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India: Recent Economic Developments

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INDIA

Recent Economic Developments

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Approved by the Asia and Pacific Department

August 2, 2000

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I. INTRODUCTION[1]

1. **India's economic performance in recent years has been remarkable.** After slowing in 1997/98, in response to a weak harvest and the effects of the Asia crisis, GDP growth averaged 6¼ percent in the subsequent two years, among the highest in the world. The balance of payments also remained comfortable, despite the regional slowdown, turmoil in international capital markets, international sanctions, and sharply higher oil prices. During the past two years, the current account deficit is estimated to have remained close to 1–1¼ percent of GDP, capital inflows surged, contributing to a sharp increase in domestic stock prices, and India's foreign exchange reserves rose by $8.6 billion to $38 billion. Inflation, which had increased sharply in late 1998, also fell with an improvement in agricultural supply conditions and reached an 18-year low of 2 percent in mid-1999.

2. **The capable handling of monetary and exchange rate policies contributed significantly to the favorable economic performance.** In response to pressures stemming from the regional crisis, the Reserve Bank of India (RBI) tightened monetary conditions between mid-1997 and August 1998, while accommodating an orderly depreciation of the rupee. However, as exchange market pressures moderated, monetary policy shifted in early 1999 to supporting the industrial recovery—the Bank Rate was cut by 1 percentage point in February 1999 and bank cash reserve requirement also were lowered during the year. The government followed in late 1999 and early 2000 by lowering interest rates on provident fund and postal saving deposits, and the RBI reduced the Bank Rate and repo rate by a further 1 percentage point on April 1, 2000, and also cut the cash reserve ratio.

3. **Nonetheless, significant challenges still face the Indian economy**. The durability of the recovery remains a question, given signs that much of the growth in recent years has been fueled by fiscal stimulus and private consumption. Private investment appears to have been constrained by high interest rates, lack of infrastructure, and crowding out by the public sector. Inflation also has rebounded strongly in early 2000, particularly with the adjustment of administered energy and fuel prices, and the scope for monetary policy to sustain noninflationary growth is complicated by the large fiscal deficit. Moreover, recent data suggest that, despite rapid growth in recent decades, the poverty rate remains high, with more than a third of the population estimated to be living below the official poverty line.

4. **The fiscal situation has deteriorated markedly in recent years, erasing much of the consolidation that was achieved during the mid-1990s**. The overall public sector deficit has increased steadily from 8¼ percent of GDP in 1995/96 to an estimated 11 percent of GDP in 1999/00, reflecting roughly equivalent erosions in the fiscal positions of the central and state governments. Slippages from the central government's 1999/00 budget were severe, with the deficit reaching 7 percent of GDP, and the states' fiscal position also weakened considerably. Although the central government's 2000/01 budget contained

[1] Prepared by Christopher Towe.

important reforms to the tax system, it suggests that little or no deficit reduction will be achieved in the coming year.

5. **Political uncertainties also appear to have delayed progress in the area of structural reform**. This was particularly noticeable during 1999, ahead of the elections that were concluded in October. Nonetheless, a number of key reforms have been implemented in recent years, including in the areas of urban land reform, the insurance sector, foreign exchange management, telecommunications, and trade and capital account liberalization. The authorities also have continued to strengthen the regulation and supervision of banks and other deposit-taking institutions. Nonetheless, regulatory and other structural impediments in the industrial and agricultural sectors remain significant.

6. **Many of these issues are addressed in the following chapters.** Chapter II reviews recent economic developments, and Chapter III describes fiscal developments at the central and state levels. Monetary policy and financial market developments are discussed in Chapters IV and V, and the balance of payments and trade policy are reviewed in Chapters VI and VII. Chapter VIII describes structural policy developments.

II. Economic Activity and Prices[1]

A. Overall Developments

1. **The Indian economy recovered strongly in 1998/99, and real GDP growth (at market prices) rose to 6¾ percent from 4½ percent in 1997/98.** However, the pickup mainly reflected a sharp rebound in agricultural production, which had been adversely affected by a poor monsoon in 1997 (Table II.1). Activity in the industrial and service sectors slowed in response to the continued effects of the Asian crisis and the previous year's drop in agricultural incomes. On the expenditure side, the recovery was supported by a sharp rise in private sector consumption growth from 2½ percent in 1997/98 to 5 percent in 1998/99, which was boosted by the increase in agricultural incomes and the sharp increase in civil service salaries (Table II.2). In particular, wage hikes associated with the Fifth Pay Commission contributed to average annual public sector consumption growth of 12½ percent in 1997/98–98/99.[2] Investment growth increased only modestly, rising to 5½ percent in 1998/99, from 4¾ percent in the previous year, as a sharp decline in household investment partially offset a significant pickup in capital accumulation by the public and private corporate sectors.

2. **Advance estimates indicate that GDP growth moderated to 6 percent in 1999/00, roughly equal to India's potential growth rate (see Section B).** This was largely due to a sharp slowdown in the agricultural sector, where growth eased to ¾ percent, which more than offset an acceleration in industrial sector growth to 7 percent. Growth in the services sector remained roughly constant at 8¼ percent in 1999/00, reflecting rapid increases in financial services and moderation of government services and trade.

Agriculture

3. **Agricultural output surged by 7¼ percent in 1998/99, following a 2 percent decline the year before.** Foodgrain production reached a record high of 203 million tonnes (Table II.3). Nonfood items such as oilseeds, sugarcane, cotton, and tea also recorded strong growth. However, flooding and excessively high temperatures in some parts of the country negatively affected the supply of cotton, fruits, and vegetables. Supply shortages for potatoes and onions were particularly severe, and the prices of these commodities rose sharply during July–November 1998.

4. **More recently, advance estimates indicate that agricultural sector growth slowed to ¾ percent in 1999/00.** Although the monsoon was considered normal, with total rainfall during the entire season being 96 percent of the annual average rainfall, 7 out of 35

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[1] Prepared by Daniel Kanda.

[2] See Chapter III for a more detailed discussion.

meteorological sub-divisions recorded deficient rainfall. Heavy rains and flooding in some states, periods of deficient rainfall, and the super-cyclone in Orissa, also adversely affected agricultural output. Thus, production of wheat, cotton, coarse cereals, pulses, and oilseeds are estimated to have fallen in 1999/00.

Box II.1. India: Estimates of Agriculture Production

The agricultural year in India is divided into the rabi (winter) and kharif (summer) seasons. Estimates during the year of agricultural output vary widely, depending on methodologies used, and can change during the year depending on the outcome of the monsoons. Official estimates are usually based on the Ministry of Agriculture estimates that are compiled as follows:

- The first set of estimates is prepared in September following the Ministry's Rabi Conference of state governments and union territories. During this conference, estimates of the kharif crop are prepared based on surveys by the state governments. In addition, projections for the rabi crop also are made, which are made public.

- A second set of estimates is published in January/February. These figures include firmer estimates of the kharif output, based on actual crop cutting, and estimates of the rabi crop are made on the basis of surveys.

- A subsequent set of estimates results from the March/April Kharif Conference, where more precise estimates of the rabi crop are made available and final data for the fiscal year are released.

Industry

5. **Growth in the industrial sector slowed sharply during the three years to 1998/99.**[3] Industrial sector growth fell to 4 percent in 1998/99, down from 6 percent the year before and well below the recent peak of 11¾ percent growth achieved in 1995/96. The slowdown reflected several factors that dampened both consumer and business demand. These included spillovers from the weak agricultural output in 1997/98, depressed capital markets, and a sharp drop in exports to regional partners. In addition, weaker business investment reflected a buildup of excess capacity in the mid-1990s and inadequate infrastructure (Chart II.1).

6. **However, with the pickup in domestic and foreign demand, industrial sector growth increased to 7 percent in 1999/00**. A recovery in the manufacturing sector has been the principal factor behind the recent strengthening of industrial activity. Following lacklustre growth of 4 percent in 1998/99, manufacturing sector output, which has a weight of 79 percent in the Index of Industrial Production (IIP), grew by 9¼ percent in 1999/00. The pickup in manufacturing growth was due to basic goods, intermediate goods, and consumer

---

[3] The industrial sector is here defined to include mining and quarrying, manufacturing, electricity, gas and water supply, and construction.

goods output, pointing to strong household demand (Table II.4). By contrast, output of capital goods slowed to 5¼ percent in 1999/00, down from 11¾ percent in 1998/99, suggesting that investment in machinery and equipment remained weak (Chart II.2).

7. **The recent financial performance of the corporate sector confirms that an industrial recovery is underway**. After declining for three straight years, Profits After Tax (PAT) for manufacturing companies increased by 15 percent in the first half of 1999/00.[4] Growth in net sales of manufacturing companies also increased to 20¾ percent in the first half of 1999/00, compared to 9½ percent in the corresponding period of 1998/99. For the entire corporate sector, sales grew 17¾ percent, and PAT grew 8 percent in the first half of 1999/00. While comprehensive data for the whole of 1999/00 are not yet available, a survey of 502 companies by the ***Business Standard*** reported a 41½ percent growth in net profits and a 21 percent growth in sales for the last quarter of the year, suggesting continued strong financial performance.

Services

8. **The service sector remained the fastest growing sector of the economy in 1998/99, although growth slowed slightly to 8¼ percent from 9 percent for the previous year.** The slowdown reflected a 2 percent decline in railway freight traffic, stagnant cargo handling at major ports after 10½ percent growth in 1997/98, and a decline in growth of new telephone connections from 27 percent in 1997/98 to 16½ percent in 1998/99. However, the lack of fiscal discipline contributed to strong growth in public administration services, and the information technology sector continued to grow rapidly. **In 1999/00, advance estimates indicate that services sector growth was roughly unchanged at 8¼ percent**. A substantial increase in financial services growth was largely offset by declines in growth of other services such as public administration and trade.

9. **The rapid growth of the services sector has led to a steady increase in its share of GDP, from around 39 percent in 1990/91 to 47 percent in 1999/00.** The sector has been led by telecommunications activity—new telephone connections grew at an average annual rate of 25½ percent during 1994/94-1998/99—and the computer software sector—where exports (which constitute the bulk of software output) expanded by 54 percent (in U.S. dollars) in 1998/99.

Investment

10. **Gross fixed capital formation fell to 21½ percent of GDP at current prices in 1998/99, from 22¾ percent in the previous year.** This was entirely due to a decline in the rate of private fixed investment, as public sector fixed investment remained constant at

[4] Based on a sample of 1,078 listed companies reported by the Centre for Monitoring the Indian Economy (CMIE).

6½ percent of GDP. Corporate fixed investment declined by ½ percentage point to 7½ percent of GDP, while household fixed investment declined by almost one percentage point to 7¼ percent of GDP (Table II.5). However, a major contributory factor for the decline in the share of fixed investment was that the overall GDP deflator grew much faster (9 percent) than the investment deflator (4 percent).

11. **In constant-price terms**, the only category of fixed investment that fell as a share of GDP (by ½ percentage point) in 1998/99 was household fixed investment. This reflected the boom in consumption, and more than offset pickups in public and private corporate sector fixed investment. The share of private corporate sector fixed investment increased marginally, reflecting the pickup in consumer demand and improvement in the business outlook following the bumper harvest. Public sector fixed investment increased by ¼ percentage point of GDP, after fiscal slippages had caused it to decline in the previous three years. Although data for 1999/00 are not yet available, a substantial decline in growth of capital goods production and subdued growth in non-oil imports suggest investment weakened.

Saving

12. **The gross domestic saving rate fell to 22¼ percent of GDP in 1998/99, down from 24¾ percent of GDP in 1997/98,** reflecting weakness in both the private sector and public sector saving rates. As regards the private sector, the household saving rate fell by ½ percentage point to 18½ percent of GDP in 1998/99, as a result of a decline in the physical saving rate that more than offset an increase in the financial saving rate. The lower physical saving rate largely reflected the surge in private consumption growth that occurred after the bumper agricultural harvest. Corporate saving fell for the third straight year to 3¾ percent of GDP in 1998/99, owing to the effect of the industrial slowdown on profits. The decline in public savings reflected continued fiscal slippage in 1998/99.

Labor market

13. **Employment in the organized sector grew by ½ percent in 1997/98, the last year for which data are available** (Table II.6). Public sector employment, which accounts for about 69 percent of employment in the formal sector, fell by ½ percent, while private sector employment rose by 1 percent. Female employment, which accounts for about 16½ percent of formal sector employment has grown at an average of 3½ percent per year over the period 1992/93–1996/97, much faster than male employment (½ percent over the same period).

Inflation

14. **After accelerating in the latter half of 1998, inflation declined to historically low levels**. In particular, wholesale price inflation rose from 3¾ percent in February 1998 to

7¼ percent in November (on a 12-month basis) owing to effect of shortages of key agricultural commodities (fruits and vegetables).[5] Thereafter, however, inflation declined markedly as agricultural supply conditions eased, and fell to a low of 2 percent by July 1999 (Chart II.3). Inflation began to edge up subsequently, particularly with the 40 percent increase in diesel fuel prices that was implemented in October and the increases in wheat and other food prices that were introduced as part of the 2000/01 budget, and inflation rose to 6 percent by April 2000. Nonetheless, inflation for 1999/00 as a whole averaged only 3½ percent, an 18-year low, and expected inflation for 2000/01, as measured by the May 2000 Consensus Forecast, has edged down to 5 percent.

15. **Inflation measured using the consumer price index (CPI) followed broadly similar trends (Table II.7)**. CPI inflation increased steadily from 4¾ percent in mid-1997 to a peak of 19¾ percent by November 1998 (on a 12-month basis), reflecting its greater weight on food items, but fell to zero in November 1999. Thereafter CPI inflation began rising, reaching 4¾ percent in March 2000.

B. Potential Output and Total Factor Productivity Growth

16. **An economy's potential level of output is often defined as the level of output that results when all resources are utilized at normal levels, or the level of resource utilization where inflation is stable or nonaccelerating**. Potential output is often estimated using the Hodrick-Prescott filter to isolate the underlying trend value of GDP. Applying this approach to real GDP data for India suggests that potential output growth was low and stagnant—about 3½ percent per annum—during 1962/63-1972/73.[6] Subsequently, potential growth increased steadily, reaching just under 6 percent by 1996/97 and remaining at around this level to 1999/00.

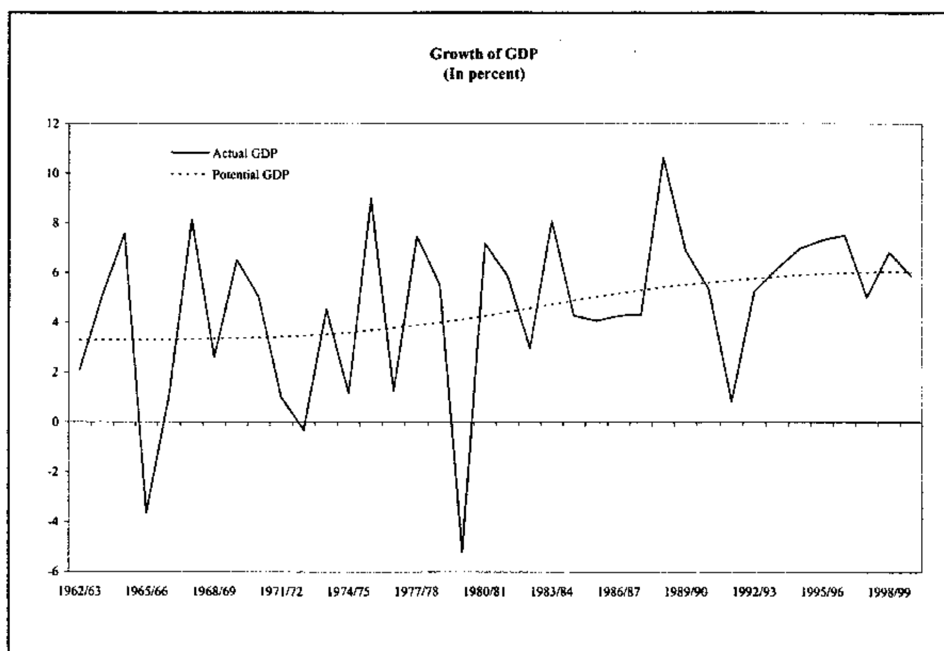
17. **A key issue is the extent to which the apparent increase in potential growth since the early 1970s resulted from a pickup in labor or capital inputs or from productivity gains**. To address this question, total factor productivity (TFP) growth was estimated using the following equation, which assumes a Cobb-Douglas production function:

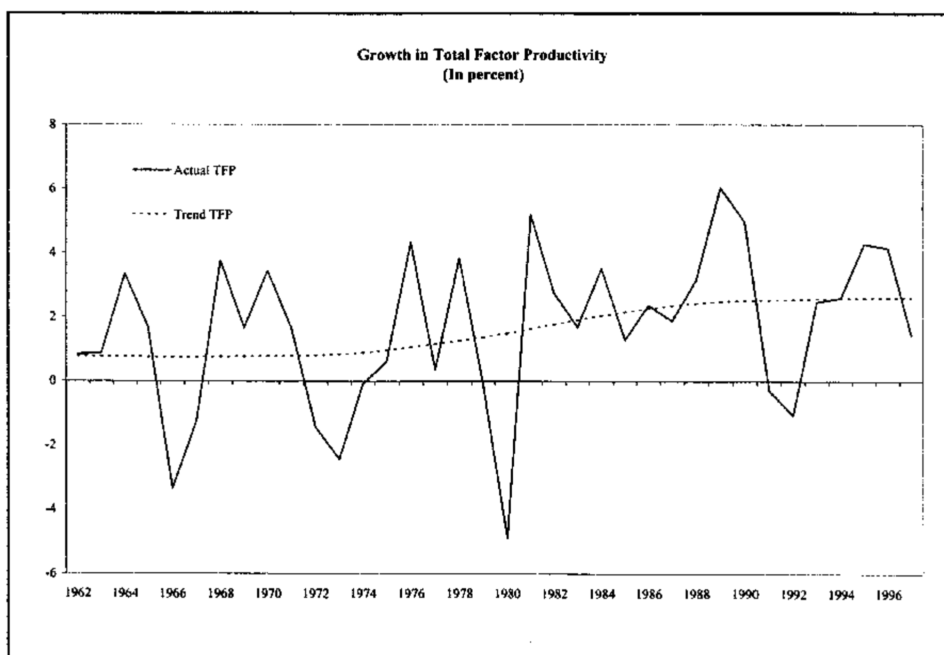
Growth of TFP = Growth of output – [α][Growth of capital] - [1-α][Growth of labor],

---

[5] The WPI is the most commonly used price index in India. Revised WPI data were released in April 2000, based on 1993/94 weights, which have raised measured inflation rates in recent months by around ¾ percentage point.

[6] Since consistent historical GDP data are not available, the estimates were based on data constructed by splicing the national accounts series for 1993/94-1999/00, which are based on 1993/94 weights, to the older series, which were based on 1980/81 weights.





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

where α was assumed to equal the historical income share of capital (0.32). Capital was measured by the net fixed capital stock, while labor was measured by actual employment. Trend TFP was estimated using the Hodrick-Prescott filter. The estimates indicate that after stagnating throughout the 1960s and early 1970s, trend growth in total factor productivity (TFP) increased steadily after 1974, reaching 2½ percent per annum by 1996.

C. Estimating the Expenditure Side of the National Accounts

18. In India, data on the expenditure side of the National Accounts are released with a lag of about 10 months, while data on the production side of the accounts are released with a much shorter lag (advance estimates for 1999/00 were released in February 2000). This raises the question of whether the expenditure components can be estimated from the production side of the data. This issue is particularly relevant for private consumption and fixed investment, since information on the public sector and the balance of payments is available from other sources.

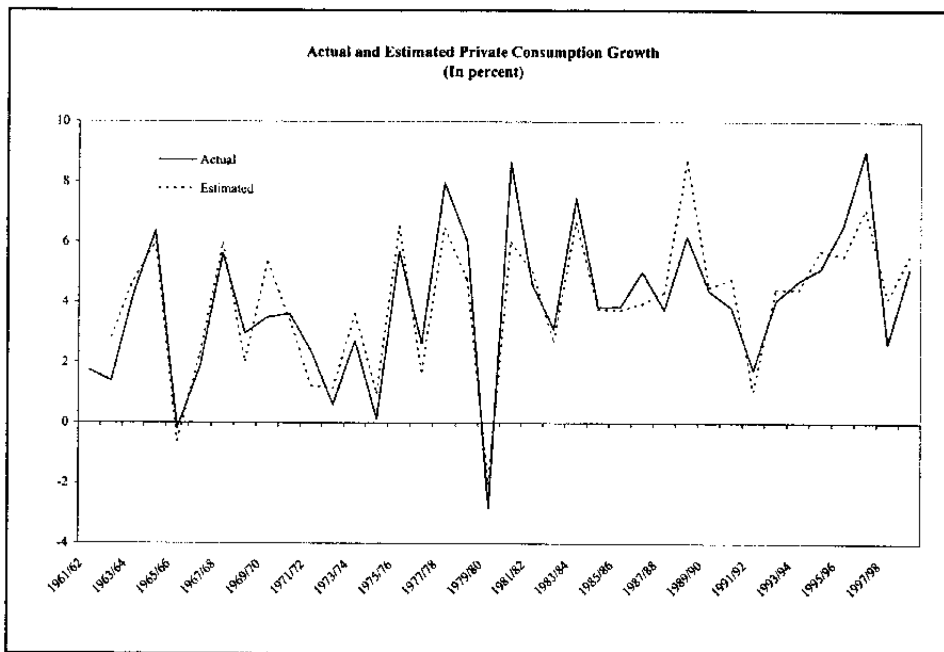
19. In the case of **private consumption**, an equation was estimated in which private consumption growth (C) was regressed on current and lagged growth in the agriculture (A) sector, current growth in the industrial (I) and services (S) sectors, and lagged consumption growth. With the exception of the coefficient of services growth, all coefficients are precisely estimated and are significant at the 10 percent level, and the equation's R^2 indicates a good fit. Interestingly, the lag structure on agricultural growth suggests that a pickup in the agricultural sector has a large contemporaneous impact that is partly reversed in the subsequent year.

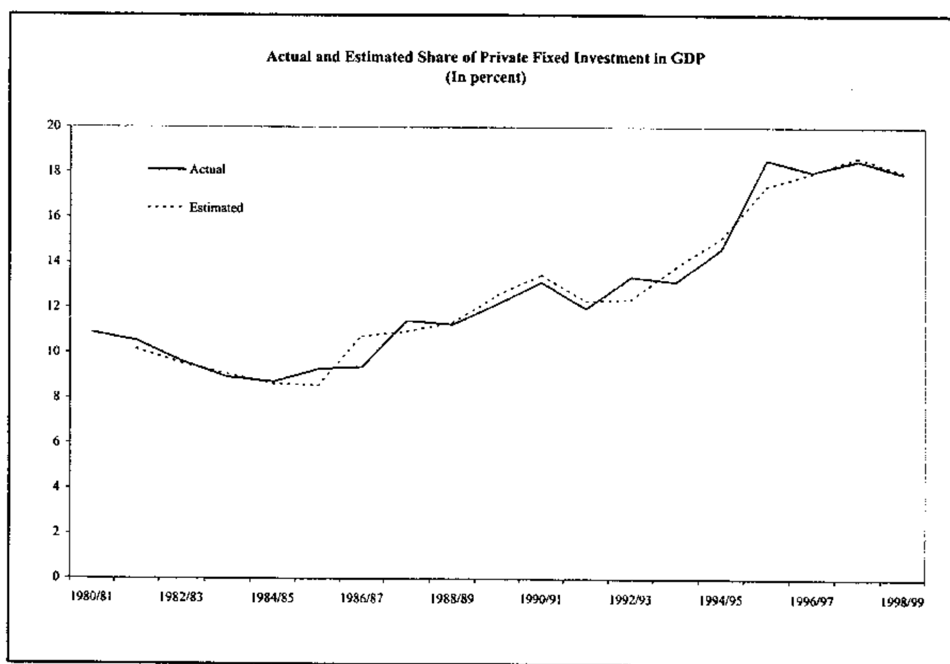
20. As for **private fixed investment**, the preferred equation was one in which the ratio of private fixed investment to GDP at factor cost (INVGDP) was a function of the current and lagged ratio of industrial output to GDP (IGDP), lagged ratio of services output to GDP (SGDP), and the lag of INVGDP. A noticeable feature of the equation is that the short-term impact of changes in the share of industrial output on the private fixed investment rate exceeds the long-term impact.

Least Squares Estimates of the Private Fixed Investment Rate (INVGDP) and Private Consumption Growth (C) Equations

Fixed Investment			Consumption		
Variable	Estimated Coefficient	p-value	Variable	Estimated Coefficient	p-value
CONSTANT	-21.33	0.0016	CONSTANT	0.16	0.8175
IGDP	1.97	0.0002	A	0.25	0.0000
IGDP(-1)	-1.75	0.0032	A(-1)	-0.10	0.0455
SGDP (-1)	0.47	0.0393	I	0.21	0.0128
INVGDP(-1)	0.71	0.0000	S	0.23	0.1027
			C(-1)	0.23	0.0934

Fixed Investment		Consumption	
R-squared	0.97	R-squared	0.81
Sample	1981/82-1998/99	Sample	1962/63-1998/99
F-test for first order serial correlation: p-value = 0.1.		F-test for first order serial correlation: p-value = 0.57.	

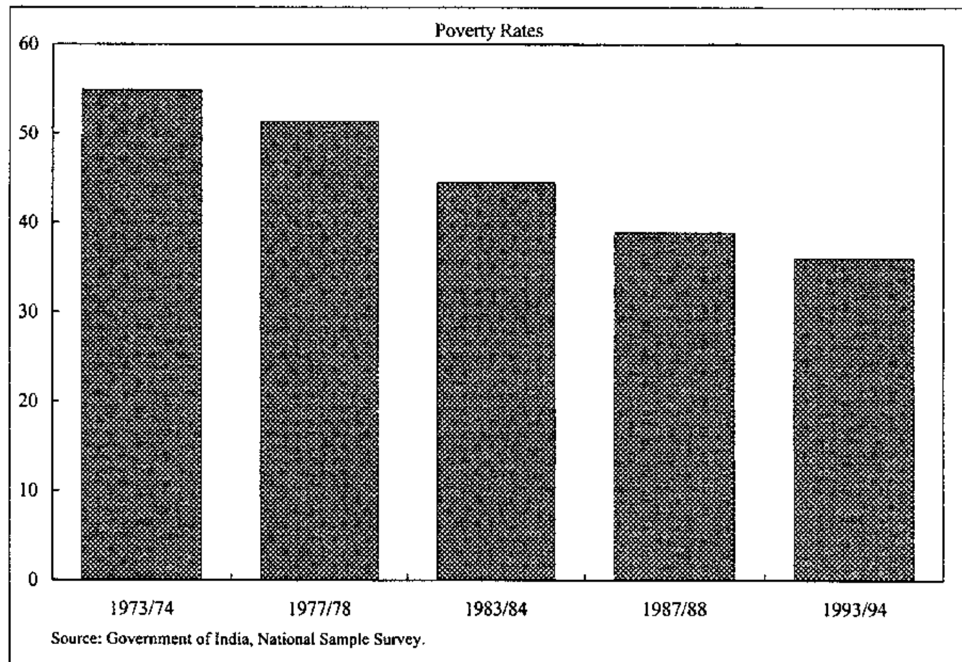




Sources: Data provided by the Indian authorities; and staff estimates.

D. Poverty Trends

21. **Official estimates indicate an impressive decline in the poverty ratio** from 55 percent of the population in 1973/74 to 36 percent of the population in 1993/94.[7]

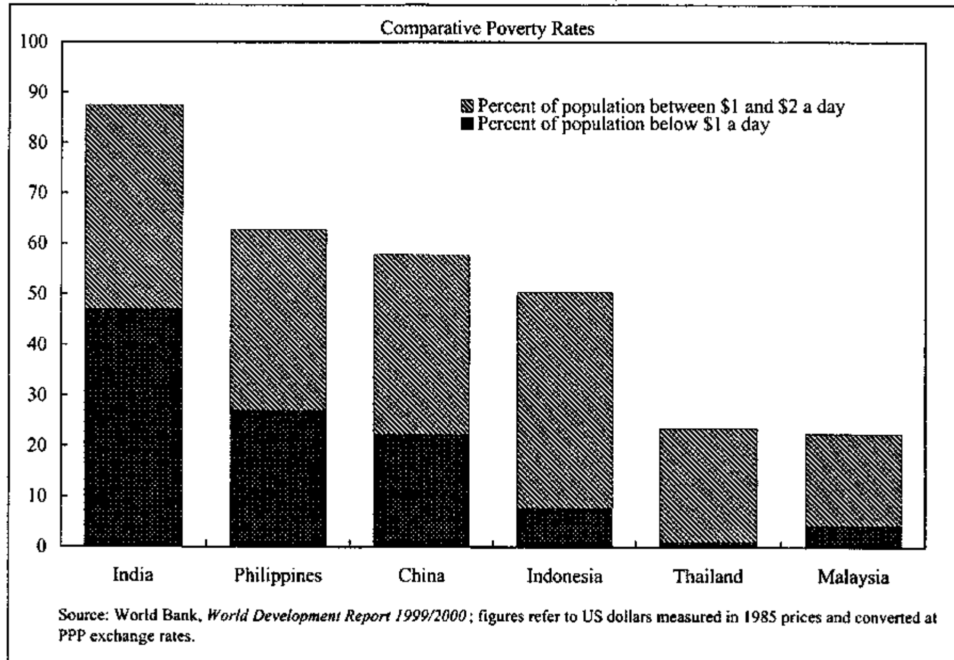


Source: Government of India, National Sample Survey.

However, given population growth during this period, the number of poor has actually remained roughly stable at around 320 million. Poverty in India therefore remains very high—both in absolute terms and compared to other countries in the region.[8]

[7] More recent official estimates are not available. Data underlying official poverty estimates are collected and analyzed by the National Sample Survey (NSS), which carries out two types of consumer expenditure surveys. The first is an annual pilot survey with very limited sample size and coverage; the second is conducted roughly every five years and has large coverage. Poverty lines are computed by the Planning Commission, largely according to a methodology recommended by a government-commissioned Expert Group on Estimation of Proportion and Number of Poor. The Expert Group further suggested that only the five-year survey data be used to estimate poverty ratios, since their recommended methodology involved construction of state-specific poverty lines and the annual sample coverage was inadequate for this purpose. A five-year survey was due out in 1998/99, but has been delayed.

[8] The World Bank's *World Development Report 1999/2000* suggests an even more severe poverty problem, with almost half of the population living on less than $1 per day (on a purchasing power parity adjusted basis) and seven-eighths of the population living on less continued



Source: World Bank, *World Development Report 1999/2000*; figures refer to US dollars measured in 1985 prices and converted at PPP exchange rates.

Other social indicators, including access to safe water and infant mortality rates, have shown more encouraging improvements.

22. **The government's poverty alleviation programs have most recently focused on generation of employment in rural areas**, with central outlays averaging about ½ percent of GDP, or 4 percent of total expenditures and net lending. Many other anti-poverty programs, such as the Public Distribution System (PDS), and public spending on education and health care have been found to benefit the non-poor disproportionately more than they benefit the poor.[9]

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than $2 per day in 1994. However, recent research (A. Deaton and A. Tarozzi, "Prices and Poverty in India", Princeton University unpublished manuscript, December 1999), which uses price indices calculated from the NSS data instead of CPI data, paints a more optimistic picture. Deaton and Tarozzi's preliminary findings indicate that rural poverty rates declined from 38 percent in 1987/88 to 33 percent in 1993/94 (compared to official estimates of 39 percent and 37 percent, respectively), while urban poverty rates declined from 22 percent to 18 percent during the same period (compared to official estimates of 40 percent and 33 percent, respectively).

[9] World Bank, *India: Reducing Poverty in India*, Report No. 17881-IN, June 1998. In the 2000/01 budget, the allocation of food grains under the PDS to consumers below the poverty line was doubled to 20 kilograms in an attempt to give greater benefits to the poor.

Social and Demographic Indicators

	Units	India		Comparator groups		
		15-20 years ago	Most Recent Estimate	South Asia	Low-Income Countries	Lower-Middle-Income Countries
Life expectancy at birth	Years	55	63	62	63	68
Physicians	Per thousand people	0.4	0.4	0.4	1.0	2.0
Hospital beds	Per thousand people	0.8	0.8	0.7	1.8	5.1
Immunisation from measles	Percent of children under 12 months	16	81	81	80	89
Safe water	Percent of population with access	54	85	81	69	78
Total fertility rate	Births per woman	4.8	3.2	3.4	3.1	2.5
Infant mortality rate	Per thousand live births	108	70	75	68	35
Male literacy	Percent of male population 1/	45	67 2/	51	54	84
Female literacy	Percent of female population 1/	29	41 2/	37	42	78
Primary school enrollment	Percent of school-age population	65	92 2/	77	86	94

Source: *World Bank, World Development Indicators;* and *Selected Education Statistics, Government of India.*

1/ Fifteen years old or older
2/ Data from *Selected Educational Statistics, 1997/98* (Government of India, Department of Education)

23. In addition to faster growth, studies on India have indicated that **critical ingredients to poverty reduction** include increased public spending to expand the poor's access to quality health care and education (particular at the primary school level), more effective targeting of public works programs, and improvements to physical infrastructure.[10]

[10] See World Bank, *Reducing Poverty in India*; and Chapter IV of the accompanying *Selected Issues* volume.

Table II.1. India: GDP at Factor Cost by Sector of Origin, 1994/95-1999/00 1/

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00
	(In billions of rupees, at current prices)					
Agriculture and allied activities	2,787.7	3,031.2	3,626.1	3,874.5	4,693.4	4,954.9
Mining and quarrying	226.2	251.1	275.7	329.3	332.5	354.3
Manufacturing	1,537.3	1,897.9	2,146.9	2,301.5	2,509.1	2,735.6
Electricity, gas, and water supply	237.8	276.8	299.4	336.0	380.7	456.1
Construction	463.3	552.2	633.2	784.5	922.4	1,037.2
Trade, hotels, and restaurants 2/	1,181.0	1,440.8	1,710.5	1,904.7	2,134.2	3,568.9
Transport, storage, and communications	609.7	705.4	833.3	977.0	1,130.4	...
Financing, insurance, real estate, and business services	1,034.3	1,253.5	1,380.4	1,575.6	1,818.1	2,062.9
Community, social, and personal services	1,064.6	1,263.3	1,467.5	1,761.4	2,203.1	2,496.1
GDP at factor cost	9,141.9	10,672.2	12,372.9	13,844.5	16,123.8	17,665.9
	(In billions of rupees, at constant 1993/94 prices)					
Agriculture and allied activities	2,540.9	2,518.9	2,760.9	2,707.9	2,901.8	2,926.4
Mining and quarrying	219.2	231.5	232.6	253.6	252.3	253.5
Manufacturing	1,389.3	1,595.8	1,722.0	1,791.6	1,856.9	1,987.6
Electricity, gas, and water supply	207.5	221.6	233.7	250.4	270.3	291.9
Construction	425.3	457.0	467.9	516.2	545.5	594.6
Trade, hotels, and restaurants 2/	1,093.1	1,251.5	1,337.7	1,397.6	1,514.8	2,442.6
Transport, storage, and communications	560.2	621.7	679.4	736.1	790.7	...
Financing, insurance, real estate, and business services	955.4	1,028.0	1,101.4	1,231.2	1,306.7	1,443.8
Community, social, and personal services	967.7	1,044.0	1,108.4	1,243.5	1,379.2	1,514.0
GDP at factor cost	8,358.6	8,969.9	9,643.9	10,128.2	10,818.3	11,454.4
	(Percentage change at constant prices)					
GDP at factor cost	7.0	7.3	7.5	5.0	6.8	5.9
Agriculture	5.0	-0.9	9.6	-1.9	7.2	0.8
Industry 3/	9.2	11.8	6.0	5.9	4.0	6.9
Services	7.0	10.3	7.1	9.0	8.3	8.2

Source: Data provided by the Indian authorities.

1/ 1999/00 data are advance estimates.
2/ 1999/00 estimate includes transport and communication.
3/ Includes mining and quarrying, manufacturing, electricity, gas and water supply, and construction.

Table II.2. India: GDP at Market Prices by Expenditure Components, 1993/94-1998/99

	1993/94	1994/95	1995/96	1996/97	1997/98	Est. 1998/99
	(In billions of rupees, at current prices)					
Private consumption	5,774	6,610	7,587	8,996	9,777	11,213
Government consumption	977	1,086	1,287	1,456	1,715	2,164
Gross fixed capital formation	1,843	2,221	2,910	3,139	3,439	3,780
Construction	876	1,001	1,225	1,345	1,587	1,800
Machinery and equipment	967	1,219	1,685	1,794	1,852	1,980
Change in stocks	-17	157	222	-158	101	65
Exports of goods and services	861	1,016	1,307	1,449	1,652	1,971
Imports of goods and services	860	1,047	1,450	1,610	1,843	2,225
GDP at market prices 1/	8,592	10,099	11,820	13,620	15,156	17,626
	(In billions of rupees, at constant 1993/94 prices)					
Private consumption	5,774	6,069	6,466	7,050	7,234	7,604
Government consumption	977	990	1,070	1,118	1,237	1,416
Gross fixed capital formation	1,843	2,036	2,433	2,469	2,586	2,730
Construction	876	917	994	1,009	1,122	1,195
Machinery and equipment	967	1,120	1,439	1,460	1,463	1,535
Change in stocks	-17	145	188	-123	79	49
GDP at market prices 1/	8,592	9,223	9,929	10,619	11,104	11,854
GDP deflator	100.0	109.5	119.0	128.3	136.5	148.7
	(Percentage change at constant prices)					
Consumption	4.9	4.6	6.7	8.4	3.7	6.5
Private	4.7	5.1	6.5	9.0	2.6	5.1
Government	6.4	1.3	8.0	4.5	10.6	14.5
Gross fixed capital formation	5.5	10.5	19.5	1.5	4.7	5.6
Construction	-1.6	4.6	8.5	1.5	11.3	6.4
Machinery and equipment	9.8	15.8	28.5	1.5	0.2	4.9
GDP at market prices	4.8	7.3	7.7	7.0	4.6	6.8
GDP at factor cost	6.2	7.0	7.3	7.5	5.0	6.8
GDP deflator at market prices	9.4	9.5	8.7	7.7	6.4	8.9

Source: Data provided by the Indian authorities.

1/ Includes statistical discrepancy. Data on exports and imports of goods and services at constant prices are not available.

Table II.3. India: Agricultural Production and Yields, 1993/94-1999/00 1/ 2/

(Production in millions of tons, unless otherwise indicated; yield in kg per hectare)

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00
Production							
Foodgrains	184.3	191.5	180.4	199.4	192.3	203.0	201.6
Rice	80.3	81.8	77.0	81.7	82.5	86.0	88.6
Wheat	59.8	65.8	62.1	69.4	66.3	70.8	70.1
Coarse grains	30.8	29.9	29.0	34.1	30.4	31.5	29.4
Pulses	13.3	14.0	12.3	14.2	13.0	14.8	13.6
Oilseeds 3/	21.5	21.3	22.1	24.4	21.3	25.2	21.5
Cotton 4/	10.7	11.9	12.9	14.2	10.9	12.2	10.5
Jute 5/	7.3	8.0	7.7	10.0	10.0	8.7	8.4
Sugarcane	229.7	275.5	281.1	277.6	279.5	295.7	292.6
Tea 6/	0.8	0.8	0.8	0.8	0.8	0.9	0.8
Yields							
Foodgrains	1,502	1,548	1,491	1,614	1,552	1,619	1,644
Rice	1,889	1,911	1,797	1,882	1,900	1,928	1,979
Wheat	2,375	2,559	2,483	2,679	2,485	2,583	2,665
Maize	1,602	1,570	1,595	1,720	1,711	1,755	1,655
Pulses	600	610	552	635	567	622	618
Oilseeds	799	843	851	926	816	944	841
Cotton	249	257	242	265	208	223	200
Jute	1,907	1,949	1,875	1,998	1,950	1,955	1,952
Sugarcane 7/	67	71	68	66	71	73	72
Tea	1,796	1,767	1,755	1,810	1,868	1,996	...
Production of:							
Kharif foodgrains	100.4	101.1	95.1	103.9	101.6	103.3	104.3
Rabi foodgrains	83.9	90.4	85.3	95.5	90.7	99.7	97.3

Sources: Government of India, Economic Survey; and data provided by the Indian authorities.

