreign assets of RBI	2,640	3,582	4,844	6,128	6,131	6,023	5,982	5,900	6,178	6,230	6,413	6,445
	(Contribution to reserve money growth)											
Reserve money	11.4	9.2	18.3	12.1	15.1	15.1	15.4	17.1	17.2	17.2	15.2	14.7
Net domestic assets of RBI	-10.6	-18.7	-15.9	-17.4	-6.3	-0.1	2.3	6.8	0.3	-3.2	...	...
Claims on government (net)	-0.6	-9.3	-20.5	-14.4	-3.3	-4.8	-4.5	-2.3	-8.4	-10.5	-7.7	-5.7
Net foreign assets of RBI	22.0	27.9	34.2	29.4	21.4	15.2	13.1	10.2	16.9	20.4	...	...
Monetary survey												
	(In billions of rupees; end-period)											
Broad money (M3)	14,984	17,180	20,057	22,539	23,471	23,510	23,598	23,758	24,054	24,693	24,867	25,009
Currency with public	2,408	2,716	3,155	3,558	3,719	3,769	3,754	3,706	3,711	3,639	3,794	3,866
Deposits	12,547	14,431	16,825	18,917	19,707	19,698	19,794	20,002	20,295	21,002	21,027	21,095
Non-bank deposits at RBI	29	33	77	65	45	43	49	50	48	52	46	48
Net domestic assets	11,874	13,243	14,791	16,047	16,975	17,122	17,239	17,481	17,499	18,086	18,077	18,187
Domestic credit	13,479	15,755	17,617	20,384	20,780	20,901	21,096	21,329	21,488	21,950	22,466	22,645
Net credit to government	5,896	6,765	7,455	7,579	7,724	7,707	7,649	7,696	7,643	7,545	7,784	7,724
Of which: RBI	1,522	1,207	449	-180	-12	-161	-87	-75	-255	-340	-113	-79
Credit to commercial sector 2/	7,583	8,990	10,162	12,805	13,056	13,193	13,448	13,633	13,846	14,405	14,682	14,921
Of which: commercial bank lending	5,897	7,292	8,408	11,004	11,280	11,411	11,612	11,758	11,978	12,561	12,844	13,059
Nonfood	5,357	6,797	8,048	10,593	10,862	10,953	11,164	11,362	11,575	12,166	12,446	12,634
Other items (net)	-1,605	-2,512	-2,826	-4,338	-3,805	-3,779	-3,857	-3,848	-3,989	-3,864	-4,389	-4,458
Net foreign assets	3,110	3,937	5,266	6,493	6,496	6,388	6,359	6,277	6,555	6,607	6,790	6,822
	(Twelve-month percent change)											
Broad money (M3)	14.1	14.7	16.7	12.4	13.8	14.1	13.7	14.0	14.3	18.0	16.4	17.0
Net domestic assets	11.7	11.5	11.7	8.5	13.2	15.6	14.9	16.3	14.7	19.1	16.3	18.5
Domestic credit	13.6	16.9	11.8	15.7	16.1	16.6	16.5	17.2	16.8	19.0	16.4	16.6
Net credit to government	15.2	14.7	10.2	1.7	3.4	2.4	1.2	1.1	0.3	0.6	2.9	2.3
Credit to commercial sector 2/	12.4	18.5	13.0	26.0	25.2	26.9	27.6	28.8	28.5	31.6	25.2	25.7
Of which: commercial bank lending	15.3	23.7	15.3	30.9	30.4	32.1	32.1	33.1	32.6	36.5	29.6	29.7
Nonfood	13.6	26.9	18.4	31.6	32.1	33.5	33.6	35.1	34.0	37.9	30.9	31.0
Net foreign assets	24.5	26.6	33.7	23.3	15.5	10.2	10.4	8.2	13.2	15.0	16.5	13.1
	(Contribution to broad money growth)											
Net domestic assets	9.4	9.1	9.0	6.3	9.6	11.2	10.8	11.8	10.7	13.9	11.9	13.3
Net credit to government	5.9	5.8	4.0	0.6	1.2	0.9	0.4	0.4	0.1	0.2	1.0	0.8
Of which: RBI	-0.1	-2.1	-4.4	-3.1	-0.7	-1.0	-0.9	-0.5	-1.7	-2.1	-1.6	-1.2
Credit to commercial sector 2/	6.4	9.4	6.8	13.2	12.7	13.6	14.0	14.6	14.6	16.5	13.8	14.3
Net foreign assets	4.7	5.5	7.7	6.1	4.2	2.9	2.9	2.3	3.6	4.1	4.5	3.7

Sources: Reserve Bank of India; and staff estimates.

1/ Data are for April - March fiscal years.

2/ Starting in May 2002, figures include ICICI, formerly a large development finance institution, which merged with ICICI Bank Ltd. to form a new commercial bank.

Table 6. India: Central Government Operations, 2001/02–2005/06

	2001/02	2002/03	2003/04		2004/05		2005/06	
			Budget 2/	Actual 1/	Budget 2/	Outturn prov.	Budget 2/	Staff proj.
(In billions of rupees)								
Total revenue and grants	2,142	2,453	2,711	2,795	3,254	3,214	3,680	3,680
Net tax revenue 3/	1,342	1,601	1,878	1,887	2,355	2,264	2,751	2,771
Gross tax revenue	1,871	2,163	2,515	2,544	3,177	3,050	3,700	3,727
<i>Of which:</i> corporate tax	366	462	515	636	884	836	1,106	1,117
income tax	320	369	441	414	509	483	662	605
excise taxes	726	823	968	908	1,092	992	1,215	1,159
customs duties	403	449	494	486	543	577	532	611
Less: States' share	528	561	638	658	822	786	950	957
Nontax revenue	783	832	819	887	863	920	898	877
Grants	18	19	15	22	36	31	32	32
Total expenditure and net lending	3,588	3,934	4,380	4,198	4,668	4,538	5,192	5,177
Current expenditure 3/	3,144	3,531	3,834	3,778	4,016	4,011	4,634	4,618
<i>Of which:</i> interest payments	1,075	1,178	1,232	1,241	1,295	1,265	1,339	1,346
wages and salaries	299	314	330	322	349	353	372	372
subsidies	312	435	499	443	435	446	474	474
Capital expenditure and net lending 4/	444	403	545	420	652	528	558	559
Overall balance 5/	-1,446	-1,482	-1,668	-1,403	-1,414	-1,324	-1,511	-1,497
Overall balance (authorities' definition) 6/	-1,410	-1,450	-1,536	-1,233	-1,374	-1,280	-1,511	-1,497
Financing	1,446	1,482	1,668	1,403	1,414	1,324	1,511	1,497
External (net)	56	-119	36	-135	81	129	97	96
Domestic (net)	1,390	1,601	1,633	1,538	1,333	1,195	1,415	1,401
<i>Of which:</i> market borrowing	908	1,041	1,072	860	904	456	1,103	1,092
small savings and other funds	210	139	175	672	56	360	80	80
disinvestment receipts	36	32	132	170	40	44	...	...
(In percent of GDP)								
Total revenue and grants	9.4	10.0	9.9	10.1	10.4	10.4	10.6	10.6
Net tax revenue 3/	5.9	6.5	6.8	6.8	7.5	7.3	7.9	8.0
Gross tax revenue	8.2	8.8	9.1	9.2	10.2	9.8	10.6	10.8
Corporate tax	1.6	1.9	1.9	2.3	2.8	2.7	3.2	3.2
Income tax	1.4	1.5	1.6	1.5	1.6	1.6	1.9	1.7
Excise taxes	3.2	3.3	3.5	3.3	3.5	3.2	3.5	3.3
Customs duties	1.8	1.8	1.8	1.8	1.7	1.9	1.5	1.8
Less: States' share	2.3	2.3	2.3	2.4	2.6	2.5	2.7	2.8
Nontax revenue	3.4	3.4	3.0	3.2	2.8	3.0	2.6	2.5
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure and net lending	15.8	16.0	15.9	15.2	14.9	14.6	14.9	14.9
Current expenditure 3/	13.8	14.3	13.9	13.7	12.9	12.9	13.3	13.3
<i>Of which:</i> interest payments	4.7	4.8	4.5	4.5	4.1	4.1	3.8	3.9
wages and salaries	1.3	1.3	1.2	1.2	1.1	1.1	1.1	1.1
subsidies	1.4	1.8	1.8	1.6	1.4	1.4	1.4	1.4
Capital expenditure and net lending 4/	2.0	1.6	2.0	1.5	2.1	1.7	1.6	1.6
Overall balance 5/	-6.4	-6.0	-6.1	-5.1	-4.6	-4.3	-4.3	-4.3
Overall balance (authorities' definition) 6/	-6.2	-5.9	-5.6	-4.5	-4.4	-4.1	-4.3	-4.3
Financing	6.4	6.0	6.1	5.1	4.6	4.3	4.3	4.3
External (net)	0.2	-0.5	0.1	-0.5	0.3	0.4	0.3	0.3
Domestic (net)	6.1	6.5	6.0	5.6	4.3	3.8	4.1	4.0
<i>Of which:</i> market borrowing	4.0	4.2	3.9	3.1	2.9	1.5	3.2	3.2
small savings and other funds	0.4	0.0	0.0	2.2	0.0	1.1	0.1	0.1
divestment receipts	0.2	0.1	0.5	0.6	0.1	0.1	0.0	0.0
Memorandum items:								
Military expenditure	2.4	2.3	2.4	2.2	2.5	2.4	2.4	2.4
Primary balance	-1.6	-1.2	-1.6	-0.6	-0.4	-0.2	-0.5	-0.4
Revenue balance 7/	-4.4	-4.4	-4.1	-3.6	-2.5	-2.6	-2.7	-2.7
Central government debt 8/	60.1	63.3	64.9	62.9	64.0	63.8	64.1	64.4
Loan recoveries from the debt swap scheme 9/	...	...	...	1.7	0.4	1.4	...	...
Nominal GDP (in Rs. billion)	22,720	24,633	27,435	27,600	31,049	31,055	34,816	34,631

