February 2007
IMF Country Report No. 07/63

India: 2006 Article IV Consultation—Staff Report; Staff Statement; and Public Information Notice on the Executive Board Discussion

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with India, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 17, 2006, with the officials of India on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 29, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff statement of December 20, 2006 updating information on recent developments; and

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its December 20, 2006 discussion of the staff report that concluded the Article IV consultation.

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

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INTERNATIONAL MONETARY FUND

INDIA

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the 2006 Article IV Consultation with India

Approved by Wanda Tseng and Matthew Fisher

November 29, 2006

- **Discussions**: Held in Mumbai and Delhi during October 3–17 with Reserve Bank of India Governor Reddy, Deputy Governors Mohan and Gopinath, Ministry of Finance Secretary Jha, other senior officials, market participants, and other private sector representatives.
- **Team**: Ms. Tseng (head), Mr. Kramer, Ms. Purfield, Ms. Poirson, Ms. Oura (all APD), Mr. Sy (MCM), Mr. Felman (Senior Resident Representative). Messrs. Misra, Executive Director, and Prasad, Senior Advisor, also participated in discussions.
- **Exchange system**: Managed float.
- **Economic statistics**: are adequate for surveillance purposes but some weaknesses remain (see Appendix V).
- **Previous Article IV consultation**: The authorities and the Fund have generally agreed on broad policy priorities. The last Article IV Consultation concluded on February 6, 2006, and the staff report was published as IMF Country Report No. 06/55. The Fund emphasized that macroeconomic policies should remain vigilant in view of upside risks to inflation and that accelerating structural reforms would bolster medium-term growth prospects. During 2006, India has tightened monetary policy and reduced the fiscal deficit. Steps were also taken to deepen financial markets, raise limits on FDI, and increase private investment in infrastructure. However, oil pass-through has remained partial, while progress on subsidy reforms, liberalization of labor laws, and privatization has proven difficult.

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EXECUTIVE SUMMARY

- **India's performance remains impressive**. The economy is in a fourth year of rapid expansion, with growth ranging around 8 percent and becoming more broad-based. Inflation is contained. Credit and asset markets are booming, partly reflecting financial deepening. Economic activity and financial markets have been resilient despite volatile oil prices, slowing U.S. growth, and tightening global liquidity.

- **In this environment, the main policy challenges are maintaining price and financial stability, while advancing fiscal and structural reform**:

  - Demand pressures are building, raising the risk of higher inflation down the road. The central bank's stance of continued gradual removal of monetary accommodation is appropriate and going forward would provide insurance against a possible inflation overshoot.

  - Rapid credit growth may pressure asset quality. Vigilant supervision, improved risk management and further tightening of prudential standards would provide early warning of any emergent vulnerabilities.

  - Broader and deeper financial markets would support economic and financial stability over the medium term. Continued steps to promote more liquid government securities markets, broaden the investor base, and foster corporate debt and derivatives markets would be useful.

  - Public debt, while declining relative to GDP, is high. Measures are needed to achieve the center's medium term targets, and fiscal space is needed for priority social spending. Steps are warranted on both revenue and expenditure sides, including broadening the tax base and reforming subsidies. Better targeting the tax incentives for SEZs would reduce the risk of an erosion of the tax base. Overperforming on the 2006/07 budget would also help contain overheating pressures.

  - Despite fast growth, job creation in the organized (formal) sector is lackluster, and poverty remains widespread. Steps are needed to enhance infrastructure and further liberalize the trade regime.