1/ Relates to crop years, July-June.
2/ 1999/00 data are preliminary estimates
3/ Nine major oilseeds.
4/ In million bales of 170 kg each.
5/ In million bales of 180 kg each.
6/ Data are for calendar years. For example, data under the heading 1993/94 are for 1993.
7/ In metric tons per hectare.

Table II.4. India: Industrial Production Index, 1995/96-1999/00 1/

(Annual percentage change)

	Weight	1995/96	1996/97	1997/98	1998/99	1999/00
All industries	100.0	12.7	5.6	6.6	3.9	8.3
Manufacturing	79.4	13.8	6.7	6.7	4.3	9.3
Food products	9.1	6.8	3.5	-0.4	0.7	4.1
Beverages, tobacco, and related products	2.4	13.3	13.5	19.3	12.9	7.6
Cotton textiles	5.5	10.6	12.0	2.3	-7.7	7.0
Wool, silk and man-made fibre textiles	2.3	14.7	10.5	18.5	2.8	12.0
Jute and other vegetable fibre textiles	0.6	7.7	-4.3	16.6	-7.3	-0.9
Textile products (including wearing apparel)	2.5	35.7	9.5	8.5	-3.5	2.0
Wood and wood products	2.7	24.0	7.0	-2.6	-5.8	-16.2
Paper and paper products	2.7	15.6	9.1	6.9	16.0	7.1
Leather and leather and fur products	1.1	14.2	9.4	2.2	8.1	12.2
Rubber, plastic, petroleum, and coal products	5.7	7.8	2.0	5.2	11.3	-1.2
Basic chemicals and chemical products	14.0	11.3	4.7	14.5	6.6	22.4
Nonmetallic mineral products	4.4	21.9	7.7	13.8	8.2	23.2
Basic metals and alloy industries	7.5	15.8	6.7	2.6	-2.5	4.9
Metal products and parts except machinery and equipment	2.8	-3.8	10.2	8.4	17.8	-2.5
Machinery and equipment (other than transport equipment)	9.6	19.5	5.2	5.5	1.2	17.4
Transport equipment and parts	4.0	17.4	12.9	2.6	15.6	1.6
Other manufacturing industries	2.6	13.2	5.2	-2.7	5.8	-14.1
Mining and quarrying	10.5	9.5	-1.9	5.9	-1.7	0.7
Electricity generation	10.2	8.1	4.0	6.6	6.5	6.6
Industrial production index classified by use:						
Basic goods	35.5	10.7	3.0	6.5	1.4	5.2
Capital goods	9.7	4.1	9.3	5.3	11.8	5.2
Intermediate goods	26.4	19.1	8.1	8.1	5.9	15.2
Consumer goods industries	28.4	12.4	5.2	5.7	2.4	5.9
Durables	5.1	25.8	4.6	7.8	4.7	13.4
Nondurables	23.3	9.3	5.3	5.1	1.8	3.9

Source: Data provided by the Indian authorities.

1/ Percentage change over corresponding period in the previous year.

Table II.5. India: Saving and Investment, 1993/94-1998/99

(In percent of GDP at market prices)

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99
Gross domestic saving	22.5	25.0	25.5	23.3	24.7	22.3
Private sector	21.9	23.3	23.5	21.6	23.3	22.3
Household saving	18.4	19.8	18.5	17.1	19.0	18.5
Physical saving	7.4	7.8	9.6	6.7	8.6	7.6
Financial saving	11.0	12.0	8.9	10.4	10.4	10.9
Corporate saving	3.5	3.5	5.0	4.5	4.3	3.8
Public sector	0.6	1.7	2.0	1.7	1.4	0.0
Gross capital formation 1/	23.0	26.1	27.2	24.6	26.2	23.4
Gross fixed capital formation	21.4	22.0	24.6	23.0	22.7	21.4
Private sector	13.5	13.2	16.9	16.1	16.2	14.9
Corporate sector	6.0	5.9	8.1	8.6	8.0	7.6
Household	7.5	7.3	8.8	7.5	8.2	7.3
Public sector	8.0	8.8	7.7	6.9	6.5	6.5
Changes in stocks	-0.2	1.6	1.9	-1.2	0.7	0.4
Private sector	-0.4	1.6	2.0	-1.2	0.5	0.3
Public sector	0.2	0.0	-0.1	0.1	0.2	0.1
Errors and ommissions	1.8	2.6	0.7	2.7	2.8	1.5
Saving-investment gap 1/	-0.5	-1.2	-1.8	-1.3	-1.5	-1.0
Private sector 1/	7.0	5.9	3.9	4.0	3.8	5.5
Public sector	-7.5	-7.1	-5.6	-5.3	-5.3	-6.6
Memorandum item						
Investment deflator (percentage change)	...	9.0	9.6	6.3	4.6	4.1

Sources: Government of India, Economic Survey; and data provided by the Indian authorities.

1/ Includes errors and omissions.

Table II.6. India: Employment and Labor Statistics, 1993/94-1997/98

(In millions of persons, end-of-period)

	1993/94	1994/95	1995/96	1996/97	1997/98
Employment in the organized sector 1/	27.4	27.5	27.9	28.3	28.4
Public sector	19.4	19.5	19.4	19.6	19.5
Central government	3.4	3.4	3.4	3.3	3.3
State government	7.3	7.4	7.4	7.5	7.5
Public enterprises	6.5	6.5	6.5	6.5	6.5
Local authorities	2.2	2.2	2.2	2.2	2.2
Private sector	7.9	8.1	8.5	8.7	8.8
Agriculture	0.9	0.9	0.9	0.9	0.9
Manufacturing	4.6	4.7	5.0	5.2	5.2
Other	2.4	2.5	2.6	2.6	2.7
Number of job seekers (end-December) 3/	36.7	36.7	37.4	39.1	40.1
Number of work days lost through					
industrial disputes 2/ 4/	21.0	16.3	20.3	17.0	22.1
Strikes 4/	6.7	5.7	7.8	6.3	9.4
Lockouts 4/	14.3	10.6	12.5	10.7	12.7

Source: Data provided by the Indian authorities.

1/ All establishments in the public sector and nonagricultural private establishments with ten or more employees.
2/ For industrial disputes involving ten or more workers.
3/ For example, data under the heading 1993/94 refer to end-December 1994.
4/ Data are for calendar years. For example, data under the heading 1993/94 are for 1994.

Table II.7. India: Price Developments, 1995/96-1999/00

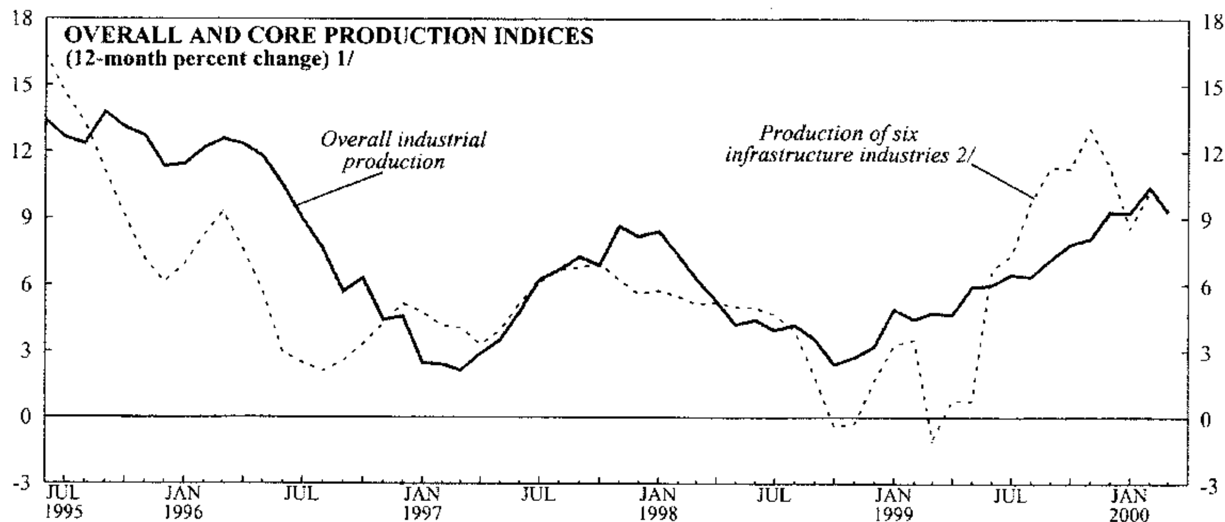
	Weight	1995/96	1996/97	1997/98	1998/99	1999/00
	(Annual percentage change; end of period)					
Wholesale Price Index (WPI), 1993/94 weights	100.0	4.4	5.4	4.5	5.3	6.5
Primary commodities	22.0	3.1	9.2	4.6	7.6	4.0
Food	15.4	7.7	11.6	4.0	9.3	7.1
Nonfood	6.1	-6.1	3.3	7.2	2.7	-3.5
Minerals	0.5	-10.7	17.0	-8.3	17.8	-11.6
Fuel, power, light, and lubricants	14.2	5.1	13.3	13.7	3.2	26.7
Manufactured products	63.7	4.7	2.4	2.3	4.9	2.4
Food products	11.5	3.8	10.6	5.8	9.2	-0.3
Beverages, tobacco, and tobacco products	1.3	4.0	10.4	8.3	9.4	3.3
Textiles	9.8	-1.3	-9.0	1.5	-2.1	1.8
Wood and wood products	0.2	7.8	0.0	64.6	-0.1	-4.9
Paper and paper products	2.0	15.3	-7.1	1.8	14.5	5.0
Leather and leather products	1.0	2.0	4.4	6.2	0.1	14.6
Rubber and plastic products	2.4	7.2	-1.6	-0.2	0.1	0.1
Chemicals and chemical products	11.9	6.6	4.9	0.7	11.0	5.5
Nonmetallic mineral products	2.5	7.8	-3.6	-2.4	2.9	-0.9
Basic metals, alloys and metal products	8.3	6.3	3.7	3.3	1.0	3.2
Machinery and machine tools	8.4	3.9	3.0	-1.5	1.1	-0.5
Transport equipment and parts	4.3	8.0	5.0	3.1	2.3	4.7
Consumer Price Index (CPI)	100.0	8.9	10.0	8.3	8.9	4.8

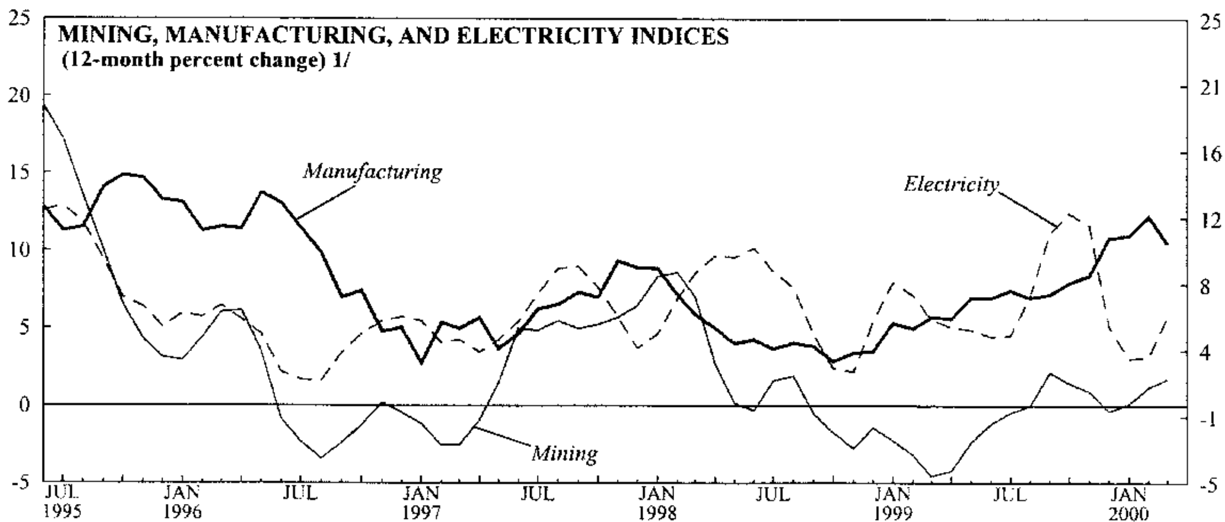
Source: Data provided by the Indian authorities.

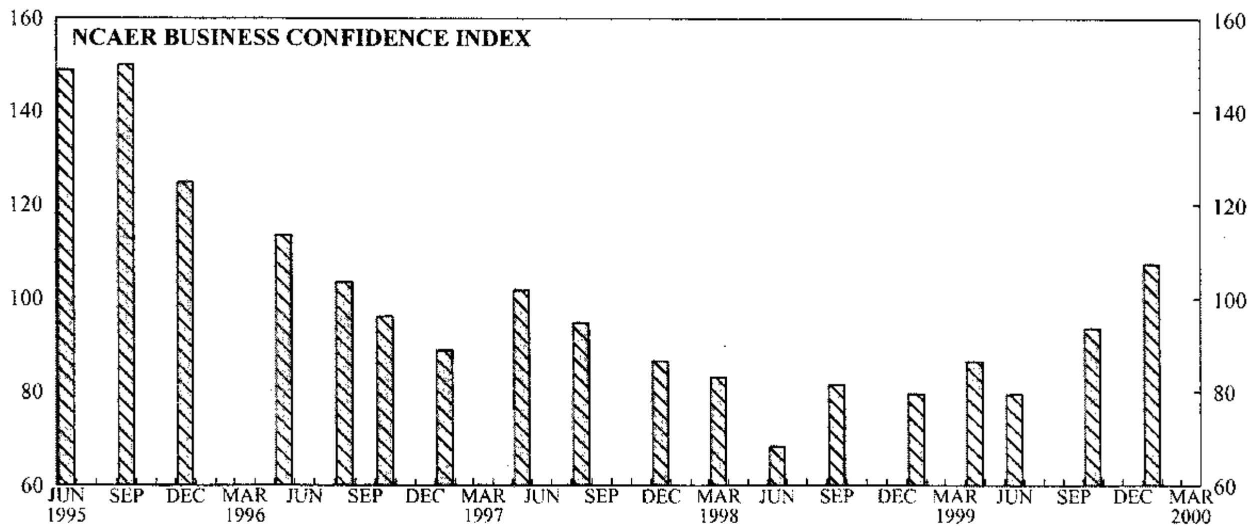
CHART II.1

INDIA

Industrial Production and Business Confidence, 1995-2000







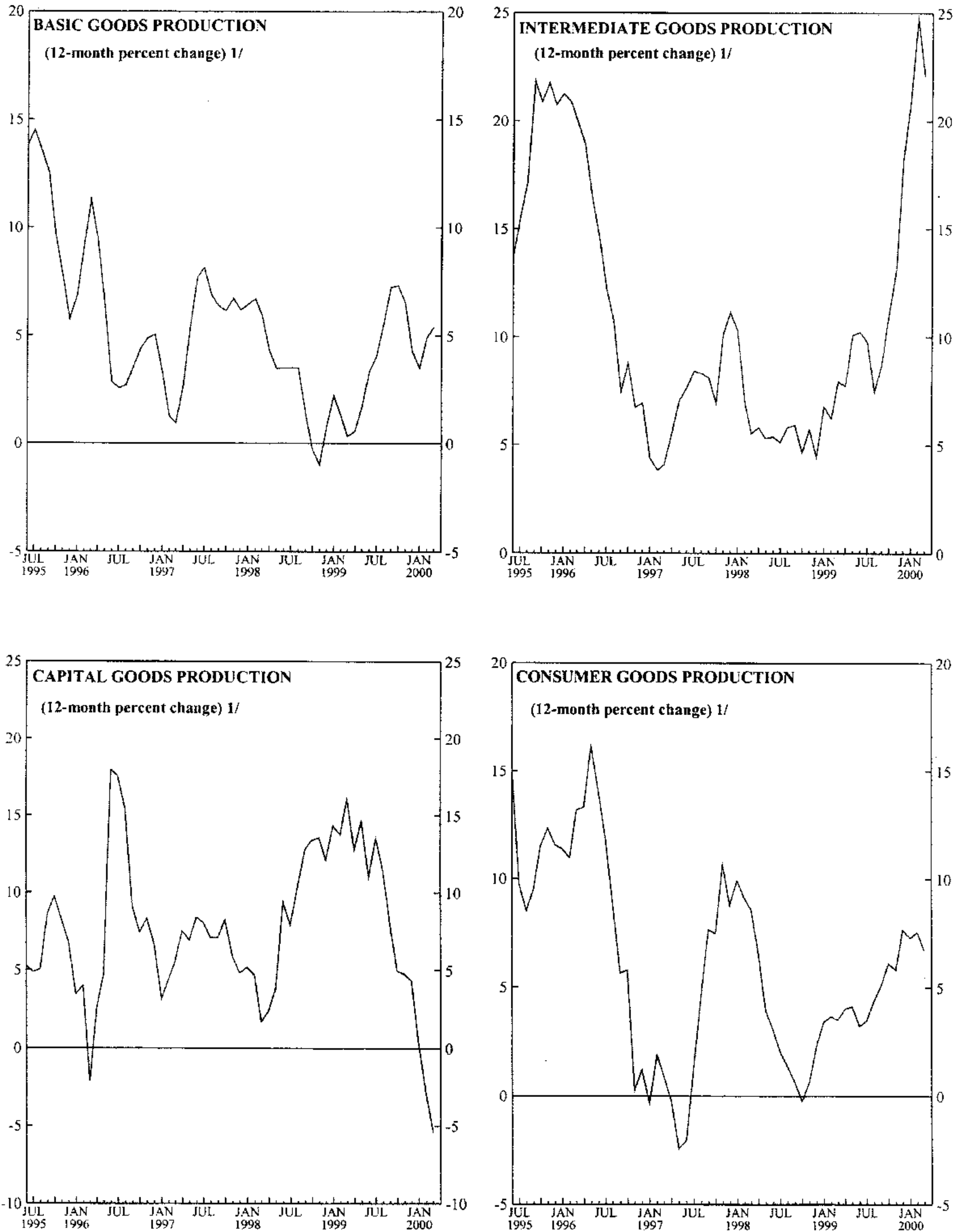
Sources: Data provided by the Indian authorities, CEIC, and NCAER.

1/ Three-month moving average.
2/ Based on weighted average of the electricity, coal, steel, crude petroleum, petroleum products, and cement indices.

CHART II.2

INDIA

Components of Industrial Production, 1995-2000



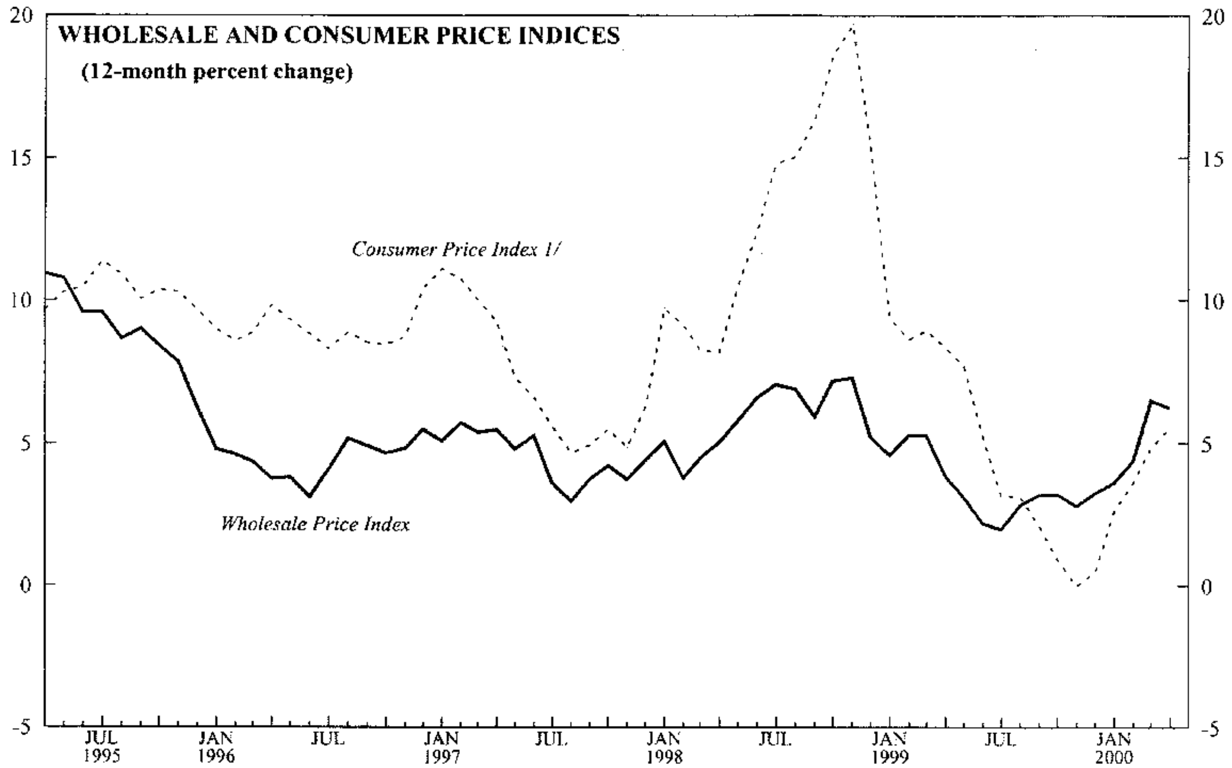
Source: Data provided by the Indian authorities.

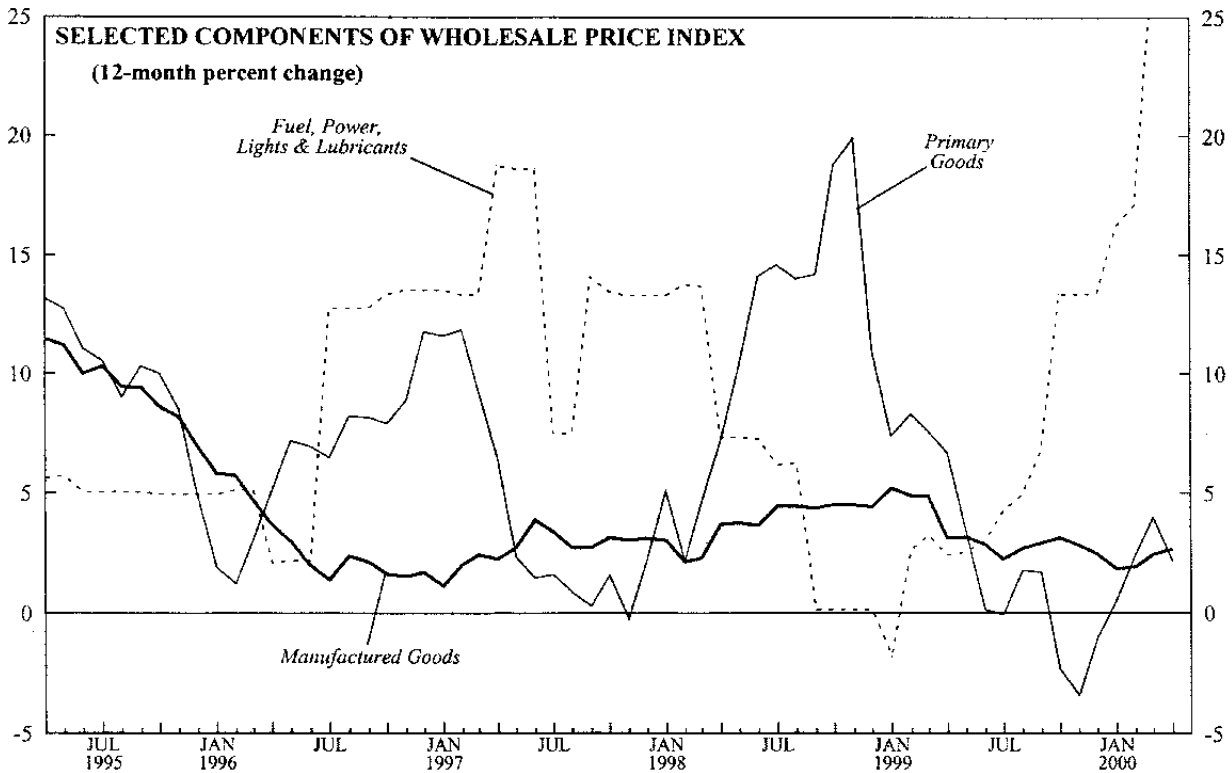
1/ Three-month moving average.

CHART II.3

INDIA

Inflation Indicators, 1995-2000





Source: Data provided by the Indian authorities.

1/ For industrial workers.

III. Recent Fiscal Developments[1]

A. Fiscal Trends Over the Last Decade

1. **The overall deficit of the consolidated public sector has risen sharply in recent years, erasing most of the consolidation that was achieved during the first half of the 1990s** (Chart III.1, upper panel).[2] Major fiscal adjustment by the central and state governments and the public sector undertakings (PSUs) in the wake of the 1991 balance of payments crisis helped reduce the deficit of the consolidated public sector by 3 percentage points to 8¼ percent of GDP by 1995/96.[3] Since then, however, balances of both the central and state governments have deteriorated, and the public sector deficit is estimated to have reached 11 percent of GDP in 1999/00.

2. **Moreover, high deficits and public sector debt levels have adversely affected the composition of expenditure at both the central and state government levels.** The debt-service bill has increased steadily, reflecting the reduced share of external concessional financing and pressures on interest rates exerted by the high public sector debt stock—which has averaged in excess of 80 percent of GDP during the decade (Chart III.1, lower panel). In addition, financial sector liberalization has reduced the scope for government pre-emption of domestic saving at nonmarket rates.[4] Higher debt-service payments combined with significant increases in salaries and wages in recent years have crowded out spending on infrastructure, health, and education (Chart III.2, top panel).

3. **At the central government level, the deficit has increased by more than 2 percentage points since 1996/97**, to reach an estimated 7 percent of GDP in 1999/00. This erosion reflects a lack of tax buoyancy and weak expenditure discipline. Tax reforms enacted during the decade—including significant cuts in customs duties—were not accompanied by sufficient base-broadening measures, and the tax revenue ratio (net of tax transfers to the states) fell steadily from 7.7 percent of GDP in 1991/92 to 6.5 percent of GDP in 1999/00 (Chart III.2, middle panel). On the expenditure side, cuts in subsidies and defense expenditures made in the early 1990s were not sustained. Also, as discussed above, the debt-service bill increased steadily throughout the decade, and civil service salaries and

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[1] Prepared by Patricia Reynolds and Cyrus Sassanpour.

[2] The consolidated public sector is comprised of the central government, state governments, public sector undertakings (PSUs) of the central government, and the accounts of the Oil Coordinating Committee (OCC).

[3] All ratios to GDP are calculated using the revised series (1993-94 base year); GDP figures prior to 1993-94 are constructed using the growth rates of the old series (1980-81 base year).

[4] Interest rate trends are discussed in greater detail in Chapter III of the accompanying *Selected Issues* volume.

pensions rose sharply beginning in 1997/98, following implementation of wage increases recommended by the Fifth Pay Commission.[5]

4. **Deficits at the state government level have also deteriorated significantly,** from an aggregate of 2.7 percent of GDP in 1995/96 to around 4.5 percent of GDP in 1999/00 (staff estimate), reflecting weakness in both revenues and expenditures. Tax and grant transfers from the central government have been negatively affected by structural weaknesses in central tax collections and fiscal federal relations (see Box III.1), as well as the center's consolidation efforts. States' own tax receipts have been undermined by a narrow base and the competitive provision of tax concessions (see Box III.2), while nontax revenues have been affected by poor cost recovery rates for public services and utilities (Chart III.2, bottom panel). On the expenditure side, although state outlays were reduced by 1.6 percent of GDP in the five years following the 1991 crisis, they subsequently increased strongly with rising interest payments and the upward revision of civil service pay scales beginning in 1998/99.[6]

5. **In contrast, the PSU sector has achieved a relatively durable adjustment**, with its consolidated deficit declining from 2.7 percent of GDP at the start of the decade to an estimated 1.8 percent of GDP in 1999/00. This reduction primarily reflects restructuring and downsizing efforts, accompanied by a steady decline in central government budgetary support for PSUs (loans and support for losses), and stricter requirements for enterprises to finance investments either through internal resources or market borrowings (Chart III.3). Tighter budget constraints, in turn, have caused PSU plan expenditures to fall sharply relative to GDP.[7] PSUs involved in the petroleum and telecom industries have been among the more

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[5] Pay scales for central government civil servants are determined by the awards of the Pay Commission, a constitutionally-mandated body set up to make recommendations about every ten years. Recommendations of the Fifth Pay Commission, which submitted its report in January 1997, included a three-fold increase in basic pay scales, downsizing of 30 percent in each government department and agency over a 10-year period, and an overhaul of the organizational structure of the central government. Although the wage awards were incorporated beginning with the 1997/98 budget—resulting in a permanent increase in central government wages and salaries of roughly 0.5 percent of GDP—the recommended reorganization and staffing cuts were not implemented.

[6] State governments are not obliged to adopt the Pay Commission recommendations, but in practice have tended to follow central government pay revisions with a year or so lag.

[7] Plan expenditures are jointly determined by the Planning Commission, Ministry of Finance, central government spending ministries, and—where relevant—state governments. These consist mainly of outlays for development projects, and have both capital and current expenditure components.

Box III.1. India: Fiscal Federal Issues

India's fiscal federal system involves a fairly complex system of expenditure responsibilities and transfers.

Tax-sharing arrangements

- Tax sharing-arrangements between the center and states are reviewed by a Finance Commission convened every five years, and have typically involved fixing the percentages of centrally-collected excise and personal income taxes that will be shared with the states. This arrangement has created incentives for the central government to focus most heavily on developing nonshared taxes, especially customs duties.
- The Tenth Finance Commission (1995-2000) recommended that 77½ percent of personal income taxes and 47½ percent of excise taxes collected by the center be shared with the states, while also suggesting an alternative scheme to devolve 29 percent of almost all central government tax receipts to the states. In February 2000, the new government approved this alternative scheme in large part, and a new bill was passed by Parliament in May.
- The Eleventh Finance Commission (2000-2005), which is expected to submit its final report by end-June 2000, is reviewing *inter alia* the revenue-sharing arrangement and the principles governing grants to states for the next five years. As an interim measure for the 2000/01 budget, the Commission assigned 80 percent of centrally-collected income taxes and 52 percent of excise taxes to the states.
- However, the horizontal distribution of tax revenues across states for 2000/01 and beyond will not be announced until the Commission publishes its final report. Currently, the distribution is based on population, but also provides compensation to states with weak tax bases, poor infrastructure development, and low levels of per capita income. Many analysts have suggested that the system provides inadequate incentives for states to implement fiscal and structural reforms.

Other tax issues

- Although states have been given constitutional responsibility for taxing the agricultural sector, they have been ineffective in expanding the tax base in this area. In fact, the agricultural sector—which accounts for one-third of national income—is a major beneficiary of direct and indirect subsidies.
- States also have made extensive use of entry taxes—termed "octroi"—to boost revenues at other states' expense, distorting trade and production decisions.
- Sales tax competition among the states—in particular through the provision of tax holidays to businesses—has been severe. A November 1999 agreement among the states was struck to establish floors on sales tax rates and eliminate this incentive (Box III.2).
- Efforts to develop a nationwide VAT have been complicated by the fact that the center only has constitutional jurisdiction over excises at the manufacturing level. Recent efforts by states to develop a common VAT will require significant improvements in tax administration and will be complicated by the fact that jurisdiction over services has not been constitutionally granted to either the center or the states.

Expenditure assignment and financing

- Plan assistance is provided to the states to fund both central and state projects, with the total amount of this assistance largely at the discretion of the central government. Allocation across states of support for central and centrally-sponsored plan schemes is also largely discretionary. Assistance for state plans is typically distributed as 30 percent grants and 70 percent loans (for low-income states, the split is 90 percent and 10 percent, respectively), and state plan funds are allocated across states according to a formula based on population (60 percent weight), per capita income (25 percent weight), and fiscal performance (7½ percent weight).
- Some observers have suggested that the system does not allocate resources toward states that have demonstrated effective project implementation. Moreover, funding often goes to projects without consideration of the states' ability to finance the recurrent spending requirements that arise once the project is completed.

Financing issues

- States can access the domestic market directly to mobilize up to 35 percent of their gross borrowing program, which according to the Constitution is subject to central government approval. A number of states (Punjab, Andhra Pradesh, Tamil Nadu, and Karnataka) exercised this option in 1998/99 and 1999/00. Nevertheless, the bulk of market borrowing by the states is still effected through "package" issues of state government securities with a uniform maturity (typically 10 years), and at pre-determined coupon rates which set a small premium to yields on central government securities of similar maturity. A few financially stronger states have been able to borrow directly from the market at more favorable rates.
- States automatically obtain 75 percent (now 80 percent) of deposits received by the postal saving system (Box III.3). These deposits are onlent to the states at high rates of interest, but in long maturities, and have been actively encouraged by the states since such funds do not fall under centrally-imposed borrowing limits.
- Borrowing limits also are not adjusted for borrowing against provident funds of state employees, or for guarantees of the debt of off-budget entities.
- Moreover, borrowing limits are sometimes relaxed by additional central government transfers at year-end to cover accrued financing requirements.

Box III.2. India: Harmonization of State Sales Taxes

The structure of domestic trade taxes in India is very complex and, until recently, there were wide differences between the states with regard to tax rates and coverage. Domestic taxes are also inefficient with a strong cascading element in intra-and inter-state transactions. These complexities and disparities have been exacerbated over the years as the states sought to attract investment by offering incentives in the form of tax exemptions, waivers, deferrals, and refunds. The efficiency of the system and state revenues has been further undermined by weak tax administration and enforcement.

A number of states had attempted to introduce input credit mechanisms in their sales taxes to reduce cascading. These VAT-type taxes were levied either on the basis of turnover or on a select group of commodities. However, implementation difficulties have compelled most states to abandon this approach.

In a landmark decision reached in November 1999, the state governments agreed to harmonize their sales tax structures. As a part of this agreement, which became effective in January 2000:

- Uniform floor rates (0, 4, 8 and 12 percent) apply to a uniform set of commodities. The states have the option of taxing commodities in each slab up to the rate of the higher slab. In addition, two uniform special floor rates of 1 and 20 percent apply, respectively, to petroleum products and to gold, silver, and precious stones.

- No new tax incentives are to be granted by the states, and existing incentives are to be gradually phased out.

- Preparations are to be made to introduce a uniform VAT at the state level by April 1, 2001 with technical assistance from the central government.

profitable enterprises—due partly to regulatory advantage, and partly to improved efficiency in the wake of deregulation—and now account for almost half of PSU plan expenditures.[8]

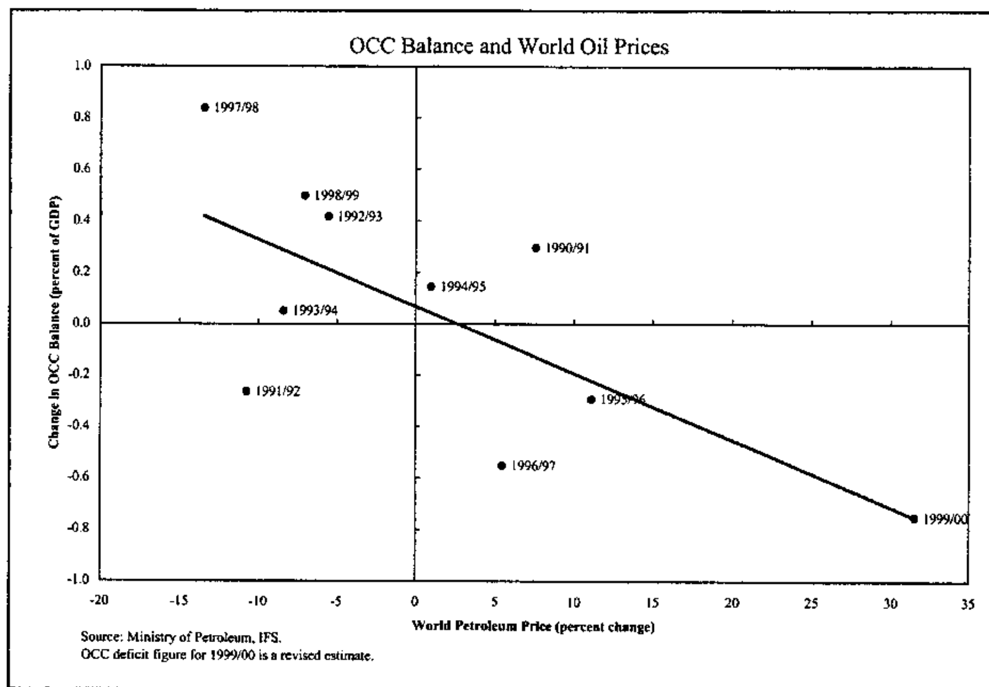
6. **Throughout the decade, the balance on the accounts of the Oil Coordinating Committee (OCC) has fluctuated inversely with respect to world oil prices**, reflecting lags in adjustments to domestic prices (chart).[9] However, the deficits have trended downward in recent years (and even turned to significant surplus) as a result of the 1997 petroleum sector reforms, which included a phased withdrawal of the administered pricing mechanism.[10] Implementation of the reforms was facilitated by the drop in world oil prices in 1998, and the need to repay debts associated with previous years' deficits. 1999/00 was an exception to this recent trend, and an OCC deficit re-emerged as a result of delays in

[8] World Bank, *India—Policies to Reduce Poverty and Accelerate Sustainable Development*, Report No. 19471–IN, January 2000.

[9] The OCC facilitates the provision of subsidies on key consumer petroleum products (diesel, kerosene, and liquid petroleum gas (LPG)) by operating a series of accounts which track the payments to and receipts from producers and importers of crude oil, refineries, marketing companies, and distributors. The operation of the OCC is discussed in greater detail in Chapter II of *India—Selected Issues* (IMF Staff Country Report No. 97/74, September 1997).

[10] Petroleum sector reforms are discussed in Box III.2 of *India—Recent Economic Developments* (IMF Staff Country Report No. 98/120, November 1998).

adhering to scheduled price adjustments in the face of the significant rise in world petroleum prices.



B. Central Government Fiscal Performance in 1998/1999

7. **Against a background of sluggish economic activity, the 1998/99 central government budget sought to achieve modest deficit reduction while boosting growth through increased public investment spending**, especially in infrastructure (Table III.1). The deficit was targeted at 5.5 percent of GDP—a 0.4 percentage point reduction relative to the 1997/98 outturn—to be accomplished primarily through increased tax collections.[11] Tax revenues were projected to rise by 0.4 percent of GDP in response to a rationalization of excise tax rates, a 4 percent surcharge on import duties, and measures to improve tax compliance and widen the tax base—including the expansion of a mandatory tax filing scheme, new filings by VDIS respondents, and the inclusion of additional services under the

[11] Excluding divestment receipts from revenues, and utilizing the revised national accounts figures. Official deficit figures include divestment receipts in revenues; on this basis, the budgeted deficit for 1998/99 was 5.2 percent of GDP, relative to 5.9 percent of GDP in 1997/98.

service tax net.[12] [13] On the expenditure side, a reduction in net lending to state governments was expected to free modest resources for higher plan spending.