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

1/ Ratios utilize the CSO's estimates of nominal GDP.

2/ Ratios utilize implicit GDP in the gross fiscal deficit to GDP ratio given in Union Budget.

3/ Including the surcharge on Union duties transferred to the National Calamity Contingency Fund.

4/ Authorities' treatment of state debt swap scheme (DSS) in 2002-05 shows the prepayment by States of on-lent funds to the center as net lending.

The Center's prepayment of its debt to the National Small Savings Fund (NSSF) is treated as a capital expenditure.

5/ Staff's definition treats divestment receipts as a below the line financing item.

6/ Authorities' definition treats divestment as a receipt item.

7/ Total revenue and grants less current expenditure.

8/ External debt measured at historical exchange rates.

9/ Prepayment by states of central loans under the DSS.

Table 7. India: General Government Operations, 2001/02–2005/06 1/

	2001/02	2002/03	2003/04		2004/05			2005/06	
			Rev. est.	Prov. 2/	Budget	Rev. est.	Staff proj. 3/	Budget	Staff proj.
(In billions of rupees)									
Total revenue and grants	3,992	4,498	5,193	5,112	6,090	6,040	6,058	7,014	7,028
Tax revenue 4/	3,152	3,584	4,177	4,121	5,008	4,915	4,884	5,824	5,838
Nontax revenue 5/	823	895	987	970	1,046	1,094	1,143	1,158	1,158
Grants	18	19	29	22	36	31	31	32	32
Total expenditure and net lending 6/	6,293	6,884	7,944	7,607	8,478	8,549	8,347	9,693	9,699
General government balance	-2,301	-2,386	-2,751	-2,495	-2,388	-2,509	-2,289	-2,680	-2,671
RBI: gross fiscal deficit 7/	-2,264	-2,350	-2,602	-2,329	-2,460	-2,581	...	...	...
Financing	2,301	2,386	2,751	2,495	2,388	2,509	2,289	2,680	2,671
External (net)	56	-119	-117	-135	81	90	129	97	96
Domestic (net)	2,245	2,506	2,868	2,630	2,307	2,419	2,160	2,583	2,575
Disinvestment receipts	36	32	145	170	40	41	44	0	0
(In percent of GDP)									
Total revenue and grants	17.6	18.3	18.8	18.5	19.5	19.4	19.5	20.1	20.3
Of which: tax revenue 4/	13.9	14.5	15.1	14.9	16.0	15.8	15.7	16.7	16.9
nontax revenue 5/	3.6	3.6	3.6	3.5	3.4	3.5	3.7	3.3	3.3
Total expenditure and net lending 6/	27.7	27.9	28.8	27.6	27.1	27.5	26.9	27.8	28.0
General government balance	-10.1	-9.7	-10.0	-9.0	-7.7	-8.1	-7.4	-7.7	-7.7
(Including disinvestment receipts)	-10.0	-9.5	-9.4	-8.4	-7.6	-7.9	-7.2	-7.7	-7.7
Domestic financing (net)	9.9	10.2	10.4	9.5	7.4	7.8	7.0	7.4	7.4
Memorandum items:									
Consolidated general government									
Revenue balance 7/	-7.0	-6.6	-6.2	-5.8	-3.9	-4.1	-3.9	...	-3.4
Primary balance	-3.9	-3.3	-3.5	-2.7	-1.6	-2.0	-1.3	-1.7	-1.7
Non-defense capital expenditure	2.9	2.8	3.6	3.1	3.2	3.3	2.8	0.6	0.6
Net interest payments	6.2	6.4	6.5	6.4	6.1	6.0	6.1	6.0	6.0
General government balance	-10.1	-9.7	-10.0	-9.0	-7.6	-8.1	-7.4	-7.7	-7.7
Central government	-6.4	-6.0	-5.3	-5.1	-4.6	-4.6	-4.3	-4.3	-4.3
State and union territory governments	-4.2	-4.1	-5.1	-4.4	-3.6	-3.8	-3.6	-3.1	-3.1
Consolidation items 8/	0.5	0.5	0.5	0.4	0.5	0.4	0.4	-0.3	-0.3
General government debt	81.7	85.7	86.1	86.1	85.6	86.0	86.1	85.6	86.0

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

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

2/ Based on central government provisional unaudited outturn and RBI's estimate of provisional outturn for state finances.

3/ Based on central government provisional unaudited outturn and staffs' projection of state finances.

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

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

6/ Expenditure and net lending = Total expenditure and net lending of CG, less net loans and grants to states and union territories, plus total expenditure of states (excluding interest payments on CG loans).

7/ From the *RBI Handbook of Statistics*, 2004-05, and the *RBI Annual Report 2005*; the authorities treat disinvestment proceeds above-the-line as capital receipts.

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

Table 8. India: Indicators of Financial System Soundness, 2001/02–2004/05

	2001/02	2002/03	2003/04	2004/05
Measures of financial strength and performance 1/				
Risk-weighted capital adequacy ratio (CAR)	12.0	12.7	12.9	12.8
Public sector banks	11.8	12.6	13.2	12.9
Domestic private banks	12.5	12.8	13.7	12.2
Foreign banks	12.9	15.2	15.0	14.0
Number of institutions not meeting 9 percent CAR	3	2	2	2
Public sector banks	2	0	0	0
Domestic private banks	1	2	2	2
Foreign banks	0	0	0	0
Net nonperforming loans (percent of outstanding net loans) 2/ 3/	5.5	4.4	2.9	2.0
Public sector banks	5.8	4.5	3.0	2.1
Domestic private banks	5.7	5.0	2.8	2.2
Foreign banks	1.9	1.8	1.5	0.9
Gross nonperforming loans (percent of outstanding loans) 3/	10.4	8.8	7.2	5.2
Public sector banks	11.1	9.4	7.8	5.5
Domestic private banks	9.6	8.1	5.8	4.4
Foreign banks	5.4	5.3	4.6	2.8
Number of institutions with net NPLs above 10 percent of advances	22	13	9	4
Public sector banks	3	2	0	0
Domestic private banks	5	3	3	0
Foreign banks	14	8	6	4
Net profit (+)/loss (-) of commercial banks 4/	0.8	1.0	1.1	0.9
Domestic private banks	0.7	1.0	1.1	0.8
Foreign banks	0.7	1.0	1.0	1.3
Balance sheet structure of commercial banks				
Loan/deposit ratio	53.4	56.9	53.6	59.4
Investment in government securities/deposit ratio	39.5	42.7	40.5	37.5
Lending to sensitive sectors (in percent of private credit)				
Real estate	1.4	1.7	1.6	2.2
Capital market	0.5	0.3	0.4	0.3
Commodities	1.4	1.2	1.2	1.0

Sources: Indian authorities; and staff estimates.

1/ Some loan classification and provisioning standards do not meet international standards.

2/ Gross nonperforming loans less provisions.

3/ Starting in 2001/02, figure includes ICICI, formerly a large development finance institution, which merged with ICICI Bank Ltd. in 2002.

4/ In percent of total assets.