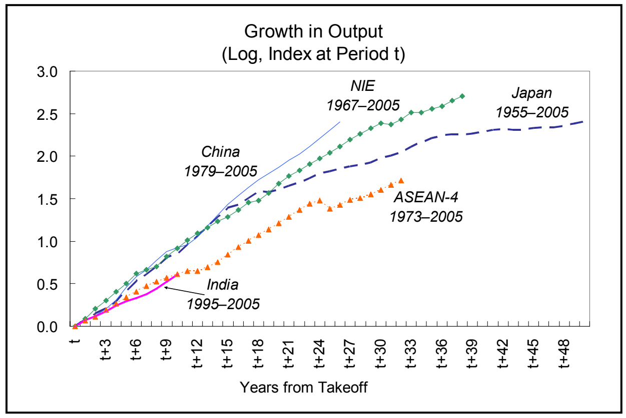
- **Decisive progress on these fronts would further boost sustainable growth and reduce poverty over the medium term, consistent with the authorities' objectives**. The strong conjuncture provides a favorable environment to accelerate the government's reform program to achieve this outcome.

I. Background

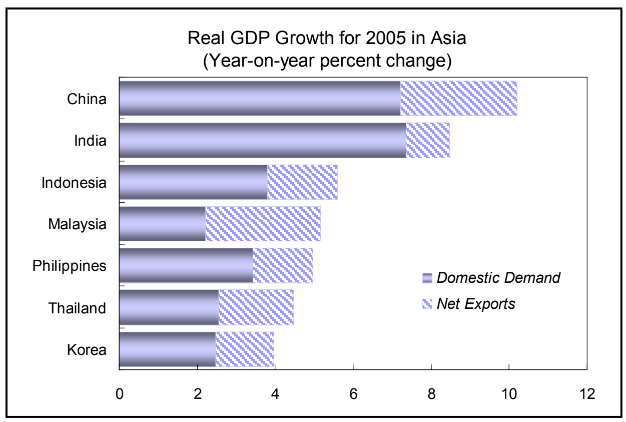
[Quoting Victor Hugo], "no power on earth can stop an idea whose time has come"…"and the emergence of India is one such idea. We have come far and this idea…is now an accepted axiom."

Prime Minister Singh, October 2006

1. **India has emerged as one of the world's fastest-growing economies**. GDP growth has ranged around 8 percent for four years running. The expansion has been resilient in the face of volatile oil prices and slowing U.S. growth. Exports market share remains modest, but prospects for brisk export growth bodes well for a rising market share over time. As elsewhere, investors have shrugged off the May/June emerging market turbulence, while Indian corporates are expanding overseas through high-profile acquisitions.



2. **In contrast to much of East Asia, where rebalancing demand is a policy issue, domestic demand is the main driver of activity**. India's consumption/GDP ratio—nearly two-thirds—is one of the highest in Asia, perhaps reflecting a high share of disposable income in GDP. In addition, following a period of corporate restructuring, investment has rebounded strongly, fed by buoyant corporate profits. Meanwhile, exports are growing apace as well, reflecting India's increasing integration into the global economy.



3. **Looking to the medium term, prospects are good for a sustained and robust expansion if reform momentum is maintained**. India appears to be in the beginning phase of a long-run takeoff that began in the mid-1990s on the heels of structural reforms. Going forward, the coming sharp rise in working-age population will support growth. Continued growth at staff's estimated trend (7.5 percent annually) would double per capita real income in 13 years, and faster growth could be achievable under decisive reforms. However, sustained reforms and job creation would be needed to take full advantage of the demographic dividend and attain India's full potential to improve living standards.

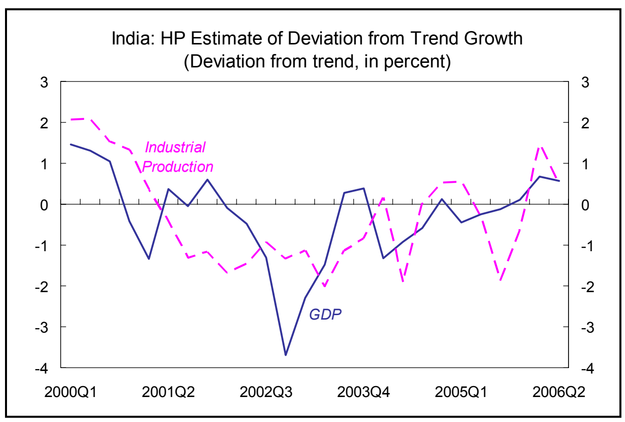
4. **Building consensus for these reforms will remain challenging**, reflecting the need to forge consensus among multiple and diverse coalition partners, as well as between the center and states.[1] In this context, progress on reforms is likely to remain steady and gradual, with issues such as labor market reform, privatization, and reducing public ownership of banks difficult.