8. **In the event, the central government deficit rose to 6.8 percent of GDP in 1998/99,** due to both revenue shortfalls and expenditure overruns.[14] **Total revenues and grants** fell almost 1 percentage point short of target, owing largely to lower excise and customs collections. Excise tax revenues were adversely impacted by slowing industrial growth, while customs revenues were affected by lower trade volumes and a decline in import unit values (particularly for petroleum products). However, corporate and personal income tax collections were only slightly below target, as improved income tax collection and lower depreciation provisions made by PSUs (mainly oil refineries) offset the impact of slower growth.

9. **Total expenditures and net lending** in 1998/99 were 0.4 percent of GDP higher than budgeted. Significant shortfalls in plan and capital expenditures were more than offset by larger outlays for interest payments, pensions and subsidies, and higher grants and on-lending against small savings collections to state governments (see Box III.3). Larger interest payments resulted from higher-than budgeted borrowing, and the replacement of maturing domestic debt at higher interest rates. Cost-of-living adjustments and higher-than-expected backpayments associated with the Fifth Pay Commission awards raised pension outlays, and a hike in payments to manufacturers and importers of fertilizer in late 1998 increased subsidy payments. Higher onlending to state governments resulted from strong growth of small savings collections, which were actively encouraged by the states in order to finance their growing deficits (discussed below).

10. **The central government's deficit in 1998/99 was financed almost entirely from domestic sources,** as has historically been the case (Chart III.4, top panel). The increase in the deficit over 1997/98 was met largely by higher market borrowing, although the increase

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[12] The Ministry of Finance has launched several tax amnesty schemes in India in recent years, in order to bring more of the large underground economy under the tax net. The Voluntary Disclosure of Income Scheme (VDIS) was introduced in 1997. While some tax payers were estimated to have reduced their effective tax rate to below 10 percent in 1997/98, these respondents were henceforth required to file taxes on an annual basis, thereby permanently increasing the tax base.

[13] The Indian constitution does not explicitly assign rights of taxation on service transactions, and there is some controversy as to whether it should fall under the jurisdiction of the central or state governments. The central government has imposed taxes on a limited number of services in recent years, although associated revenues have averaged only around 1 percent of total tax revenues.

[14] On the authorities' definition, the deficit was 6.4 percent of GDP, compared to the budget target of 5.2 percent of GDP (see footnote 10).

Box III.3. India: Small Savings Schemes

Background
An extensive system of small savings schemes are administered by the central government in India, principally in the form of deposits made with post offices. Through March 1999, three-fourths of the amount collected under these schemes were on-lent to the governments of the states where the deposits were made. Interest rates on the loans during 1998/99 were 13.5-14 percent, while most deposit rates ranged between 9 percent and 13.5 percent. However, tax incentives also applied to these deposits, implying that effective deposit rates were even higher. Given the tax incentives and administration costs born by the central government, the loans to the states implied a significant interest rate subsidy, compounded by the maturity mismatch between deposits and loans—loan maturities are typically 25 years with a 5-year grace period, while deposit maturities range only up to five years.

This arrangement has had the effect of softening the states' budget constraints. Although states are subject to annual borrowing limits set by the central government, these limits are not adjusted for the on-lending from small savings schemes. As a result, state governments have made vigorous efforts to increase small savings deposits, including by offering incentives to depositors.

Accounting treatment
From 1991, the inflow from small savings schemes was treated as below-the-line financing in the central government's main fiscal account, while the 75 percent of collections that were on-lent to state governments were recorded under capital expenditures and net lending. In the states' fiscal accounts, on-lending of small savings deposits by the center was treated as a financing item. In consolidating the general government and public sector accounts, loans between the center and the states net out, and total inflows from small savings schemes were recorded as financing, while no adjustment was made to general government expenditures.

Given strong growth of small savings deposits, and since on-lending against these deposits was treated as an explicit expenditure item, the old accounting treatment inflated the central government deficit in recent years—by 1.3 percent of GDP in fiscal year 1998/99, in particular. This prompted the authorities to announce in the 1999/2000 budget a change in accounting treatment effective April 1, 1999.

Small savings collections and associated withdrawals have subsequently been shown as credits to and debits from, respectively, a new "National Small Savings Fund," recorded in a separate central government account. One quarter of the accumulated net balance of this fund is invested in central government securities, while the remaining three quarters is invested in state government securities.[1] Only the central (state) government securities sold to the new fund are shown as financing on the central (state) governments' main fiscal account. However, since funds borrowed by the states against small savings collections are no longer treated as an explicit expenditure item of the center, the new system substantially lowers the central government's measured deficit—although the consolidated states' and general government deficits have been unaffected.

[1] From 2000/01, 20 percent of the accumulated net balance are to be invested in central government securities, and 80 percent in state government securities.

Small Savings Schemes and Fiscal Accounting
(In percent of GDP)

	Old Accounting Treatment		New Accounting Treatment	
	1998/99 Revised Est.	1999/00 Budget Est.	1998/99 Revised Est.	1999/00 Budget Est.
Central government				
Revenue 1/	8.9	9.6	8.9	9.6
Expenditure	15.7	15.4	14.4	14.1
Of which: Onlending from small savings	1.3	1.3	...	...
Balance	-6.8	-5.8	-5.5	-4.5
Financing	6.8	5.8	5.5	4.5
Of which: Small savings collections	1.9	1.7	0.6	0.4
State governments				
Revenue 1/	10.4	10.8	10.4	10.8
Expenditure	14.7	14.8	14.7	14.8
Balance	-4.3	-3.9	-4.3	-3.9
Financing	4.3	3.9	4.3	3.9
Of which: Borrowing against small savings	1.3	1.3	1.3	1.3
Consolidated public sector				
Revenue 1/	19.2	19.7	19.2	19.7
Expenditure	28.9	28.6	28.9	28.6
Balance	-9.7	-8.9	-9.7	-8.9
Financing	9.7	8.9	9.7	8.9
Of which: Small savings collections	1.9	1.7	1.9	1.7

Source: Data provided by the Indian authorities.

1/ Excludes divestment proceeds.

in small saving collections was also an important source of funding. On March 31, 1999, total liabilities of the central government—including small saving deposits, provident funds, and other accounts—stood at Rs 8.8 trillion, or 50 percent of GDP. Of this, only about 3 percentage points were external liabilities, while 26 percentage points were in the form of domestic securities and loans, largely held by domestic banks and other financial institutions (Chart III.4, bottom panel).

C. Central Government Fiscal Performance in 1999/2000

11. **The 1999/2000 central government budget targeted a deficit of 5.8 percent of GDP**—1 percentage point lower than the outturn for 1998/99.[15] About one-third of this improvement was to be achieved through expenditure reductions, while tax reforms and a pickup in industrial activity were expected to generate 0.7 percent of GDP in additional revenues.

12. **On the revenue side**:

- New tax measures were expected to increase revenues by a total of Rs 93 billion (0.5 percent of GDP). These included a temporary 10 percent income tax surcharge imposed on corporations and higher-income individual taxpayers, a Rs 1 per liter diesel fuel tax, and the replacement of 5 percent in special duties on imports (imposed between 1996 and 1998) with a new 10 percent surcharge.[16]

- Measures to streamline the tax system included a reduction in the number of ad valorem excise rates from 11 to 3 (although a number of special excise surcharges were also imposed), and a reduction in the number of tariff bands from 7 to 5.

- Also, new tax incentives were introduced to stimulate the capital markets, corporate restructuring, bank provisioning, research and development, the housing sector, and the entertainment industry.

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[15] This measure of the deficit includes on-lending from small savings collections in central government net lending. From 1999/00, official deficit figures exclude on-lending from the central government's accounts. Excluding on-lending from expenditures and net lending, and including divestment receipts from revenues (see footnote 10 and Box III.3), the official deficit target for 1999/00 was 4.0 percent of GDP, compared to 5.0 percent of GDP in 1998/99 measured on the same basis.

[16] However, the proceeds from the Rs 1 per liter levy were to be earmarked for the Central Road Fund (50 percent) and initiatives in rural development and social sectors.

13. On the **expenditure side**:

- Food subsidies were budgeted to fall by 0.1 percent of GDP, due to increases in the prices of foodgrains sold through the Public Distribution System (PDS) announced in February.[17]

- After substantial increases in 1998/99, due to higher-than-anticipated inflation and associated cost-of-living adjustments, pension payments were expected to remain roughly constant in rupee terms, implying a decline of 0.1 percentage points relative to GDP. Central government wages and salaries were also budgeted to fall slightly as a result of downsizing efforts—in particular, the abolition of four Secretary-level posts and the associated merger and rationalization of central government departments.

- Higher-budgeted spending on central government plan programs and other capital expenditures was roughly offset by lower budgeted loans and grants to state governments and PSUs.

14. **Other policy initiatives** announced in the 1999/00 budget included the initiation of a system of zero-based budgeting, and continued emphasis on divestment as a source of financing. In addition, Finance Minister Sinha projected that the central government deficit would decline to under 2 percent of GDP over the next four years (under revised accounting standards), that a full-fledged VAT would be introduced over the medium term, and that customs duties would be lowered to "Asian levels" in five years.

15. **The estimated outturn for 1999/00 indicates a central government deficit in excess of 7 percent of GDP—1¼ percent of GDP in excess of the budget target.**[18] Most of the slippage was on the expenditure side, with tax revenues only 0.1 percent of GDP under target. In particular:

- Interest payments were 0.3 percent of GDP higher, due to higher-than-budgeted borrowing.

- Military expenditures exceeded the budget allocation by 0.2 percent of GDP, as a result of the border conflict with Pakistan in 1999.

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[17] Key food items (mainly wheat, rice, and sugar) are sold to the public through the PDS, at central issue prices fixed by the government, using an extensive network of Fair Price Shops. Food subsidies and the role of the PDS are discussed in greater detail in Chapter IV of *India—Selected Issues*, (IMF Staff Country Report No. 96/132, January 1997).

[18] The authorities' definition of the deficit puts the 1999/00 estimated outturn at 5.6 percent of GDP, compared to the budget target of 4.0 percent of GDP (see footnotes 10 and 14, and Box III.3).

- Higher pension outlays (0.2 percent of GDP) resulted from larger-than-expected backpayments associated with the Fifth Pay Commission awards, especially for military retirees.

- Given the dire financial situation of many states, Rs 30 billion (0.2 percent of GDP) in tax advances to state governments were converted into medium-term loans. In addition, increased grant support for state plans boosted central government plan expenditures by 0.2 percent of GDP.

- Central government emergency assistance to the state Orissa, which was devastated by a cyclone in November, totaled almost 0.1 percent of GDP.

- Outlays on subsidies were slightly higher than targeted (0.1 percent of GDP) owing to post-budget increases in fertilizer subsidies and the high costs of maintaining large grain stockpiles—as lower world prices of wheat increased farmers' incentives to sell wheat to the government at fixed minimum support prices.

16. **Financing** of the deficit in 1999/00—totaling an estimated Rs 1.4 trillion[19]—again came mostly from domestic sources. Most of the Rs 771 billion in market borrowing was provided by the banking sector, with net commercial bank credit to government of about Rs 588 billion. Given the net repayment by the central government to the RBI of Rs 39 billion, the remaining Rs 222 billion or so in debt was bought by insurance companies and mutual funds. Rs 517 billion was borrowed against small savings, provident funds, and special deposits. Political uncertainties slowed the pace of divestment, and privatization receipts—at Rs 26 billion—fell far short of the Rs 100 billion target.

D. 2000/01 Central Government Budget

17. **The 2000/01 central government budget targeted a deficit of 7.1 percent of GDP, implying little consolidation relative to the expected outturn for 1999/00.**[20] Although new tax measures were expected to increase revenues and significant cuts had been targeted for food and fertilizer subsidies, these had been offset by pressures to increase military expenditures and mandated increases in transfers to the states.

18. **New tax measures** were expected to yield Rs 48.9 billion (0.2 percent of GDP), while improved buoyancy of excise and customs collections was budgeted to increase gross

[19] This amount includes the states' share of small saving collections, as under the old accounting treatment.

[20] On the authorities' accounting basis, the deficit was budgeted to decline by 0.5 percentage points, to 5.1 percent of GDP, owing to the anticipated increase in divestment receipts (see footnote 17 and Box III.3).

tax collections by a further 0.3 percent of GDP. However, more than half of the total increase would be transferred to state and union territory governments, according to the interim recommendations of the Eleventh Finance Commission.[21] Key measures included:

- The three-rate MODVAT excise tax was replaced by a single-rate (16 percent) CENVAT excise tax, although many items would still be exempt or subject to special rates. This restructuring was expected to yield around 0.1 percent of GDP in additional revenues.

- The special additional duty (SAD) on manufacturing imports was extended to cover imports by traders, for an expected revenue gain of about 0.1 percent of GDP.

- The tax exemption on export earnings was to be phased out in equal increments over the next five years.[22]

- The tax rate on dividends and income distributed by domestic companies and debt-oriented mutual funds was increased from 10 percent to 20 percent, reducing the disparity between the tax treatment of dividends and interest income.[23]

- Offsetting some of these expected revenue gains were anticipated revenue losses of 0.2 percent of GDP, owing to a reduction in the peak rate of customs duty from 40 percent to 35 percent, and cuts in duties on crude oil and selected petroleum products.[24]

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[21] Tax-sharing arrangements between the central and state governments are reviewed by a Finance Commission convened every five years. See Box III.1.

[22] Corporate tax collections were budgeted to rise by Rs 50 billion (¼ percent of GDP) in 2000/01 in response to new measures, which would include the phase out of the tax exemption on export earnings, the continuation of the 10 percent surcharge on corporate incomes, as well as the impact of new tax concessions and exemptions.

[23] Income distributed under the US-64 and other open-ended equity-oriented schemes of the UTI and other mutual funds would continue to be exempt from taxation. All new personal income tax measures combined—including the increase in the dividend tax rate and the 15 percent surcharge on higher-income taxpayers—were expected to yield Rs 11 billion (0.05 percent of GDP) in 2000/01.

[24] Given the special surcharge of 10 percent, the effective peak rate is now 38.5 percent. Although the tariffication of 714 items previously subject to quantitative restrictions, announced at end-March, was effected at the new peak rate, the budget did not make a provision for increased customs revenues from this source.

- In addition, new tax concessions and exemptions were introduced, including for Small Scale Industrial units (SSIs), new ventures in backward areas, and the film industry.

19. On the **expenditure side**:

- The defense budget was slated to increase to Rs 586 billion, representing an increase of 0.2 percent of GDP relative to the 1999/00 outturn (which was already inflated by Kargil-related defense expenditures), and an increase of almost 0.5 percent of GDP relative to the 1998/99 outturn.

- Food subsidies were budgeted to decline by 0.1 percent of GDP, through increases in prices charged by the Public Distribution System. Above-poverty-line (APL) customers would pay "economic cost"—the price paid to producers—for foodgrains, while the price paid by below-poverty-line (BPL) consumers would increase to 50 percent of economic cost. However, since the monthly allocation to BPL consumers would be doubled, the government estimated that total monthly expenditures by a typical BPL family of four would decline.

- Fertilizer subsidies were also budgeted to decline by 0.1 percent of GDP, following 7–15 percent increases in fertilizer prices. Moreover, it was announced that the retention pricing scheme for fertilizers would be phased out over the medium term.[25]

- Grants to states and UTs were budgeted to increase by 0.4 percent of GDP, as per the interim recommendations of the Eleventh Finance Commission.

- A number of programs were introduced to promote rural housing, the provision of basic services, and credit flow to SSIs and the agricultural sector.

20. **Other initiatives** announced in the budget included the further gradual extension of the zero-based budgeting system to all remaining departments; and the constitution of the Expenditure Reforms Commission—first announced in the 1999/00 budget—to make recommendations on rationalization of government activities, civil service reform, and reduction of explicit and implicit subsidies.

21. **Prior to its passage by Parliament in May 2000, the Finance Minister introduced several amendments to the budget's tax proposals.** These included 10-year tax holidays to some exporters and research and development companies; more favorable tax treatment of employee stock options and venture capital funds; higher tax exemption limits for housing loans and infrastructure bonds; increases in customs duties on tea, coffee, poultry meat, and other items, in order to protect domestic industries; and exemption of

[25] The retention pricing scheme guarantees a cost-plus-rate-of-return margin to fertilizer manufacturers. Fertilizer subsidies are discussed in greater detail in Chapter IV of *India—Selected Issues*, (IMF Staff Country Report No. 96/132, January 1997).

several items from the new 16 percent CENVAT. It was estimated that these measures would reduce revenues by about Rs 10 billion, or 0.05 percent of GDP.

E. State Government Finances 1998/99–1999/00

22. **State finances deteriorated sharply in 1998/99**, with the combined deficits of the states and union territories[26] widening to 4.3 percent of GDP from 2.9 percent of GDP in the previous year. All states recorded deficits, with six states accounting for 55 percent of the total (Chart III.5). The structural weaknesses in state finances were exacerbated in 1998/99 by a 1.1 percent of GDP increase in the states' wage bill and pension payments, following the upward revision of the central government's pay scale.[27] At the same time, state tax revenues and transfers of central tax revenues were adversely affected by the sluggish economy, and grant transfers were reduced by fiscal difficulties at the central level (Chart III.6 and Table III.2).

23. **Owing to the severe deterioration in fiscal positions, eleven states signed memoranda of understanding (MOUs) with the central government in 1999/00**. These involved the provision of short-term loans (totaling an estimated Rs 30 billion) by the central government and relaxation of states' borrowing limits, in exchange for commitments to reform.[28] Although the overall reform parameters were agreed jointly, policy design was left primarily to individual states, and included enhanced user charges and fees, improved targeting of subsidies, divestment, and reforms to tax systems, civil services, and power sectors

24. **While details of these commitments were not made public, the states' aggregate deficit in 1999/00 was budgeted to fall to 3.9 percent of GDP**. Total revenue and grants were expected to increase to 10.8 percent of GDP, 0.4 percent of GDP higher than the preliminary 1998/99 outturn. The state budgets anticipated higher grants from the center (particularly for plan schemes) as well as significantly larger tax collections due to the expected recovery in industrial production. Own tax receipts were also expected to be boosted by 0.3 percent of GDP due to additional revenue mobilization by a number of states

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[26] Includes 25 states and the National Capital Territory of Delhi.

[27] See footnotes 4 and 5. State government wage and salary payments are included under both developmental expenditures (e.g., for teachers) and nondevelopmental expenditures (e.g., for state government administrators).

[28] The central government initially accelerated transfer of budgeted central tax and plan grants; in December 1999, Rs 30 billion in transfers were converted to three-year loans under a newly-created Extended Ways and Means Advances Facility. In addition, some states were allowed to borrow Rs 20 billion in excess of borrowing limits set by the central government at the beginning of 1999/00.

under the MOU reforms.[29] Total state expenditure was expected to remain broadly unchanged at 14.8 percent of GDP, although an increase in nondevelopment expenditure (due to the lingering effects of the wage adjustment and higher interest payments) was expected to be offset by lower development expenditure, relative to GDP.

25. **Although comprehensive data on state finances in 1999/00 are not yet available, states' performance under the MOUs appears to have been mixed**, as the election climate from April to October made it difficult for the states to implement many politically-sensitive measures.[30] On the basis of available information on transfers from the center, the states' borrowing during the year, and fragmentary data available on expenditure, their combined deficit is estimated at about 4.5 percent of GDP.

26. **The states' fiscal deficits have been financed predominately by loans and advances from the center and by market borrowing.** Divestment proceeds have been insignificant. In 1998/99, resources mobilized through government–sponsored saving schemes, provident funds, and postal deposits increased by almost 60 percent and comprised over 70 percent of net loans from the center (Box III.3). Market borrowing by the states through issues of long-term securities also increased in 1998/99. Recently, the states have been encouraged to access the market directly, within the approved borrowing program, thus giving them greater flexibility with regard to the timing, maturity and the cost of borrowing. This has also prompted the states to seek credit ratings and has enabled the market to assess state risks independently.

27. **The combined outstanding liabilities of the states is estimated to have exceeded 20 percent of GDP by end-March 2000**, with loans and advances from the center accounting for an increasing share of the total (60 percent in March 1999). In addition, the state governments have accumulated large contingent liabilities (totaling 4.7 percent of GDP at end-March 1999) arising from explicit guarantees extended against borrowing by state enterprises and institutions, mostly for infrastructure projects. There have already been a few cases where such guarantees have been invoked by lenders. As a part of their fiscal reform efforts, a number of states have initiated legislation to place statutory limits on guarantees and establish sinking funds, and some have begun issuing guarantees more selectively. Moreover, with effect from 2000/01, the RBI has requested banks and financial institutions to assign a risk weight of 20 percent to state government securities outside of market borrowing, and a risk weight of 100 percent on guaranteed bonds of defaulting entities.

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[29] The states are also expected to benefit from the recent harmonization of sales tax rates and the gradual elimination of tax exemptions (Box III.2), although the revenue impact in 1999/00 would be small.

[30] Consolidated data on state finances are compiled and published by the RBI, typically nine to ten months after the end of the fiscal year.

Table III.1. India: Central Government Operations, 1996/97-2000/01

	1996/97	1997/98	1998/99		1999/00		2000/01
			Budget	Accounts	Budget	Rev. Est.	Budget
	(In billions of rupees)						
Total revenue and grants	1,317.7	1,406.5	1,703.0	1,577.0	1,920.9	1,890.2	2,134.0
Net tax revenue	937.0	956.7	1,168.6	1,046.5	1,323.7	1,264.7	1,462.1
Gross tax revenue	1,287.6	1,392.2	1,577.1	1,438.0	1,768.6	1,699.8	2,002.9
Less: States' share	350.6	435.5	408.5	391.5	445.0	435.1	540.8
Nontax revenue	368.7	439.6	523.9	520.7	590.1	617.1	664.6
Grants	11.9	10.2	10.5	9.9	7.2	8.5	7.3
Total expenditure and net lending	1,989.5	2,304.8	2,663.2	2,769.3	3,070.4	3,274.6	3,666.8
Current expenditure	1,644.2	1,870.8	2,183.7	2,256.1	2,462.3	2,625.6	2,908.3
Of which: Major subsidies	140.4	182.4	194.8	210.6	224.4	232.1	214.9
Interest payments	594.8	656.4	750.0	778.8	880.0	914.3	1,012.7
Wages and salaries	190.5	259.3	293.4	289.0	316.1	374.6	328.4
Capital expenditure and net lending 1/	345.3	434.0	479.6	513.1	608.1	649.0	758.5
Overall balance	-671.9	-898.3	-960.2	-1,192.2	-1,149.6	-1,384.3	-1,532.7
Financing	671.9	898.3	960.2	1,192.2	1,149.6	1,384.3	1,532.7
External (net)	29.9	10.9	23.4	19.2	8.5	9.1	-0.4
Domestic (net)	642.0	887.4	936.9	1,173.0	1,141.1	1,375.3	1,533.2
Of which: Divestment receipts	3.8	9.1	50.0	58.7	100.0	26.0	100.0
	(Percent of GDP)						
Total revenue and grants	9.7	9.3	9.8	8.9	9.6	9.7	9.9
Total expenditure and net lending	14.6	15.2	15.3	15.7	15.4	16.8	17.0
Current expenditure	12.1	12.3	12.5	12.8	12.3	13.5	13.5
Of which: Major subsidies	1.0	1.2	1.1	1.2	1.1	1.2	1.0
Interest payments	4.4	4.3	4.3	4.4	4.4	4.7	4.7
Wages and salaries	1.4	1.7	1.7	1.6	1.6	1.9	1.5
Capital expenditure and net lending 1/	2.5	2.9	2.8	2.9	3.0	3.3	3.5
Overall balance	-4.9	-5.9	-5.5	-6.8	-5.8	-7.1	-7.1
Memorandum items:							
Military expenditure	2.2	2.3	2.4	2.3	2.3	2.5	2.7
Primary balance	-0.6	-1.6	-1.2	-2.3	-1.3	-2.4	-2.4
Revenue balance 2/	-2.4	-3.1	-2.8	-3.9	-2.7	-3.8	-3.6
Overall balance (authorities' definition) 3/	-4.9	-5.9	-5.2	-6.4	-4.0	-5.6	-5.2
Central government debt	49.6	51.4	...	49.7	49.6	...	...
Nominal GDP (Rs billion) 4/	13,620	15,156	17,405	17,626	19,989	19,446	21,547

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

1/ Includes onlending to the states from Small Savings Schemes.
2/ Total revenues and grants less current expenditures.
3/ Authorities' definition excludes onlending to states of small savings collections from capital expenditure and net lending beginning in 1999/00; divestment receipts are included in nontax revenue, rather than in domestic financing.
4/ Figure for 2000/01 is a staff projection.

Table III.2. India: Consolidated State Government Operations, 1994/95-1999/00

	1994/95	1995/96	1996/97	1997/98	1998/99 Budget	1998/99 Rev.Est.	1999/00 Budget
	(In billions of rupees)						
Total revenue and grants	1,227.5	1,380.1	1,536.3	1,721.8	1,971.7	1,834.9	2,167.3
Tax revenue	805.7	931.6	1,061.6	1,247.8	1,412.5	1,326.8	1,558.1
Share of central government revenue 1/	248.4	293.0	350.6	435.5	408.5	391.5	445.0
State taxes	557.3	638.7	711.0	812.3	1,003.9	935.3	1,113.2
Taxes on income	7.2	8.4	10.1	10.9	12.4	13.6	15.2
Taxes on property and capital transactions	62.9	72.7	74.2	83.1	108.6	94.5	112.0
Taxes on commodities and services	487.3	557.6	626.7	718.3	883.0	827.2	985.9
Nontax revenue	216.6	228.9	235.4	244.4	277.1	246.1	292.6
Grants from central government 1/	205.2	219.5	239.3	229.6	282.2	262.1	316.5
Total expenditure	1,504.5	1,694.4	1,910.8	2,165.8	2,575.7	2,592.4	2,949.2
Developmental	1,043.5	1,148.2	1,320.1	1,452.7	1,633.6	1,752.5	1,875.0
Social services	488.7	578.4	654.6	735.2	871.6	948.4	1,024.5
Economic services	554.8	569.8	665.5	717.5	762.0	804.1	850.6
Nondevelopmental	495.6	553.8	621.0	717.7	986.4	887.9	1,094.2
Of which: Interest payments	194.1	219.3	255.8	301.1	364.2	369.2	449.5
Administrative services	116.6	133.9	149.5	170.8	...	219.1	...
Pensions	61.5	78.1	98.3	116.0	...	159.0	...
Less: Recovery of loans and advances	52.3	35.0	57.5	54.9	21.6	29.4	24.5
Other (net) 2/	17.7	27.4	27.3	50.3	-22.6	-18.6	4.4
Overall balance	-277.0	-314.3	-374.4	-444.0	-604.0	-757.6	-781.9
Financing	277.0	314.3	374.4	444.0	604.0	757.6	781.9
Market borrowings (net)	40.8	58.9	65.2	72.8	75.5	106.8	100.7
Loans from central government (net)	141.8	151.8	177.7	226.4	212.1	301.9	326.6
Of which: Small savings	85.6	86.0	89.3	137.2	119.7	208.0	225.3
Other 3/	94.4	103.6	131.6	144.9	316.4	348.8	354.5
Of which: Asset sales	0.0	0.0	1.9	2.0	6.0	5.0	3.0
	(Percent of GDP)						
Total revenue and grants	12.2	11.7	11.3	11.4	11.3	10.4	10.8
Share of central government revenue 1/	2.5	2.5	2.6	2.9	2.3	2.2	2.2
States' taxes	5.5	5.4	5.2	5.4	5.8	5.3	5.6
States' nontax revenue	2.1	1.9	1.7	1.6	1.6	1.4	1.5
Central government grants 1/	2.0	1.9	1.8	1.5	1.6	1.5	1.6
Total expenditure	14.9	14.3	14.0	14.3	14.8	14.7	14.8
Developmental	10.3	9.7	9.7	9.6	9.4	9.9	9.4
Nondevelopmental	4.9	4.7	4.6	4.7	5.7	5.0	5.5
Overall balance	-2.7	-2.7	-2.7	-2.9	-3.5	-4.3	-3.9
Financing	2.7	2.7	2.7	2.9	3.5	4.3	3.9
Market borrowings (net)	0.4	0.5	0.5	0.5	0.4	0.6	0.5
Loans from central government (net)	1.4	1.3	1.3	1.5	1.2	1.7	1.6
Other 3/	0.9	0.9	1.0	1.0	1.8	2.0	1.8
Memorandum items:							
Revenue balance 4/	-0.6	-0.7	-1.2	-1.1	-1.5	-2.3	-2.0
Net resources transferred from Center to States 1/	5.9	5.6	5.6	5.9	5.2	5.4	5.4

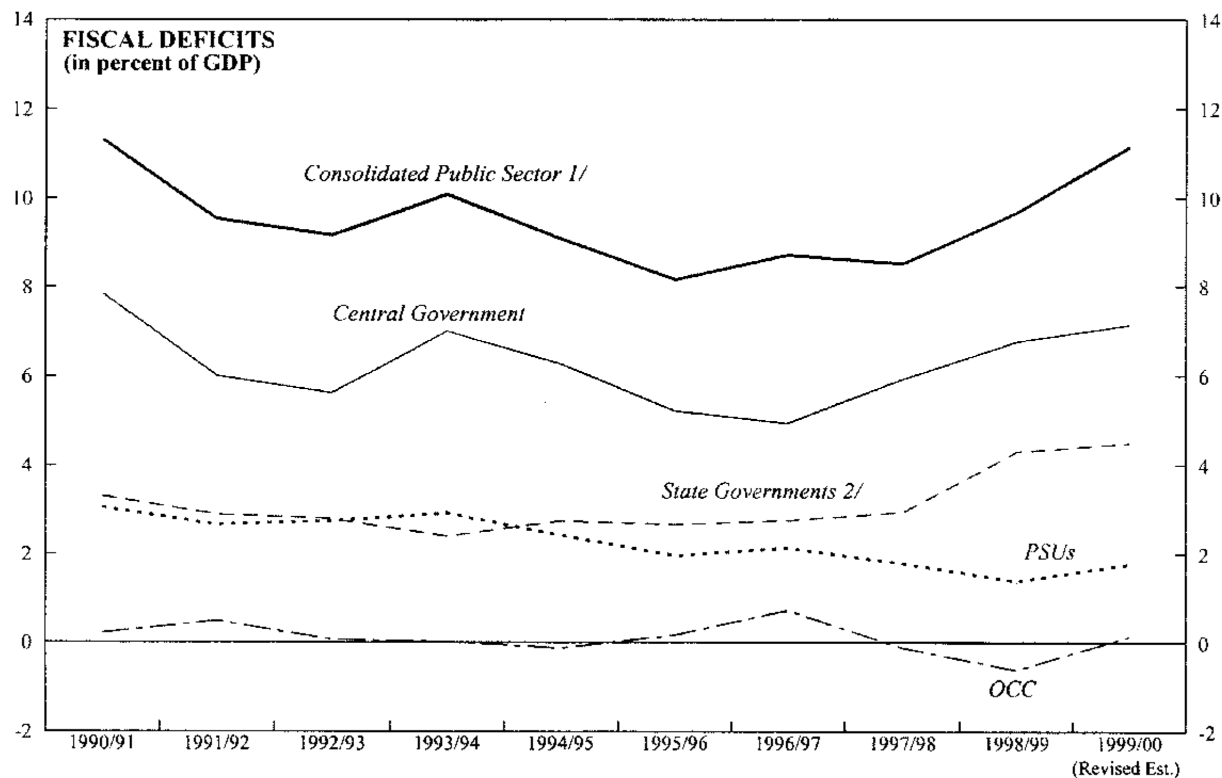
Source: RBI Bulletin; RBI Reports on Currency and Finance; Union budget documents; and staff estimates.

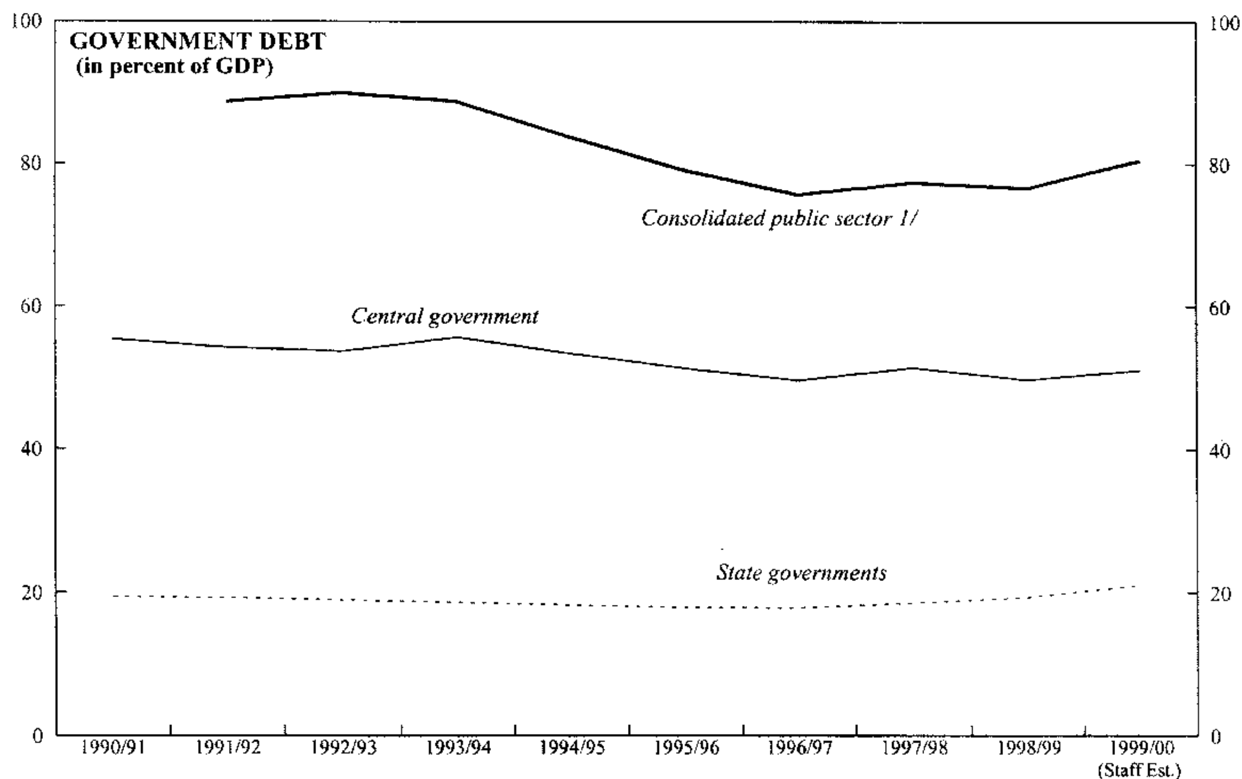
1/ Data on central government tax and grant transfers are taken from Union budget documents, rather than from state sources.
2/ Includes other expenditure, and discrepancies between central government and state sources on (i) share of central government revenue and (ii) grants from central government.
3/ Includes other financing, and discrepancy between central government and state sources on loans from central government.
4/ Total revenues and grants less current expenditures.

CHART III.1

INDIA

Government Deficits and Debt, 1990/91 - 1999/2000





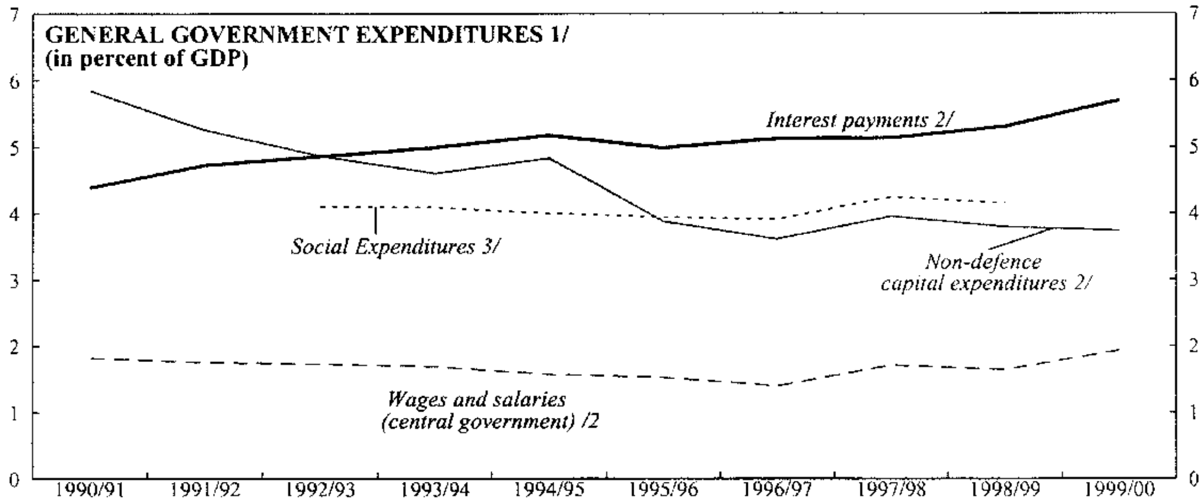
Source: Union budget documents, Reserve Bank of India, Public Enterprise Survey, and staff estimates.

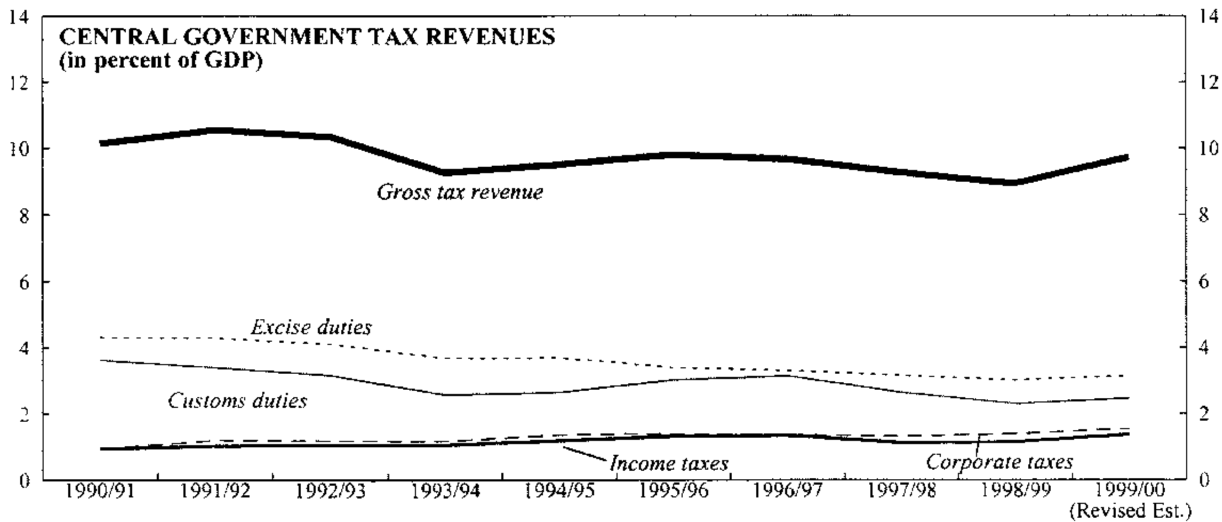
1/ Consolidated public sector comprises central and state governments, central public sector undertakings (PSUs), and the Oil Coordinating Committee (OCC). Figures are staff estimates.
2/ 1999/00 figure is a staff estimate.