Table 9. India: Macroeconomic Framework, 2001/02–2009/10 1/

	2001/02	2002/03	2003/04	Prov. 2004/05	Projections				
					2005/06	2006/07	2007/08	2008/09	2009/10
Growth (percent change)									
Real GDP (at factor cost)	5.8	4.0	8.5	6.9	7.6	6.8	6.5	6.5	6.5
Real GDP (at factor cost, on calendar year basis)	4.5	4.7	7.3	7.2	7.6	6.8	6.8	6.7	6.7
Prices (percent change, period average)									
Wholesale prices (1993/94 weights)	3.6	3.4	5.4	6.4	5.2	6.7	4.4	3.9	3.9
Consumer prices	4.3	4.0	3.9	3.8	4.4	6.2	3.8	3.4	3.4
GDP deflator	3.4	4.1	3.2	5.2	3.7	4.5	3.7	3.3	3.3
Interest rate on general government domestic debt (percent)	9.4	9.1	8.8	8.4	8.1	7.9	8.1	8.1	8.2
Saving and investment (percent of GDP)									
Gross saving 2/	23.4	26.1	28.1	26.6	26.8	27.3	28.1	28.8	29.1
Gross investment 3/	22.6	24.8	26.3	27.5	29.7	29.8	30.4	30.9	31.3
Fiscal position (percent of GDP) 4/									
Central government deficit	6.4	6.0	5.1	4.3	4.3	3.8	3.3	3.0	2.7
General government deficit	10.1	9.7	9.0	7.4	7.7	7.0	6.5	6.3	6.0
General government debt	81.7	85.7	86.1	86.1	86.0	84.2	82.9	81.5	80.4
External trade (percent change, BOP basis)									
Exports (in U.S. dollar terms)	-1.6	20.3	20.4	24.9	20.3	16.5	16.9	17.2	17.4
Imports (in U.S. dollar terms)	-2.8	14.5	24.4	48.4	35.9	18.1	14.2	14.5	15.3
Balance of payments (in billions of U.S. dollars)									
Current account balance	3.4	6.3	10.6	-6.4	-23.1	-21.2	-20.9	-21.2	-22.9
(in percent of GDP)	0.7	1.2	1.8	-0.9	-3.0	-2.5	-2.3	-2.1	-2.1
(in percent of GDP, calendar year basis)	0.3	1.4	1.2	-0.1	-2.5	-2.6	-2.4	-2.2	-2.1
Foreign direct investment, net	4.7	3.2	3.4	3.0	4.6	7.5	10.9	11.9	12.8
Portfolio investment, net (equity and debt)	2.0	0.9	11.4	8.9	9.3	9.7	8.7	9.5	10.3
Overall balance	11.8	17.0	31.4	26.2	4.5	5.4	6.6	7.2	5.9
External indicators									
Gross reserves (US\$ bn. end-period)	54.7	76.1	113.0	141.5	146.0	151.4	158.0	165.2	171.1
(in months of imports) 5/	8.0	9.3	8.7	7.7	6.8	6.1	5.6	5.0	4.5
External debt (percent of GDP, end-period)	20.7	20.6	18.6	17.9	17.9	17.5	16.9	16.2	15.6
Of which : short-term debt 6/	3.0	3.8	1.9	2.7	2.4	2.8	3.1	3.4	3.9
Ratio of gross reserves to short-term debt (end-period)	3.8	4.0	10.0	7.4	9.5	7.3	6.3	5.4	4.7
Debt service (percent of current acct. receipts)	13.8	16.3	16.3	4.7	6.9	3.9	4.4	4.2	4.0

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

1/ Data are for April-March fiscal years.

2/ Differs from official data due to revisions in the current account.

3/ Statistical discrepancy adjusted.

4/ Onlending of small savings collections to state governments excluded from central government expenditures and net lending; divestment proceeds treated as below-line financing.

5/ Imports of goods and services projected over the following twelve months.

6/ Residual maturity basis, except contracted maturity basis for medium and long-term non-resident Indian accounts.

Table 10. India: External Debt Sustainability Framework, 2001/02–2010/11
(In percent of GDP, unless otherwise indicated)

	Actual			Projections							Debt-stabilizing non-interest current account 6/ -2.6
	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	
Baseline: external debt	20.7	20.6	18.6	17.9	17.9	17.6	17.0	16.3	15.7	15.3	
Change in external debt	-1.6	-0.1	-2.0	-0.7	0.1	-0.3	-0.6	-0.7	-0.6	-0.4	
Identified external debt-creating flows (4+8+9)	-3.1	-3.4	-7.2	-3.1	0.0	-0.6	-0.9	-1.0	-1.0	-1.1	
Current account deficit, excluding interest payments	-1.6	-2.0	-2.5	0.5	2.2	1.8	1.5	1.4	1.4	1.3	
Deficit in balance of goods and services	1.7	1.4	1.5	3.4	6.0	5.7	5.4	5.3	5.3	5.1	
Exports	13.0	14.6	14.9	19.1	22.8	24.5	26.4	28.4	30.9	33.5	
Imports	14.7	16.0	16.4	22.5	28.8	30.2	31.8	33.6	36.1	38.6	
Net nondebt creating capital inflows (negative)	-1.4	-0.8	-2.5	-1.7	-1.8	-2.1	-2.2	-2.2	-2.2	-2.2	
Automatic debt dynamics 1/	-0.1	-0.6	-2.3	-1.9	-0.4	-0.3	-0.3	-0.3	-0.2	-0.2	
Contribution from nominal interest rate	0.9	0.7	0.7	0.5	0.8	0.8	0.8	0.8	0.7	0.7	
Contribution from real GDP growth	-1.1	-0.8	-1.5	-1.1	-1.2	-1.1	-1.1	-1.0	-1.0	-1.0	
Contribution from price and exchange rate changes 2/	0.1	-0.6	-1.5	-1.2	...	...	...	...	...	...
Residual, including change in gross foreign assets (2-3) 3/	1.5	3.3	5.2	2.4	0.1	0.3	0.3	0.3	0.4	0.7	
External debt-to-exports ratio (in percent)	159.7	140.7	124.6	93.4	78.8	71.8	64.5	57.5	50.9	45.6	
Gross external financing need (in billions of U.S. dollars) 4/	8.0	8.1	8.7	15.2	39.1	36.5	41.7	46.4	53.2	56.5	
In percent of GDP	1.7	1.6	1.4	2.2	5.1	4.4	4.6	4.7	5.0	4.9	
Scenario with key variables at their historical averages 5/					17.9	16.0	14.2	12.6	10.9	9.5	-1.7
Key macroeconomic assumptions underlying baseline											
Real GDP growth at market prices (in percent)	5.1	4.1	8.6	6.9	7.3	6.5	6.5	6.5	6.5	6.5	
GDP deflator in US dollars (change in percent)	-0.9	2.6	8.7	7.6	3.7	1.5	1.9	2.4	1.4	1.4	
Nominal external interest rate (in percent)	4.2	3.8	4.2	2.8	4.7	4.7	4.8	4.9	5.0	5.0	
Growth of exports (U.S. dollar terms, in percent)	0.2	20.5	20.3	47.4	32.5	16.5	16.9	17.2	17.4	17.4	
Growth of imports (U.S. dollar terms, in percent)	-3.3	16.4	20.8	58.0	42.3	13.4	14.3	15.4	16.0	15.6	
Current account balance, excluding interest payments	1.6	2.0	2.5	-0.5	-2.2	-1.8	-1.5	-1.4	-1.4	-1.3	
Net non-debt creating capital inflows	1.4	0.8	2.5	1.7	1.8	2.1	2.2	2.2	2.2	2.2	

1/ Derived as $[r - g - \rho(1+g) + \alpha\alpha(1+r)]/(1+g+\rho+g)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \alpha\alpha(1+r)]/(1+g+\rho+g)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

India—Medium-Term Fiscal Outlook

The government is targeting substantial consolidation by 2009/10. The central and state governments would balance their current deficits by 2008/09 and reduce their overall deficits to 3 percent of GDP or below by 2009/10, meeting the FRBM and TFC targets. These targets require a 3¾ percentage points reduction in the general government’s current deficit by 2008/09.

The baseline scenario envisages that the central government meets FRBM targets but states’ adjustment falls short of the TFC targets. Helped by rising revenue, a continued real wage bill freeze, reform of major subsidies, and the consolidation of low-priority programs, the central government achieves current balance by 2008/09. States sharply reduce their deficits in 2005/06 thanks to higher transfers, but the adjustment stalls in subsequent years as central government transfers decrease. Growth stabilizes at 6½ percent as capital expenditure rises (2½ percentage points cumulatively by 2009/10). While debt declines to 80 percent of GDP by 2009/10, it remains vulnerable to shocks (Table I.1 and Figure I.1).

In a best case (reform) scenario, both the center and states meet their medium-term targets. Given spending needs, an adjustment of this magnitude would require annual revenue increases of about 0.9 percent of GDP and improvements in the efficiency of public expenditure. As capital spending increases (3¼ percentage points of GDP cumulatively by 2009/10), growth would accelerate to 8 percent and debt would decline to under 77 percent of GDP.

Without a change in policies debt would rise. General government revenue would rise only moderately (less than ½ percentage point per annum). The primary deficit would remain unchanged at around 2 percent of GDP. Current deficit targets would be missed. Growth would slow to 6 percent and with rising interest rates, the growth-interest differential fades by 2009/10.