5. **Against this backdrop, the 2006 Article IV consultation focused on the four main policy challenges facing India, which are also priorities in the government's agenda**. They are: achieving fiscal sustainability while financing development; managing price and financial stability; fostering a deeper and broader financial sector; and promoting more job-intensive, inclusive growth. In discussing policies for inclusive growth, as many structural issues are long standing and well covered in prior consultations, this consultation focused on issues in the policy debate that are most macro relevant—special economic zones, infrastructure, and trade.

II. Economic Backdrop

6. **Growth remains strong, inflation contained and the current account deficit manageable** (Table 2, Figure 1).

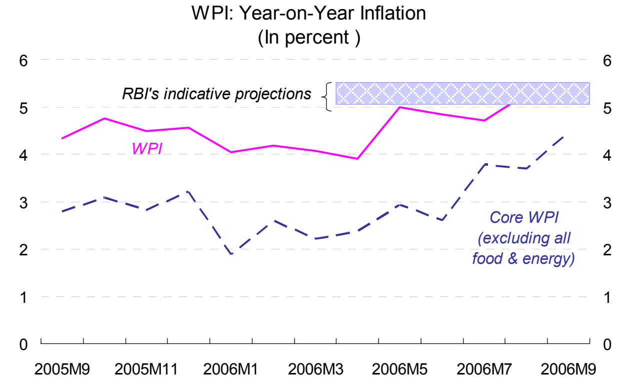
- *The economy continues to grow above trend*. In the first quarter of 2006/07,[2] demand accelerated to almost 9 percent y/y, and recent indicators show continued momentum. Growth is broad based, with robust consumption, investment and exports. With manufacturing expanding at over 10 percent y/y, industry has joined services as an engine of growth, and corporate profitability is strong. A normal monsoon is supporting agriculture.



[1] In key state elections earlier this year, the coalition's supporting partners carried several states by large margins. Upcoming races include six state elections slated for 2007 and the 2008/09 general elections.

[2] The fiscal year runs April-March.

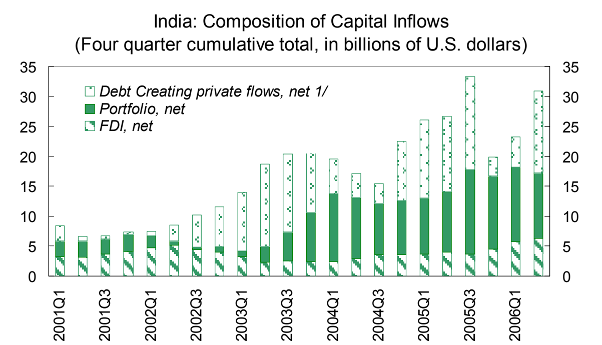
- *WPI inflation is contained,* partly reflecting limited-pass through of higher world oil prices to domestic LPG and kerosene (Box 1), cuts in import duties, monetary tightening, administrative steps to dampen food-price pressures, and competition from imports. However, high food prices are contributing to CPI inflation (industrial workers) exceeding 6 percent.



Sources: CEIC Data Company Ltd; the authorities; and, IMF staff calculations.

- *The current account deficit is widening.* Buoyant imports have offset rising goods and services exports, pushing up the trade deficit (Table 3, Figure 2).