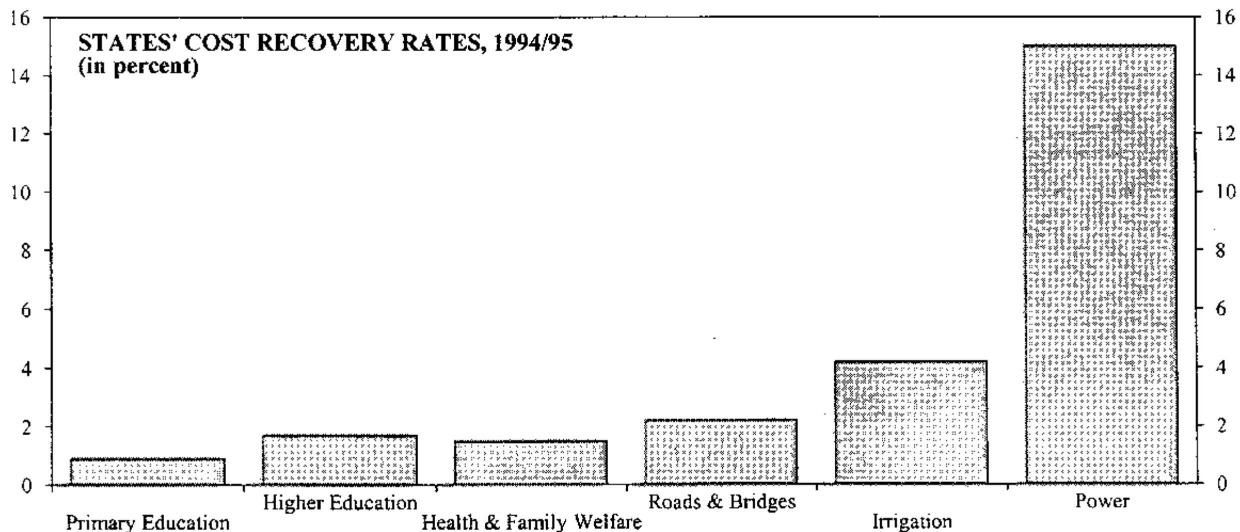
CHART III.2

INDIA

Fiscal Indicators - Central and State Governments







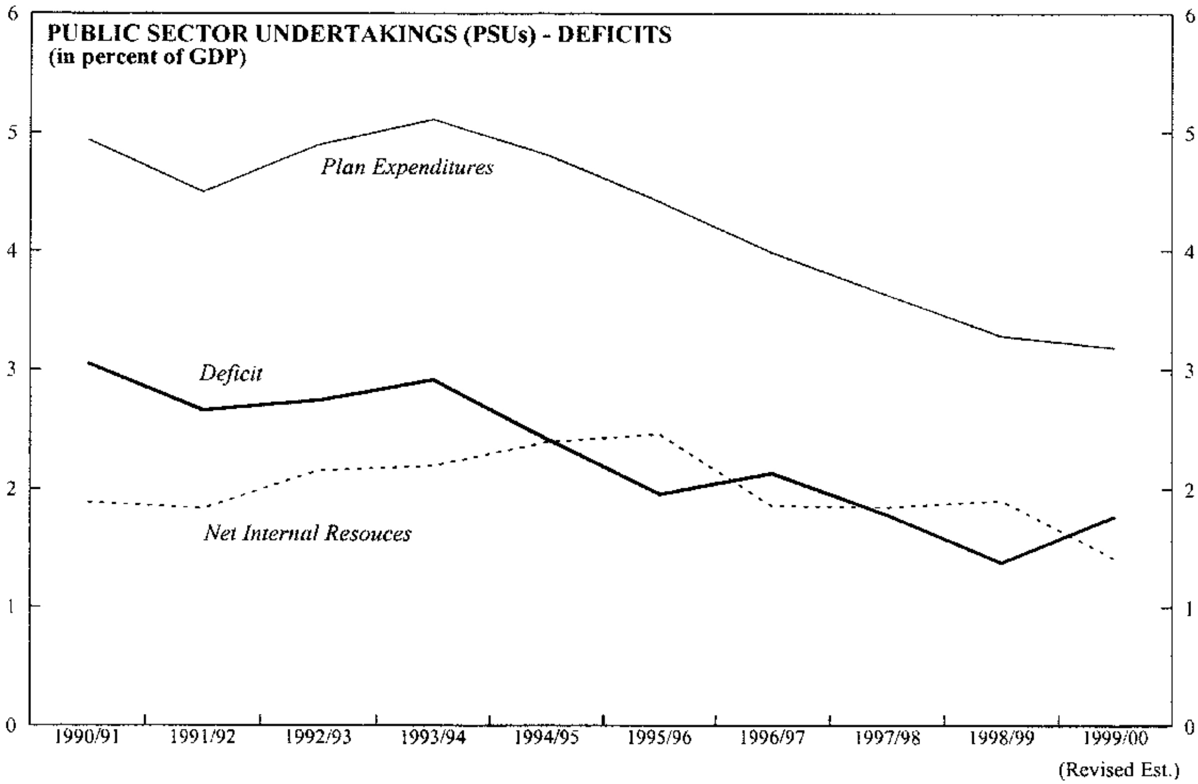
Source: Union budget documents, Reserve Bank of India, Government Subsidies in India (1997).

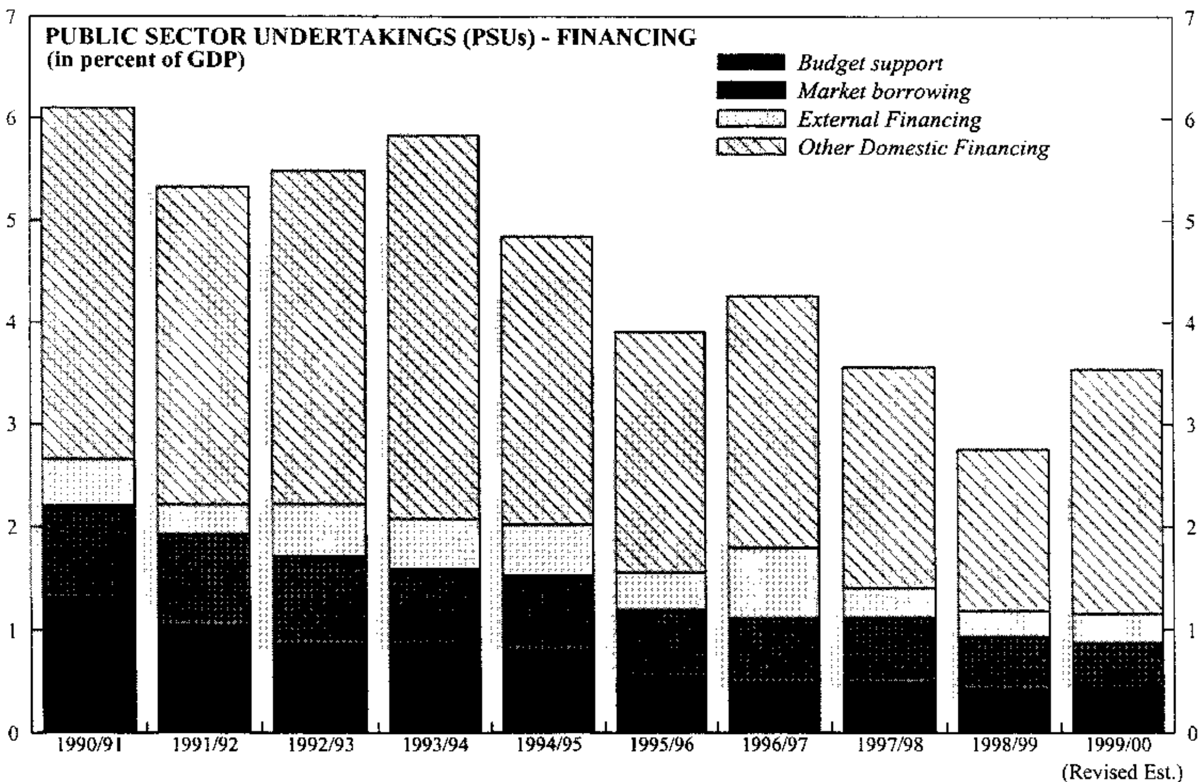
1/ General government comprises central and state governments.
2/ 1999/00 figures are revised estimates (central government) or budget estimates (state governments).
3/ Expenditures on education, family welfare, medical & public health, and water supply & sanitation. 1997/98 figures are revised estimates; 1998/99 figures are budget estimates.

CHART III.3

INDIA

Fiscal Indicators - PSUs, 1990/91 - 1999/2000



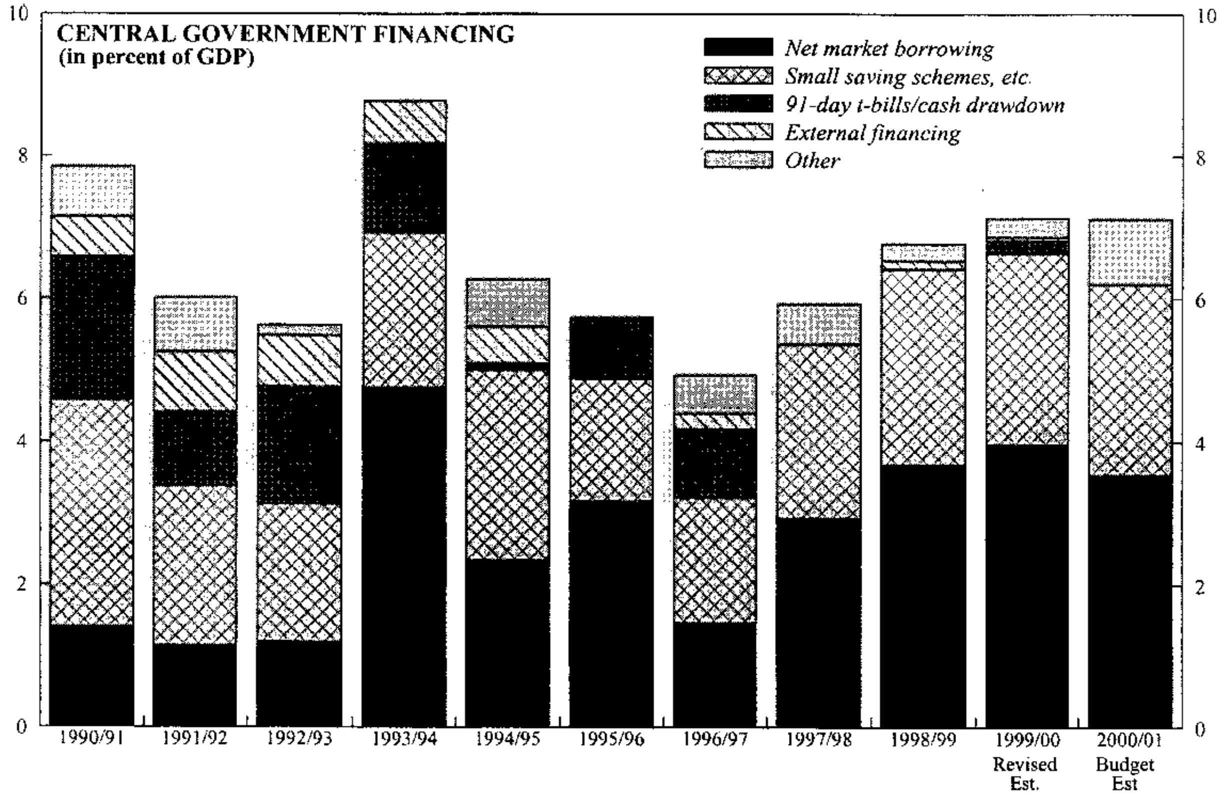


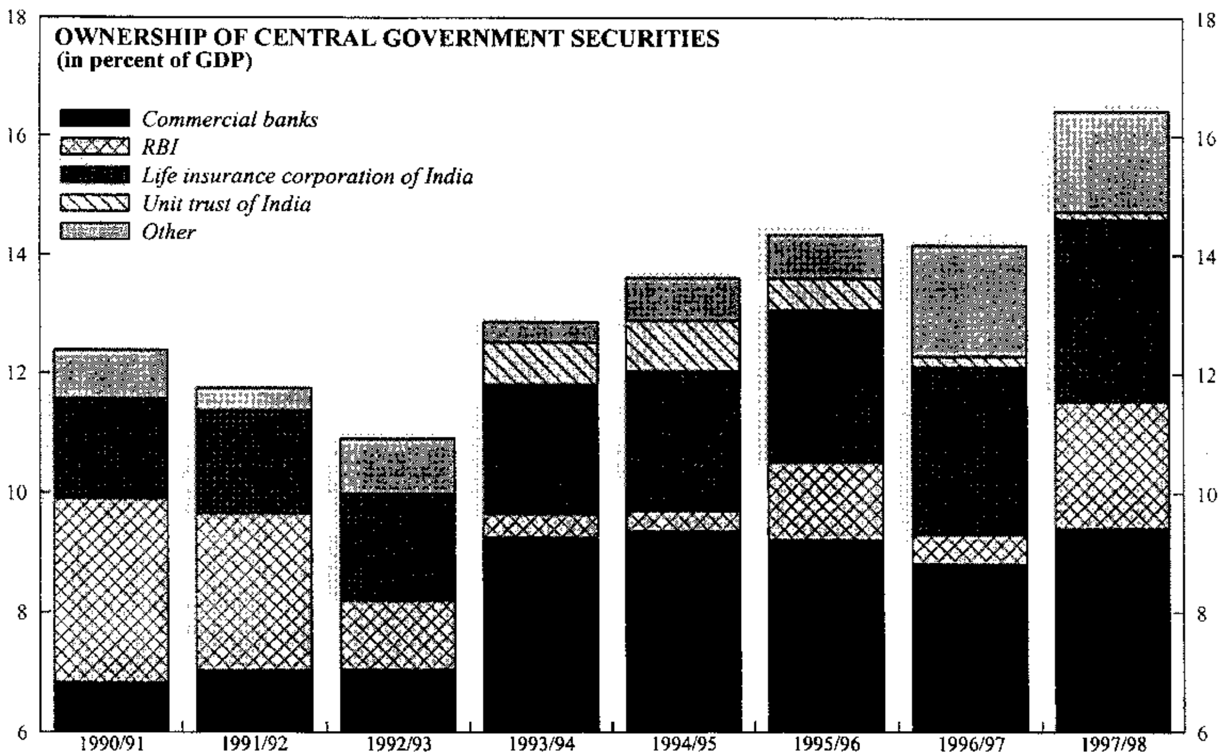
Source: Union budget documents.

CHART III.4

INDIA

Central Government Financing and Debt, 1990/91 - 2000/01

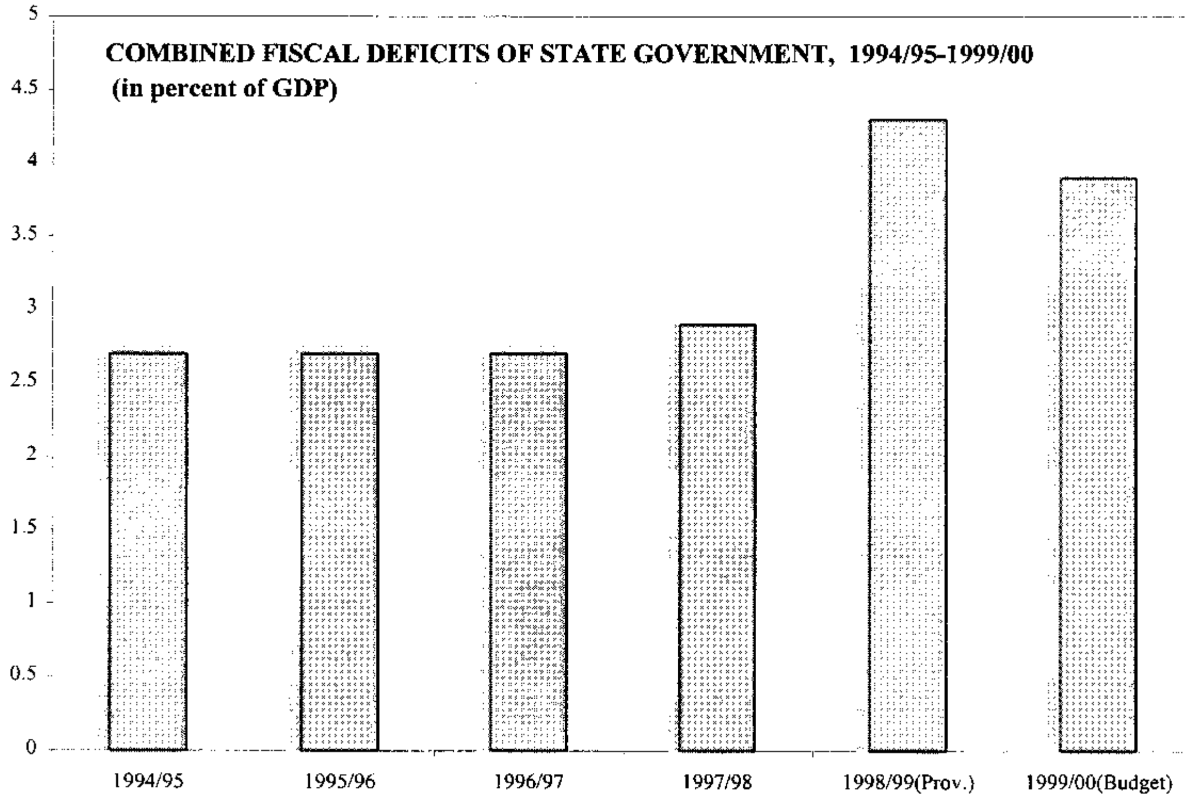


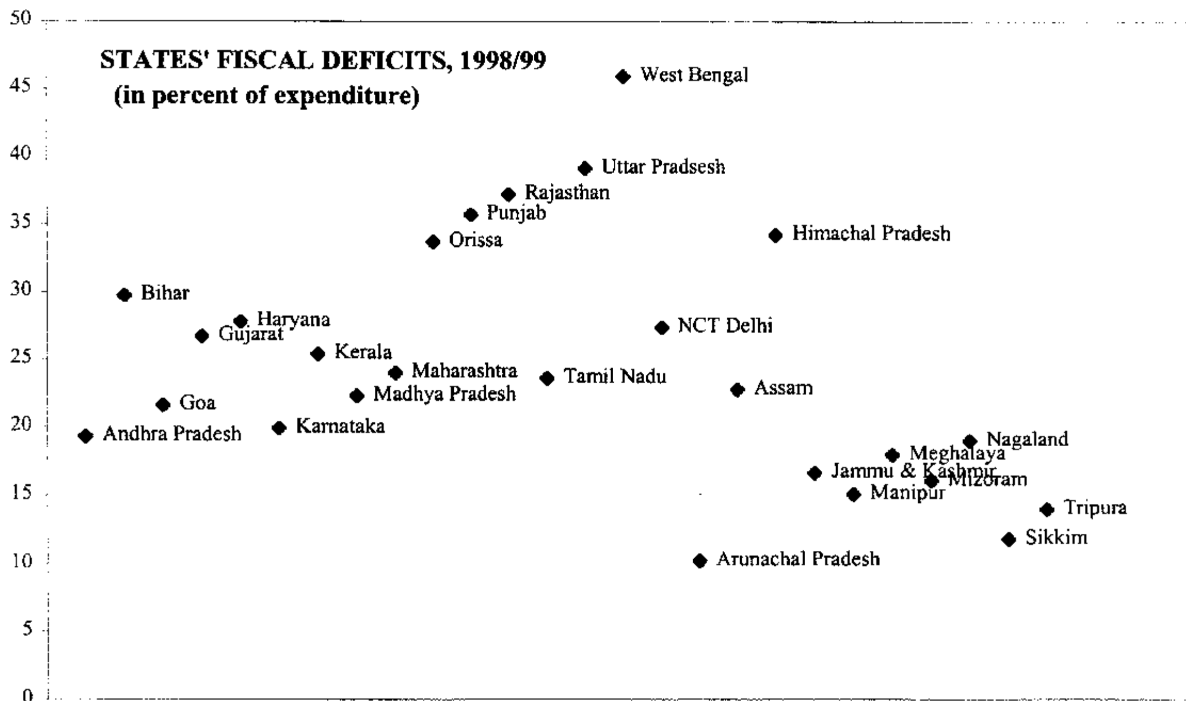


Sources: Union budget decuments, Reserve Bank of India, and staff estimates.

CHART III.5
INDIA

State Governments' Fiscal Deficits



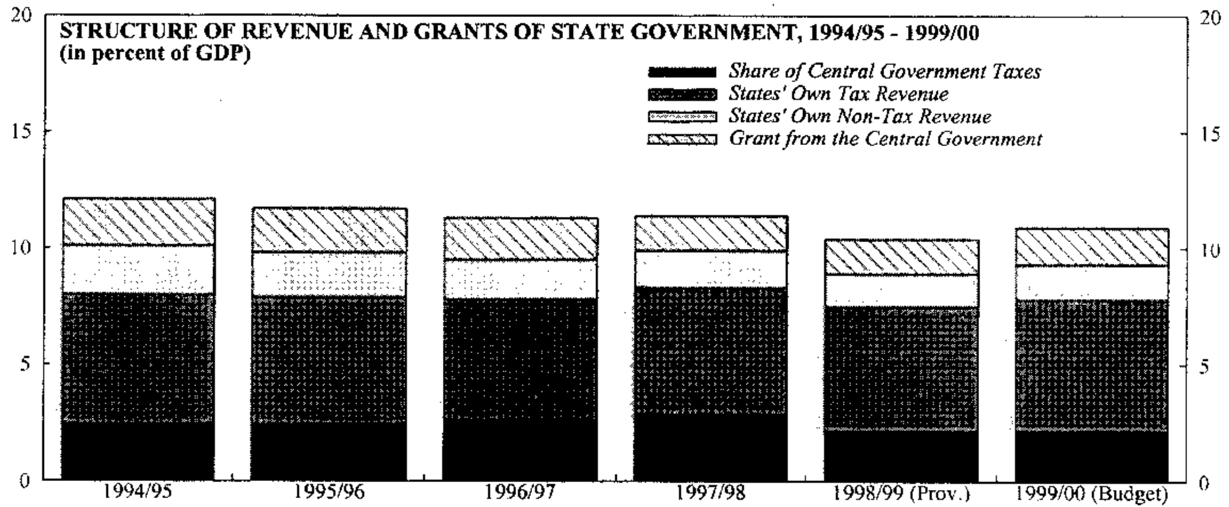


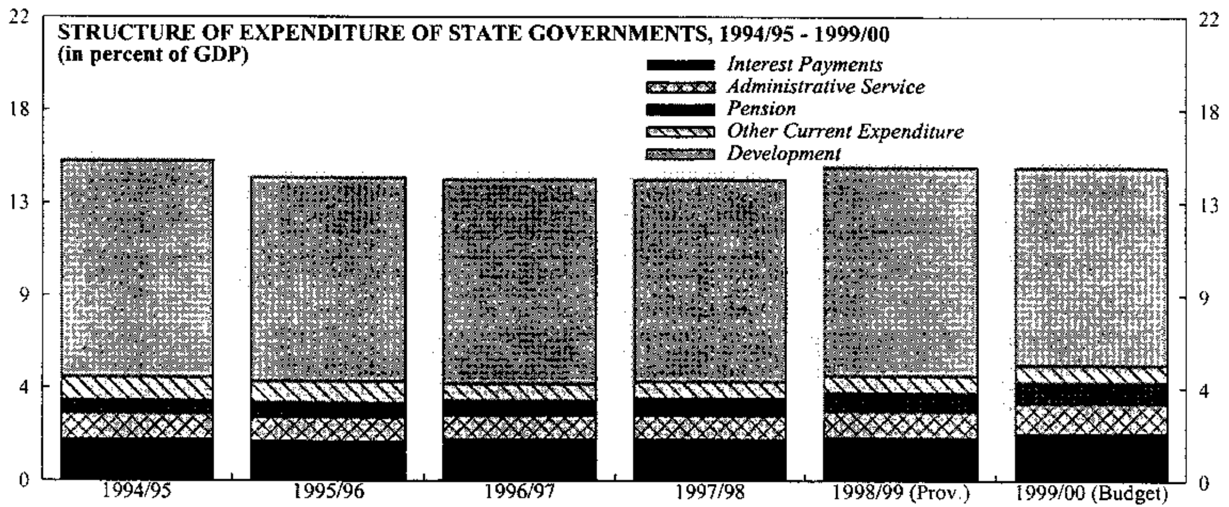
Source: Reserve Bank of India

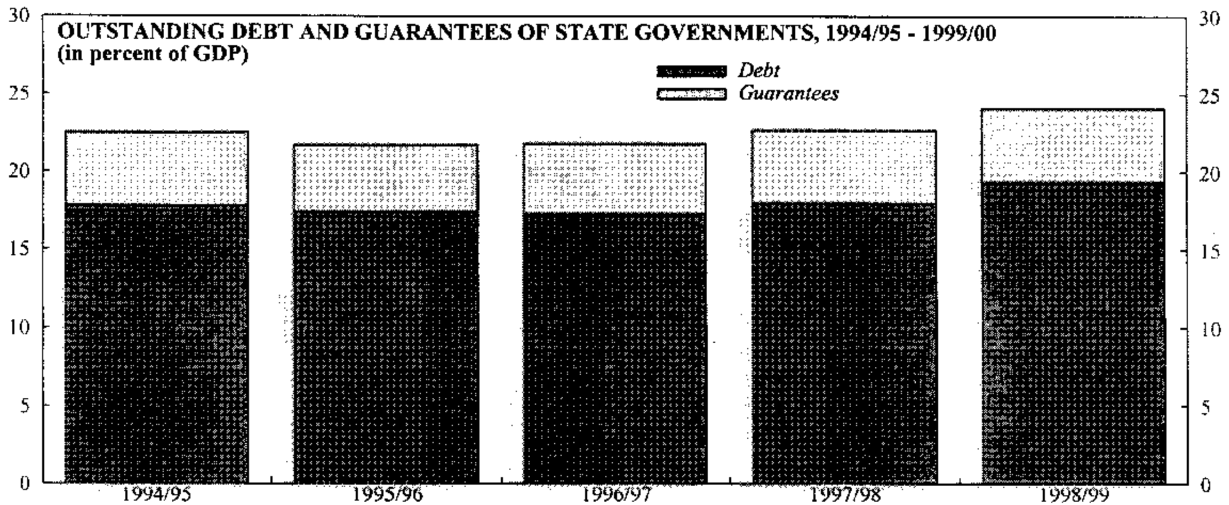
CHART III.6

INDIA

State Governments' Fiscal Developments, 1994/95-1999-00







Source: Reserve Bank of India.

IV. Monetary and Financial Market Developments[1]

A. Monetary Policy and Interest Rate Developments

1. The substantial downward pressure on the rupee that began in August 1997 ended the easing trend in monetary policy that had been in place since early 1996. The Reserve Bank of India (RBI) initially sought to secure a soft landing for the currency through intervention in the spot and forward markets and a modest tightening in monetary policy in November 1997. A more decisive move was made in January 1998 when the cash reserve ratio (CRR) was raised to 10½ percent and the Bank and repurchase (repo) rates were both increased by 2 percentage points to 11 percent and 9 percent, respectively (Chart IV.1 and Table IV.1).

Table IV.1. India: Selected Monetary Indicators, 1994/95-2000/01

(End-of-period)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	May 2000/01
				(Percent change)			
Reserve money	22.1	14.9	2.8	13.2	14.5	8.1	...
M3	22.4	13.6	16.2	18.0	19.2	13.6	...
NM3 1/	21.2	12.0	15.5	17.8	17.7	...	...
Credit to commercial sector	23.1	17.7	9.2	15.1	14.2	16.4	...
				(Percent)			
Cash Reserve Ratio (CRR)	15.0	14.0	10.0	10.3	10.5	9.0	8.0
Bank rate	12.0	12.0	12.0	10.5	8.0	8.0	7.0
91-day Treasury bill yield	12.0	13.0	8.0	7.3	8.8	9.2	8.7
Commercial bank PLR 2/	15.0	16.5	14.5-15.0	14.0	12.0-13.0	12.0-13.0	11.3-11.8

Source: Reserve Bank of India.

1/ New broad money series. See Box IV.4 for details.
2/ Relates to five major banks

2. This tightening of monetary conditions had little impact on the yields of short-dated government paper, as the RBI absorbed securities through private placements. However, secondary market yields on longer-dated paper increased sharply, resulting in a steepening of the yield curve (Chart IV.2). Banks also raised their prime lending rates (PLRs) by 1 percentage point to 14 percent, while the discount rate on commercial paper (CP) rose sharply as the risk premia attached to the corporate sector increased with the uncertainty generated by the regional crisis.[2]

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[1] Prepared by Tim Callen.

[2] Commercial banks are now free to set most interest rates. Exceptions are on small loans (less than Rs 200,000), on which the rate cannot exceed the PLR, export credit, and savings accounts, where the rate is currently set at 4 percent. Most banks currently charge a spread of 4 percent over PLR on their lending. In the October 1999 *Monetary and Credit Policy*

(continued...)

3. As stability returned to the foreign exchange market, the RBI eased monetary conditions during March–June 1998, reducing the Bank Rate, repo rate, and CRR to 9 percent, 5 percent, and 10 percent, respectively. The increase in bond yields that had taken place at the beginning of the year was reversed, the yield curve flattened, and banks reduced their PLRs to 12¾–13 percent by end-April.

4. Renewed downward pressure on the exchange rate in the wake of the Russian default and the increase in domestic inflationary pressures necessitated further monetary tightening in August 1998. However, concerned about the weakness in the industrial sector, the RBI sought to engineer an increase in short-term rates, while leaving bank borrowing rates unchanged. To this end, the repo rate and CRR were raised to 8 percent and 11 percent, respectively, but the Bank Rate was left unchanged. In response, Treasury bill yields rose sharply, but yields on longer-dated securities were more stable and the PLR was unchanged.

5. During 1999 and early 2000, the focus of monetary policy shifted toward supporting the recovery in the industrial sector. The CRR was cut to 10½ percent in March 1999 and the Bank and repo rates were reduced to 8 percent and 6 percent, respectively. In the April 1999 *Monetary and Credit Policy Statement,* the RBI stated a "bias toward easing as circumstances permit" and reduced the CRR by a further ½ percentage point. This was followed by a phased cut in the CRR to 9 percent in November 1999, and the Bank Rate, repo rate, and CRR were reduced further to 7 percent, 5 percent, and 8 percent, respectively in April 2000.

6. **Market interest rates** generally declined during 1999 and into 2000, although the magnitude of the decline has varied across the yield curve, and did not kept pace with the fall in inflation during 1999 so that real interest rates increased (Table IV.2 and Chart IV.3; see Box IV.1 for a discussion of real interest rates). Overnight call interest rates remained quite high for much of the year, moving above the Bank Rate for extended periods, most

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Statement, the RBI announced that commercial banks would be given greater flexibility to determine their PLRs on certain types of lending.

noticeably during August–November.[3] However, yields on 14- and 91-day Treasury bills declined moderately, while 10-year bond yields fell by nearly 2 percentage points to 10½ percent. These developments have led to a considerable flattening of the yield curve.

Table IV.2. India: Real Interest Rates, 1983/84-1999/00

(In Percent)

	Real Money Market Rate				Real Lending Rate			
Calculated Using:	WPI	WPIM	CPI	WPIE	WPI	WPIM	CPI	WPIE
1983/84-1999/00 (Average)	3.4	3.8	1.9	1.3	8.4	8.8	6.9	6.2
1983/84-1990/91 (Average)	3.6	3.4	2.1	2.4	9.3	9.1	7.8	7.8
1991/92-1999/00 (Average)	3.2	4.1	1.6	0.5	7.7	8.5	6.1	4.9
1998/99	1.2	2.8	-5.9	-0.4	7.4	9.0	0.3	5.8
1999/00	5.4	5.9	5.2	2.7	9.2	9.8	9.0	6.6

Sources: Data provided by the Indian authorities; *International Financial Statistics*; *Consensus Forecasts*; and staff calculations.
Key: WPI: Wholesale Price Index
WPIM: Manufactured subcomponent of the WPI
CPI: Consumer Price Index
WPIE: Estimate of (WPI) inflation expectations derived from Consensus Forecasts.

7. The **PLR** fell to 12–12½ percent following the monetary easing in early 1999, but the considerable competition banks faced for deposits from other financial institutions, mutual funds, and government-sponsored small saving schemes limited the scope for further cuts in their lending rates. While the rates of return on small savings schemes were reduced by 1–1½ percentage points effective from January 1, 1999, these investments remained attractive given their tax advantages. However, following the reduction in rates on provident fund accounts, from 12 percent to 11 percent in early 2000, and the easing of monetary policy in April, banks reduced their PLRs to 11¼–11¾ percent. Commercial paper (CP) rates have also declined to around 10–12 percent. Indeed, CP rates for high quality corporates have

[3] In recent years, the 3–4 day repo rate and the Bank Rate have defined an informal corridor in which the call rate moves. The repo rate, the rate at which the RBI absorbs liquidity from the system, provides the floor to this corridor, and the Bank Rate, the rate at which the RBI provides liquidity through the Interim Liquidity Adjustment Facility, the upper band. This, however, is an imperfect corridor both because the maturities of the RBI's repo and refinance operations differ from the largely overnight transactions in the call money market and because there are limits on access to RBI lending facilities at the Bank Rate (additional RBI financing is only available at the Bank Rate plus 200 basis points). Boxes IV.2 and IV.3 outline reforms introduced by the RBI in its recent Monetary and Credit Policy Statements.

been below the PLR as banks have sought to provide credit to blue-chip borrowers at more competitive interest rates.

Box IV.1. India: Real Interest Rates

The level of real interest rates in an economy is an important determinant of economic activity. Indeed, as India has moved away from a highly-regulated financial system toward a more market determined framework, the real interest rate is likely to have become an increasingly important factor in credit allocation and economic activity.

The real interest rate is calculated as the nominal interest rate on a financial asset less the expected inflation rate over the maturity period of the asset. The calculation, however, is complicated both by the choice of the interest rate and by the proxy for inflation expectations. A number of interest rates could be used, and given that the correlation between interest rates at different maturities and in different asset classes is not high in India, the choice is important in determining the result. Inflation expectations could be proxied by the actual inflation rate over the preceding twelve months—with the wholesale price index (WPI), the manufacturing sector subcomponent of the WPI, or the consumer price index (CPI) being the most likely price measures to use—or by the inflation forecasts contained in *Consensus Forecasts*.[1]

Real interest rates do appear to have been higher than usual during the past year (Table IV.2 and Chart IV.3). While the level of real interest rates is lower when the estimates of inflation expectations are used (because expected inflation has generally been higher than actual inflation), they still remain above their recent and historical averages. Further, comparing real interest rates to the level that would be expected on the basis of an econometric relationship between real interest rates and the output gap suggests that real rates have been higher than would be expected at this stage of the economic cycle.[2]

A number of structural factors could help explain the high level of real interest rates. Chief among these are: the large stock of nonperforming loans in the banking system; the still high pre-emptions of bank assets; the large government borrowing requirement; and the attractive, nonmarket-determined rates of interest offered on government-sponsored saving schemes, which also carry attractive tax benefits.

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[1] Consensus Forecasts asks economic forecasters for their projections of CPI and WPI inflation for both the current and following financial years.

[2] The equation estimated was as follows: $realr_t = c + ogap_{t-1}$, where realr is the real interest rate, c is a constant, and ogap is the output gap (derived from the Hodrick-Prescott filter). The output gap was defined using industrial output rather than GDP.

Box IV.2. India: Reforms Introduced in the April and October 1999 Monetary and Credit Policy Statements

Operation of monetary policy

- An Interim Liquidity Adjustment Facility (ILAF) was introduced. As part of this the general refinance facility was replaced by a collateralized lending facility under which banks can borrow 0.25 percent of their fortnightly average outstanding deposits (in 1997/98) for two weeks at the Bank Rate and a further 0.25 percent at the Bank Rate plus 2 percentage points.

- Nonbank participants in the money markets were given access to RBI repos.

- In order to simplify commercial banks' cash management, the RBI introduced a two week lag in the maintenance of the stipulated CRR requirement by banks. For example, the CRR to be maintained in the fortnight beginning January 1, 2000 was based on net demand and time liabilities as at December 17, 2000.

Government securities and money markets

- The number of primary dealers (PDs) was increased from 10 to 13. Minimum bidding commitments are now being obtained from each PD to ensure that the notified auction amount is fully absorbed.

- A calendar of Treasury bill issues was announced for the entire year. A 182-day Treasury bill was introduced with bi-weekly auctions.

- Regulation of money market mutual funds was transferred to SEBI, while guidelines for the trading forward rate agreements/interest rate swaps were introduced.

Interest rates

- The 30 percent interest surcharge on import finance that had been introduced in January 1998 was withdrawn. The minimum 20 percent interest rate on overdue export bills was withdrawn, with banks allowed to set this rate at their own discretion.[1] Banks were also given greater flexibility in determining their lending rates.

Capital account

- The minimum maturity of foreign currency nonresident (FCNR(B)) deposits was raised from six months to one year. At the same time, the requirement that banks maintain an incremental CRR of 10 percent on liabilities incurred since April 11, 1997 was withdrawn.

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[1]On May 25, 2000, the RBI imposed a 50 percent surcharge on the lending rate for import financing and a minimum 25 percent per annum rate on overdue export bills.

Box IV.3. India: April 2000 Monetary and Credit Policy Statement

Monetary policy: The statement left policy-related interest rates and the CRR unchanged—although it indicated policy would continue to be geared toward supporting growth, it also stressed the need to guard against emerging inflation pressures. For 2000/01, the RBI projected real GDP growth of 6½–7 percent and an inflation rate of around 4½ percent. An M3 target was not announced, in line with the new "multiple indicator" approach, but M3 growth was projected at 15 percent.

RBI liquidity management: The statement announced the replacement of the Interim Liquidity Adjustment Facility (ILAF) with a full-fledged Liquidity Adjustment Facility (LAF) in a phased manner. In the first phase, effective June 5, 2000, the additional collateralized lending facility (ACLF), through which banks and primary dealers borrow at the Bank Rate plus 200 basis points, would be replaced with daily, variable rate, repo auctions with same-day settlement. The fixed repo system will be abolished at this stage. The LAF, operating through auction-based repos and reverse repos, would set a corridor for money market rates and help develop the shorter-end of the yield curve.

Money market reforms: In order to integrate the money and foreign exchange markets, rupee interest rate derivatives will be permitted to be benchmarked to foreign exchange forward rates, in addition to existing money and debt market rates. The minimum maturity of certificates of deposits was reduced from three months to 15 days, bringing them on par with commercial paper and term deposits.

Financial sector reforms: The statement introduced specific guidelines for bank participation in the insurance business, restrictions on floating rate loans were removed, and banks were given greater autonomy in setting rates on deposits. Development finance institutions were given approval, in principle, to convert to universal banks, subject to meeting all prudential norms applicable to banks.

Prudential reforms: In a move towards consolidated supervision, banks were asked, on a voluntary basis, to include the risk-weighted components of their subsidiaries into their own balance sheets. Banks were also advised to earmark additional capital over a period of time, beginning in March 2001, to avoid any loss of net worth once the balance sheets are consolidated. The RBI indicated that it would develop a plan in line with best international practices to move toward risk-based supervision from the transaction-based supervision now being practiced; it would revise prudential norms for non-Statutory Liquidity Requirement investments by banks; and review the possibility of extending to NBFCs the bank guidelines on asset liability management and risk management.

B. Monetary Aggregates

8. **Reserve money** grew by 14½ percent in 1998/99, compared with 13¼ percent in 1997/98 (Chart IV.4 and Table IV.3). On the liabilities side, the pickup in reserve money growth was fueled by strong increases in currency in circulation on account of the turnaround in the agricultural sector (which is more cash reliant that other sectors) and the sharp rise in primary product prices which required the holding of higher cash balances for transaction purposes. Growth in bankers deposits with the RBI was considerably lower than in 1997/98, as funds held by the RBI under the incremental CRR introduced in May 1991 were released.[4] On the assets side, net foreign assets of the RBI continued to rise strongly, albeit at a slightly slower rate than in 1997/98, driven by the RBI's purchase of the proceeds from the RIB issue in the foreign exchange market in August 1998. RBI credit to government rose strongly, contributing 7¾ percentage points to reserve money growth, as the government finances continued to deteriorate. RBI credit to banks rose substantially as recourse to its refinance facilities increased with the move of money market interest rates above those on export refinance facilities following the tightening of monetary policy in August 1998 (export refinance rates were actually reduced to 7 percent from August 1998 until March 31, 1999).