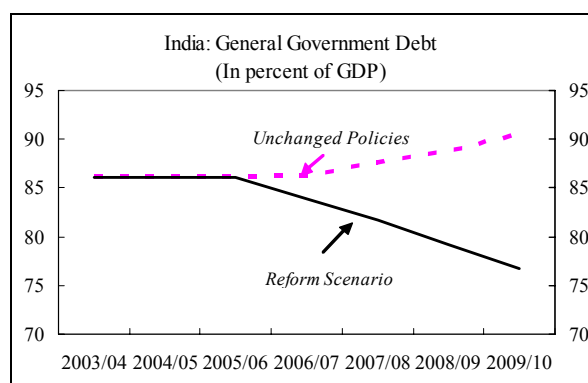
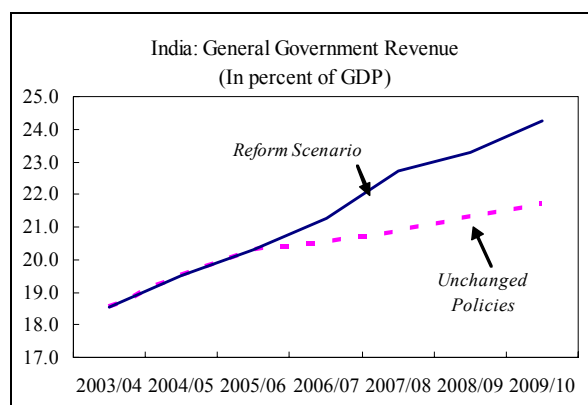
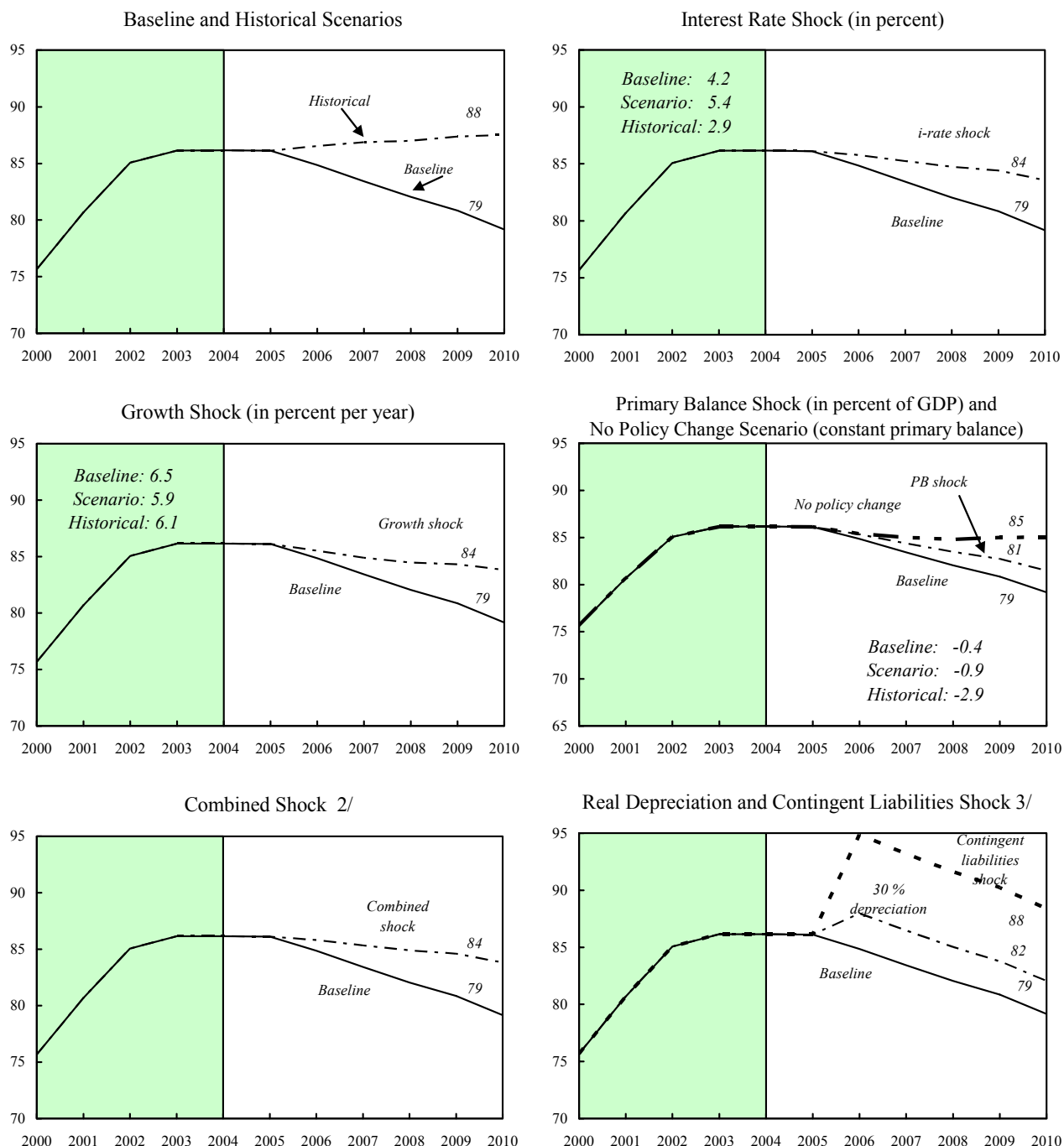


Figure I.1. India: Public Debt Sustainability: Bound Tests 1/

(Public debt, in percent of GDP)



Sources: International Monetary Fund; country desk data; and staff estimates.

1/ Shaded areas represent actual data Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.

3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table I.1. India: Public Sector Debt Sustainability Framework, 2000–2010
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					Debt-stabilizing primary balance 9/	
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009		2010
1 Baseline: public sector debt 1/	75.7	80.7	85.1	86.2	86.2	86.1	84.9	83.4	82.1	80.9	79.2	
<i>Of which</i> : foreign-currency denominated	10.0	9.5	8.7	7.3	6.4	6.4	6.2	6.0	5.7	5.7	5.5	
2 Change in public sector debt	2.8	5.0	4.4	1.1	0.0	0.0	-1.3	-1.4	-1.4	-1.2	-1.7	
3 Identified debt-creating flows (4+7+12)	4.2	5.0	3.6	0.4	-1.9	-1.2	-1.5	-1.6	-1.4	-1.4	-1.7	
4 Primary deficit	4.0	3.9	3.4	2.8	1.7	1.6	1.1	0.6	0.4	0.2	-0.2	
5 Revenue and grants	17.6	17.6	18.2	18.5	19.3	20.1	20.9	21.7	22.1	22.4	22.8	
6 Primary (noninterest) expenditure	21.7	21.6	21.5	21.3	21.0	21.7	22.0	22.3	22.4	22.6	22.6	
7 Automatic debt dynamics 2/	0.3	0.9	0.2	-2.7	-3.8	-3.0	-2.6	-2.2	-1.7	-1.6	-1.5	
8 Contribution from interest rate/growth differential 3/	-0.5	0.6	0.3	-2.3	-3.4	-3.0	-2.6	-2.2	-1.7	-1.6	-1.5	
9 <i>Of which</i> : contribution from real interest rate	3.1	3.3	3.8	3.4	2.1	2.7	2.4	2.8	3.2	3.3	3.3	
10 <i>Of which</i> : contribution from real GDP growth	-3.6	-2.7	-3.5	-5.7	-5.6	-5.7	-5.0	-5.0	-4.9	-4.9	-4.8	
11 Contribution from exchange rate depreciation 4/	0.8	0.3	0.0	-0.4	-0.3	...	...	...	...	...	...
12 Other identified debt-creating flows	-0.1	0.2	0.0	0.3	0.2	0.2	0.0	0.0	0.0	0.0	0.0	
13 Privatization receipts (negative)	-0.1	-0.1	-0.1	-0.5	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	
14 Recognition of implicit or contingent liabilities	0.0	0.3	0.1	0.8	0.5	0.2	0.0	0.0	0.0	0.0	0.0	
15 Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16 Residual, including asset changes (2-3) 5/	-1.5	0.0	0.8	0.7	1.9	1.2	0.3	0.2	0.0	0.2	0.0	
Public sector debt-to-revenue ratio 1/	428.8	457.3	468.4	465.9	446.5	427.8	405.5	384.8	371.8	360.5	347.1	
Gross financing need 6/	...	...	...	...	...	...	...	...	...	...	...
In billions of U.S. dollars	...	...	...	...	...	...	...	...	...	...	...
Scenario with key variables at their historical averages 7/	...	...	...	...	...	...	...	...	...	...	...
Scenario with no policy change (constant primary balance) in 2005–2010	...	...	...	...	...	...	...	...	...	...	...
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	5.4	3.9	4.7	7.4	7.3	7.4	6.5	6.6	6.5	6.5	6.6	
Average nominal interest rate on public debt (in percent) 8/	8.8	8.8	8.6	8.4	8.0	7.8	8.0	7.9	7.9	7.9	7.9	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.9	4.9	5.2	4.7	3.1	3.7	3.4	3.9	4.5	4.6	4.7	
Nominal appreciation (increase in U.S. dollar value of local currency, in percent)	-7.0	-3.0	0.3	5.3	4.6	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	3.9	3.9	3.4	3.7	4.9	4.1	4.5	4.0	3.4	3.3	3.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	6.3	3.3	4.5	6.2	5.6	11.4	7.7	8.0	7.3	7.3	6.7	
Primary deficit	4.0	3.9	3.4	2.8	1.7	1.6	1.1	0.6	0.4	0.2	-0.2	