7. **Strong capital inflows comfortably financed the current account deficit**. Inflows remain dominated by portfolio flows and external commercial borrowings (ECBs, which remain subject to capital controls), particularly convertible bonds. Foreign institutional investor (FII) inflows rebounded after the May/June stock market correction. Gross FDI inflows have begun to rise, partly offset by a pickup in outward investment by Indian corporates (Box 2).[3] Reserves rose to $167 billion by end-October 2006, a level equivalent to about 7½ months of imports of goods and services or about 7¼ times short-term external debt. To facilitate the expansion of Indian corporations' overseas activities, the RBI continues to cautiously raise limits on external commercial borrowings (by $250 million to $750 million) and recently doubled the amount banks can extend in credit to joint ventures abroad to 20 percent of banks' capital.



1/ The decline in capital inflows in 2005Q4 relates to $7.1 billion redemption of India millennium deposits.

[3] The regulatory regime for FDI has been gradually liberalized since 1991, and is no longer particularly restrictive by international standards.

Box 1. India: Rangarajan Committee on Pricing and Taxation of Petroleum Products

The Rangarajan report submitted in February 2006 made several major recommendations.

- A new pricing mechanism for petrol and diesel whereby oil companies have the freedom to set retail prices based on the trade parity price (a weighted average of the import parity and the export parity prices in the ratio of 80:20),which would operate as an indicative ceiling price.
- For petrol and diesel, reducing the customs duty from 10 percent to 7.5 percent; moving from a combination of ad valorem and specific taxes to specific taxes; and implementing a uniform sales tax.[1/]
- Restricting kerosene subsidies to below-poverty-line families, using a single retail price and passing subsidies through mechanisms such as debit cards, and financed through the budget.
- Gradually eliminating the subsidy on LPG (a one-time increase in cooking gas followed by further increases toward market level), which the Committee saw no merit in as it is used mainly by above-poverty-line families.

If implemented, according to the report these measures would eliminate subsidies on petrol and diesel, and reduce the subsidies on kerosene and LPG from 0.8 percent to 0.4 percent of 2005/06 GDP. The report also suggested that subsidies should be financed through specific taxes with the remainder through the budget, rather than financed through under-recoveries of upstream companies and the issuance of oil bonds.

Since the report was issued, the government has reduced the customs duty for petrol and diesel. While the trade parity price has been adopted, the automatic pricing mechanism for petrol and diesel has not become operational. In addition, reforms on kerosene and LPG subsidies have yet to be implemented.

India: Pricing of Petroleum Products (Delhi) 1/

	Gasoline	Diesel	Kerosene	LPG
Price changes since December 2003 (in percent)	41	49	0	22
Gap from full pass-through prices 2/ (in percent; staff estimates)	-4	10	170	58

Sources: Bloomberg L.P.; Indian Oil Corporation Ltd.; and IMF staff estimates.

1/ In Indian rupees.
2/ Full pass-through prices are estimated by adding international prices, freight and insurance costs, import duties, excise taxes, distribution and marketing costs, and state sales taxes with information provided by the Ministry of Petroleum.

1/ At the central level, taxation of petrol and diesel is already largely specific, but at the state level, it is largely ad valorem and varies widely across states.

Box 2. India Goes Global—The Boom in Overseas Acquisitions

The emergence of globally-competitive private corporates in India has triggered an unusual boom: its corporates have started to acquire foreign firms. Such acquisitions amounted to $7.2 billion in the first three quarters of 2006,[1/] then doubled in a single deal in October, when Tata Steel announced it would be spending $8–9 billion to take over Corus, a U.K./Dutch steelmaker. Such large acquisitions mark a coming of age for Indian companies. If sustained, they could also rewrite the development textbook. For when Japan and Korea began their overseas investment drives, their GDP per capita was ten times higher that that of India today. And although China and Russia have begun expanding overseas at a much earlier stage of development, their GDP per capita is still much higher than India's. Equally striking, India's outward FDI is exceptionally large relative to its still-small inward FDI. So, what explains India's sudden surge in acquisitions?

To begin with, Indian corporates have been taking over foreign firms, primarily in Europe and the United States, to gain direct access to advanced markets and technology. In other words, while other countries have imported technology through inward FDI, India is obtaining it through acquisitions. One reason why Indian corporates have been able to do this is that their business models are very similar to western ones, both in terms of framework and governance, and they have managers who have been trained in western universities and speak English.