9. Reserve money growth eased considerably to 8 percent (y/y) in 1999/00, primarily due to a decline in bankers balances with the RBI as the CRR was reduced during the year. RBI credit to government actually declined over the year despite the continued deterioration in the fiscal situation as the RBI was able to sell securities into the market, both to commercial banks and other financial institutions. The strong external sector performance resulted in a significant increase in the RBI's net foreign assets, which contributed 10¾ percentage points to reserve money growth.

10. **Broad money** growth, at 19¼ percent, remained strong in 1998/99, and once again exceeded the RBI's indicative target range for the year of 15–15½ percent (Table IV.4).[5] The contribution of net foreign assets, at 4¾ percentage points, was unchanged from 1997/98 as the proceeds from the RIB issue offset weakness in other capital inflows. Net credit to government contributed 6¾ percentage points to broad money growth, somewhat higher than in 1997/98. Bank credit to the commercial sector slowed during 1998/99 in line with the

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[4] In May 1998, the RBI announced that it would release the remaining two-thirds (one-third was released in October 1992) of the balances held under the 10 percent incremental CRR imposed between May 1991 and April 1992. These were released in installments between May 1998 and March 1999.

[5] The RBI has recently released broad money data calculated under a revised methodology (see Box III.4). However, a detailed breakdown is only published from March 1999, and there is a significant lag in publication, so the discussion here focuses on the old M3 series. If the proceeds from the Resurgent India Bond (RIB) issue were excluded from broad money (in line with the residency criteria), then growth in 1998/99 would have been 17 percent.

Box IV.4. India: Revised Monetary Aggregates

In its October 1999 *Monthly Bulletin*, the RBI published new monetary data based on the recommendations of the Working Group on *Money Supply: Analytics and Methodology of Compilation*. The major methodological change is the introduction of the residency concept in the calculation of the aggregates. A number of other modifications to the coverage and construction of the monetary aggregates have also been made.

Reserve money (M0)

- RBI refinance to the National Bank for Agriculture and Rural Development (NABARD) is classified as RBI credit to the commercial sector rather than to banks.

Intermediate monetary aggregate (NM2)

- A new intermediate aggregate has been introduced (between M1 and M3) which includes currency and residents' short-term bank deposits, defined as deposits with a contracted maturity up to, and including, one year (M1 only includes noninterest bearing deposits). However, not all commercial banks are in a position to provide this deposit breakdown at present, so the data on short-term bank deposits is estimated from a sample of large public sector banks (45 percent of the time deposits of these banks were short-term).

Broad money (NM3)

- Broad money is defined as NM2 plus long-term deposits of residents as well as call/term borrowings from nonbank sources. The crucial difference between the old M3 series and NM3 is the exclusion of nonresident repatriable foreign currency fixed liabilities which were previously included in time deposits, but which will now be classified as a foreign liability of the banking system. Also excluded from NM3 are pension and provident fund assets which had previously been included in other liabilities of the banking system.

Credit aggregates

- Bank investments in securities not eligible for inclusion under the SLR (such as commercial paper and purchases of shares/debentures/bonds) are included in bank credit to the commercial sector. Further, net commercial bank lending to primary dealers, which is currently treated as an interbank transaction, will be included as bank credit to the commercial sector.

The new series for broad money (NM3) shows a lower growth rate during the course of most of 1998 and 1999 due to the exclusion of non-resident Indian (NRI) foreign currency repatriable fixed deposits from the definition of deposits. The RBI will continue to publish data for both the old and new series, particularly given the lags that currently exist in the publication of the new data.

weakening of activity in the industrial sector, contributing 7½ percentage points to broad money growth compared to 8¼ percentage points in 1997/98. In recent years, bank finance to the commercial sector has increasingly been provided through channels other than direct lending. Commercial bank subscriptions to commercial paper and other similar instruments accounted for around one third of total bank financing of the commercial sector in 1998/99, broadly the same as in 1997/98. Investment in commercial paper does not carry any priority lending requirements, and banks are also able to offer more competitive interest rates to blue-chip borrowers through this channel as direct lending cannot be at an interest rate below the PLR.

11. Broad money growth slowed to 13½ percent (y/y) in 1999/00, well below the 15½–16 percent target range announced for the year by the RBI in its April *Monetary and Credit Policy Statement*. However, this growth rate was distorted by the last reporting Friday falling on March 24 in 1999/00, one full week ahead of the book closing at the end of the financial year. This meant that the full impact of "window dressing," which usually results in a year-end increase in deposits, was not as apparent in the 1999/00 data, leading to a sharp drop in the end-March growth rate. Indeed, broad money grew by 17 percent (y/y) in February 2000, and growth returned to 16 percent in April. Credit to the commercial sector has picked up strongly in recent months, contributing 8¼ percentage points to broad money growth in 1999/00, as activity in the industrial sector accelerated, while net bank credit to the government has slowed somewhat as the fiscal deficit has increasingly been financed outside the banking system. Government securities, however, remain attractive to the commercial banks as they continue to seek to strengthen their balance sheets, and their holdings of government and other approved securities stood at 34¼ percent of net demand and time liabilities in March 2000, well above the 25 percent SLR requirement.

12. Financing provided by the **all-India Financial Institutions (AIFIs)** slowed during 1998/99. These institutions are traditionally term lenders as opposed to the working capital finance provided by the commercial banks, although this distinction is becoming blurred. Sanctions and disbursements rose by 19¼ percent and 7½ percent, respectively, compared to growth rates of 44½ percent and 29 percent in 1997/98. This slowdown can probably be attributed to a number of factors that discouraged investment expenditure including: the slowing in industrial activity; the uncertain external environment; domestic uncertainties related to political developments and international sanctions. However, disbursements by the AIFIs picked up during the first eleven months of 1999/00 as industrial activity accelerated.

Table IV.3: India: Reserve Money, 1996/97-1999/00 1/

	1996/97	1997/98	1998/99	1999/00			
				June	Sept.	Dec.	Mar.
			(In billions of rupees, end-of-period)				
Reserve money	2,000	2,264	2,593	2,592	2,550	2,647	2,802
Currency in circulation	1,372	1,511	1,758	1,916	1,830	2,001	1,967
Currency with public	1,321	1,456	1,690	1,852	1,766	1,931	1,893
Cash with banks	51	55	69	64	64	70	74
Bankers deposits	596	718	797	627	675	613	805
Other deposits	32	35	38	49	46	33	31
Net domestic assets of RBI	1,052	1,105	1,214	1,156	1,115	1,128	1,144
Claims on government	1,242	1,352	1,525	1,560	1,510	1,572	1,483
Center	1,207	1,336	1,454	1,536	1,489	1,530	1,398
States	35	15	71	23	21	42	84
Claims on banks	70	71	133	96	108	93	168
Claims on commercial sector	62	82	122	93	98	90	153
Other items (net)	-323	-399	-566	-593	-601	-627	-660
Net foreign assets	948	1,159	1,380	1,435	1,435	1,519	1,659
			(Annual growth rates)				
Reserve Money	2.8	13.2	14.5	12.8	13.3	11.3	8.1
Currency in circulation	11.9	10.1	16.4	16.8	16.7	19.4	11.9
Bankers deposits	-13.1	20.5	11.0	2.0	4.4	-7.5	0.9
Net domestic assets of RBI	-12.6	5.1	9.8	1.2	10.3	1.2	-5.8
Claims on government	2.3	8.8	12.9	3.7	10.7	5.3	-2.8
Net foreign assets	28.0	22.2	19.0	24.2	15.8	20.2	20.2
Memorandum item:							
Contribution of RBI credit to government to annual growth of reserve money (percentage points)	1.5	5.5	7.7	2.4	6.5	3.3	-1.6

Source: Data provided by the Indian authorities.

1/ Except for March 31, all other quarters are on a last reporting Friday basis.

Table IV.4. India: Monetary Survey, 1996/97-1999/00 1/

	1996/97	1997/98	1998/99	1999/00			
				June	Sept.	Dec.	Mar.
	(In billions of rupees, end of period)						
Broad money (M3)	6,960	8,213	9,786	10,078	10,477	10,887	11,117
Currency with public	1,321	1,456	1,690	1,852	1,766	1,931	1,893
Deposits	5,607	6,722	8,059	8,176	8,665	8,923	9,193
Nonbank deposits at RBI	32	35	38	49	46	33	31
Net domestic assets	5,905	6,832	8,019	8,313	8,767	9,082	9,173
Domestic credit	6,649	7,639	8,816	8,993	9,317	9,815	10,173
Net credit to government	2,886	3,306	3,868	4,110	4,240	4,412	4,414
RBI	1,242	1,352	1,525	1,560	1,510	1,572	1,483
Other banks	1,644	1,954	2,343	2,550	2,730	2,840	2,931
Credit to commercial sector	3,763	4,333	4,948	4,883	5,077	5,403	5,759
Commercial bank lending	2,784	3,241	3,688	3,636	3,807	4,105	4,342
Other 2/	979	1,092	1,260	1,247	1,270	1,298	1,417
Other items (net)	-744	-807	-798	-680	-550	-733	-1,000
Net foreign assets	1,055	1,381	1,768	1,764	1,710	1,805	1,944
	(Annual growth rates)						
Broad money (M3)	16.2	18.0	19.2	17.9	16.3	17.4	13.6
Currency with public	11.7	10.2	16.1	17.2	16.6	20.4	12.0
Deposits	17.4	19.9	19.9	18.1	16.2	16.9	14.1
Net domestic assets	14.2	15.7	17.4	16.7	17.4	19.4	14.4
Domestic credit	10.4	14.9	15.4	13.9	15.0	16.6	15.4
Net credit to government	12.0	14.5	17.0	13.9	15.4	16.1	14.1
Credit to commercial sector	9.2	15.1	14.2	13.9	14.7	17.0	16.4
Of which: Commercial bank lending	9.6	16.4	13.8	14.0	15.1	18.3	17.7
Net foreign assets	28.4	30.9	28.0	24.3	11.1	8.2	10.0
	(Contribution to M3 growth)						
Net domestic assets	11.4	13.3	14.4	13.9	14.4	15.9	11.8
Of which: Net credit to government	5.1	6.0	6.8	5.9	6.3	6.6	5.6
Credit to commercial sector	5.2	8.2	7.5	7.0	7.2	8.5	8.3
Net foreign assets	3.9	4.7	4.7	4.0	1.9	1.5	1.8

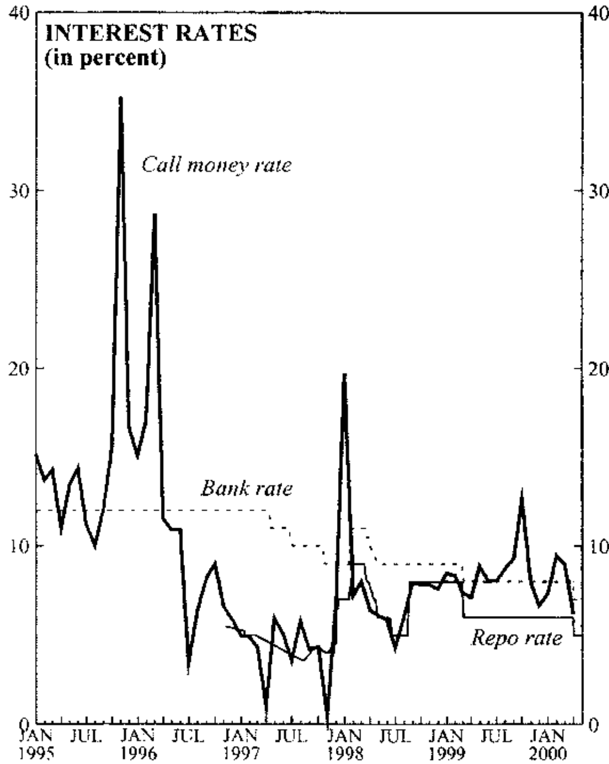
Source: Data provided by the Indian authorities.

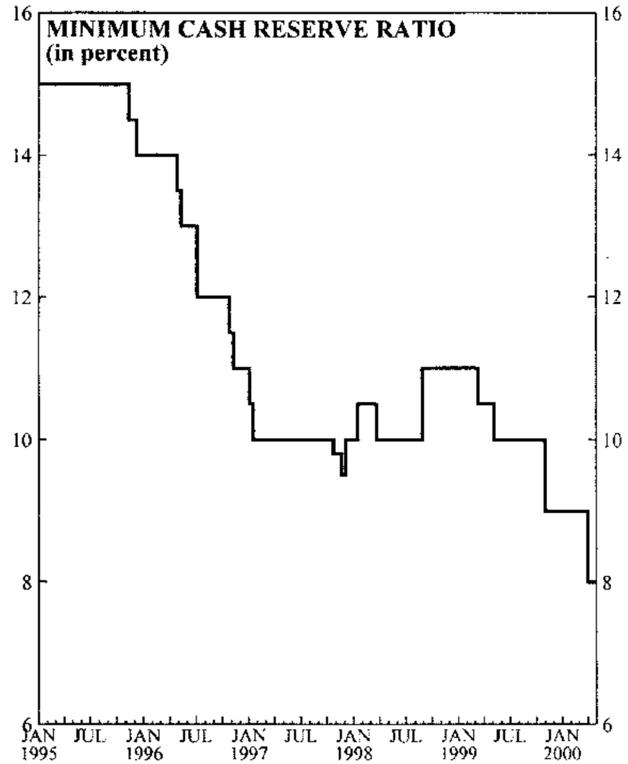
1/ End-year data are a consolidation of March 31 data for the RBI and the last reporting Friday data for commercial banks.
2/ Includes RBI commercial credit, bank holdings of securities, and credit to cooperatives.

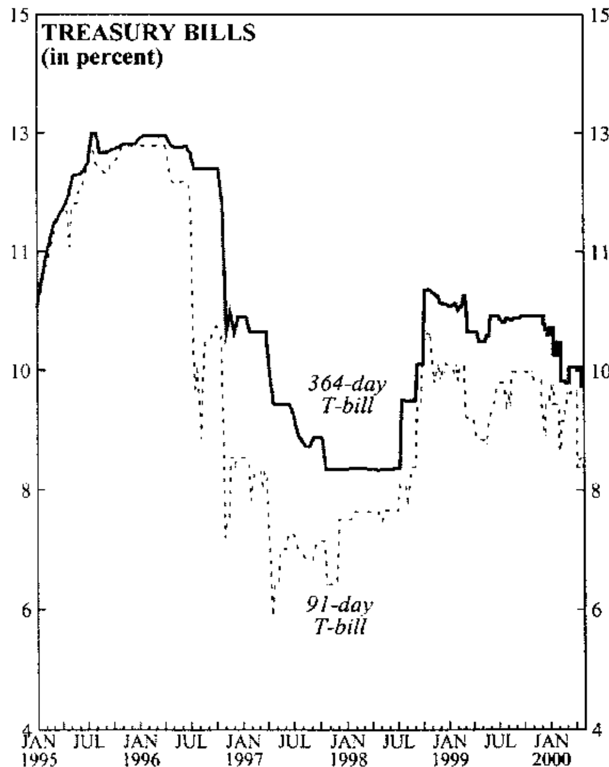
CHART IV.1

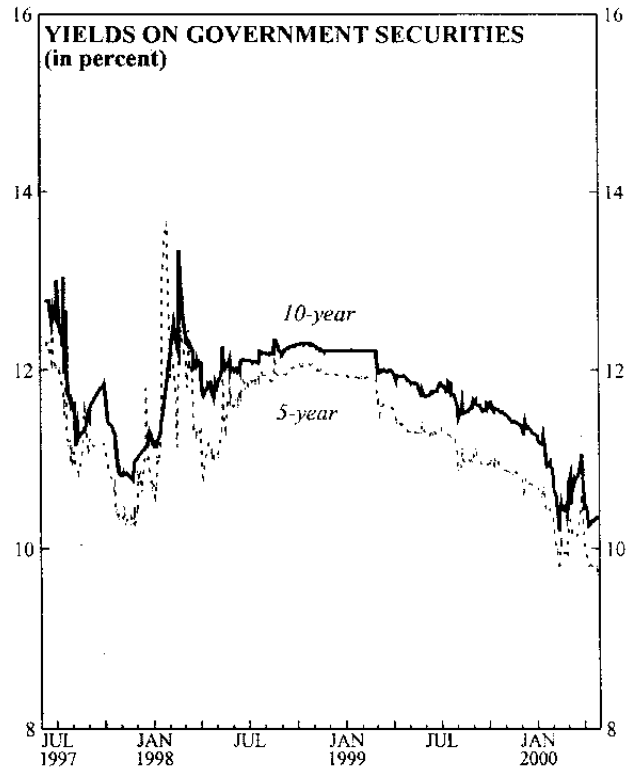
INDIA

Monetary Indicators, 1995-2000







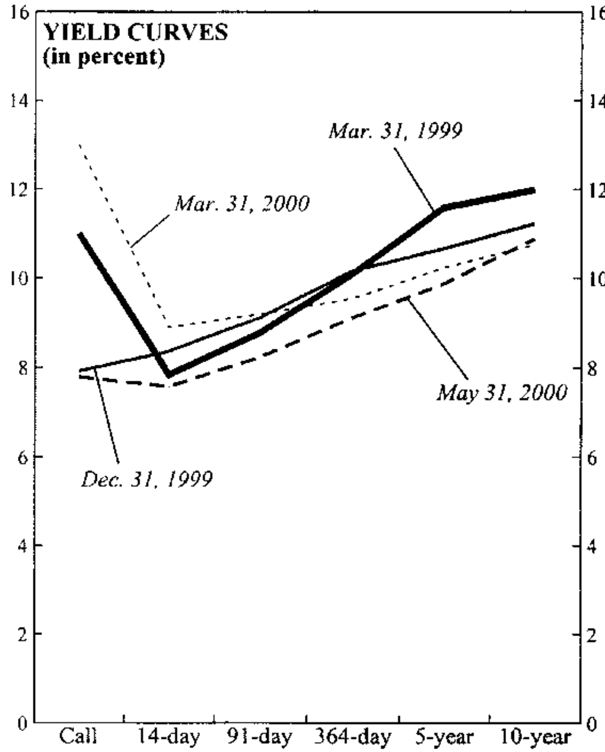


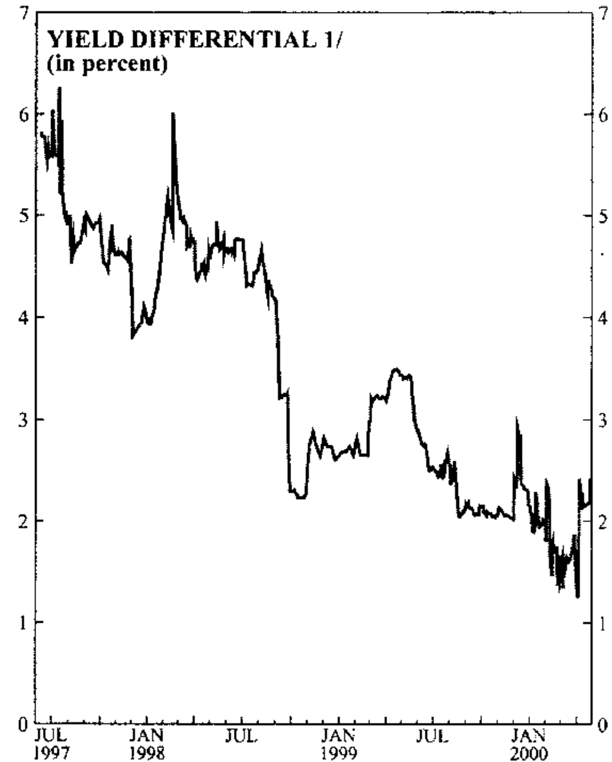
Sources: Data provided by the Indian authorities; and Reuters.

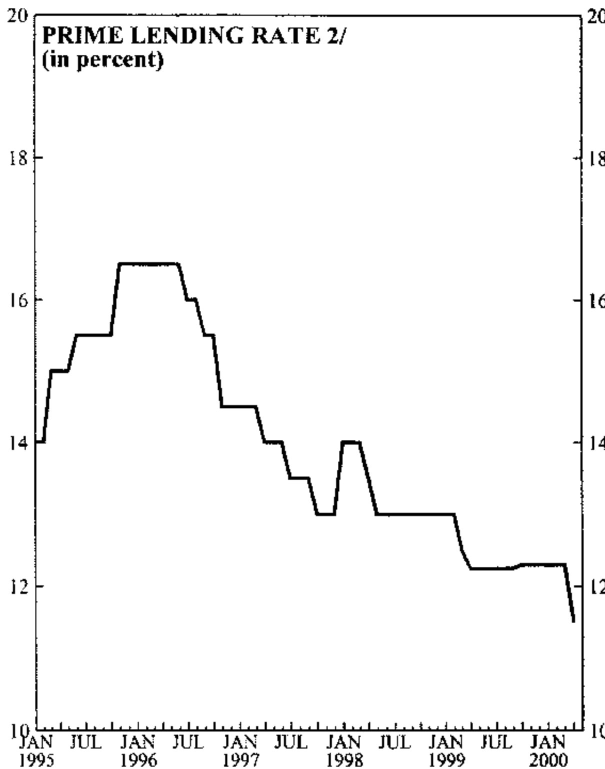
CHART IV.2

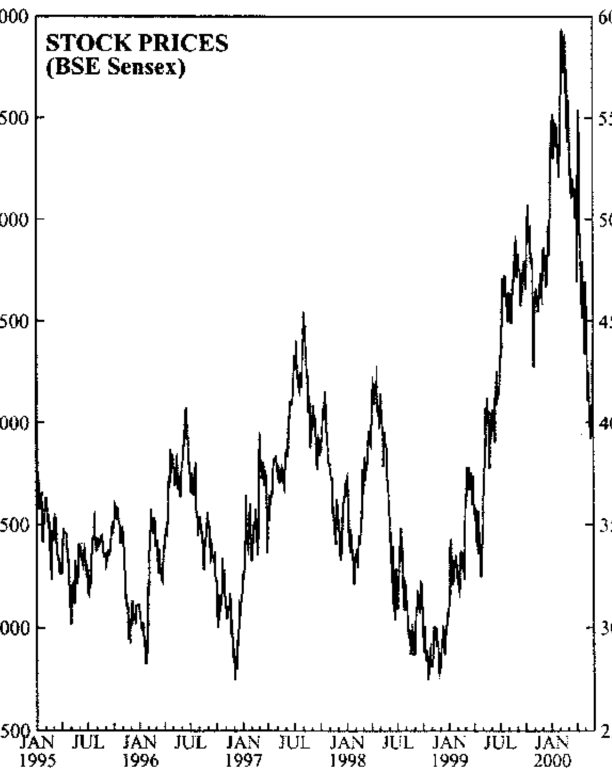
INDIA

Financial Market Developments, 1995-2000









Sources: Data provided by the Indian authorities; and Reuters.

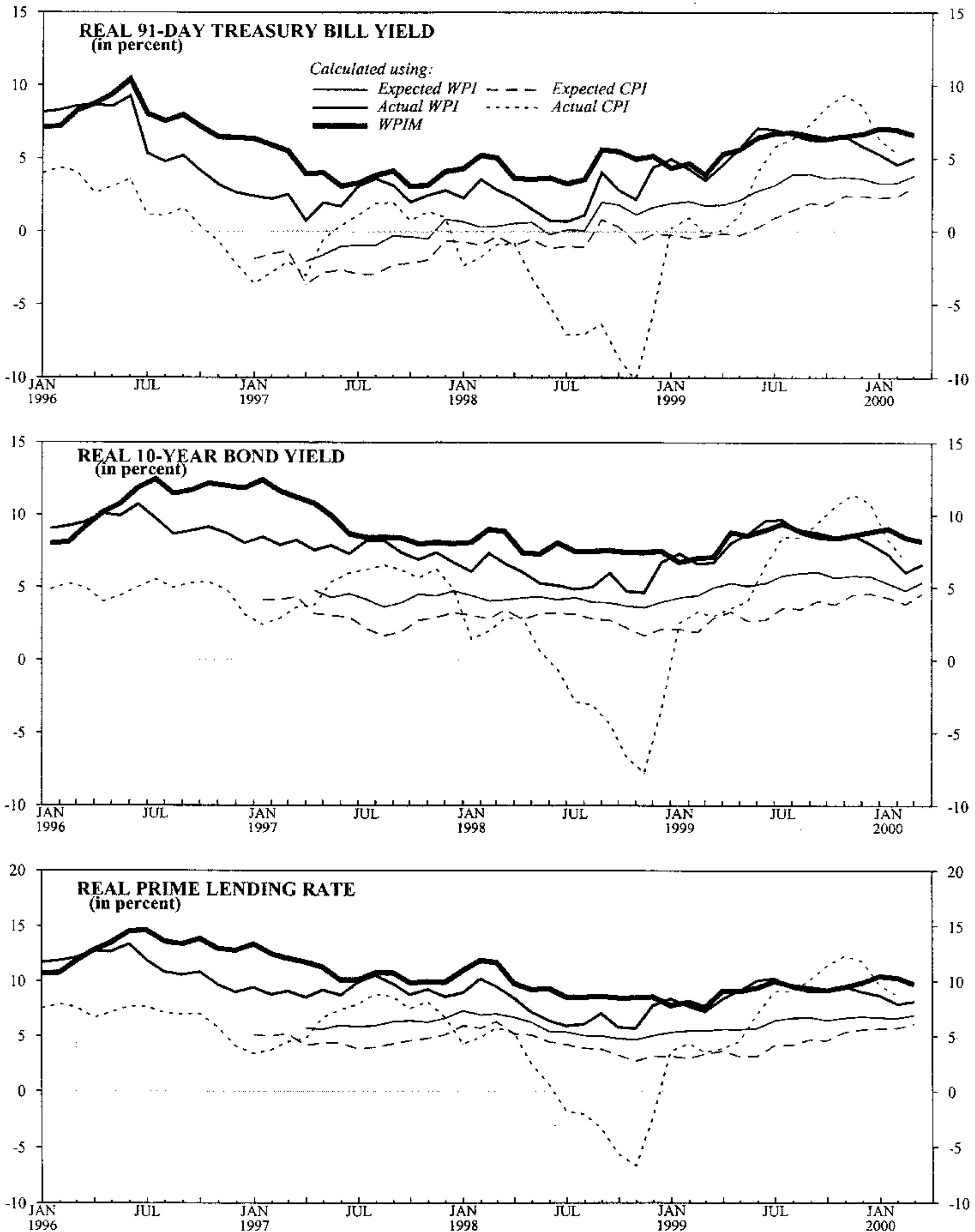
1/ Difference between 10-year secondary market yield of central government securities and 91-day Treasury bill yield. Increases indicate a steeper yield curve.

2/ Prime lending rate of the State Bank of India.

CHART IV.3

INDIA

Real Interest Rates, 1996-2000

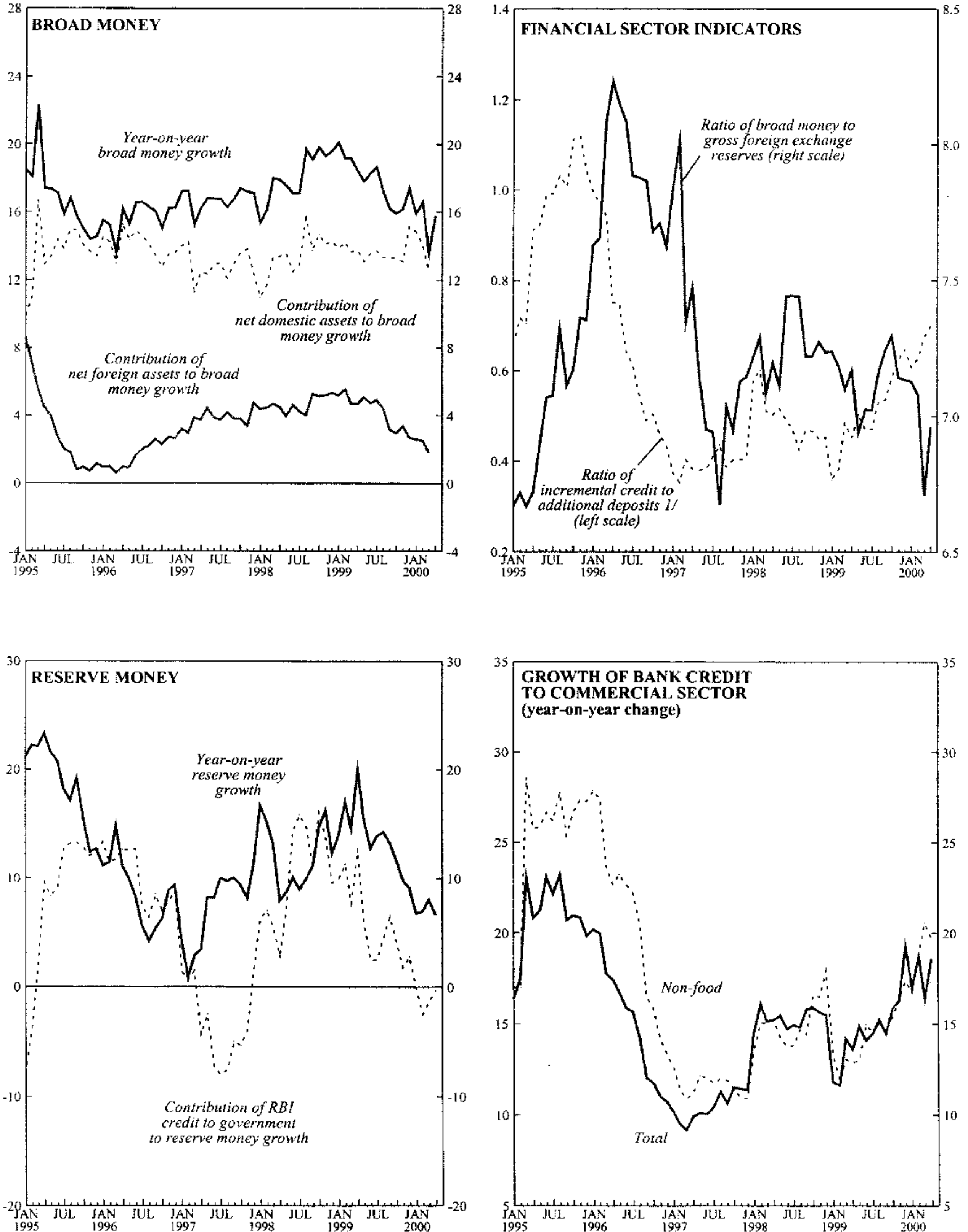


Sources: Data provided by the Indian authorities; Consensus Forecasts, and staff calculations.

CHART IV.4

INDIA

Selected Monetary Indicators, 1995-2000



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

1/ Twelve-month increase in credit to the private sector as a ratio of the twelve-month increase in commercial bank deposits.

V. FINANCIAL SECTOR REFORMS AND PERFORMANCE[1]

1. After showing a gradual improvement in recent years, the **operating performance of commercial banks** deteriorated in 1998/99 (Table V.1). Gross profits declined from 1.8 percent to 1.5 percent of total assets, while net profits (i.e., after accounting for provisions) declined from 0.8 percent to 0.5 percent of assets. The decline in profitability was due to both weaker interest and noninterest income. Interest income fell as lending rates declined and banks moved to provide financing for blue-chip companies through instruments such as commercial paper at interest rates lower than the prime lending rate, while interest expenses rose as banks faced increasing competition for deposits from government-sponsored saving schemes and other saving vehicles.

2. Public, domestic private, and foreign banks all experienced lower profits. The decline in gross profits was particularly marked among the foreign banks which, in addition to a decline in interest margins, also saw their operating expenses rise substantially. Gross profitability of foreign banks, however, remains considerably higher than that of the domestic banks because they enjoy considerably higher net interest income, partly due to their lower level of nonperforming assets. The differential in net profitability is not as great because of the higher provisioning of the foreign banks.

3. The average **capital adequacy ratio** of the public sector banks fell marginally to 11.2 percent in 1998/99, with all but one of the 27 public sector banks meeting the 8 percent minimum capital ratio (Table V.2). Nonperforming loans (NPLs) of the public sector banks, on both a gross and net basis, declined slightly during 1998/99 to 15.9 percent and 8.1 percent of advances respectively, despite the difficult conditions in the industrial sector during the year. The gross NPLs of the domestic private and foreign banks have risen quite sharply over the past two years, although aggressive provisioning by the foreign banks has meant that their net NPLs have remained broadly unchanged. During 1998/99, the government contributed an additional Rs 4 billion to the capital of three public sector banks bringing its recapitalization contribution since 1994 to a cumulative Rs 204 billion (1¼ percent of current GDP) of which Rs 64 billion has subsequently been returned by four of the banks.

4. The RBI has continued to strengthen **the supervisory and regulatory framework for commercial banks**. Recent measures have included:

- An increase in the minimum capital adequacy ratio to 9 percent effective March 31, 2000 (to be raised to 10 percent at some unspecified point in the future).

- A tightening of provisioning norms. Banks are required to make a general provision of 0.25 percent of assets for the year ending March 31, 2000. Further, an asset will be

[1] Prepared by Tim Callen.

treated as doubtful if it has remained in the substandard category for 18 months from March 31, 2001 (previously a 24-month period applied), while banks are required to assign a 100 percent risk weight to state government guaranteed securities issued by defaulting entities (from April 1, 2000).

- Introduction of additional risk weights. A 2.5 percent risk weight was imposed for market risk on government/other approved securities from March 31, 2000, while a 100 percent risk weight for open foreign exchange and gold positions was introduced on March 31, 1999.

- Continued tightening of mark-to-market requirements. In the 1999/00 financial year, 75 percent of a bank's portfolio of government and other approved securities was required to be marked-to-market.

- Greater disclosure. Effective March 31, 2000, banks will be required to disclose the maturity pattern of their loans and advances, investment securities, deposits and borrowings, foreign currency assets and liabilities, movements in NPLs, and lending to sensitive sectors.

5. In the 2000/01 budget, it was announced that the **government's minimum shareholding** in the nationalized banks would be reduced to 33 percent from its current level of 51 percent to enable the banks to raise the capital needed for them to continue to meet the new capital adequacy standards. However, the government stated that such equity sales would be done "without changing the public sector character of the banks."

6. The **Development Finance Institutions** had a difficult year in 1998/99 as their large exposures to hard hit sectors such as steel, cement, and textiles put pressure on their loan portfolios. While the increase in NPLs and decline in capital ratios was generally modest, the Industrial Finance Corporation of India (IFCI) was particularly hard hit and saw a sharp increase in NPLs and a decline in its capital ratio to near the 8 percent minimum. To help shore up the capital of IFCI, the government is reported to have injected Rs 5.6 billion, partly through subscription to a rights issue. The regulatory and supervisory framework applying to the DFIs has also been tightened along similar lines to the measures introduced for the commercial banks.

7. A new regulatory framework for **Nonbank Finance Companies (NBFCs)** was put in place by the RBI in January 1998 and was subsequently amended in December 1998. Under the new framework, all NBFCs are required to register with the RBI and need to meet a minimum net-owned funds requirement to operate. NBFCs that are approved to accept public deposits will be subject to extensive regulation, while those not accepting public deposits will be regulated in a limited manner. Those companies accepting public deposits are required to comply with prudential norms on income recognition, asset classification, accounting standards, provisioning, capital adequacy, and credit/investment concentration norms. Capital adequacy norms were raised to 10 percent (by end-March 1998) and to 12 percent (by end-March 1999). As of November 1999, registration had been granted to 641 NBFCs to accept

public deposits and to 7,322 nondeposit taking companies. The applications of 1,370 NBFCs had been rejected, while the applications of 26,744 companies were pending because they did not meet the minimum net-owned funds requirement.

8. The **stock market** performed very strongly between late 1998 and mid-February 2000, rising by over 100 percent. However, more recently, the market has weakened, declining by 30 percent from its mid-February high. With the strengthening of the secondary market, there has also been some recovery in the primary market. During the first nine months of 1999/00, private placements, which dominate equity issues, rose by 23 percent to Rs 415 billion, although funding raised by prospectus and rights issues declined to Rs 77 billion in 1999/00 from Rs 94 billion in 1998/99. Investments in mutual funds actually fell in 1998/99 due to the withdrawals from the Unit Trust of India (UTI) following the financial problems experienced by the U.S.-64 scheme in 1998.[2] However, inflows into mutual funds strengthened during 1999/00 with the strong performance of the stock market and tax incentives offered in the 1999/00 budget.

9. Recently introduced legislation will allow private sector companies to enter the **insurance industry**, breaking the current public sector monopoly held by the General Insurance Company of India (GIC) and the Life Insurance Company of India (LIC). Under the new legislation, these private companies will be allowed to have up to 26 percent foreign ownership. In January 2000, the RBI issued draft guidelines for banks and financial institutions who wish to enter the insurance sector.

[2] See Chapter VII of the accompanying *Selected Issues* volume.

Box V.1. India: The Verma Report on Restructuring Weak Public Sector Banks

In February 1999 the RBI established a working group under the Chairmanship of M.S.Verma to establish criteria for assessing the strength of banks and to suggest measures for the revival of weak public sector banks. The Working Group submitted its report in October 1999.

To identify weak banks, the Committee suggested the use of seven parameters: the capital adequacy ratio; the coverage ratio (defined as the ratio of equity capital and loan loss provisions less nonperforming loans to total assets); the rate of return on assets; the net interest margin; the ratio of operating profit to average working funds; the ratio of costs to income; and the ratio of staff costs to income. For five of these parameters, the median of all public sector banks was suggested as the threshold, while 8 percent and 0.5 were suggested as the threshold for the capital adequacy and coverage ratios respectively. On this basis the Committee identified three weak banks and a further six that were "showing strong signs of distress and runned a high risk of slipping into the category of weak banks."

For the three weak public sector banks, the working group recommended a revival strategy consisting of: (i) operational restructuring involving basic changes to work practices, the adoption of modern technology, and a significant reduction in the number of staff, primarily through Voluntary Retirement Schemes (VRSs); (ii) cleaning up of the balance sheets by transferring a portion of the nonperforming loans to an Asset Reconstruction Fund (ARF); and (iii) improved governance practices and managerial efficiency. The group recommended the establishment of a Financial Restructuring Authority with statutory backing to oversee the restructuring process of the three weak banks (and of other banks in the future if needed). The group also highlighted the importance of institutional reform, particularly changes in the legal system, to improve debt recovery mechanisms.

The overall cost of restructuring the three weak banks over the next three years was estimated by the working group to be of the order of Rs 5.5 billion, broadly equivalent to the capital injections the three banks have received since 1994. Of this, Rs 3 billion would go toward enhancing the capital of the banks, Rs 1 billion would finance the transfer of NPLs to the ARF, and the remainder would finance the staff rationalization measures and the upgrading of technology.