1/ General government. Gross debt is used.
 2/ Derived as $[(r - \pi(1+g) - g + \alpha\epsilon(1+r))/(1+g+\pi+gr)]$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ϵ = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
 3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as $-g$.
 4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\epsilon(1+r)$.
 5/ For projections, this line includes exchange rate changes.
 6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
 7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
 8/ Derived as nominal interest expenditure divided by previous period debt stock.
 9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

India—Fund Relations

(As of October 31, 2005)

I.	Membership Status:	Joined 12/27/45; Article VIII.			
II.	General Resources Account:	SDR Million	% Quota		
	Quota	4,158.20	100.00		
	Fund holdings of currency	3,175.77	76.37		
	Reserve position in Fund	982.43	23.63		
III.	SDR Department:	SDR Million	% Allocation		
	Net cumulative allocation	681.17	100.00		
	Holdings	2.99	0.44		
IV.	Outstanding Purchases and Loans:	None			
V.	Financial Arrangements:				
	Type	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
	Stand-By	10/31/1991	06/30/1993	1,656.00	1,656.00
	Stand-By	01/18/1991	04/17/1991	551.92	551.92
	EFF	11/09/1981	05/01/1984	5,000.00	3,900.00
VI.	Projected Obligations to Fund (SDR million; based on existing use of resources and present holdings of SDRs):				

	Forthcoming				
	2005	2006	2007	2008	2009
Charges/Interest	4.65	19.78	19.78	19.84	19.78
Total	4.65	19.78	19.78	19.84	19.78

VII. Exchange Rate Arrangement:

Since March 1, 1993, the Indian rupee has floated against other currencies, although the Reserve Bank of India intervenes in the market periodically. As per the Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER), the exchange rate in India is classified as managed floating with no pre-announced path for the exchange rate. On August 20, 1994, India accepted the obligations of Article VIII, Sections 2, 3, and 4 of the IMF Articles of Agreement. India maintains some restrictions on the making of payments and transfers for current account transactions which are subject to approval under Article VIII, Section 2(a): restrictions related to nontransferability of balances under the Indo-Russia mutual debt agreement of 1993; restrictions arising from unsettled inoperative bilateral payments agreements with three Eastern European countries; and a restriction on transfer of amortization payments on loans by nonresident relatives. The Executive Board has not granted approval of these measures. A restriction on remittances for

overseas TV advertising was removed in February 2004. Staff are seeking clarifications from the authorities regarding certain exchange measures under India's Foreign Exchange Management (Current Account Transactions) Rules, 2000.

VIII. Article IV Consultation:

The previous Article IV consultation discussions were held in October 2004. The staff report (IMF Country Report No. 05/86) was discussed by the Executive Board on January 24, 2005.

IX. FSAP Participation and ROSCs:

The data model of the ROSC (IMF Country Report No. 04/96) was issued in April 2004; FSSA/FSAP report was issued in January 2001; a fiscal transparency ROSC (www.imf.org) was issued in February 2001.

X. Technical Assistance:

Department	Purpose	Date of Delivery
MAE	Government securities market	2/94
MAE	Foreign exchange market	2/95
FAD	Expenditure control	5/95
FAD	Public expenditure management	8/95
FAD	Public expenditure management (follow-up)	5/96
MAE	Government securities market (follow-up)	7/96
STA	SDDS and statistics	12/96
STA	Balance of payments statistics	12/97
STA	SDDS and statistics	2/98
FAD	State level fiscal database and debt register	11/04
FAD	Pilot study on public private partnerships	12/04
STA	Balance of payments statistics	09/05

XI. Outreach and Other Activities:

Department	Purpose	Date of Delivery
OAP/APD/NCAER	Conference: A Tale of Two Giants: India's and China's Experience with Reform and Growth	11/03
FAD	Conference: International Experiences with Fiscal Reform	1/04
APD/FAD	Seminar: Decentralization: International Experiences with Subnational Debt Controls	1/04
APD	Training: Applying Debt Sustainability Templates to Indian States	3/04
APD	Training: Revenue Forecasting	5/05

XI. Resident Representative:

A resident representative's office was opened in November 1991. Mr. Michael Wattleworth is the current Senior Resident Representative.

India—Relations with the World Bank Group

The World Bank's total support to India of \$2.89 billion in FY05 was the largest amount received by an individual country, and more than double the \$1.4 billion recorded in FY04. As part of this total, India was also the largest recipient of IDA assistance, with credits totaling \$1.1 billion. IFC also recorded a strong commitment in FY05 of \$412.5 million. The World Bank Group's program of support combines policy dialogue with diversified IBRD/IDA lending, IFC investments and analytical and advisory activities in the sectors that are important to reducing poverty and sustaining growth.

The Bank Group's Board of Directors discussed a new Country Strategy (CAS) for India on August 26, 2004. The CAS jointly covers the programs of IBRD/IDA and IFC for the period of FY05-08. With over one-quarter of the world's poor in India, the overarching challenge is how to scale up the impact of Bank Group assistance in order to help India move closer to achieving its development goals—including the goal of halving poverty by 2015.

Scaling up assistance will entail a strengthened Bank Group program at the Center, as well as more lending to the states compared to recent years. For state level lending, the strategy is to retain an essentially reform and performance-based approach to the states, and to also seek new opportunities for engagement with the largest and poorest states in India in order to help strengthen the environment for reform. The expansion in lending will primarily be for investment in infrastructure development, human development and rural livelihoods. Through adjustment lending, continued emphasis is also being placed on support to fiscal and governance reforms at the state level.

Adjustment lending to finance state level reforms will be limited to 15 percent of total IBRD/IDA lending for the CAS period. Overall lending levels will fall within an upper bound of \$2.15 billion per year for IBRD, on average for the four years of the CAS, and the IDA limits for India established by the IDA Deputies. Financial operations since 1998/99 are summarized below.

India: World Bank Group Financial Operations

(In millions of U.S. dollars) 1/

	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
Commitments 2/	1,588	699	2,450	2,830	2,092	1,328	2,705
IBRD	591	190	1,495	1,904	951	698	1,463
IDA	996	509	955	926	1,141	630	1,242
Disbursements	1,443	1,468	1,761	1,997	1,533	1,816	1,835
IBRD	576	644	706	803	647	892	818
IDA	866	824	1,054	1,195	886	924	1,017
Repayments	1,130	1,228	1,361	1,147	3,491	2,403	784
IBRD	842	899	994	724	3,031	1,871	201
IDA	288	330	367	424	460	532	582
Debt outstanding and disbursed	26,575	26,746	25,968	26,466	26,243	27,019	28,527
IBRD	8,013	7,816	7,080	7,010	5,082	4,238	4,865
IDA	18,562	18,930	18,888	19,456	21,161	22,781	23,662

Source: World Bank.

1/ On a fiscal year basis beginning April 1.

2/ Based on loan approval date.

India—Relations with the Asian Development Bank

The Asian Development Bank (AsDB) operations in India began in 1986. Cumulative public sector loan commitments totaled \$14.3 billion as of June 30, 2005 for 80 loans. With an additional \$0.4 billion private sector loans (the latter without government guarantee), total loan commitments amounted to \$14.7 billion. These funds have been provided from the Bank's ordinary capital resources (OCR). Also, AsDB has approved 23 equity investments. The AsDB's lending and equity activities are summarized below.

India: Asian Development Bank Financial Operations

(In millions of U.S. dollars, as of June 30, 2005)

Calendar Year	OCR Loan Commitments	Private Equity	Disbursements
1986–90	2,318	11	339
1991–95	3,312	60	2,131
1996	600	...	592
1997	563	16	645
1998	250	--	620
1999	625	--	605
2000	1,150	--	487
2001	1,500	--	270
2002	1,163	25	577
2003	1,430	--	658
2004	1,200	30.3	381.4
2005	146	26	290
Total	14,257	168.3	7,595.4

Source: Asian Development Bank.