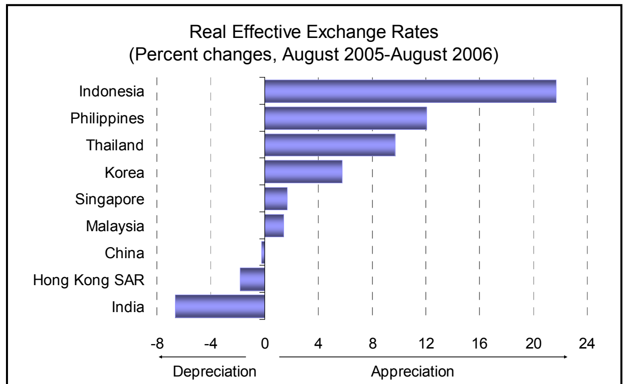
A second factor has to do with finance. After a decade of restructuring, the profitability of Indian corporates is very high, while their leverage—unlike in East Asia—is quite low. Consequently, international financial firms have been willing to help fund these acquisitions, especially given the current benign global financial environment. In many cases, acquisitions have taken the form of leveraged buy-outs, whereby a special purpose vehicle (SPV) is incorporated in the country of acquisition, and then borrows against the cash flow and assets of the acquired company. This mechanism not only allows the Indian company to take over foreign companies of much large scale, but also leaves financial room for the parent company to make further acquisitions abroad and expand domestically.

A third factor has to do with competitiveness. India's shopping list belies the conventional perception that India has a comparative advantage only in information technology and related services. Initially, the overseas boom was indeed triggered by software companies, which wanted to enlarge and diversify their customer base, establish an on-site presence for their clients, and move up the value chain. But over the past few years, as manufacturing companies have also emerged as internationally efficient and low-cost producers, they have also started to acquire foreign firms, including in the textiles, auto parts, chemicals, and now steel sectors. Further, these acquisitions are not confined to large corporates: smaller manufactures have now joined the race overseas, too.

Better information is needed to monitor and manage any attendant risks. Banks should be aware of their clients' worldwide financial exposures, including leverage taken on through overseas financial activities. In addition, macroeconomic data on outward FDI can be improved, specifically to include outflows financed through offshore vehicles.

1/ According to Dealogic.

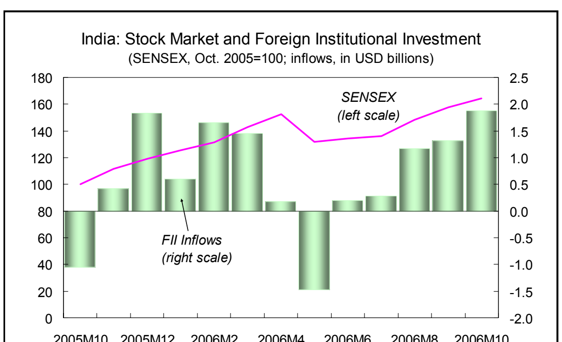
8. **The rupee has fluctuated against the U.S. dollar and its real effective value is broadly around its 2004−2005 level**. The rupee depreciated against the U.S. dollar in the first half of 2006, against a backdrop of tightening global liquidity and a widening current account deficit. In addition, the RBI intervened in the foreign exchange market, easing exchange-rate volatility and smoothing domestic liquidity pressures that arose following the redemption of Indian Millennium Development Bonds.[4] Since then, the rupee has regained ground against the dollar and the RBI has intervened only occasionally, both buying and selling dollars.