Table V.1. India: Financial Performance of Indian Commercial Banks, 1994/95-1998/99

(As a percent of total assets)

	Net Interest Income	Interest Income	Interest Expense	Noninterest Income	Total Income	Operating Expenses	Gross Profits	Provisions	Net profits
All commercial banks									
1994/95	3.00	8.63	5.63	1.40	4.40	2.76	1.64	1.22	0.42
1995/96	3.13	9.36	6.23	1.50	4.63	2.94	1.69	1.54	0.15
1996/97	3.22	9.88	6.66	1.45	4.67	2.85	1.82	1.15	0.67
1997/98	2.95	9.27	6.32	1.52	4.47	2.63	1.84	1.02	0.82
1998/99	2.79	9.19	6.40	1.33	4.12	2.65	1.47	0.98	0.49
Average 1994/95-1998/99	3.02	9.27	6.25	1.44	4.46	2.77	1.69	1.18	0.51
Public sector banks									
1994/95	2.92	8.61	5.69	1.32	4.24	2.83	1.41	1.16	0.25
1995/96	3.08	9.20	6.12	1.40	4.48	2.99	1.49	1.56	-0.07
1996/97	3.16	9.69	6.53	1.32	4.48	2.88	1.60	1.03	0.57
1997/98	2.91	9.10	6.19	1.33	4.24	2.66	1.58	0.81	0.77
1998/99	2.81	9.02	6.21	1.21	4.02	2.65	1.37	0.95	0.42
Average 1994/95-1998/99	2.98	9.12	6.15	1.32	4.29	2.80	1.49	1.10	0.39
Old private sector banks									
1994/95	3.03	8.89	5.86	1.46	4.49	2.33	2.16	1.00	1.16
1995/96	3.14	10.15	7.01	1.56	4.70	2.60	2.10	1.04	1.06
1996/97	2.93	10.65	7.72	1.48	4.41	2.52	1.89	0.98	0.91
1997/98	2.57	10.00	7.43	1.71	4.28	2.31	1.97	1.16	0.81
1998/99	2.15	9.93	7.78	1.33	3.48	2.27	1.21	0.73	0.48
Average 1994/95-1998/99	2.76	9.92	7.16	1.51	4.27	2.41	1.87	0.98	0.88
New private sector banks									
1994/95	...	...	...	...	...	...	...	...	...
1995/96	2.84	9.25	6.41	1.82	4.66	1.89	2.77	0.92	1.85
1996/97	2.88	10.14	7.26	2.04	4.92	1.94	2.98	1.24	1.74
1997/98	2.23	9.27	7.04	2.39	4.62	1.76	2.86	1.32	1.54
1998/99	1.98	9.19	7.21	1.54	3.52	1.74	1.78	0.75	1.03
Average 1995/96-1998/99	2.48	9.46	6.98	1.95	4.43	1.83	2.60	1.06	1.54
Foreign banks									
1994/95	4.25	9.88	5.63	2.41	6.66	2.73	3.93	2.27	1.66
1995/96	3.74	10.46	6.72	2.38	6.12	2.77	3.35	1.77	1.58
1996/97	4.13	11.08	6.95	2.49	6.62	3.00	3.62	2.44	1.18
1997/98	3.93	10.42	6.49	2.95	6.88	2.97	3.91	2.94	0.97
1998/99	3.46	10.25	6.79	2.44	5.90	3.37	2.53	1.63	0.90
Average 1994/95-1998/99	3.90	10.42	6.52	2.53	6.44	2.97	3.47	2.21	1.26

Source: Report on Trends and Progress of Banking in India, Reserve Bank of India, 1998/99.

Table V.2. India: Indicators of Financial System Soundness, 1994/95 - 1999/00

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00
Measures of financial strength and performance 1/						
Risk-weighted capital ratio (27 public sector banks)	...	8.7	10.0	11.5	11.2	...
Number of institutions not meeting 8 percent RWCR						
Public sector banks	14	8	2	1	1	...
Domestic private banks	...	6	4	4	4	...
Foreign banks	...	0	0	0	0	...
Net nonperforming loans (percent of outstanding loans) 2/						
Public sector banks	10.7	8.9	9.2	8.2	8.1	...
Domestic private banks	...	4.3	5.4	5.3	6.9	...
Foreign banks	...	1.3	1.9	2.3	2.0	...
Number of institutions with net NPLs above 8 percent of advances						
Public sector banks	...	15	15	13	14	...
Domestic private banks 3/	...	5	7	8	10	...
Foreign banks 3/	...	1	4	11	14	...
Gross nonperforming loans (percent of outstanding loans)						
Public sector banks	19.5	18.0	17.8	16.0	15.9	...
Net profit(+)/loss(-) of commercial banks (percent of total assets)	0.4	0.2	0.7	0.8	0.5	...
Public sector banks	0.3	-0.1	0.6	0.8	0.4	...
Domestic private banks	1.1	1.2	1.1	1.0	0.7	...
Foreign banks	1.7	1.6	1.2	1.0	0.9	...
Balance sheet structure of commercial banks						
Loan/deposit ratio	54.7	58.6	55.1	54.1	51.7	50.7 5/
External deposits (percent of total deposits) 4/	8.5	5.6	4.1	11.5	13.1	12.7 6/
Of which : Foreign currency deposits (percent of total deposits)	...	...	...	5.0	6.4	6.2 6/
Foreign currency loans (percent of total) 7/	6.3	6.2	5.0	4.6	4.3	3.9 5/
Real estate loans (percent of private credit)	0.6	0.5	0.6	0.7	0.5	0.5 8/

Source: Data provided by the Indian authorities.

1/ Loan classification and provisioning standards do not meet international standards.
2/ Gross nonperforming loans less provisions.
3/ Not weighted by asset size.
4/ External deposits comprise foreign currency deposits and non-resident (external) rupee accounts (NRE accounts) which can be freely repatriated abroad. Several classes of deposit were reclassified as external in June 1997.
5/ As of October 1999.
6/ As of August 1999.
7/ Refers only to commercial bank purchase or discount of foreign bills. No other information is available.
8/ June 1999.

VI. External Sector Developments[1]

A. Current Account

1. The **current account** deficit narrowed to 1 percent of GDP in 1998/99, from 1¼ percent of GDP in 1997/98 (Chart VI.1 and Table VI.1). However, this figure masks differing trends between the first and second halves of the year; the deficit deteriorated markedly to 1¾ percent of GDP in the four quarters to September 1998, but then narrowed to near balance in the second half of the year. In the first three quarters of 1999/00, the deficit remained around 1 percent of GDP. The improvement in the current account deficit since mid-1998/99 is attributable to a 1 percentage point narrowing in the trade deficit to 3 percent of GDP.

2. **Exports** declined by 4 percent in dollar terms in 1998/99 after growing by 4½ percent in 1997/98. This weakness largely reflected a drop in export volumes which are estimated to have declined by 2½ percent, following growth of 11½ percent the previous year.[2] The decline was largely due to the effects of the Asian crisis as exports to that region fell by 16¾ percent, more than offsetting strong export growth to the United States (see Box VI.1 for a discussion of the structure of India's exports). Agricultural exports declined by 9 percent and manufactured exports by 2¾ percent. Within the manufacturing sector, however, performance was mixed. Some sectors recorded strong growth (gems and jewelry and clothing grew by 11 and 12½ percent, respectively), while others saw substantial declines (textiles by 14½ percent, engineering goods by 16¼ percent, and chemicals by 8¾ percent).

Box VI.1. India: The Structure of India's Exports

Manufactured goods account for 75 percent of India's exports, with gems and jewelry, clothing, and textiles being the most important, and agricultural products make up most of the remainder. Major export destinations are fairly evenly spread between Western Europe, Asia, and the United States, with each accounting for around one-quarter of the total. However, the goods exported vary by region: exports to Asia are more concentrated on agricultural products, raw materials, and industrial machinery, whereas to the United States and Europe they are more focused on clothing, textiles, and jewelry. In terms of structure and destination, India's export basket most closely resembles those of Pakistan and China, with all three countries heavily dependent on clothing and textiles (Table VI.2).

3. Exports began to recover in late 1998/99, and growth accelerated to 23½ percent (y/y) in the December 1999 quarter (Chart VI.2). Exports to the Asian region have been

[1] Prepared by Tim Callen.

[2] Export volume figures are derived from partner country import price deflators from the IMF's World Economic Outlook (WEO).

particularly strong, increasing by 21¼ percent (y/y) during April 1999–January 2000, in response to the recovery of these economies and the appreciation of their currencies which improved Indian competitiveness, while those to the United States grew by 16 percent (y/y) (Chart VI.3). Manufactured exports grew by 13½ percent, although agricultural exports weakened somewhat further. Many of the sectors that were depressed in 1998/99 have enjoyed strong recoveries with the largest turnarounds occurring in the textiles and engineering sectors, while exports of gems and jewelry have also strengthened further.

4. **Imports** declined by 7 percent in dollar terms and by 4 percent in volume terms in 1998/99. The weakness in international oil prices resulted in a 21½ percent decline in oil imports. In addition, the impact of sanctions on defense related imports, the slowing in activity in the domestic industrial sector, and an easing in the rapid growth of gold imports led to a 4½ percent decline in non-oil imports.

5. Import growth has accelerated during 1999/00, reaching 19¾ percent (y/y) in the December quarter. The rebound in oil prices since early 1999 resulted in a 63¾ percent increase in oil imports, and growth in non-oil imports has recently begun to rebound with the recovery in the industrial sector. In an attempt to reduce gold imports, the government granted permission for the establishment of gold deposit schemes to mobilize domestically held gold in the 1999/00 budget (Box VI.2).

6. The surplus on the **services account** increased to ½ percent of GDP in 1998/99 from ¼ percent of GDP in 1997/98. This was almost entirely attributable to an improvement in the "miscellaneous" category, which includes exports of computer software. However, during the first three quarters of 1999/00 the surplus on the services balance narrowed somewhat, despite anecdotal evidence that software exports continued to grow strongly. The **investment income** deficit remained unchanged at ¾ percent of GDP in 1998/99 as interest earnings and payments both increased and dividend payments overseas remained unchanged. **Net transfers** declined to 2½ percent of GDP in 1998/99, from 3 percent of GDP in 1997/98, although this was largely linked to the liberalization of gold imports.[3]

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[3] Prior to their liberalization in October 1997, gold imports took place either through the "baggage route" (where nonresident or returning Indians were allowed to bring up to 10 kilograms of gold into the country) or through special import licenses. Imports through the baggage route were recorded in the balance of payments statistics both as a noncustoms import and as a private transfer (so they had no overall impact on the balance of payments as the foreign exchange used to purchase the gold was earned outside India). Since the liberalization, imports have increasing taken place through the normal customs route, resulting in an increase in customs imports, and a decline in noncustoms imports and private transfers.

Box VI.2. India: The Gold Deposit Scheme

India is the world's largest consumer of gold, but prior to 1991 the import of gold was restricted under the 1963 Gold Control Order. This resulted in excess domestic demand for gold and a widening spread between domestic and international gold prices.

Restrictions on the import of gold were gradually eased during the 1990s. Returning or nonresident Indians are now permitted to import up to 10 kilograms of gold, while imports are also permitted under the Special Import License Scheme. Since October 1997, thirteen authorized agencies and three state-owned agencies have been permitted to import gold for sale to specified categories of jewelers and domestic consumers. These measures have resulted in a narrowing of the spread between domestic and international prices and a substantial increase in gold imports. The present stock of gold in India is estimated at around 13,000 tons.

In view of the sharp rise in official gold imports in recent years, the government proposed a Gold Deposit Scheme in the 1999/00 budget to mobilize idle gold and to try and reduce imports. The RBI published broad guidelines for the implementation of the scheme in October 1999 and the State Bank of India (SBI) launched the first scheme in December. Under the SBI scheme, a deposit of a minimum of 200 grams of gold jewelry or bullion can be made with the bank. The bank issues a interim deposit certificate, has the gold assayed, and then issues a final deposit certificate ranging from three to seven years maturity and bearing an interest rate of 3 to 4 percent. There is a provision for early redemption after an initial one year lock-in period. The interest paid on the deposit is tax free and the deposit is not subject to capital gains or wealth tax. Gold deposits may be used as collateral for rupee loans, while banks may deploy the gold as gold loans to the domestic jewelry industry or jewelry exporters, or may sell the gold domestically. Banks offering the scheme are able to hedge their exposure through international commodity exchanges.

B. Capital Account

7. The **capital account** in 1998/99 was significantly affected by the turmoil in world financial markets and the imposition of sanctions on India following its testing of nuclear weapons in May 1998. The decline in reserves that followed the drying up of capital inflows and the concurrent widening of the current account deficit led to the authorities' decision to issue Resurgent India Bonds (RIBs) in August 1998 (Box VI.3). These bonds raised $4.2 billion and accounted for about one-half of the net capital inflows during the year.

8. **Net foreign direct investment (FDI)** declined to only $2.4 billion in 1998/99 from $3.5 billion in 1997/98. FDI inflows to India, which have averaged less than ¾ of a percent of GDP over the past five years, are low by the standards of many other countries in the Asian region. Investment was concentrated in the engineering, chemicals, services, and electronics sectors. FDI inflows remained weak in the first eleven months of 1999/00, totaling only $1.9 billion. According to A.T. Kearney's January 2000 FDI Confidence Index, India's absolute attractiveness as an FDI destination increased compared to the previous survey in June 1999, but it still slipped to eleventh on the list of preferred destinations from sixth previously, as the attractiveness of other markets improved more rapidly. The survey

found that while companies are attracted by India's market potential, poor infrastructure and lack of transparency were viewed as obstacles to investment.[4]

Box VI.3. India: The Resurgent India Bond Issue

The Resurgent India Bonds (RIBs) were launched by the State Bank of India (SBI) in August 1998 to raise financing from nonresident Indians. The bonds, which are of a five-year maturity and are denominated in U.S. dollars, pound sterling, and deutsche marks, raised $4.2 billion. The dollar-denominated bonds, which accounted for over 90 percent of the total funds raised, carry an interest rate of 7.75 percent, the sterling bonds 8 percent, and the deutsche mark bonds 6.25 percent.

Deposits were collected both by the SBI and also by a number of other collecting banks with branches abroad on behalf of SBI. As part of the agreement, these banks were entitled to receive 50 percent of their collections in the form of fixed-rate rupee deposits from the SBI at 9.5 percent for five years. Most of the dollar funds raised were sold by the SBI to the RBI, resulting in a substantial increase in official reserves.

The RBI maintains a "maintenance of value" account to finance any exchange rate losses incurred on the bonds before they mature. This account is funded by the government and the SBI (the SBI's exchange losses are limited to exchange rate depreciation of 1 percent per annum with the government absorbing any remainder).

9. A small net outflow of **portfolio investment** occurred during 1998/99 (Chart VI.4). With the onset of the Asian crisis, foreign institutional investors (FIIs) withdrew funds from Indian markets between August 1997 and August 1998, while Indian companies lost access to overseas equity and debt markets. As sentiment to emerging markets improved during the course of 1999 and the outlook for the domestic economy strengthened, FII inflows resumed, averaging $130 million a month during the first ten months of 1999/00, and then accelerating markedly in February to nearly $500 million.[5] Portfolio inflows were also bolstered in 1999/00 by a number of ADR issues from Indian companies (Box VI.4).

10. **External commercial borrowing**, excluding the RIB issue, fell sharply in 1998/99 reflecting the deceleration in industrial growth, the widening spreads on Indian (and developing countries in general) debt in international markets, and the high forward premia on the rupee. The new borrowing that did take place was largely concentrated in the power sector. Despite the turmoil in international financial markets, **nonresident Indian (NRI)**

[4] See A.T. Kearney, *FDI Confidence Index*, January 2000, Vol.3., Issue 1. The index is based on a survey of the world's 1,000 largest companies.

[5] RBI data on FII inflows is only available until February. SEBI data, which is available on a daily basis, shows continued strong inflows until mid-May, but then some outflows in recent weeks.

deposit inflows increased to $1.7 billion in 1998/99, from $1.1 billion in 1997/98. Deposits under the foreign currency nonresident (FCNR(B)) scheme actually declined slightly, perhaps due to the diversion of potential inflows into the RIB issue, but inflows into rupee-denominated accounts increased strongly. The importance of external assistance as a financing source for India continued to decline in 1998/99, while the net outflow of **short-term debt** reflected the decline in import demand and the difficult conditions in international financial markets. Inflows of external commercial borrowing and short-term debt remained negligible in the first three quarters of 1999/00, but NRI deposits continued to increase.

11. India's **external debt** indicators remain favorable (Table VI.3). Total external debt stood at $99 billion (22¼ percent of GDP) in December 1999, while short-term debt (on a contracted-maturity basis) was only $4.7 billion (1 percent of GDP). The ratio of **short-term debt-to-official reserves** declined to 13¼ percent in December 1999, and the debt-service ratio declined to 18 percent in 1998/99, from 19 percent in 1997/98. At end-1999, a little over 50 percent of India's external debt was denominated in U.S. dollars, while concessional debt accounted for around 39 percent of the outstanding stock. The Indian government has provided **guarantees** on borrowings by public sector enterprises, development finance institutions, and in some instances to private companies. Such contingent liabilities amounted to $7.5 billion in December 1999, down from a peak of $12.3 billion in March 1995.[6]

C. Exchange Rate and International Reserves

12. The Asian crisis and its aftermath put the **exchange rate** under downward pressure on a number of occasions. This initially occurred in August 1997, and intensified in November 1997, causing the RBI to intervene in both the spot and forward markets and to tighten monetary policy. The pressure on the rupee resumed in the aftermath of the sanctions imposed on India in May 1998, and intensified in August 1998 at the height of market tensions following the Russian default. In the latter instance the RBI again tightened monetary policy and also introduced a number of administrative measures, including the withdrawal of the facility to rebook cancelled forward contracts for imports. Uncertainty regarding the outcome of the September/October 1999 general elections again put downward pressure on the exchange rate in August 1999. In this case the RBI responded by announcing it would meet oil import and government debt payments directly from reserves and that it stood ready to intervene, either by itself or through the SBI, as needed.

13. The **rupee** depreciated by 7 percent against the U.S. dollar and in nominal effective terms in 1998/99 (Chart VI.5). The depreciation of the real effective exchange rate was more modest at 3½ percent given the higher inflation rate in India than in its trading partners during the year. However, the depreciation of the real rate was sufficient to offset the

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[6] See *India's External Debt: A Status Report*, Government of India, June 2000.

Box VI.4. India: Depositary Receipts[1]

Since 1992, Indian companies have been allowed to issue Depositary Receipts (DRs), financial instruments that represent negotiable certificates (in registered form) of an ownership interest in an Indian private issuer's securities. DRs are issued by a foreign market-based commercial bank or trust company (the depositary), and the underlying securities are usually deposited in India with a financial institution known as the custodian. Indian DRs have been issued in various international markets, primarily in the form of Global Depositary Receipts (GDRs) in London or Luxembourg, but also in the form of American Depositary Receipts (ADRs) in the United States. Because ADRs are governed by most of the same regulatory and reporting requirements applicable to U.S.-based companies, and trade and settle on U.S. markets, they are attractive vehicles for U.S. financial agents to diversify their portfolios.

- **Size and performance of the Indian DR market.** India has been one of the most prolific DR issuers in the world. Between April 1992 and February 2000, around 65 Indian companies raised a total of $7.4 billion through DRs. This compares with $9.5 billion in foreign investment that was raised over the same period through the Foreign Institutional Investors channel (i.e., portfolio investments by authorized investment and mutual funds). Although Indian DRs have been available in the United States since 1992, when Reliance Industries made a private placement of ADRs, the first public listings of Indian ADRs occurred in 1999, when two information technology companies, Infosys and Satyam Infoway, were listed on the NASDAQ, and ICICI, a financial conglomerate, was listed on the NYSE. In late March, ICICI Bank, a subsidiary of ICICI, also listed on the NYSE.

- **Rules governing DRs.** Until recently Indian companies faced strict constraints governing which companies could issue DRs, as well as where proceeds from any such issues could be kept, to which uses they could be put, and to what extent they could be converted into rupees. During 1998/99, all end-use restrictions on DR issue proceeds were removed, except the prevailing restrictions on investment in stock markets or real estate. Recently, it was decided that Indian companies would be able to access DR markets through an automatic route without prior approval of the Ministry of Finance, subject to specified norms and post-issue reporting requirement. However, DRs issues are still limited by the same sectoral restrictions that apply to FDI.

- **Do DRs have implications for systemic vulnerability?** Proceeds from DR issues are registered in the Indian balance of payments as portfolio inflows. Once issued, the physical DRs remain abroad (as there is only a one-way fungibility of shares), so sales of DRs, as transactions between nonresidents, do not enter the balance of payments. To this extent, DRs help insulate India from adverse shifts in market sentiment (naturally, a turn in market sentiment could affect future DR issues, and hence the level of portfolio inflows). Dividends to DR holders are the same as those paid on domestically held shares, so that Indian firms do not bear an exchange rate risk.

- **Spillovers of DRs on domestic capital market and accounting standards development.** One concern raised by the availability of the DR channel for raising finance is that it may stymie the development of local capital markets, as stronger firms (for example, those with internationally accepted accounting principles) choose to tap foreign markets rather than raise capital domestically. However, the availability of DRs as a financing vehicle can also encourage the adoption of international accounting standards in local markets, which can help to improve accountability and transparency in the corporate sector of emerging markets, and thereby increase the access of emerging markets to finance from industrial countries.

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[1] This box was prepared by Andrea Richter.

appreciation that has taken place in 1997/98. During 1999/00, the rupee depreciated by a further 2¾ percent against the U.S. dollar, but in nominal and real effective terms it has been broadly unchanged.

14. Uncertainty about the investment intentions of foreign investors following the recent decline in the stock market (which is down by 30 percent from its high in mid-February) has contributed to some weakness in the rupee in recent weeks. Although the decline has been small (about 2 percent), it has drawn considerable attention from financial market participants and the press given the period of stability that preceded it. In response to these developments, the RBI issued a statement on May 25, 2000 in which it emphasized that it is not targeting any particular level of the rupee and that it is inappropriate to focus only on the U.S. dollar rate (the rupee has been stronger against other currencies). Nonetheless, as a temporary measure, it imposed an interest rate surcharge of 50 percent on the lending rate for import finance, and a penal (25 percent) rate for overdue export bills. It also stated that, if necessary, it would meet government debt-service and oil import payments directly from reserves and that it stood ready to intervene in the market as needed.

15. The **overall balance of payments position** improved during 1998/99 and **foreign exchange reserves** increased to $32½ billion (6 months of imports of goods and services) in March 1999, compared to $29¼ billion in March 1998 (Table VI.4). Reserves continued to rise in 1999/00, reaching $38 billion (6½ months of imports of goods and services) in March 2000. The RBI has unwound a substantial proportion of the forward position it built up in defense of the rupee in late 1997/early 1998—net forward liabilities peaked at $3.2 billion in January 1998—and net forward liabilities of the RBI stood at $675 million in March 2000.

D. External Sector Reforms

16. **Trade reform** has continued over the past two years. In the April 1999 EXIM policy statement, 894 items were moved from the restricted list to the list of freely importable items and 414 additional items were moved from the restricted list to the special import license (SIL) list. Following these changes, 700 items remained on the restricted list, 685 items are on the SIL list, and 44 on the canalized list. All of these items, except 36 on the canalized list, have been freely importable from SAARC countries since August 1998.

17. In November 1997, the Dispute Settlement Body (DSB) of the World Trade Organization (WTO) established a panel to review India's application of quantitative restrictions on imports of agricultural, textile and industrial products following a complaint by the United States. The panel found in favor of the United States and the ruling was subsequently upheld by the Appelate Body following an appeal by the Indian authorities. Bilateral negotiations to implement the ruling of the DSB followed, and in December 1999 it was agreed that India would eliminate all remaining QRs by April 1, 2001, with one-half to these eliminated on April 1, 2000 (see Chapter VII for more details on trade policy).

18. The authorities have continued to make progress toward **capital account convertibility**. Measures have been taken to liberalize restrictions on FDI and portfolio investment, to broaden the access of Indian companies to foreign equity markets, and to ease restrictions on external commercial borrowing (Box VI.5).

Box VI.5. India: Capital Account Liberalization

- In February 2000, the government announced that FDI investment under Rs 6 billion would be available through the RBI automatic route except for thirteen sectors that have been placed on a negative list, areas reserved for the small scale sector where foreign investment already exceeds 24 percent, and seven sectors where sectoral investment caps apply. To invest in these sectors, or above the investment caps, permission is required from the Foreign Investment Promotion Board.

- In January 2000, the government permitted Indian companies to issue American Depository Receipts (ADRs) and Global Depository Receipts (GDRs) without prior approval and also to privately place ADRs and GDRs with overseas investors.

- The 24 percent of equity ceiling for FII investment can be raised to 40 percent (previously 30 percent) by the Indian company's board (February 2000).

- External commercial borrowing (ECB) guidelines were relaxed in August 1998. The average minimum maturity of ECBs was reduced to 5 years for loans above $20 million (three years for loans smaller than $20 million) and ECB was allowed to be used for project-related rupee expenditure (except for investment in the stock market or real estate). The average maturity requirement outside the ECB cap was reduced from 10 and 20 years to 8 and 16 years, respectively, for loans, up to $100 million and $200 million, respectively. Exporters are now permitted to raise three times their average export earnings up to a maximum of $200 million, double the previous level. New norms also allow prepayment of outstanding loans with a residual maturity of up to one year. The government delegated power to the RBI to sanction ECBs up to $10 million (January 1999), and simplified other clearance procedures (February 2000).

- In October 1999, the minimum maturity on FCNR(B) deposits was raised from six months to one year.

- Authorized dealers (ADs) were allowed to offer forward cover facilities to FIIs to cover a specified portion of the market value of their equity investments in India. Indian entities with an underlying commodity price exposure were permitted to use futures/options contracts on international commodity exchanges to hedge their exposure (not available for oil and petroleum products).

Table VI.1. India: Balance of Payments 1995/96-1999/00 1/

(In billions of U.S. dollars)

	1995/96	1996/97	1997/98	1998/99	Q3 1998/99	Q4 1998/99	Q1 1999/00	Q2 1999/00	Q3 1999/00
Current account balance	-5.9	-4.6	-5.5	-4.0	-1.2	0.3	-2.0	-1.5	-0.6
Trade balance	-11.4	-14.8	-15.5	-13.2	-3.4	-1.7	-4.2	-3.4	-3.8
Exports, f.o.b.	32.3	34.1	35.7	34.3	8.2	9.5	8.1	9.7	10.2
Imports, c.i.f.	43.7	48.9	51.2	47.5	11.7	11.2	12.3	13.0	14.0
Oil	7.5	10.0	8.2	6.4	1.5	1.5	2.0	2.4	2.5
Non-oil	36.1	38.9	43.0	41.1	10.2	9.8	10.3	10.6	11.5
Customs	29.1	29.1	33.3	35.4	8.8	8.6	8.7	9.6	9.2
Noncustoms	7.0	9.8	9.8	5.7	1.4	1.2	1.6	1.0	2.3
Nonfactor services balance	-0.2	0.7	1.3	2.2	0.8	0.3	0.2	-0.1	0.7
Receipts	7.4	7.5	9.4	13.2	3.0	3.9	3.1	3.2	3.7
Payments	7.5	6.7	8.1	11.0	2.3	3.6	2.9	3.3	3.1
Net investment income	-3.2	-3.3	-3.5	-3.5	-1.0	-1.1	-0.8	-1.0	-0.8
Credits	1.4	1.1	1.6	1.9	0.5	0.5	0.5	0.5	0.5
Debits	4.6	4.4	5.1	5.5	1.5	1.6	1.3	1.5	1.3
Transfers, net	8.9	12.8	12.2	10.6	2.5	2.7	2.8	3.1	3.3
Capital account balance	4.7	11.4	10.0	8.3	2.0	3.0	3.5	0.9	2.7
Direct investment, net	2.0	2.7	3.5	2.4	0.3	0.6	0.4	0.6	0.4
Portfolio investment, net	2.7	3.3	1.8	-0.1	-0.1	0.6	0.9	0.5	0.3
Of which: FIIs and others	2.1	1.9	1.2	-0.3	-0.1	0.4	0.9	0.1	0.3
GDR/ADR issues	0.7	1.4	0.6	0.3	0.0	0.3	0.0	0.3	0.0
External assistance, net	0.9	1.1	0.9	0.8	0.3	0.6	0.0	0.1	0.4
Commercial borrowing, net	1.3	2.9	4.0	4.4	-0.1	0.2	0.0	0.1	-0.2
Short-term credit, net	0.0	0.8	-0.1	-0.7	0.0	0.2	0.2	0.1	0.0
NRI deposits, net	1.1	3.4	1.1	1.7	0.8	0.9	0.6	0.3	0.6
Rupee debt	-1.0	-0.7	-0.8	-0.8	-0.1	-0.2	-0.5	0.0	0.0
Other capital (including errors and omissions)	-2.4	-2.0	-0.5	0.6	0.9	0.0	1.9	-0.7	1.3
Overall balance	-1.2	6.8	4.5	4.2	0.8	3.3	1.5	-0.5	2.1
IMF, net	-1.7	-1.0	-0.6	-0.4	-0.1	-0.1	-0.1	-0.1	-0.1
Increase in gross reserves (-)	2.9	-5.8	-3.9	-3.8	-0.7	-3.2	-1.4	0.6	-2.0
Memorandum items:									
Foreign exchange reserves	21.7	26.4	29.4	32.5	30.1	32.5	33.2	33.0	34.9
In months of imports of goods and services	4.7	5.3	6.0	6.0	5.7	6.0	6.0	5.8	6.0
Export value (in US$ terms; percent change)	20.3	5.6	4.5	-3.9	-5.3	2.4	4.9	10.4	23.5
Import value (in US$ terms; percent change)	21.6	12.1	4.6	-7.1	-12.3	-16.3	-1.9	7.5	19.8
Exports (in volume terms; percent change)	12.5	9.8	11.6	-2.4	...	...	...	...	...
Imports (in volume terms; percent change)	13.3	14.3	12.4	-4.0	...	...	...	...	...
Current account (percent of GDP) 2/	-1.7	-1.2	-1.3	-1.0	-1.7	-1.0	-0.9	-1.0	-0.9
External debt (percent of GDP)	26.5	24.4	22.9	23.3	...	...	...	...	...
Short-term external debt (percent of GDP) 3/	1.4	1.8	1.2	1.0	...	...	...	...	...
Debt-service ratio (percent)	24.3	21.2	19.1	18.0	...	...	...	...	...

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

1/ Indian authorities' presentation. Fiscal year runs from April 1 - March 31.

2/ For quarterly data, figures shown are the cumulative sum of the last four quarters as a percent of GDP.

3/ Contracted maturity basis.

Table VI.2. India: Principal Exports of Selected Asian Economies, 1997

(Percent of total exports)

	India	Pakistan	China	Thailand	Indonesia	Malaysia	Philippines
Agriculture	17.1	10.8	7.0	18.5	11.4	8.6	8.3
Gems and jewelry	14.6	...	...	...	...	...	...
Textiles	14.0	52.0	7.6	3.5	4.2	1.6	1.1
Clothing	13.7	23.2	17.3	6.4	5.6	3.0	4.9
Chemicals	10.1	0.6	5.6	4.3	3.6	3.5	1.5
Machinery	7.9	0.4	22.0	36.5	7.0	52.2	30.0
Iron and steel	3.6	0.0	2.7	0.9	0.6	0.8	0.2
Other	19.0	13.0	37.8	29.9	67.6	30.3	54.0
Memorandum items:							
Correlation between export shares 1/	1.00	0.69	0.63	0.36	0.21	0.09	0.15
Correlation between export destinations 2/	1.00	0.99	0.61	0.89	0.75	0.79	0.70

Sources: United Nations Statistical Office, Trade Analysis and Reporting System (TARS) database; data provided by the Indian authorities; IMF, Recent Economic Developments (various issues); and staff estimates.

1/ Correlation between commodity shares of total exports of India and the respective country, based on two-digit SITC classification. Coefficients close to zero indicate the two countries do not compete in the same commodities.

2/ Correlation between the destination of total exports of India and the respective country.

Table VI.3. India: External Debt, 1994/95-1999/00

(In billions of U.S. dollars; end-of-period)

	1994/95	1995/96	1996/97	1997/98	1998/99	Dec. 1999/00
Medium and long term	85.1	80.5	79.2	82.6	88.6	89.8
Multilateral	28.5	28.6	29.2	29.6	30.5	31.1
Government borrowing	26.1	26.1	26.4	26.3	27.0	27.3
Concessional	17.8	17.6	17.6	17.8	18.6	19.0
Of which: IDA	17.4	17.3	17.3	17.5	18.3	18.3
Nonconcessional	8.4	8.5	8.7	8.5	8.4	8.3
Of which: IBRD	7.1	6.9	6.8	6.4	6.1	6.1
Nongovernment borrowing	2.4	2.6	2.8	3.2	3.6	3.8
Bilateral	20.3	19.2	17.5	17.0	17.5	18.6
Government borrowing	16.8	15.5	13.7	13.0	13.4	14.4
Concessional	16.8	15.2	13.4	12.8	13.3	14.0
Nongovernment borrowing	3.4	3.7	3.8	4.0	4.0	4.2
Export credit	6.6	5.4	5.9	6.5	6.9	6.8
Commercial borrowing	13.0	13.9	14.3	17.0	21.0	19.9
Of which: Commercial bank loans	5.8	6.7	8.4	10.0	10.4	10.4
Nonresident Indian (NRI) deposits 1/	12.4	11.0	11.0	11.9	12.3	13.4
IMF	4.3	2.4	1.3	0.7	0.3	0.1
Short term	4.3	5.0	6.7	5.0	4.4	4.7
Of which: NRI deposits 2/	2.3	2.9	3.8	2.2	2.2	2.2
Total convertible currency debt	89.4	85.5	86.0	87.7	92.9	94.5
(In percent of GDP)	(27.8)	(24.2)	(22.4)	(21.5)	(22.2)	(21.2)
Nonconvertible currency debt	9.6	8.2	7.5	5.9	4.7	4.5
Total external debt	99.0	93.7	93.5	93.5	97.7	99.0
(In percent of GDP)	(30.8)	(26.5)	(24.4)	(22.9)	(23.3)	(22.3)

Source: Government of India.

1/ Deposits above one year's maturity. Excludes nonrepatriable, nonresident rupee deposits.
2/ Deposits of up to one year's maturity.

Table VI.4. India: Official Reserves, 1994/95-1999/00

(In millions of U.S. dollars; end-of-period)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00
Gold 1/	699	654	620	596	546	542
SDR holdings	7	82	2	1	8	4
Reserve position in IMF	331	311	295	285	663	658
Foreign exchange	20,809	17,044	22,367	25,975	29,522	35,058
Gross reserves	21,846	18,091	23,285	26,856	30,739	36,262
Use of Fund credit	4,300	2,374	1,313	664	288	26
Memorandum items:						
Gross reserves (gold valued at market prices) 2/	25,186	21,687	26,423	29,367	32,490	38,036
Outstanding net forward sales (-) / purchases (+)	...	-2,216	-345	-1,792	-802	-675
Net reserves 3/	20,886	17,097	24,765	26,911	31,400	37,335

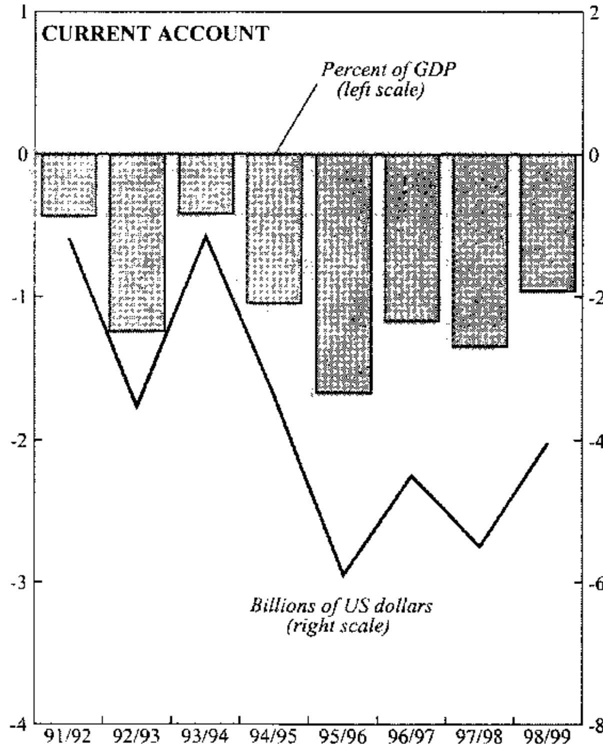
Sources: IMF, International Financial Statistics; and data provided by the Indian authorities.

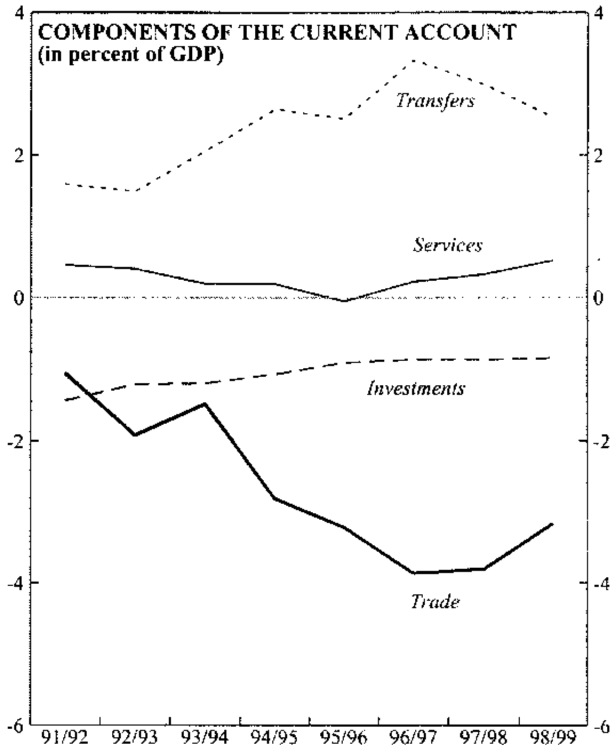
1/ Gold valued at SDR 35 per troy ounce.
2/ Excluding Reserve position in the Fund.
3/ Defined as gross reserves (with gold valued at market prices) minus use of Fund credit and outstanding forward liabilities.