AsDB's core operational strategy in India remains poverty-reduction through infrastructure-led growth. More than 75 percent of its ongoing and proposed assistance focuses on transport (national highways, state roads, and rural roads), urban (water and sanitation, waste management, urban transport, city planning, and municipal reforms), and energy (power sector reforms, investments for upgrading transmission and distribution systems, hydropower generation, and improvement in energy efficiency) sector operations. AsDB's assistance pipeline for the period 2006–2008 is provided in the Country Strategy and Program Update 2005.

India—Statistical Issues

1. While India's macroeconomic statistics are adequate for surveillance, weaknesses remain in the timeliness and coverage of certain statistical series. India has an elaborate system for compiling economic and financial statistics and produces a vast quantity of data covering virtually all sectors of the economy. India subscribed to the SDDS on December 27, 1996 and started posting its metadata on the Dissemination Standards Bulletin Board on October 30, 1997. It is currently in observance of the SDDS, and it uses flexibility options for timeliness of data on general government operations and on the periodicity and timeliness of labor market data. The authorities are planning further improvements in the timeliness, periodicity, and coverage of data in a number of statistical areas as detailed below. Many key financial variables are available on a weekly or monthly basis, most of which are published in official documents or disseminated through press releases.

2. The data module of the Report on Observance of Standards and Codes (ROSC, IMF Country Report No. 04/96) was published in April 2004. It assesses India's data dissemination practices against the SDDS requirements and assesses the quality of six datasets based on the Data Quality Assessment Framework (DQAF) developed by STA. In addition, it lists prioritized recommendations to improve national accounts, consumer and wholesale price indices, fiscal, monetary, and balance of payments statistics. The data ROSC identified issues related to the periodicity, coverage, and quality of statistical series.

- **National accounts:** The CSO rebased the annual national accounts statistics and began publishing quarterly data in 1999. The CSO has recently reduced the dissemination lag for quarterly releases to two months from three months and is planning to release a new series of national accounts, with base year 1999–2000 in January 2006. However, quarterly data are only available from 1996Q2 and relate only to production-based data. Information on major expenditure categories is only available with considerable delay (at least ten months after the end of the fiscal year), providing limited guidance for short-term policies. The CSO is planning to disseminate quarterly expenditure-based aggregates starting in 2007 and is aiming to reduce the dissemination lag for the annual expenditure-based estimates to three months.
- **Industrial production index (IPI):** In May 2000, the CSO took the welcomed step of releasing a revised time series for IPI, using the new WPI (base year 1993/94) series as a deflator. The government has also contracted a private company, CMIE, to increase the number of respondents and products in the sample, as recommended by the data ROSC.
- **Price statistics:** The Consumer Price Indices (CPIs) are based on weights that are at least twenty years old and do not fully capture price developments in the economy. However, the CSO plans to publish shortly a revised CPI with a 2001 base year and a new producer price index. Presently, there are four CPIs, each based on the consumption basket of a narrow category of consumers (namely industrial workers,

urban and nonmanual employees, agricultural laborers, and rural laborers). In addition, the CSO is in the process of compiling an all-India CPI covering the general population of urban and rural sectors separately. The CPIs are published with a lag of about one month. The WPI is published weekly with a lag of two weeks and are subject to large revisions, especially in periods of rising inflation. A new WPI series was published in 2000 with updated weights, new categories, and a revised base year (1993/94). However, the representativeness of the index may be undermined by the collection of prices from a relatively small sample of products and the infrequent updating of weights.

- **External sector statistics:** While the concepts and definitions used to compile balance of payments statistics are broadly in line with the fifth edition of the *Balance of Payments Manual (BPM5)*, the Reserve Bank of India's (RBI) presentation does not follow the *BPM5*. Furthermore, trade data have quality, valuation, timing, and coverage problems, and data on trade prices, volumes, and composition are not regularly available on a timely basis. Starting January 2001, external debt statistics are available on a quarterly basis with a one quarter lag. Estimates of short-term external debt are presented in the debt statistics on an original maturity basis. The short-term maturity attribution on a residual maturity basis is only available annually (and excludes residual maturity of medium- and long-term nonresident Indian accounts). The international investment position (IIP) statistics cover the sectors prescribed in the *BPM5* and these data are disseminated within six months of the reference period in respect of annual data. India began disseminating the Data Template on International Reserves and Foreign Currency Liquidity as prescribed under the SDDS in December 2001. The more up-to-date information on certain variables, such as total foreign reserves, foreign currency assets, gold, and SDRs, are available on a weekly basis and are disseminated as part of a weekly statistical supplement on the RBI website.
- **Monetary and financial statistics:** The RBI website and the *RBI Bulletin* publish a wide array of monetary and financial statistics, including interest rates, exchange rates, foreign reserves, the monetary survey, and results of government securities auctions. The frequency and quality of data dissemination have improved substantially in recent years. However, some crucial data, such as the RBI's forward liabilities and intervention data, are still published with lags of two to three months.
- The ROSC data module mission of May 2002 found that the concepts and definitions used by the RBI to compile monetary statistics were in broad conformity with the guidelines provided in the *Monetary and Financial Statistics Manual (MFSM)*. Nevertheless, the following concepts and principles deviate from the *MFSM*: (1) the resident sector data do not provide sufficient information on the sectoral distribution of domestic credit. Specifically, under their present sectorization scheme, the authorities subdivide the resident nonbank sector data by (i) central government, (ii) state government, and (iii) the commercial sector (including other financial corporations, public and other nonfinancial corporations, and other resident sectors);

and (2) commercial banks add accrued interest to credit and deposit positions on a quarterly basis only. The mission has recommended that the authorities adopt the full range of sectors prescribed in the *MFSM* and include accrued interest on a monthly basis instead of reflecting it only on a quarterly basis.

- **Fiscal operations:** The Ministry of Finance posts selected central government monthly fiscal data and quarterly debt data on its website. However, no monthly data on fiscal performance at the state level are available, and annual data are available only with an eight to ten month lag. Consolidated information is unavailable on local government operations. In addition, data on the functional and economic classification of expenditures are available with considerable lag, and there is scope to improve the analytical usefulness of the presentation of the fiscal accounts. Reporting to the Fund for publication in the *Government Finance Statistics Yearbook (GFSY)* is adequate, but only cash data is reported, and the coverage is limited to the central government.

3. In addition to the ROSC recommendations, the authorities are presently addressing a number of data compilation issues which were identified in the August 2001 *Report of the National Statistical Commission*, including:

- The revision of statistical and data reporting methods in order to keep pace with the shift to a more market-oriented economy following the elimination of industrial licensing.
- The need for the Central Statistical Organization (CSO) to initiate procedures through which its interaction with other agencies in the decentralized statistical system is made more proactive as well as effective. The planned establishment of the National Statistical Commission is a first step.

India—Table of Common Indicators Required for Surveillance

As of December 13, 2005

	Date of latest observation	Date received	Frequency of Data ⁶	Frequency of Reporting ⁶	Frequency of Publication ⁶	Memo Items ⁷ :	
						Data Quality – Methodological soundness ⁷	Data Quality – Accuracy and reliability ⁸
Exchange Rates	12/13/05	12/13/05	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	12/2/05	12/9/05	W	W	W		
Reserve/Base Money	12/2/05	12/9/05	W	W	W	O, O, LO, LO	O, O, O, O, O
Broad Money	11/25/05	12/9/05	BW	BW	BW		
Central Bank Balance Sheet	9/05	7/05	A	A	A		
Consolidated Balance Sheet of the Banking System	8/05	7/05	A	A	A		
Interest Rates ²	12/13/05	12/13/05	D	D	D		
Consumer Price Index	11/26/05	12/9/05	W	W	W	O, LNO, O, O	LNO, LO, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	7/05	7/05	A	A	A	LNO, LO, O, O	O, O, O, O, LO
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	10/05	10/05	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	7/05	7/05	A	A	A		
External Current Account Balance	10/05	10/05	Q	Q	Q	LO, O, LO, O	LO, O, O, O, LO
Exports and Imports of Goods and Services	10/05	10/05	Q	Q	Q		
GDP/GNP	9/05	9/05	Q	Q	Q	LO, LNO, LO, LO	LNO, LNO, O, O, LO
Gross External Debt	11/05	11/05	Q	Q	Q		

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

²Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³Foreign, domestic bank, and domestic nonbank financing.

⁴The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

⁵Including currency and maturity composition.