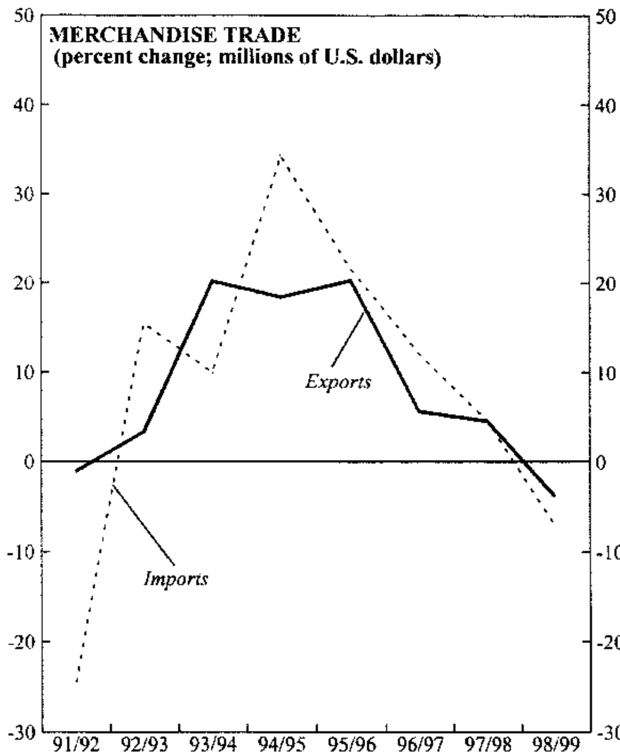
CHART VI.1

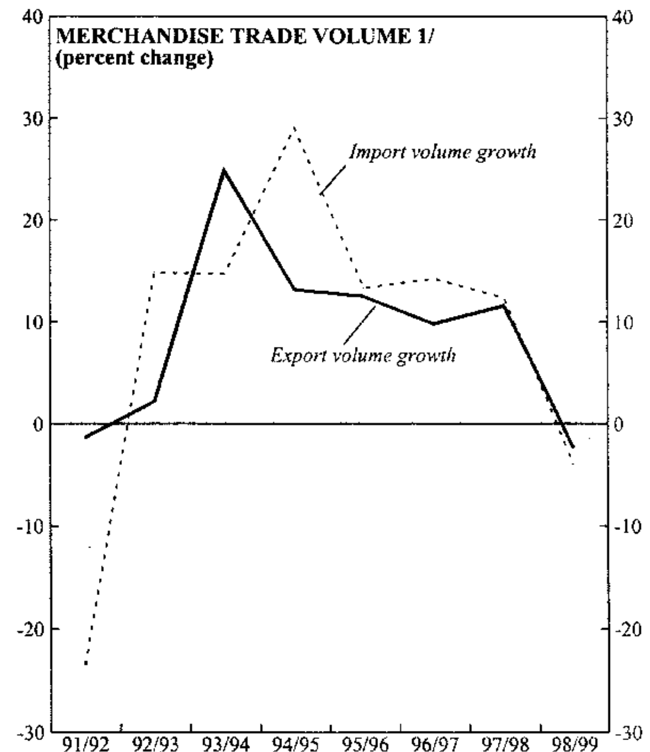
INDIA

Current Account Developments, 1991/92 - 1998/99









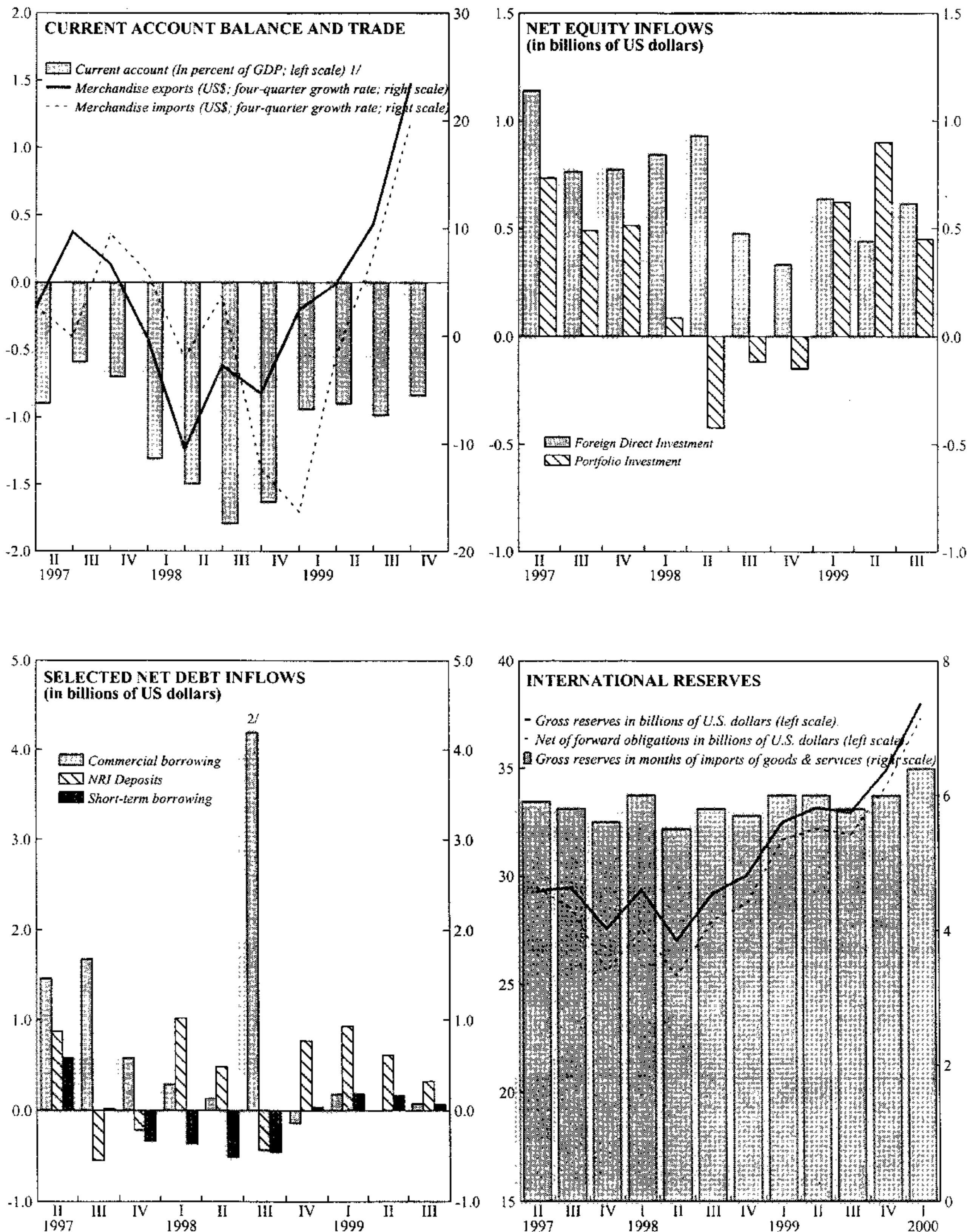
Source: Data provided by the Indian authorities; and staff estimates.

1/ Volume estimates are derived from partner country trade price deflators from the WEO database.

CHART VI.2

INDIA

Quarterly External Sector Developments, 1997-2000



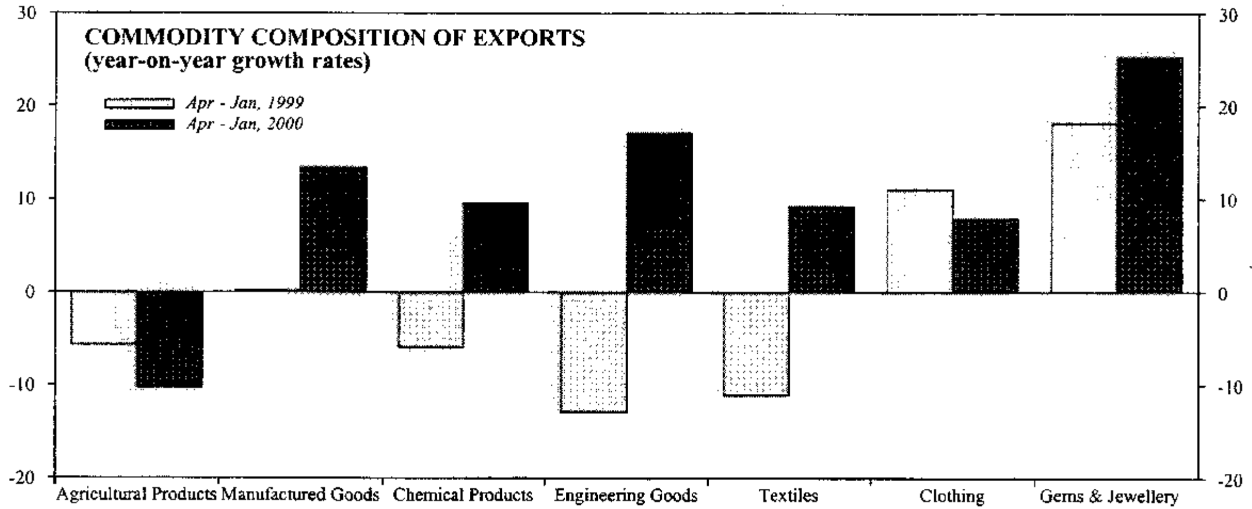
Source: Reserve Bank of India.

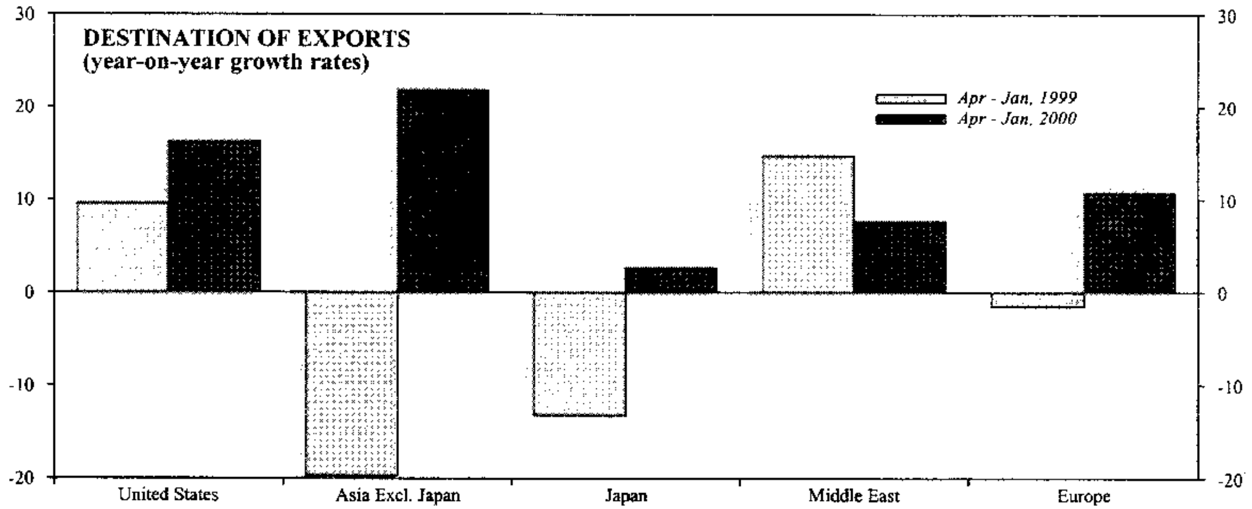
1/ Shown as the sum of the preceding four quarters.
2/ Reflects proceeds from the Resurgent India Bond issue.

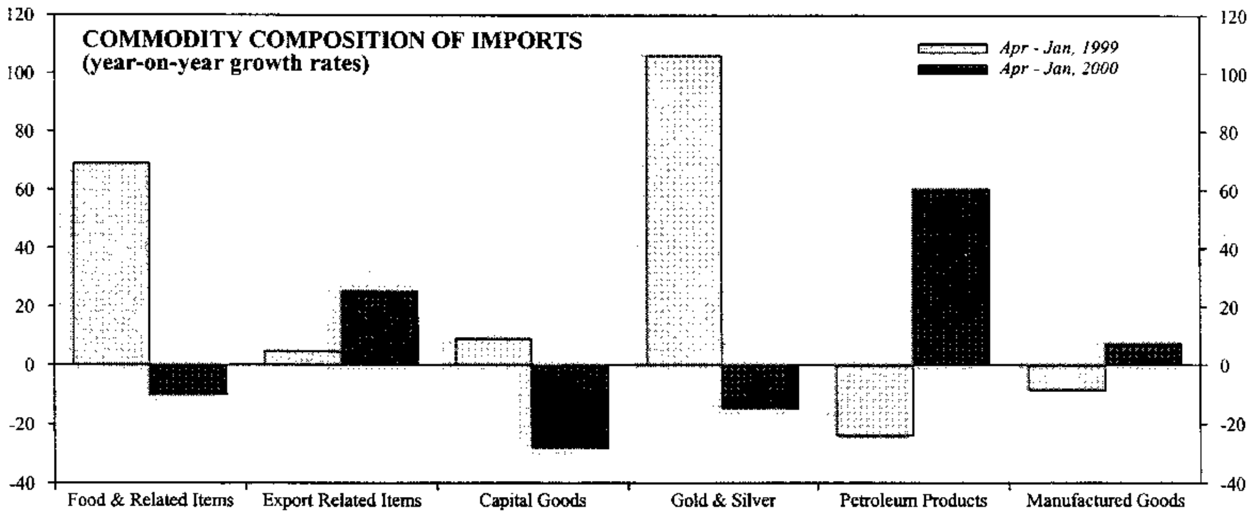
CHART VI.3

INDIA

Merchandise Exports and Imports, 1998/99 - 1999/00





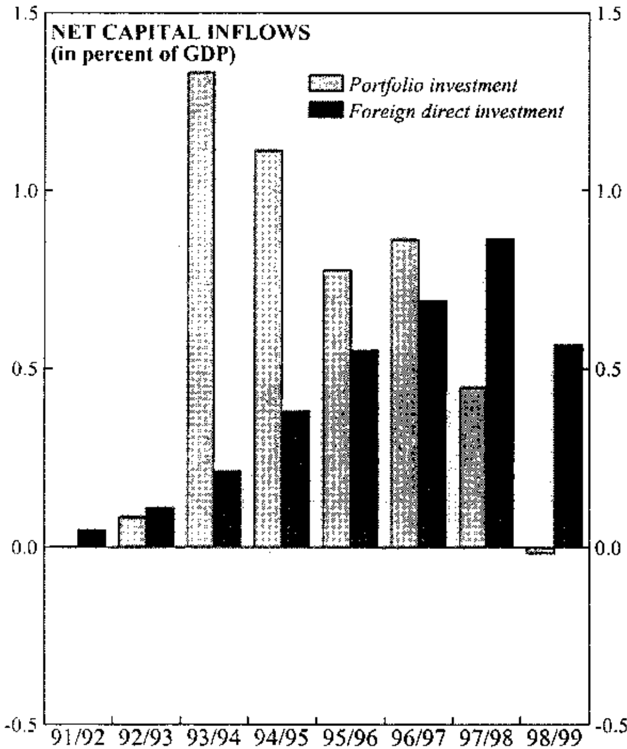


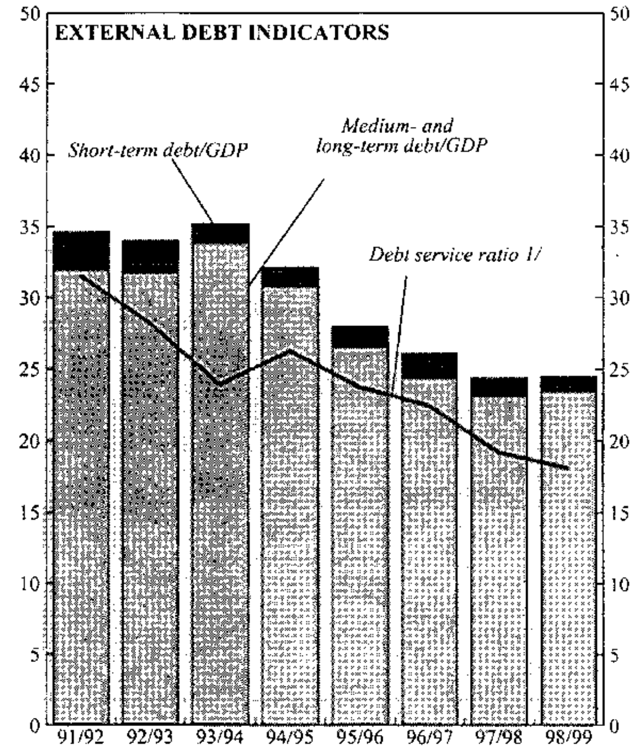
Source: Centre for Monitoring the Indian Economy.

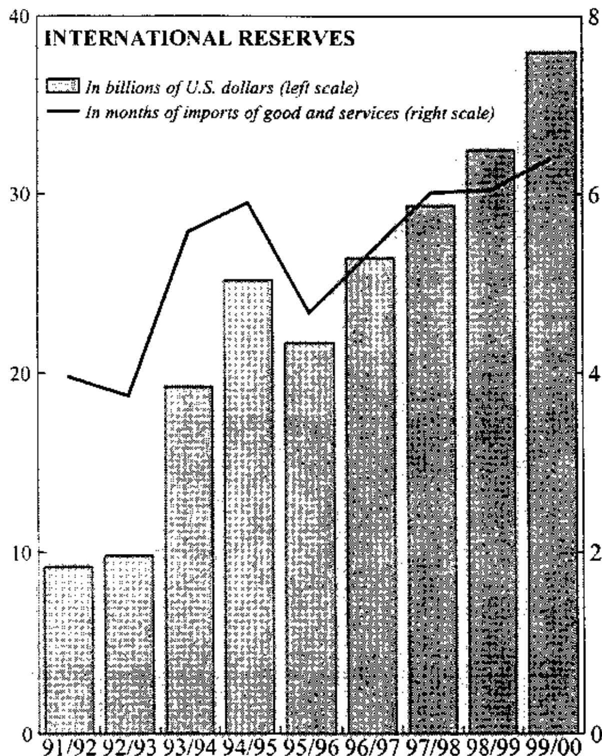
CHART VI.4

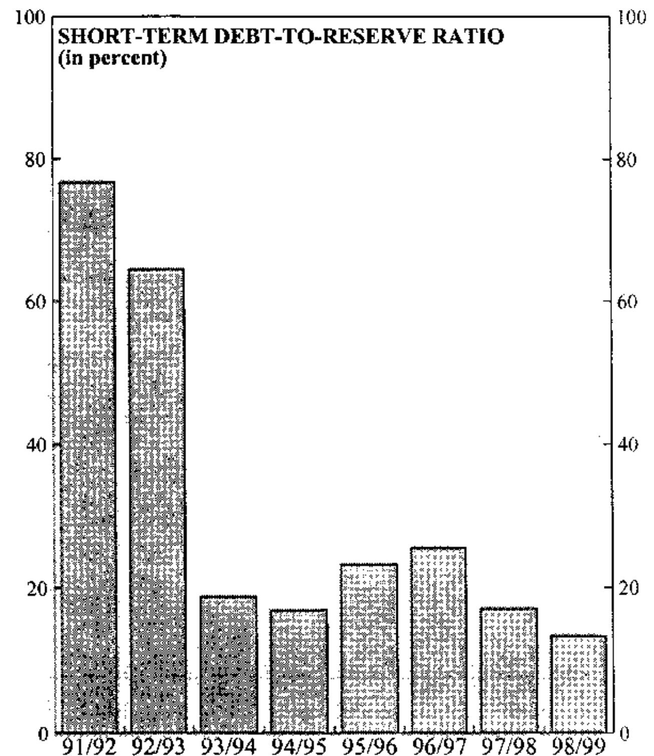
INDIA

Selected External Indicators, 1991/92-1999/00









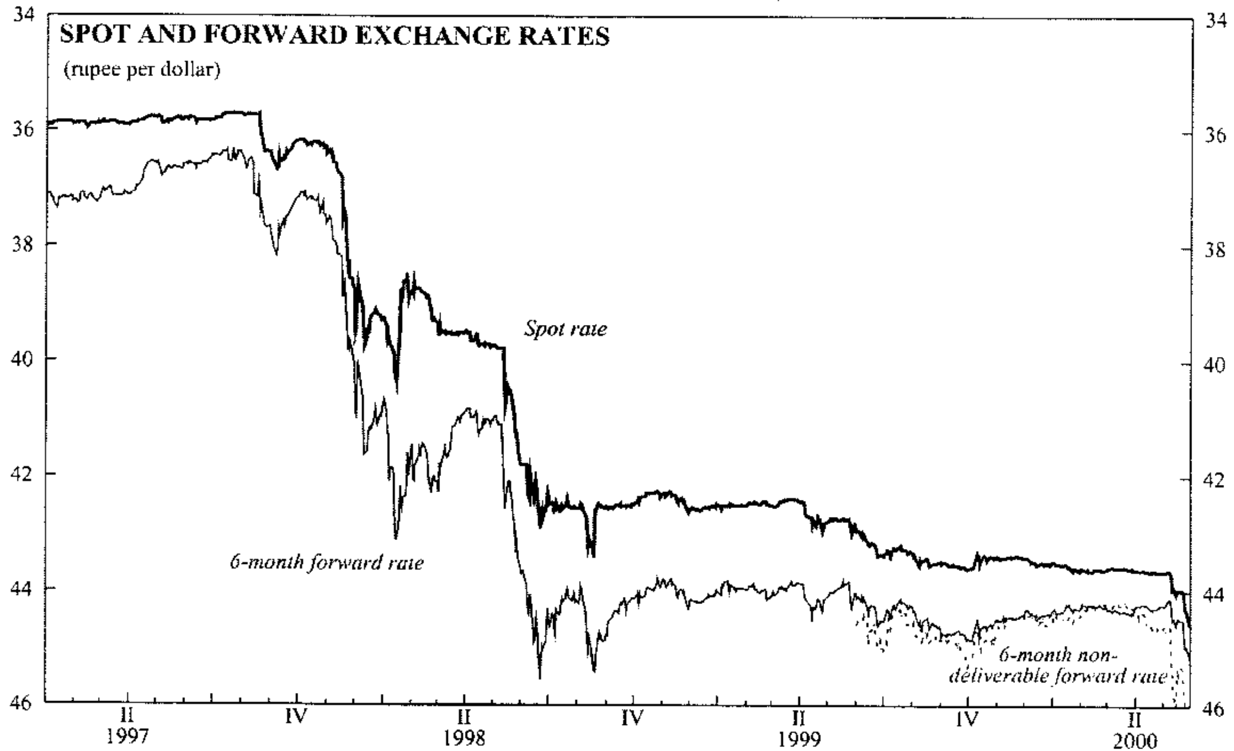
Source: Reserve Bank of India

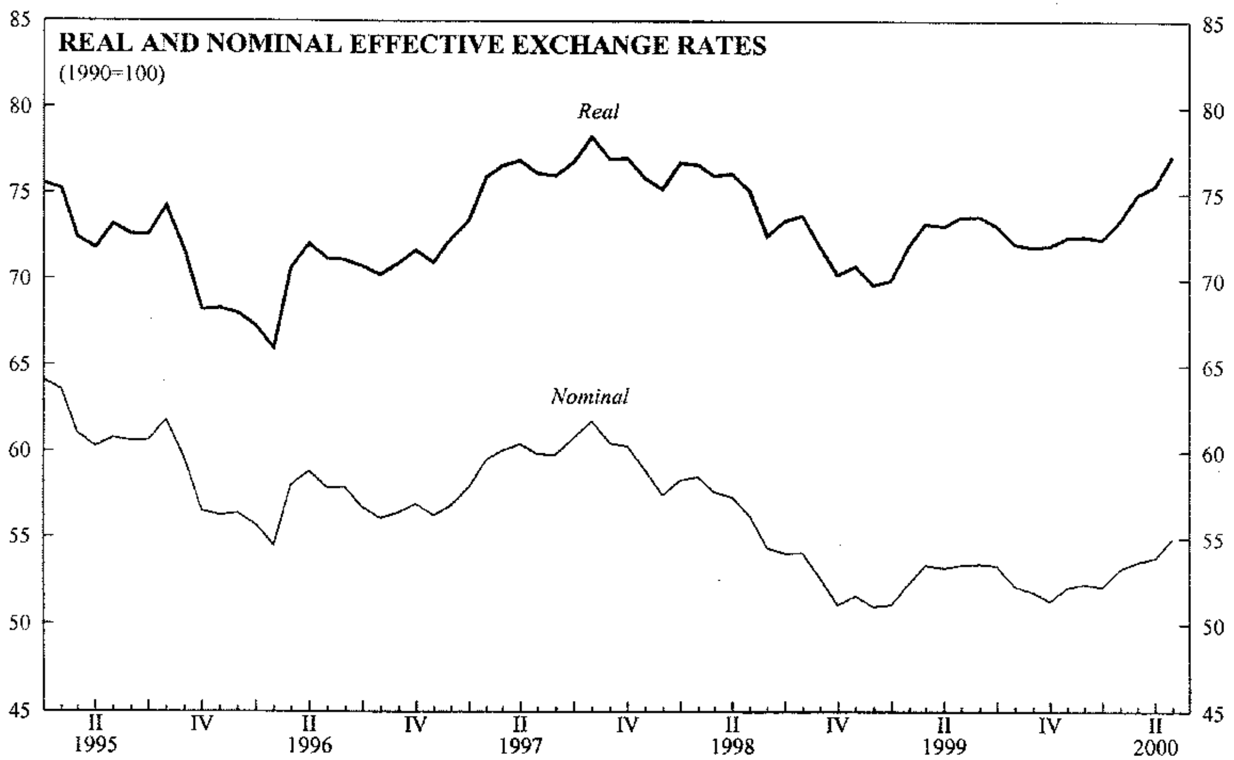
1/ In percent of current receipts.

CHART VI.5

INDIA

Exchange Rate Developments, 1995-2000



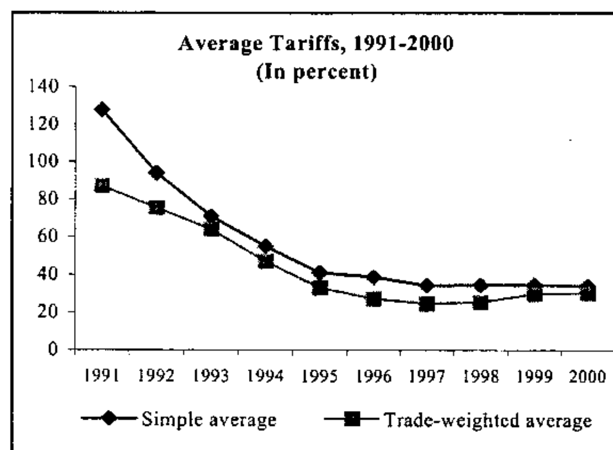


Sources: Data provided by the Indian authorities; IMF, Information Notice System; and WEFA.

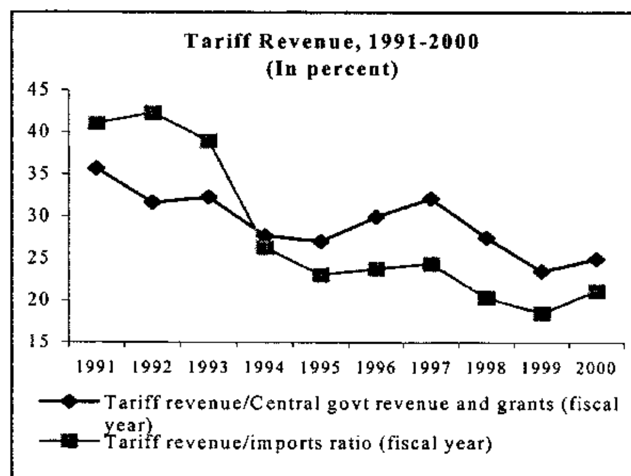
VII. Recent Trade Policy Developments[1]

A. Overview

1. **India significantly liberalized its trade regime during the 1990s,** as tariffs were lowered and nontariff barriers (NTBs) were reduced. Prior to 1991, India had one of the most complicated and protectionist regimes in the world, and imports and exports were subject to significant tariff and nontariff measures. However, during 1991-97, the simple average of India's tariffs was lowered from 128 percent to 34 percent, and licensing requirements were liberalized for imports of capital goods, raw materials, and components.[2] Export incentives were largely limited to measures that provided exporters duty-free access to imported intermediate inputs and raw materials.



2. **Tariff revenue also declined as a share of government revenue and imports.** During the period of 1992–2000 government revenue and grants increased on average by 13 percent per year in nominal terms and total imports increased by some 20 percent per year, both well above an average growth in custom duty revenues of 10 percent per year. During the 1991–97 period, tariff revenue declined as a share of government revenue and grants from 41 percent to 24 percent and as a share of imports from 36 percent to 32 percent.



3. **Recent trade liberalization has focused on the removal of NTBs.** Since 1997, the authorities have made substantial progress toward phasing out remaining quantitative restrictions (QRs) on agricultural, textile, and industrial products, and investment policies

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[1] Prepared by Johannes Herderschee.

[2] A description of India's trade policy reform during 1991–97 is included in *India—Selected Issues*, (IMF Staff Country Report No. 97/74, September 1997).

were adjusted in the context of the implementation of the WTO TRIMs Agreement.[3] The government has announced a timetable for the removal of the outstanding quantitative restrictions by April 2001. Average tariffs have been relatively steady since 1997, but the authorities have stated their intention to reduce tariffs significantly over the medium term.[4] However, India's use of antidumping duties has increased in recent years and India has become one of the world's most active user of such measures.

4. **India's exports also have increasingly become a target for countervailing duties.** India's export incentives include duty-free access to raw materials and intermediate inputs, as well as the exemption of export income from corporate income tax. Countervailing duty cases initiated against India's exports increased from an average of one per year during 1992–96, to an average of five during 1997–99, and an average of ten antidumping duties per year were initiated against India's exports during 1997–99.

B. Nontariff Barriers

5. **Nontariff barriers were the main instrument to protect domestic production prior to 1991, but over 80 percent of 6-digit tariff lines are now free of NTBs, and India is committed to removing the remaining QRs by April 2001.** Prior to 1991, 90 percent of production was protected by some sort of NTB. By May 1995, 20 percent of tradable consumer goods had been liberalized, and the overall share of manufacturing covered by QRs had fallen to 36 percent. However, roughly two-thirds of total value added (including the agricultural sector) was still protected by QRs.

6. **Since 1997, India has used five broad categories of import licenses:** (i) Open General Licenses (OGL) for products that can be freely imported; (ii) licenses that are used to enforce health, environmental, and security regulations; (iii) licenses that are used to administer quantitative restrictions; (iv) canalized imports that may only be imported by state trading enterprises, and (v) Special Import Licenses (SILs). Special import licenses are used for items for which quantitative restrictions or canalization requirements have been recently been removed. Special import licenses are provided to selected exporters as an export incentive and can be traded freely (prices are reportedly in the range of 1–3 percent of the

---

[3] Selected provisions of the WTO Agreements apply with a delay to developing countries. The Customs Valuation Agreement, the TRIMs Agreement, most provisions of the TRIPS Agreement, and some provisions of other agreements applied to India as of January 1, 2000.

[4] The 1999/2000 budget speech refered to bringing Indian tariffs down to "Asian levels," which are estimated to be in the range of 15–20 percent. Compared to other countries, India's trade regime currently still rates a "10" on the IMF's 10-point index of trade restrictiveness, but the implementation of these and other measures could reduce its rating to a "3" over the medium term.

import value). Typically, after items have been subject to SILs for approximately 2–3 years, they are moved to the OGL category.

7. **There has been significant progress in easing of import licensing requirements during recent years.** In April 1997, a total of 542 8-digit tariff lines (about one-sixth of those remaining on the list) were removed from the list of items subject to quantitative restrictions. In 1998, quantitative restrictions on some 340 items were removed.[5] In the March 1999 EXIM policy, 894 items were shifted to the OGL list and an additional 414 items were moved to the Special Import License list. In addition, about 20 items, mostly edible oils were decanalized.[6] The March 2000 EXIM policy statement announced de-licensing of 714 import items effective April 1, 2000.

8. **As of January 1, 2000, roughly 17 percent of 6-digit tariff lines were partially or fully covered by some NTB.** At the 8-digit level, 695 lines were covered by quantitative restrictions, 685 items were covered by special import licenses, and 44 items remained reserved for state trading companies. Quantitative restrictions and special import licenses applied to a wide range of agricultural and consumer products, but were particularly prevalent in the textile, clothing and automobile sectors. State trading requirements applied mainly to bulk agricultural products, petroleum, gasoline, and fertilizers. For imports from South Asian Association for Regional Cooperation (SAARC) member countries, quantitative restrictions were abolished on August 1, 1998 and state trading restrictions applied to 36 items (8 less than other to imports from other trading partners). By import value, tariff lines that were partially or fully covered by some licensing or state trading requirement represented 37 percent of imports using 1996 trade weights, of which 9 percent were subject to quantitative restrictions, 27 percent were canalized (including petroleum imports), and 1 percent was subject to SILs.[7]

9. **India is committed to removing all quantitative restrictions on imports of agricultural, textile, and industrial products by April 2001.** Since the establishment of the WTO, India had justified the use of specific QRs under the WTO rules as necessary for

[5] The number of products that are delicenced are indicative only, as some licenses apply to 6-digit tariff lines while others apply to 8-digit lines.

[6] An import ban on imports of second-hand machinery was introduced in 1999, but later relaxed to allow for imports of machinery less than ten years old.

[7] As trade data are available at 6-digit Harmonized System (HS) disaggregation and import licensing is done at the 8-digit level, in calculation these shares it was assumed that import licensing applied to the whole 6-digit tariff line even if only part of it was covered at the 8-digit level. Consequently, the share of imports subject to quantitative restrictions and SILs may be somewhat overstated.

balance of payment reasons.[8] Following inconclusive consultations in the WTO Balance of Payment Committee, these restrictions were successfully challenged by the United States under the WTO dispute settlement procedures. In December 1999, India reached a bilateral agreement with the United States under which it agreed to phase out the disputed measures by April 2001.

C. Tariffs

10. **Following a significant decline in import duties during the 1991–97 period, the average tariff remained broadly unchanged during 1997–2000.** During this period, the simple average of the basic rate plus the special customs duty remained around 34.0 percent (Table VII.1). The average for agricultural products remained unchanged at 25 percent, the average tariffs for mining products was around 23 percent, and the average for manufacturers at 35 percent. Tariffs for consumer goods declined, since the 10 percent import surcharge was not imposed on the highest standard rate (40 percent) that was applied to most consumer goods. The introduction of a minimum tariff rate of 5 percent in April 1999 further reduced the standard deviation of the tariff regime which declined from 15 percent on April 1, 1997 to 13 percent in January 1, 2000. The 2000/01 budget lowered the average tariff rate by around ½ percentage point.

Table VII.1. India: Tariff Structure, 1997/98–1999/00
(In percent)

	1997/98	1998/99		1999/00	
	Basic + Special Customs Duty	Basic + Special Customs Duty	Total Customs Duty 1/	Basic + Special Customs duty	Total Customs Duty 1/
Simple average	34.4	34.5	40.2	34.0	39.6
Agricultural products	24.6	25.0	29.6	24.6	29.2
Mining products	24.4	24.4	29.4	21.7	26.6
Manufacturing	35.1	35.3	41.0	34.7	40.4
Consumer goods	39.8	39.9	45.9	37.1	42.9
Intermediate goods	34.7	35.1	40.7	35.7	41.2
Capital goods	29.8	29.6	35.3	29.4	35.3
Memorandum items:					
Trade-weighted average	25.4	24.9	29.7	25.4	30.2
Standard deviation	14.8	14.5	15.3	13.1	14.0

Source: World Bank staff estimates.

1/ Including a special additional duty that is levied on the value of imports as well as the basic duty value and the additional duty value. The special additional duty is levied on both imports and domestic production.

[8] The WTO was established on January 1, 1995, but India used the same arguments under the GATT (1947) that applied prior to the establishment of the WTO.

11. **There has been some progress in simplifying the tariff structure during recent years.** Tariff rates of 0, 10, 20, 30, 35, 40, and 45 percent were rationalized in the 1999/00 budget to 5, 15, 25, 35, and 40 percent, and the 2000/2001 budget reduced the peak rate further from 40 percent to 35 percent.[9] A special surcharge of 2 percent applicable to all imports was introduced in the 1996/97 budget, increased to 5 percent in September 1997, and replaced by a 10 percent import surcharge in the 1999/2000 budget. In addition, preferential rates apply to imports from selected countries and tariff exemptions apply to imports for export processing and for specific end-use. Almost all India's tariffs are ad valorem rates.

12. **While tariff policy reform is generally formulated as part of the budgetary process, the authorities occasionally adjust tariffs at other times in response to specific circumstances.** In December 1999 the government hiked the import duty on sugar to 40 percent from 27 percent and that of edible oil to 27.5 percent from 16.5 percent to give protection to domestic industry. During the same month, a 50 percent customs duty on wheat was reintroduced to avoid lower world prices causing a build-up of government stocks after a record wheat harvest.[10]

13. **In spite of significant reductions in exemptions during the 1990s, tariff exemptions remain significant.** In 1997/98, net customs collections were Rs 405 billion, around 20 percent of total central government tax revenue and the value of tariff exemptions was roughly 20 percent of customs revenue (i.e., over 4 percent of central government tax revenue).[11] Key exemptions applied to selected imports used by the fertilizer, leather, foodgrain, precious stones, power and sports goods industries. In May 1999, the government also exempted 11 megapower projects from customs and countervailing duty.[12] The 2000/01 budget contained a commitment by the Finance Minister to avoid ad hoc exemptions, but left statutory exemptions largely unchanged.

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[9] Duties above 35 percent apply to less than 0.5 percent of India's tariff lines.

[10] As international prices declined, it became cheaper to buy imported wheat rather than purchase from the government at official issue prices. With a view to reducing the growth of government stocks of wheat, the government also lowered the issue prices by between Rs 2/quintal in the north zone to Rs 49/quintal in the east zone, bringing the new issue price to Rs 688–705/quintal down from Rs 690–725/quintal.

[11] Government officials estimated revenue loss as a result of tariff exemptions to be in the range of Rs 95 billion.

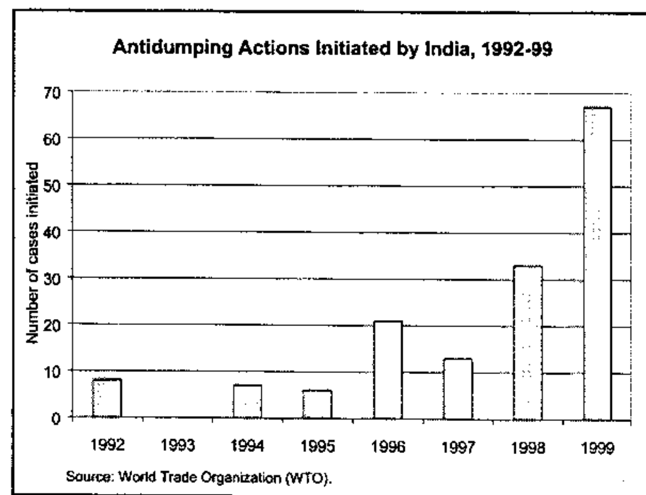
[12] Exemptions applied provided that the state in which the projects were located fulfilled several conditions, including the constitution of regulatory commissions and privatization of distribution networks in cities megapower projects, defined as thermal power plants with a capacity of 1,500 MW or more and hydroelectric power plants with a minimum capacity to 500 MW. There are seven thermal and four hydroelectric mega projects in India.

14. **Tariff preferences apply to only a small share of imports, but are set to become more important over time.** Tariff preferences are administered under a bilateral free trade agreement with Sri Lanka, as well as under a regional arrangement with its SAARC partners: Bangladesh, Bhutan, Maldives, Nepal, Pakistan, and Sri Lanka.[13] Tariff reductions under the bilateral agreement with Sri Lanka are gradually being phased in, starting April 2000. Consistent with the SAARC Preferential Trade Arrangement, India announced in August 1999 tariff concessions of 10–60 percent of the basic duty on some 1,800 tariff lines.

15. **Applied tariff rates are generally well below WTO bound rates.** India bound some 67 percent of its tariff lines in the WTO Uruguay Round, including all tariffs on agricultural products and some 66 percent of tariffs on industrial goods. Most applied tariffs are well below bound rates, and the average bound rate is 54 percent compared to the simple average of under 35 percent. Bound rates on agricultural goods range up to 300 percent, which offers few constraints on applied tariffs. As a signatory to the Information Technology Agreement, India has offered to reduce tariffs to zero on 217 items by 2005 and on some 95 lines by 2000.[14] India is currently renegotiating some of its tariff bindings with bilateral trading partners, notably for items which were previously protected by quantitative restrictions.

D. Antidumping and Countervailing Duties

16. **India's use of antidumping and countervailing measures have become more important during the 1990s.** As of end-1999, India had 61 antidumping measures in force, up from 43 at end-1998. Imports from China were most frequently targeted with 18 active cases followed by imports from Japan (6 cases), Korea (5 cases) and the United States (4 cases). On a trade-weighted basis, India was one of the most active users of antidumping measures during 1995–98 (Mattoo and Subramanian, 1999).



17. **Legislation covering antidumping and countervailing duties was amended with the Customs Tariff (Amendment) Act, 1995, in line with India's WTO obligations.** Under the Act, the Federal

[13] India also had some minor tariff preferences under the Bangkok Agreement and the Global System of Trade Preferences.

[14] The 2000/01 budget reduced tariffs on various information technology products.

Government has authority to impose antidumping and countervailing duties on goods that are imported at less than their "normal" value if such imports "injure" domestic production. A more stringent "injury" test applies to trigger safeguard measures for which neither dumping or subsidies need to be present. Investigations are launched by the Ministry of Commerce following a private sector petition. A petition has to be supported by petitioners responsible for more than 25 percent of domestic production. However, even if dumping is found to have taken place and a petition is supported by the required share of domestic producers, a national interest clause allows the government not to impose antidumping duties to protect downstream users and consumers. This national interest clause is rarely used.

E. Export Incentives and Restrictions

18. **India has used a variety of instruments to promote exports.** Most importantly, exporters are exempt from import duties on raw materials and intermediate inputs and income tax on export earnings. The 2000/01 budget announced that the income tax exemption would be phased out in equal installments over a five-year period. Exporting firms have preferential access to bank credit and selected firms receive additional incentives in the form of special import licenses, which may be sold to importers (as discussed above).

19. **Unlike in other Asian economies, export processing zones (EPZs) have not been successful in India.** The reasons for their failure include bureaucratic impediments and poor locations (Venkatesan, 1998). In contrast to the experience elsewhere in Asia, most of the firms operating in the EPZs are Indian-owned, and are established with the objective of avoiding domestic regulations. The 1999 and 2000 EXIM policy statements removed most barriers to the establishment and expansion of EPZs.

20. **Exporters outside EPZs are exempt from import duties on imported inputs through a duty exemption scheme and a duty-drawback scheme.** The duty exemption scheme exempts imports by exporters who have paid a bond as guarantee that imports will be used for export processing. Duty-drawback rates are standardized by product and published by the Ministry of Commerce and Industry. Changes announced in March 1999 that facilitated the use of these instruments appear to have coincided with an increase in their use.[15] While standard duty-drawback rates are easier to administer and reduce the scope for corruption, they are also more susceptible to countervailing measures in India's export markets.[16] The March 2000 EXIM Policy announced that the standard duty drawback rate

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[15] During the first five months of fiscal year 1999/00, amounts paid under the duty drawback scheme for exports increased from Rs 22 billion to during the first five months of 1998/99 Rs 25 billion during the first five months of 1999/00, while the amount exempted from import duties increased from Rs 9 billion to Rs 16 billion during the same two periods.

[16] The WTO Agreement on Subsidies and Countervailing Measures notes "...drawback systems can constitute an export subsidy to the extent that they result in an excess drawback of the import charges levied initially on the imported inputs for which the drawback is being

(continued…)

(Duty Entitlement Pass Book, DEPB) scheme would be subsumed into a duty drawback scheme as of March 31, 2002.

21. **Exporting firms also receive preferential access to India's highly protected domestic market through duty exemptions and exemptions from industrial regulations.** Exporters of handicraft and leather products, which account for 22 percent of India's exports, are allowed to import consumer goods duty free up to an amount of 2 percent of the previous financial year's export earnings. While industrial regulations reserve some 810 sectors for small-scale companies, larger firms are allowed to establish themselves in these sectors provided they export more than 50 percent of their output.[17]

22. **Exports are also supported by subsidized interest rates and an income tax exemption for income earned on exports.** In addition, eligible exporters are also supported through the allocation of SILs, which may be sold to importing companies, but which are to be phased out by April 1, 2001.[18] The income tax exemption for export earnings was extended in March 1999 to cover earnings from services exports, but the 2000/01 budget announced that the exemption for export income would be phased out over five years.

23. **Export taxes and quotas are applied to a small number of products to address product-specific issues.** Export taxes apply to 26 products and export levies apply to another 10 products. In practice, all products subject to export tariffs are resource based and function predominantly as resource taxes. Exports of some items are restricted on environmental and cultural ground and state-trading requirements apply to petroleum products, some minerals and seeds as well as onions. Export quotas apply only to textile and clothing products and are administered under the WTO Agreement on Textiles and Clothing (ATC), which is set to expire by the end of 2004.[19]

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claimed" (Annex III, Guidelines in the Determination of Subsitution Drawback Systems as Export Subsidies).

[17] Small-scale firms are defined as companies with and investment below Rs 10 million. The number of sectors subject to such reservations was reduced from 836 to 821 in April 1997 and to 810 in February 1999.

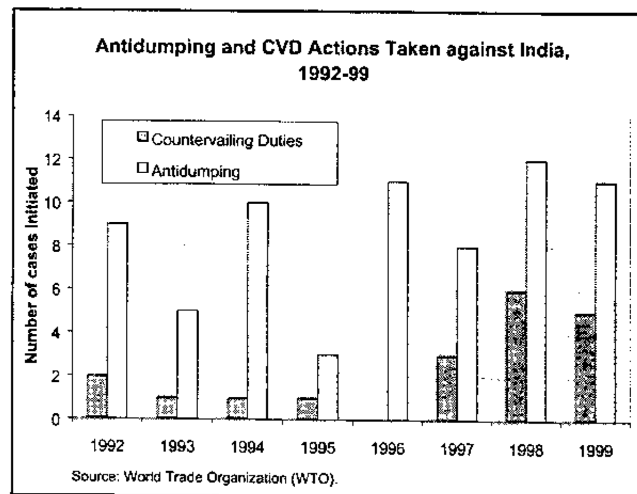
[18] Eligible exporters include small-scale firms, as well as exporters of fruit, vegetables, horticulture, electronics, and "quality" products. Total imports subject to SIL licenses were in 1999 approximately US$400 million and licenses traded at 1–3 percent of their import value, suggesting that total rents amounted to some US$4–12 million.

[19] While quota administered under the WTO-ATC Agreement are phased out in four stages it appears that most quota applied to India's exports are classified in the final phase of the transition period (WTO, 1996).

24. **Under the WTO-ATC, India limits exports of textiles and clothing to Canada, the European Union, Norway, and the United States.** Product and country-specific quota are allocated on the basis of: past performance (55 percent of quota in the case of textiles and 70 percent in the case of garments and knitwear; manufacturers exporters entitlement (15 percent of most textile categories); power loom exporters entitlements (15 percent of some textile quotas); ready goods entitlement (15 percent of textile quotas); new investor entitlement (15 percent of clothing quota), and first-come-first-served entitlement as well as other criteria (15 percent of clothing quota). India's U.S. quota utilization rates were 94.7 percent in 1997 and 97.3 percent in 1998.

25. **India's exports benefit from trade preferences in export markets under regional and GSP Schemes.** India is a member of and receives some preferential treatment from member states of the South Asian Preferential Trading Arrangement (SAPTA), which became operational on December 7, 1995. Indian exports receive preferential treatment under the GSP schemes of Australia, Bulgaria, Belarus, Canada, the Czech Republic, the European Union, Hungary, Japan, New Zealand, Norway, Poland, Russia, the Slovak Republic, Switzerland, and the United States. However, in contrast to benefits which are protected by the WTO dispute settlement mechanism, such preferences are granted on a unilateral basis and may be withdrawn at will by the importing countries.

26. **The main restrictions imposed on India's exports as applied by its trading partners on an MFN basis appear to be:** import duties that are progressively higher for finished goods, agricultural subsidies, sanitary and phytosanitary regulations, and technical barriers to trade. In addition, however, India's exports are also a frequent target for antidumping and countervailing duties. On an export-weighted basis India's exports are now one of the world's favored antidumping duty targets (Table VII.2).



F. Concluding Remarks

27. **Significant trade policy reforms were implemented during 1997–99.** Nontariff barriers were reduced significantly and the stage has been set for their elimination by April 2001. Import tariffs have also been reduced and simplified. However, even after taking account of the significant progress achieved so far, India's trade regime remains more restrictive than other rapidly growing economies. Further liberalization could contribute to India's economic development and openness to international trade.

28. **However, continued trade liberalization will need to be coordinated carefully with fiscal consolidation efforts.** Tariff rate reductions during the 1990s were associated with a drop in customs receipts as a share of GDP, and further rate reductions and the implementation of free trade and preferential tariff arrangements raises concerns about the risks to the already worrisome fiscal situation. Although there is evidence to suggest that current tariffs are above revenue maximizing rates,[20] it will be critical to ensure that rate reductions are coupled with measures to broaden the tax base including the tariffication of QRs and the withdrawal of other tax exemptions.

29. **Successful trade reform will also require complementary reforms to industrial and agricultural policies.** India's industrial sector faces significant structural rigidities that undermine its competitiveness, including the reservation of certain sectors for small-scale firms, restrictive labor laws, outmoded and ineffective bankruptcy regulations, and a large and relatively inefficient public enterprise sector. The agricultural sector also is subject to a range of restrictions that undermine efficiency, including limits on plot size, an administered pricing system for crops, and constraints on interstate trade and agroprocessing. Progress in addressing these issues will need to be accelerated in order to facilitate the adjustment to a more open trade system, and to avoid pressures to increase resort to antidumping measures.

[20] Ebrill, Stotsky, and Gropp (1999).

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Table VII.2. India: Developments in Antidumping, Selected Countries, 1992-99

	1992	1993	1994	1995	1996	1997	1998	1999
Number of cases initiated by importing country								
Argentina	14	28	17	27	22	15	8	24
Australia	71	59	15	5	17	42	13	23
Brazil	9	34	14	5	18	11	18	16
Canada	46	25	2	11	5	14	8	16
European Union	42	21	43	33	25	41	22	66
India	**8**	**...**	**7**	**6**	**21**	**13**	**33**	**67**
Korea, Republic of	5	5	4	4	13	15	3	6
Mexico	26	71	22	4	4	6	12	7
South Africa	0	0	16	16	33	23	41	7
United States	82	32	48	14	22	15	36	28
Number of cases per US$ billion of merchandise imports								
Argentina	0.94	1.67	0.76	1.40	0.92	0.50	0.25	0.92
Australia	1.58	1.26	0.27	0.08	0.25	0.62	0.19	0.32
Brazil	0.40	1.10	0.38	0.09	0.31	0.16	0.28	0.29
Canada	0.33	0.17	0.01	0.06	0.03	0.07	0.04	0.07
European Union	0.03	0.02	0.03	0.02	0.01	0.02	0.01	0.03
India	**0.34**	**...**	**0.27**	**0.17**	**0.58**	**0.33**	**0.76**	**1.49**
Korea, Republic of	0.06	0.06	0.04	0.03	0.09	0.10	0.03	0.06
Mexico	0.38	0.99	0.25	0.05	0.04	0.05	0.09	0.05
South Africa	0.00	0.00	0.75	0.59	1.23	0.82	1.43	0.24
United States	0.15	0.05	0.07	0.02	0.03	0.02	0.04	0.03
Number of cases against selected exporters								
Argentina	5	...	3	1	...	...	1	3
Australia	2	3	...	1	...	1	2	2
Brazil	18	24	9	8	10	5	6	10
Canada	8	5	1	2	1	3	3	...
China, People's Republic of	32	45	44	20	43	33	26	31
European Union	..	1		...	1	2	1	5
India	**9**	**5**	**10**	**3**	**11**	**8**	**12**	**11**
Korea, Republic of	25	17	8	14	11	15	22	29
Mexico	9	1	3	3	4	2	9	3
South Africa	2	7	4	2	6	4	5	3
United States	26	31	14	12	21	15	16	11
Cases initiated against selected exporters, per US$ billion of merchandise export								
Argentina	0.41	...	0.18	0.05	...	...	0.04	0.13
Australia	0.05	0.07	...	0.02	...	0.02	0.04	0.04
Brazil	0.49	0.62	0.21	0.17	0.21	0.09	0.12	0.21
Canada	0.06	0.04	0.01	0.01	0.00	0.01	0.01	...
China, People's Republic of	0.37	0.49	0.36	0.13	0.28	0.18	0.14	0.12
European Union	...	0.00	...	...	0.00	0.00	0.00	0.00
India	**0.39**	**0.24**	**0.39**	**0.09**	**0.31**	**0.20**	**0.28**	**0.24**
Korea, Republic of	0.31	0.20	0.08	0.10	0.07	0.10	0.24	0.27
Mexico	0.13	0.01	0.03	0.04	0.04	0.02	0.07	0.02
South Africa	0.09	0.29	0.16	0.07	0.20	0.13	0.18	0.12
United States	0.05	0.05	0.02	0.02	0.03	0.02	0.02	0.01

Source: WTO, Rules Divison Antidumping Database; IMF, *Direction of Trade Statistics, 1999 Yearbook*.

VIII. Recent Structural Policy Developments[1]

A. Introduction

1. **The process of structural reform in India began in the mid-1980s, but accelerated following the balance of payments crisis of 1991.** Key measures included industrial deregulation, and fiscal, external and financial sector reforms.

- **The investment licensing scheme in the manufacturing sector was dismantled**, and steps were taken to liberalize investment approvals procedures. Also, many areas of the economy that had previously been reserved for the public sector were opened for private investment, including power, telecommunications, mining, ports, roads, river transport, air transport, and banking.

- **External sector reforms were significant**, and included reductions in tariffs, the easing of import licensing requirements, a relaxation of controls on foreign direct and portfolio investment, and greater exchange rate flexibility. Tariffs cuts reduced the import-weighted tariff rate from 87 percent in 1990/91 to 25 percent by 1996/97, and there were substantial reductions in the number of quantitative restrictions on imports. The exchange rate regime was also liberalized. The rupee was floated in March 1992, and full current account convertibility was established in August 1994, earning India Article VIII status with the IMF.

- **In the financial sector**, interest rates were liberalized, prudential norms and supervision were strengthened, private sector competition in the banking system was increased, and reforms were introduced to develop and deepen capital and debt markets. This enabled a gradual shift toward implementing monetary policy by means of indirect rather that direct instruments.

- **Fiscal reforms** focused on rationalizing tax rates, cutting expenditures, and privatizing public enterprises. The public sector deficit was brought down to 8¼ percent by 1995/96, from 11¼ percent before the crisis.

2. **The pace and scope of reform in the latter half of the 1990s was adversely affected by political instability**, including three general elections and six changes of government between early 1996 and late 1999. Nonetheless, a number of important measures

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[1] Prepared by Daniel Kanda and Patricia Reynolds. This paper has drawn upon information from a range of sources, including the Ministry of Finance *Economic Survey*, various issues; Reserve Bank of India, *Annual Report*, various issues; Rajiv Gandhi Institute for Contemporary Studies, *Agenda for Change*, March 1998; World Bank, *India: Policies to Reduce Poverty and Accelerate Sustainable Development*, Report No. 19471-IN, January 2000; and A.V. Desai, "The Economics and Politics of Transition to an Open Market Economy," OECD Technical Paper No. 155, October 1999.

have been implemented since 1998, and these are discussed in greater detail in the following section.

B. Recent Policy Developments

Financial sector

3. **In January 2000, the Insurance Regulatory and Development Authority (IRDA) Act of 1999 was given final assent.** The Bill opened the Indian insurance sector—which has been dominated by the state-owned Life Insurance Corporation and the General Insurance Corporation—to private and foreign competition, and established a regulator (the IRDA) for the industry. Entry is subject to the requirement that paid up capital is at least Rs 1 billion in the case of insurers, and Rs 2 billion in the case of reinsurers. Ownership shares of a single domestic entity are required to be reduced to 26 percent over a 10-year period, and total foreign ownership is limited to 26 percent. In April 2000, the RBI issued prudential guidelines on bank participation in the insurance sector.

4. **A number of additional measures have been implemented recently to provide greater flexibility in the capital markets.** The Securities Contracts (Regulations) Amendment (SCRA) Bill was passed in 1999 to provide a framework for the introduction of trading in derivatives and "collective investment schemes." The Foreign Exchange Management Bill (FEMA) was also passed in 1999, to facilitate external trade and payments and promote orderly conditions in the foreign exchange market. In October 1999, banks were given the freedom to set different Prime Lending Rates (PLRs) for different loan maturities. In March 2000, the government lifted the 30-year ban on forward trading in securities, paving the way for the introduction of derivative products such as stock index futures.

5. **The Securities and Exchange Board of India (SEBI) announced measures in 1999 to liberalize the norms governing the capital market** and bring them on par with international standards. Entry norms for initial public offerings (IPOs) were relaxed, mutual funds were allowed to trade in derivatives, and regulations on employee stock options were put in place. Draft regulations on credit rating agencies were also approved.

6. **To improve mechanisms for debt recovery, in 2000 the government amended the Recovery of Debt Due to Banks and Financial Institutions Act (1993)** by widening the definition of debt and giving Debt Recovery Tribunals (DRTs) increased powers to attach the assets of defaulters. The constitutionality of this law was later upheld by the Supreme Court.

7. **In its April 1999 credit policy, the RBI took a series of steps to facilitate the development of the government securities market**. Restrictions on repurchase agreements (repos) were relaxed, with interbank repos now allowed in government securities, public sector enterprise bonds, and bonds of companies and financial institutions held in "demat"

form.[2] In addition, restrictions on the maximum maturity for repos were removed. To aid in the development of the government securities market, state governments were allowed special ways and means advances against the collateral of their investment in treasury bills, and the RBI introduced auctions for 182-day treasury bills.

External sector[3]

8. **A number of measures have been adopted recently to ease restrictions on capital flows.** In February 2000, the use of External Commercial Borrowings (ECBs) was opened to all sectors except real estate and the capital market, and quantitative limits were relaxed.[4] In addition, restrictions on the ability of Indian corporations to issue equity abroad through American Depository Receipts (ADRs) and Global Depository Receipts (GDRs) were liberalized in January 2000. Prior government approval is no longer required, but companies are subject to reporting requirements and caps on the percentage of foreign ownership of equity.

9. **In order to promote foreign direct investment,** the government established a system of automatic approvals for FDI for investments up to Rs 6 billion. However, a negative list remains, and includes investment in agriculture, the petroleum industry, defense-related equipment, and industrial explosives. There are also limits on foreign ownership of equity in various industries.[5] In order to minimize bureaucratic impediments, the government also established the Foreign Investment Implementation Authority (FIIA) as a single interface for foreign investors in obtaining all necessary approvals and to approve FDI proposals not covered under the automatic approvals route.

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[2] Securities held in dematerialized (demat) form are those that are traded electronically, and do not require exchange of paper scrips during settlement.

[3] For a discussion of trade policy developments, see Chapter VII.

[4] Companies implementing infrastructure projects via subsidiary joint ventures are permitted to tap ECB up to $200 million (the previous limit was $50 million), and ECB exposure limits on infrastructure projects have been increased to 50 percent from 35 percent (the limit can also exceed 50 percent in special cases). Export units are now allowed ECB exposure up to 60 percent of project cost. ECB clearance procedures were simplified, and 100 percent prepayment of borrowing through export earnings is now allowed.

[5] For example, foreign ownership of equity is limited to 49 percent in telecommunications, 74 percent in bulk pharmaceuticals, mining of diamonds and precious stones, and advertising, and 51 percent in hotels and tourism related industry. Also, foreign investment in small-scale industries is limited to 24 percent of capital.

Power sector

10. **Although power generation has grown strongly, power constraints remain a serious problem.** In particular, although power generation increased by 6½ percent in 1998/99, energy and peaking shortages remained high at 6 percent and 14 percent, respectively. Problems have been ascribed to the inefficiency of thermal plants and the State Electricity Boards (SEBs), which distribute electricity to most end-users. SEBs typically provided energy to the agriculture sector at well below cost, leading to heavy financial losses. Operational inefficiencies have also meant that the SEBs' transmission and distribution losses—officially estimated at around 25 percent—are among the highest in the world. In 1997/98, only three SEBs had a rate of return higher than the legally mandated minimum of 3 percent, which has limited the ability of the SEBs to invest in capacity.

11. **Power sector reforms have begun in several states.** Orissa, Haryana, Andhra Pradesh, Uttar Pradesh, and Karnataka enacted legislation to reform their power sectors, and to establish independent State Electricity Regulatory Commissions (SERCs) mandated to set economically sound power tariffs. A total of 13 states have either set up SERCs or announced that their intention to do so. Reform efforts in Orissa, Haryana, and Andhra Pradesh have been supported by the World Bank and the Department for International Development (UK), and progress has been the greatest in Orissa, where power distribution has been successfully privatized.

12. **Power sector reforms have also taken place at the central government level.** The government announced a revised power policy which envisages the development of "mega" power projects[6] in both the public and private sectors, in order to take advantage of economies of scale. The policy includes the creation of a Power Trading Corporation (PTC), which would purchase power from large power projects and sell only to states that have embarked on reforms, including by establishing independent SERCs empowered to fix tariffs. Since private sector mega projects would only have to deal with the PTC, this is expected to considerably reduce the risk of non-payment of dues. To attract private sector participation, the tax holiday for infrastructure projects was extended to the power sector. As of May 1999, there were 11 mega power projects in India.

Telecommunications

13. **Although the telecommunications sector has grown rapidly, telephone density in India remains among the lowest in the world.**[7] To enhance private sector participation in the sector, the government announced a new telecom policy in 1999 which allowed multiple

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[6] Mega power projects are defined as thermal plants that will generate at least 1,000 mw annually, or hydro plants that will generate at least 500 mw annually.

[7] In particular, switching capacity increased by 23 percent in 1998/99 alone. However, telephone density in India is 1.7 percent, compared to 11.4 percent in Thailand, 7.3 percent in China, and 2.9 percent in Indonesia (World Bank, *India: Policies to Reduce Poverty*).

fixed service operators and opened domestic long distance services to private operators. It also allowed the migration of telecom operators from the previous fixed-fee regime to a revenue-sharing arrangement.

14. The **Telecom Regulatory Authority of India (TRAI)** was reconstituted in January 2000 to give a clearer distinction between its advisory and regulatory functions. It is now mandatory for the government to seek TRAI's advice on policy and licensing issues. To separate policy and licensing from the provision of services, a separate Department of Telecom Services (DTS) was set up in October 1999 to look after all non-policy issues related to the provision of telecom services. It is envisaged that the DTS will eventually be corporatized. The Department of Telecommunications (DOT) is now be restricted to policy matters, licensing, research, and the administration and implementation of laws and treaties related to the telecom sector.

Transportation

15. **India faces significant transportation bottlenecks**. The national highways, which account for about 40 percent of the movement of goods and passengers, are very congested. As a result, commercial vehicles are only able to run 200-250 km per day compared to 600 km per day in developed countries. The government has estimated that an additional 15,766 km of highway will be required by the year 2020, out of which 4,885 km is needed by 2005.

16. To improve the **roads network**, the National Highway Authority of India (NHAI) was given the mandate to implement the National Highway Development Program in 1998/99. The Program envisages upgrading highways linking the "golden quadrilateral" of Delhi, Mumbai, Chennai, and Calcutta, as well as upgrading highways between Kashmir and Kanyakumari, Silchar and Saurashtra, and Salem and Cochin. In all, 13,252 km of highway are to be upgraded by 2009. Excises on petrol and diesel have been earmarked to finance road projects, and are estimated to yield Rs 50 billion per year—still well short of total expected funding requirements of Rs 540 billion. To encourage private sector participation in road transport, agreements for Build-Operate-Transfer (BOT) schemes have been finalized, and as of end-March 2000, 20 BOT projects with a total investment of Rs 10 billion have begun.

17. **Port capacity** is also insufficient to meet existing demand. Major ports (which handle 90 percent of all cargo) handled 252 million tons of cargo as of end-March 1999, in excess of their 240 million ton capacity. This resulted in substantial delays in pre-berthing and turnaround. Although, productivity at Indian ports improved in 1998/99, it is still much lower than that of efficient ports in the Asian region.[8]

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[8] Average turnaround time fell from 6.6 days in 1997/98 to 5.9 days in 1998/99, compared to about 8 hours turnaround in competitor ports.

18. To address the lack of port capacity, the authorities have sought to encourage greater private sector investment in this sector. Guidelines have been issued concerning private investment in ports, and the Tariff Authority for Major Ports (TAMP) began operations in April 1997, including by establishing port charges to be collected by private providers of port services. The Maritime States Development Council (MSDC) has also been formed as a forum for developing an integrated policy for the entire Indian ports sector. In addition, the government announced the corporatization of Ennore, Haldia, and Jawaharlal Nehru ports in January 1999, which is expected to enhance their ability to mobilize resources from the market and therefore reduce the need for budgetary support. At the state level, ports development programs are underway in Gujarat, Maharashtra, and Andra Pradesh, with private sector participation.

19. The productivity and financial viability of the **railways** is another important concern. The railway system suffers from undercapacity (capacity utilization is estimated at 100–120 percent along the golden quadrilateral), pressures to maintain and add uneconomic passenger lines, and weak revenue generation. The latter stems in large part from a fare system that requires freight traffic to cross-subsidize passengers, and is encouraging a diversion of freight traffic to other transport modes, including roads. Recent policy on railways has been geared towards improving staff productivity and safety by streamlining safety procedures and upgrading railway training centers. The government has also announced that the six production units of the railway ministry are to be converted into independent cost and profit centers, which would pave the way for their eventual corporatization.

20. To improve the efficiency of **airports**, the government announced in January 2000 that it was restructuring five major airports (Mumbai, Delhi, Bangalore, Chennai, and Calcutta) by leasing them to private operators for 30 years.

Land use

21. In 1999, the **Urban Land Ceiling and Regulation Act** (ULCRA) of 1976 was repealed. This legislation had constrained the housing industry as it set upper limits on the amount of land that could be owned individuals and companies, and prohibited firms from selling surplus land in urban areas without the permission of the state government (which was rarely granted).

C. The Impact of Structural Reform

22. **There is evidence to suggest that the reforms that were implemented in the 1990s paid important dividends.** The recovery from the 1991 crisis was rapid, with a sharp rise in the private investment rate and an increase in real per capita GDP growth to more than 6 percent by 1995/96 (Table VIII.1). Significant improvements in productivity were also achieved—as evidenced by increased total factor productivity growth at both the aggregate

and firm levels,[9] and by declining incremental capital output ratios, particularly in the services sector.

23. **However, per capita growth has slowed more recently,** averaging closer to 4 percent between 1997/98 and 1999/00. To some extent, this reflects the completion of cyclical catch-up following the 1991 balance of payments crisis, as well as the adverse impact of the 1997 regional crisis and agricultural supply shocks. In addition, though, economic performance appears to have been adversely affected by a reversal of fiscal adjustment. Increases in civil service wages, subsidies, and rising debt service payments pushed up the public sector deficit almost to pre-crisis levels by 1999/00, likely contributing to higher real interest rates and dampening private investment.

24. **The recent slowdown also raises questions as to whether the pace of structural reform has been sufficient to sustain income gains**. Indeed, a number of analytical studies suggest that the benefits from deeper structural reform could be significant (Table VIII.2). These include studies that have analyzed the nature of the structural impediments in India,[10] the reasons for the differences in the growth performances of India relative to China and other developing countries,[11] and the effects of structural reforms at the state level.[12] Comparisons of India and China have concluded that the much higher growth rates experienced by China—over 4 percentage points during 1980-96—have been due to the more liberal regulatory environment enjoyed by China's non-state sector (particularly with respect to agricultural sector pricing and labor laws) as well as the more attractive incentives offered by its Special Export Zones. A study of the effects of structural reforms at the state level in India found that reform-oriented states (such as Gujarat, Tamil Nadu, and Maharashtra),

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[9] See Chapter II; World Bank, *India: Policies to Reduce Poverty*; and Krishna, P. and D. Mitra, "Trade Liberalization, Market Discipline and Productivity Growth: New Evidence from India," *Journal of Development Economics,* Vol. 56 (1998), pp. 447–62.

[10] See, for example, World Bank. *India: Macroeconomic Update 1998,* and N. Bajpai and J.D. Sachs, Strengthening India's Strategy for Economic Growth, Development Discussion Paper No. 641, Harvard Institute for International Development, 1998.

[11] See, for example, N. Bajpai, T. Jian, and J.D. Sachs, Economic Reforms in China and India: Selected Issues in Industrial Policy, Development Discussion Paper No 580, Harvard Institute for International Development, 1999; World Bank, *India: Policies to Reduce Poverty*; and Kongsamut, P. and A. Vamvakidis, "Economic Growth", in *The Philippines: Toward Sustainable and Rapid Growth*, IMF Occasional Paper 187 (Washington: International Monetary Fund, 2000).

[12] See, for example, Chapter IV of the accompanying *Selected Issues* volume.

grew faster, and attracted much more private investment—both domestic and foreign—than those which have lagged behind in the reform process. [13]

25. It been suggested by a number of analysts—both inside and outside the policymaking sphere in India—that **the next wave of reforms** should include focus on a number of difficult issues that have so far remained relatively untouched.[14] These include:

Agriculture

26. Reform of the agricultural sector is key to improving living standards in the rural areas and to reversing the recent slowdown in the rate of decline of the poverty rate, since some 70 percent of the labor force still relies on the land for its livelihood.[15] The relatively poor performance of the agricultural sector during the 1990s (Table VIII.1) reflected both adverse supply shocks and the lack of agricultural reform, which in turn contributed to low investment rates and productivity in this sector, thus constraining growth. While recent efforts to increase fertilizer prices, improve foodgrain storage and distribution, and liberalize some agro-processing industries are steps in the right direction, key issues that still need to be addressed include:

- **Subsidies on power, water and fertilizer inputs** have distorted production decisions and contributed to environmental degradation, which has adversely affected productivity. Moreover, their high cost has crowded out public spending on much needed agricultural investment, in particular rural roads and irrigation.

- The operations of the **Food Corporation of India** (FCI) and the **Public Distribution System** (PDS) have distorted normal regional and seasonal commodity price

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[13] N. Bajpai, and J.D. Sachs, The Progress of Policy Reform and Variations in Performance at the Sub-National Level in India, Development Discussion Paper No. 730, Harvard Institute for International Development, 1999.

[14] In particular, see V. Kelkar, "India's Emerging Economic Challenges," *Economic and Political Weekly*, August 1999.

[15]While figures from the 1998/99 large-coverage National Sample Survey are not yet available, the unofficial small-sample surveys—which are conducted annually—indicate that the poverty rate did not decline appreciably between 1988/89 and 1998/99. See also S. Tendulkar, "Indian Economic Policy Reforms and Poverty: An Assessment," in I.J. Ahluwalia and I.M.D. Little, eds., *India's Economic Reforms and Development: Essays for Manmohan Singh* (Delhi: Oxford University Press, 1998).

variations, prevented or constrained efficient private trade, and distorted production decisions.[16]

- **Trade distortions** have also prevented the proper functioning of market mechanisms, with most agricultural imports and exports (including of farm inputs) subject to high tariffs, licensing requirements, and/or "canalization"—which grants monopoly rights for trade in particular commodities.

- **Reservation policies**, which restrict domestic production of most processed agricultural commodities and farm inputs to small-scale manufacturers, have adversely affected product quality, the level of technology, and marketing.

Infrastructure

27. Infrastructure deficiencies—particularly in power, transportation, and communications, as discussed in Section B—are among the most important impediments to growth in India. The *1998 Global Competitiveness Report* of the World Economic Forum, which examined the strengths and weaknesses of 53 countries and provided an assessment of their medium-term growth prospects, ranked India's overall infrastructure 53rd, and all aspects of infrastructure were found to have severe weaknesses.

28. Durable fiscal reform is needed to free resources for greater public spending on physical infrastructure. In addition, substantial private sector—including foreign—investment in infrastructure is required. Such involvement has so far been impeded by regulatory problems and non-transparent approvals procedures, which have created uncertainty and delayed the finalization of contracts.[17] Moreover, progress on commercialization and privatization in the power, transportation, and water sectors has been very slow.

Small Scale Industries

29. As noted by the government-commissioned Hussain Committee report in 1997, the reservation of certain products for the exclusive production by small scale industries (SSI reservation) has crippled the growth of several industrial sectors, and restricted exports in

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[16] Operations of the FCI and PDS are discussed in greater detail in Chapter IV of the *Selected Issues* (IMF Staff Country Report No. 96/132, January 1997).

[17] An important example of the adverse effects of these regulatory problems is the recent decision by the U.S. company Cogentrix to pull out of a power project in Karnataka, after 10 years and $27 million in expenditures, due to clearance delays. Approval of power purchase agreements at the state level can require clearances by as many as 27 interministerial committees (Economist Intelligence Unit, *India Country Report*, First Quarter 2000).

many areas—including garments, toys, and leather products—where India has a potential comparative advantage.[18] SSI reservation has also been an impediment to FDI, since many of the industries which would otherwise be attractive to foreign investors are reserved.

30. The need to eliminate SSI reservation has recently become even more urgent, as the removal of quantitative restrictions in April 2001 will create an anomalous situation where small scale industries face competition from imports, but large domestic firms are restricted from entry into those industries. The elimination of quotas under the Multi Fibre Agreement by 2005 also may increase competitive pressures on the Indian textiles industry.

Labor markets

31. About 8 percent of India's labor force is employed by the "organized" sector, which enjoys extensive social protection and effectively guarantees lifetime employment under the Industrial Disputes Act, the Companies Act, and the Sick Industrial Companies Act. Moreover, labor legislation has been introduced at both the central and state government levels, leading to considerable interstate variation in definitions and coverage. In contrast, the "unorganized" sector is largely market-driven and subject to little regulation or protection.

32. The 1998 Global Competitiveness Report ranked India's labor market flexibility 45th out of 53 countries. Surveys of industry carried out by the World Bank and the Confederation of Indian Industry (CII)[19] identified labor regulations as the second biggest obstacle to business operations and growth.

33. Several studies[20] have recommended that reforms focus on harmonizing state labor laws while extending them to encompass the unorganized sector. At the same time, government intervention should be reduced and labor market flexibility improved through easing restrictions on lay-offs, retrenchements and firm closures.

Legal framework

34. Industrial and corporate restructuring, contract enforcement, and debt recovery frequently have been impeded by the enormous backlog of cases and excessively complex legislative and administrative procedures. In particular, the Sick Industrial Companies Act (SICA) operates as an important disincentive to early restructuring by providing protection

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[18] Small scale industries are defined as firms with investment in plant and machinery not exceeding Rs 10 million. Production of over 800 manufactured items is reserved for SSIs, and they account for roughly 40 percent of manufacturing production in India. See Hussain Committee, *Report of the Expert Committee on Small Enterprises*, New Delhi, 1997.

[19] See World Bank, *India: Policies to Reduce Poverty.*

[20] See, in particular, Rajiv Gandhi Institute, *Agenda for Change.*

from creditors only after a company's net worth has been completely eroded. Once a medium size or large company is declared "sick," it no longer has the power to restructure on its own, as SICA requires that restructuring of such units be handled by the Board of Industrial and Financial Reconstruction (BIFR). Procedures employed by the BIFR encourage long delays, undermine governance of sick units, and adversely affect creditors (including banks), since they require consensus by all concerned parties at every stage of the restructuring process.[21]

35. Weaknesses in the legal framework, particularly those dealing with debt recovery, have been blamed for a substantial portion of the high non-performing assets of the banking system. In recognition of this, debt recovery tribunals (DRTs) were formed. New legislation has been passed recently strengthening the powers of DRTs over debt recovery cases in the banking sector. However, more fundamental reforms are needed to simplify and strengthen the entire legal framework and improve efficiency in all sectors.[22]

Public Sector Undertakings (PSUs)

36. There are about 240 central public enterprises in India, operating in a wide range of industries and services, and accounting for about 7 percent of employment in the organized sector. Given their quasi-governmental nature, many PSUs carry out activities which would not be justifiable on purely commercial grounds. This has reduced incentives for profit maximization and efficiency and, as a result, nearly half of all PSUs made losses in 1997/98.[23]

37. The resulting drain on the central government's budget has highlighted the need for a strong divestment program, which would improve PSU governance and efficiency, as well as the fiscal position of the public sector. However, progress in divesting PSUs has been slow. The government announced a new divestment policy in March 1999, under which its stake in non-strategic PSUs could be divested up to 100 percent,[24] and a new Department of Disinvestment was constituted in December to administer the divestment process.

[21] As of end-November 1999, less than one percent of companies referred to the BIFR had been revived.

[22] See World Bank, *India: Policies to Reduce Poverty.*

[23] World Bank, *India: Policies to Reduce Poverty*. The operations and profitability of PSUs are discussed in greater detail in Chapter V o IMF, *India—Selected Issues*, (IMF Staff Country Report No. 96/132, January 1997.

[24] PSUs in strategic sectors—defense, railways, and atomic energy—would not be divested.

D. Concluding Observations

38. **There is broad agreement in India that further reforms are needed**—the experience of the early 1990s has demonstrated the potential benefits of reform, and consistent views on many of the key issues emerged from the major parties during the October 1999 election. In particular, faster growth would require durable fiscal consolidation to raise national saving and crowd-in private investment spending;[25] further liberalization of foreign trade and investment flows; additional reforms to labor markets and the legal framework; and further liberalization of the agricultural, industrial, infrastructure and financial sectors to promote greater efficiency and export competitiveness. These reforms need to include removal of domestic pricing distortions, improvements to bankruptcy procedures, and an easing of restrictions on firm and farm size and regulations that make it difficult to shed labor (and therefore impede job creation). Fiscal priorities also need to be redirected toward investment in human and physical capital.

39. **Encouragingly, the new government has taken a number of initiatives that suggest a strengthened commitment to structural reform**, including liberalization of the insurance sector, automatic clearance for foreign direct investment in many sectors, and a landmark agreement on state sales tax rationalization. At the same time, however, a clearly-defined agenda for reform has yet to be established. Hence, critical and difficult challenges remain to be addressed.

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[25] See Chapter III of the accompanying *Selected Issues* volume.

Table VIII.1 Expenditure and Sectoral Components of Growth in India 1/

(In percent)

	Average			
	1951/52-79/80 2/	1980/81-90/91	1992/93-96/97	1997/98-99/00 3/
Real GDP growth 4/	1.5	3.8	4.5	4.3
Real per capita GDP growth 4/	3.7	5.9	6.4	5.9
Contribution to growth, by expenditure item: 4/				
Consumption	2.6	4.2	4.4	4.4
Private consumption	2.1	3.5	3.9	2.7
Public consumption	0.4	0.7	0.5	1.6
Gross fixed investment	0.7	1.4	1.9	1.0
Private investment	...	0.8	2.1	0.6
Public investment	...	0.5	-0.2	0.4
Net exports 5/	...	0.6	0.2	0.6
Contribution to growth, by sector: 6/				
Public	1.1	1.7	1.3	3.9
Private	2.2	4.2	5.7	2.2
Contribution to growth, by sector: 6/				
Agriculture	1.0	1.5	1.4	0.6
Industry	1.1	1.9	2.1	1.6
Services	1.4	2.4	3.2	3.9
ICORs, by sector: 7/				
Overall	...	4.2	4.1	4.8
Agriculture	...	2.0	1.5	2.6
Industry	...	5.7	6.8	10.7
Services	...	4.0	2.9	2.1

Sources: Central Statistical Organisation, *National Accounts Statistics* .

1/ Calculations based on constant price data; base year is 1980/81 for data until 1993/94, and 1993/94 thereafter.

2/ Average contributions of consumption spending, and public and private sectors are calculated over 1961/62-1979/80.

3/ 1999/00 figures on GDP and sectoral production are CSO Revised Estimates; 1999/00 figures on expenditure categories and 1998/99 and 1999/00 figures on public and private sector GDP are staff estimates; ICORs computed over 1997/98-1998/99.

4/ Measured at market prices.

5/ Includes statistical discrepancy.

6/ Measured at factor cost.

7/ The incremental capital output ratio (ICOR) is the ratio of the investment rate to the GDP growth rate; a falling ICOR over timetherefore indicates improved capital productivity.

Table VIII.2 India: Explaining India's Relative Growth Performance

	Average value (in percent)		Estimated Difference in Growth Rates 1/
	India	East Asia	(in percentage points)
Factors contributing to growth during 1970-95, as estimated by Kongsamut and Vamvakidis:			
Investment/GDP	21.9	29.6	-1.2
Net FDI/GDP	0.1	2.5	-0.8
Trade/GDP	4.5	113.5	-1.1
Government consumption/GDP	10.3	10.4	0.0
Secondary school enrollment rate	35.2	50.5	-0.3
CPI inflation rate	8.8	8.4	0.0
Convergence effect and other factors	...	...	0.2
Real per capita GDP growth (1970-95 average)	2.4	5.7	-3.3
Factors contributing to growth during 1992-95, as estimated by Bajpai and Sachs (1997):			
Saving/GDP	22.4	35.0	-1.2
Efficiency index	-0.7	0.6	-3.6
Convergence effect and other factors	...	...	2.1
Real per capita GDP growth (1992-95 average)	3.6	6.3	-2.7

Sources: Kongsamut, P. and A. Vamvakidis, "Economic Growth," in *The Philippines: Toward Sustainable and Rapid Growth*, IMF Occasional Paper 187 (Washington: International Monetary Fund, 2000); N. Bajpai and J. Sachs "India's Economic Reforms: Some Lessons from East Asia," *Journal of International Trade and Economic Development*, Vol. 6 No. 2 (1999), pp. 135-164

1/ Calculated as the estimated coefficient times the difference in the independent variable value (India - East Asia). Reported difference in growth rates of real per capita GDP are actuals