⁶Daily (D), Weekly (W), Biweekly (BW), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

⁷Reflects the assessment provided in the data ROSC (published on April 2, 2004, and based on the findings of the mission that took place during May 13–30, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

⁸Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative
February 6, 2006

1. This statement contains information that has become available since the staff report was circulated to the Executive Board on December 23, 2005. This information does not alter the thrust of the staff appraisal.
2. **Recent economic developments are broadly consistent with staff's growth and balance of payments forecasts for 2005/06.** Industrial production appears to have softened, with 8 percent growth in October-November, slightly below levels of the first half of the year. This suggests that GDP growth may be moderating somewhat from the 8 percent growth of the first half of the year, consistent with staff projections. However, domestic demand remains robust, and staff continues to see upside risks to its GDP forecast for the year. Recent data indicate that in the first half of the fiscal year (April-September) the external current account deficit reached 1³/₄ percent of projected annual GDP, in line with staff projections. Despite healthy export growth of more than 20 percent (y/y), import growth of almost 50 percent—more than 40 percent excluding oil—pushed the trade deficit above 4 percent of projected annual GDP. Strong capital inflows, led by portfolio investment, contributed to a small balance of payments surplus. Recent customs data indicate that the growth of exports and imports slowed significantly during October-December, which may also point to some moderation in GDP growth.
3. **Foreign inflows remain strong and equity prices have continued to climb.** Since mid-December, net inflows from foreign institutional investors have totaled close to US\$2 billion, contributing to a 3 percent appreciation of the rupee against the dollar. After rising by more than 42 percent in 2005, the SENSEX is up about 5 percent this year. International reserves fell by \$7 billion in late December, as expected, as India Millennium Deposits were redeemed on maturity, but have since recovered by more than US\$2 billion to reach \$139 billion on January 20.
4. **Inflation is likely to remain lower than projected in the staff report.** In contrast to expectations, the WPI has not risen appreciably since September and stood at 4.4 percent in mid-January. The moderation is broad based, and suggests that efficiency improvements and competition from imports may be helping to contain inflation. Staff has revised downward its projection for average WPI inflation to 4³/₄ percent this fiscal year and 5.5 percent next year.
5. **Despite the modest rate of inflation, the Reserve Bank of India (RBI) raised its key policy interest rate by 25 bps on January 24.** Citing concerns about rapid growth in domestic demand and monetary aggregates as well as potential pressures from future pass-through of oil prices, the RBI increased the reverse repo rate to 5¹/₂ percent. Market rates had begun to harden ahead of the announcement amid tightening liquidity in the face of rapid credit growth. However, the rate increase surprised markets and interest rates for government securities continued to increase subsequently, with rates on government securities rising 50 bps at the short end and 20 bps at the longer-end.

6. **Budgetary developments remain broadly in line with those described in the staff report.** Through December the overall central government deficit stood at 3.1 percent of projected annual GDP (72 percent of the annual budget target) and the current deficit at 2¼ percent of GDP (84 percent of budget). The government expects revenue overperformance of 0.2 percent of GDP, largely in the form of special dividends from state-owned companies. Expenditures have also been revised up by 0.2 percent of GDP, mainly due to compensation, in the form of bonds, for oil company losses arising from less than full pass-through of global oil price hikes. However, the government expects this will be more than offset by savings in other spending categories, including defense, resulting in a small fiscal overperformance.

7. **Several structural measures have been implemented. Most notably:**

- The government has announced that it will allow FDI in the retail sector for single-brand stores, up to a maximum of 51 percent.
- The government has awarded concessions for modernization of Delhi and Mumbai airports. The two winning consortiums, joint-ventures of domestic construction and foreign airport companies, will be offered a 74 percent stake in the airports.
- As a means for enhancing banking penetration in rural areas, the RBI has allowed banks to appoint business correspondents to take deposits and offer loans without opening branches.

8. **National accounts data for 2004/05 along with new historical series with base year 1999/2000 were released on January 31.** For 2004/05, real GDP growth at constant factor prices is estimated to have reached 7.5 percent, compared to earlier estimates of 6.9 percent. Both services and industry growth were revised upward by 0.4 percentage point to 9.9 percent and 8.6 percent respectively. Growth was fueled by investment which, for the third year in a row, grew by around 16 percent. Revisions to historical nominal GDP figures and the sectoral composition of GDP have been minimal.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
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Public Information Notice (PIN) No. 06/17
FOR IMMEDIATE RELEASE
February 21, 2006

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with India

On February 6, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with India.¹

Background

India's growth has remained robust in 2005/06 following a strong performance last year. With rapid growth in services broadening to encompass industry, GDP growth in 2004/05, at 7½ percent (recently revised upward from 6.9 percent) was above the historical trend. Strong momentum in manufacturing and services has continued, resulting in rising capacity utilization and soaring business confidence. Staff projects growth of over 7½ percent this year, led by strong domestic demand, and broadly in line with the Reserve Bank of India (RBI) and consensus forecasts. In 2006/07, growth is expected to decline slightly as the economy further adjusts to higher oil prices and domestic and world interest rates rise.

While inflation remains low, underlying pressures from buoyant domestic demand and higher international energy prices remain strong. Steps taken by the RBI to tighten liquidity in 2004/05, including raising reserve requirements and policy interest rates, and incomplete pass-through of higher oil prices helped keep WPI inflation low. With headline inflation hovering around 4½ percent year on year, the RBI raised overnight repo rates again in October 2005 and January of 2006, by a cumulative 50 basis points, citing concerns about the rapid pace of aggregate demand and monetary growth and high oil prices. Staff projects inflation to rise from an average of about 4¾ percent in 2005/06 to 5½ percent in 2006/07, in part reflecting the adjustment of administered fuel prices.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

After several years of current account surpluses and growing reserves, the investment recovery and consumption boom have pushed the external current account into deficit. In 2004/05, the trade deficit widened to over 5½ percent of GDP and the current account reverted into deficit for the first time in three years, notwithstanding high growth in services income. While export growth continues to be strong, a large increase in both oil and non-oil imports caused the trade deficit to widen further this year, and contribute to a sharp deterioration in the current account deficit. Staff projects it to reach 3 percent of GDP in 2005/06.

The balance of payments position remains comfortable with strong capital inflows helping finance the growing current account deficit. In 2004/05, close to half of all capital inflows were debt creating, as Indian corporates took advantage of favorable global interest rates, an appreciating rupee, and the liberalization of restrictions on external commercial borrowings to borrow abroad. While portfolio flows have continued to gain importance, FDI inflows remained weak. So far this fiscal year, capital inflows have remained strong and reserves have only fallen modestly as a result of the redemption of the India Millennium Deposits. While more reliance on debt and portfolio inflows has increased India's susceptibility to changes in investor sentiment, ample reserves and remaining capital controls limit risks of potential reversals.

Asset markets have strengthened. Net foreign investor inflows have accelerated since mid-2005, as equity prices soared. Equity prices are up around 50 percent from end-April. Ample liquidity and historically low interest rates also helped fuel property prices, which have risen in major cities by over 20 percent annually over the past two years. Concerned with speculative pressures, the RBI has raised risk-weights on housing and real estate loans and imposed controls on real estate investments aimed at curbing speculative FDI inflows.

The exchange rate has exhibited increased two-way flexibility. In the eight months to June 2005, the RBI scaled back intervention in foreign exchange markets and the rupee appreciated by 4 percent against the dollar (6½ percent in real effective terms). In the second half of 2005,—with the exception of a six-week period following China's July 21 revaluation, when the RBI intervened to stem appreciation pressures—the rupee depreciated, reflecting pressures from the growing current account deficit and renewed U.S. dollar strength.

Following three years of declining fiscal deficits, a "pause" in deficit reduction was announced for 2005/06. The central government deficit came in below target in 2004/05 for the second consecutive year at 4.1 percent of GDP (authorities' definition, including privatization receipts as revenue), helped by a cyclical rebound in revenue and expenditure compression, but also reflecting greater recourse to off-budget petroleum subsidies. This, together with a 0.8 percentage points reduction in subnational deficits, contributed to a fall in the general government deficit to under 7½ percent of GDP, enough to stabilize public debt at about 86 percent of GDP. The 2005/06 Budget deficit target of 4.3 percent of GDP falls short of the minimum reduction required by the Fiscal Responsibility and Budget Management Act. This reflected significant spending increases for key social and infrastructure needs and higher transfers to the states. The general government deficit is projected by staff to rise, for the first time in four years, to 7¾ percent of GDP.

The banking sector has continued to strengthen but some risks remain. Commercial banks have continued to reduce nonperforming assets, and aggregate capital adequacy remains high. Banks have reduced their exposure to interest rate risks, decreasing their holdings of government paper and shortening maturity. Declining profitability due to rising interest rates has been in part offset by higher credit growth. However, interest rate risk remains a concern with bank holdings of government paper (at 38 percent of assets) still high and in excess of statutory

requirements. At the same time, rapid credit growth raises concerns about credit quality and cooperative banks, accounting for about 6 percent of banking system assets, remain in poor health.

Executive Board Assessment

Executive Directors noted that the Indian economy is continuing to reap the rewards of more than 15 years of reforms. Notwithstanding high world oil prices and a weak monsoon, the economy showed remarkable resilience in 2004/05, with growth remaining robust and becoming broader-based. These trends have continued in 2005/06, and growth of more than 7½ percent for the full year is expected.

Directors supported the broad objectives of the government's economic program, in particular addressing infrastructure bottlenecks, alleviating rural poverty, and deepening global integration. They noted that current favorable economic conditions provide a good opportunity to speed structural reforms. In particular, measures to improve the business climate and reform labor laws would have a large pay-off by fostering private and foreign investment and job creation. With an acceleration of the reform process, India would be able to achieve sustained economic growth of 8–10 percent, in line with the objectives of the authorities.

Directors emphasized that macroeconomic policies should remain vigilant, in view of the evolving macroeconomic situation. Although inflation has remained contained, underlying pressures point to upside risks. In particular, domestic demand remains strong, as evidenced by a widening current account deficit and rapid credit growth. In this context, Directors recommended that fiscal policy should counter demand pressures, and they underlined the importance of overperforming on the budget and meeting the minimum adjustment required under the Fiscal Responsibility and Budget Management Act. This would not only be an appropriate macroeconomic policy response, but would also bolster the credibility of the Act and allow the central government to lead by example in efforts to encourage adjustment at the state level. In this regard, some Directors cautioned that markets might interpret the pause in deficit reduction in the current fiscal year as a weakening of the commitment to reform.

Directors underscored the need for the Indian economy to adapt to permanently higher international oil prices. They recommended moving gradually to the full pass-through of oil prices—with targeted support for the poor—which would help limit fiscal and quasi-fiscal losses and provide incentives for more efficient energy use, thus aiding competitiveness in the medium term.

Directors considered that monetary policy should remain focused on keeping inflation expectations in check. The increases in the reverse repo rate by the Reserve Bank of India in October 2005 and January 2006 were seen as appropriate, signaling the RBI's commitment to price stability and helping the adjustment to higher global interest rates. Directors welcomed the RBI's continued two-way flexibility in exchange rate management.

Directors noted that, notwithstanding the deficit reduction achieved since 2001/02, India's large public debt remains a key constraint on growth. Without further enhancing tax revenues and reducing lower-priority spending, it will be difficult to create fiscal space for the planned large and crucial increases in infrastructure and social spending. In addition, with credit to the private

sector rising fast, the risk that government borrowing needs will crowd-out the private sector has increased. Directors observed that fiscal consolidation is a prerequisite for more complete financial sector development and further opening up of the capital account.

Directors viewed an acceleration of tax reform as critical to achieve the government's deficit reduction targets. They welcomed the introduction of the value-added tax in most states and steps to widen the services tax base and modernize tax administration. Directors underscored the need to further broaden the tax base by trimming existing exemptions and eventually introducing a goods and services tax with few exemptions. Directors looked forward to the planned development of tax expenditure estimates, which would provide a valuable tool for resisting attempts to introduce new inefficient tax incentives.

Directors observed that greater spending efficiency, in particular improved targeting of subsidies, would be required to generate the needed fiscal adjustment. They viewed the government's 2004 subsidy reform blueprint as appropriate, and urged its rapid implementation. Directors underlined that the new rural employment program represents a potentially large expenditure commitment, and advised the government to proceed cautiously with it.

Directors welcomed the initiation of pension reform. The passage of the Pension Bill would allow the introduction of fully funded, defined contribution pensions, which in turn would help ensure a secure source of retirement income and aid in the development of capital markets. However, Directors pointed out that revisions to the existing defined benefit schemes for civil servants are also required to reduce large unfunded pension liabilities.

Directors noted that states have succeeded, in the aggregate, in reducing their deficits in recent years, and they welcomed recent reforms undertaken in the context of the Twelfth Finance Commission to further strengthen state finances. These reforms provide states with greater resources and incentives to undertake fiscal reform. However, Directors emphasized that state finances could be further strengthened by increasing conditionality and hardening budget constraints, including via tighter global borrowing ceilings. They called for consolidating the recent gains through tax base broadening and further reforms in the pension, subsidy, and state electric utility areas. Directors were encouraged that a number of states have already shifted to defined contribution pension systems and enacted fiscal responsibility laws.

Directors supported the government's emphasis on public-private partnerships to ensure greater private participation in investments in infrastructure. However, they cautioned that an improved regulatory framework and financial reforms to broaden the investor base are also needed. Directors viewed the 2003 Electricity Act as a solid framework for reform, and advised that it be implemented quickly.

Directors commended the underlying strength of financial regulation and the effective response to recent rapid credit growth. They advised close monitoring of fast-growing credit card debt. A further strengthening of prudential standards could be considered, where appropriate. Reliance on priority sector lending floors to deliver credit to agriculture and small and medium-sized enterprises could be reduced by addressing needed structural reforms in lending. Regulation should also be strengthened for cooperative banks. Directors urged the RBI to ensure readiness for the planned move to Basel II by continuing to enhance monitoring of banks' risk management systems, upgrade supervisory skills, and strengthen disclosure requirements. Directors considered that the current sound position of the financial system

provides a good basis for its further deepening, in particular through increasing private and foreign participation in the banking sector, including by accelerating implementation of the RBI's banking reform roadmap.

Directors emphasized that further opening of the economy would allow it to reach its full growth potential. While they commended the progress already made in bringing down tariff levels, they noted that faster convergence to ASEAN levels would be desirable. Broad-based tariff reductions would also help minimize the trade diversion potentially associated with preferential trade arrangements. Also, continued loosening of sectoral limits on foreign direct investment, together with efforts to improve the business climate and liberalize labor laws, could foster growth and job creation, while reducing India's reliance on shorter-term capital flows. Some Directors noted that further privatization could spur efficiency gains and provide resources to reduce the public debt. Directors urged the authorities to consider labor market reforms, including expanded contract employment and streamlined labor regulations and reporting requirements. Such flexibility would be key to ensuring that India can generate jobs for its rapidly expanding labor force.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

India: Selected Economic Indicators 1/

2001/02 2002/03 2003/04 2004/05 2005/06

(In percent)

Domestic economy

Change in real GDP at factor cost (base year 1999/2000)	5.8	3.8	8.5	7.5	7.6	2/
Change in industrial production	2.7	5.7	7.0	8.4	...	
Change in wholesale prices (period average)	3.4	3.4	5.4	6.4	4.7	2/
Change in consumer prices (period average)	4.3	4.0	3.9	3.8	4.5	2/

(In billions of U.S. dollars)

External economy

Merchandise exports 3/	44.7	53.8	64.7	80.8	97.3	2/
Merchandise imports 3/	56.3	64.5	80.2	119.0	161.7	2/
Current account balance 3/	3.4	6.3	10.6	-6.4	-23.1	2/
(In percent of GDP)	0.7	1.2	1.8	-0.9	-3.0	2/
Direct investment, net 3/ 4/	4.7	3.2	3.4	3.0	4.6	2/
Portfolio investment, net 3/	2.0	0.9	11.4	8.9	9.3	2/
Capital account balance 3/	8.6	10.8	16.7	31.0	27.5	2/
Gross official reserves 5/	54.7	76.1	113.0	141.5	139.5	10/
(In months of imports) 6/	8.0	9.3	8.7	7.7	5.7	10/
External debt (in percent of GDP) 5/	20.7	20.6	18.6	17.9	17.9	2/
Short-term debt (in percent of GDP) 5/ 7/	3.0	3.8	1.9	2.7	2.4	2/
Debt service ratio (in percent of current receipts)	13.8	16.3	16.3	4.7	6.9	2/
Change in real effective exchange rate (in percent) 5/	1.8	-5.4	-0.9	1.3	5.4	11/

Financial variables

Central government balance (in percent of GDP) 8/	-6.4	-6.0	-5.1	-4.3	-4.3	2/
General government balance (in percent of GDP) 8/	-10.1	-9.7	-9.0	-7.4	-7.7	2/
Change in broad money (in percent) 5/	14.1	14.7	16.7	12.4	17.7	11/
Interest rate 5/ 9/	6.1	5.9	4.2	5.3	6.7	12/

Sources: International Financial Statistics; Reserve Bank of India; Ministry of Finance; CEIC; and Fund staff estimates.

1/ Data are for April-March fiscal years as available at the time of the Executive Board meeting, unless otherwise indicated.

2/ Staff projections for 2005/06.

3/ Based on balance-of-payments data available as of December 23, 2005.

4/ Net foreign direct investment in India less net foreign investment abroad.

5/ End of period.

6/ Imports of goods and services projected over the following twelve months.

7/ Residual maturity basis, except contracted maturity basis for medium- and long-term nonresident Indian accounts.

8/ Excluding divestment receipts from revenues and onlending of small saving collections from expenditures and net lending.

9/ 91-day Treasury Bill rate.

10/ As of January 27, 2006.

11/ As of December 31, 2005.

12/ As of January 31, 2006.