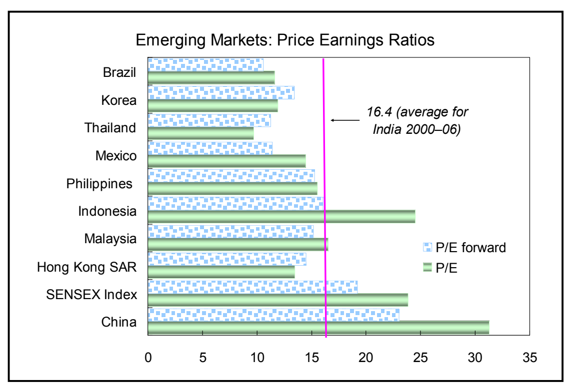
Source: IMF, INS database.

9. **Since October 2005, the RBI has gradually raised policy rates**. The reverse repo (borrowing) rate has risen 100 bps to 6 percent, while the repo (lending) rate has risen 125 bps to 7.25 percent (Table 4, Figure 3). High credit growth prompted the RBI to tighten prudential standards, including by raising general provisioning requirements and boosting risk weights in the high-growth areas, including real estate, to above Basel norms. Indicators of financial soundness (while backward looking) suggest that banks' balance sheets and income remain healthy.

10. **Financial markets continue to soar**. Stock prices recovered smartly from the May/June turbulence, reaching new historical highs on the back of strong foreign and domestic purchases. PE ratios are now high relative to other countries and India's recent past. Meanwhile, real estate prices continue to grow at a rapid clip (Figure 4).

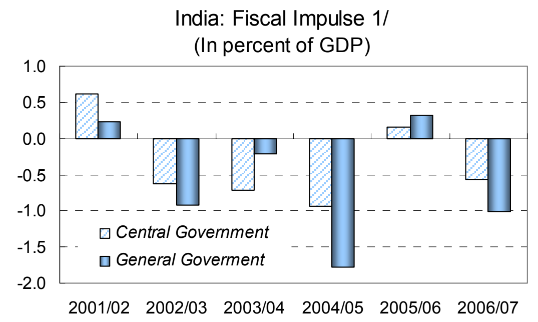


Sources: CEIC Data Company Ltd and IMF staff calculations.



[4] The Millennium Development Bonds were issued by the State Bank of India in 2000. They fell due for repayment in December 2005, with a repayment amount of some $7 billion (including accrued interest).

11. **Fiscal consolidation paused in FY 2005/06**. The general government deficit was broadly unchanged at 7.4 percent of GDP (Tables 5–6, Figure 5), with a modestly rising central government deficit broadly offset by a falling state deficit. General government debt remains high—over 80 percent of GDP—reflecting both budget deficits and off-budget subsidies.[5]



1/ Calculated using the authorities' definition (excluding off budget FCI and oil bonds).

III. Outlook and Risks

12. **The near term macroeconomic outlook is bright**. Real GDP growth is expected to ease to 8.2 percent in 2006/07, as growth moderates toward trend (Table 7). WPI inflation would remain in the 5–5½ percent range. Robust domestic demand is expected to contribute to a slight widening in the current account deficit (notwithstanding strong exports and services), readily financed by capital inflows.

13. **The balance of near-term risks is to the upside**. Reading inflationary pressures is complicated by uncertainties about the extent to which credit and output buoyancy reflect financial deepening and rising productivity, rather than overheating. That said, with GDP continuing to grow above trend, increases in international oil prices not yet fully passed through, credit and asset prices buoyant, and monetary conditions accommodative, the risk of overheating cannot be ruled out. On the international front, a sharper U.S. slowdown with potential spillovers to world growth could erode confidence in international financial markets, triggering capital outflows and volatility in emerging markets.

14. **Several factors work to limit vulnerabilities**. On the external side, reserves are equivalent to over seven months of imports, while short-term external debt amounts to only 12 percent of reserves and overall external debt is 70 percent of exports (Tables 8 and 10). The current account deficit, at 1½ percent of GDP, is manageable: external commercial borrowing is subject to quantitative, term, and end-use restrictions, and the exchange rate is flexible. Moreover, direct exposure to a global growth slowdown is modest in light of India's moderate level of trade openness and its diversified trading partners (a 1-percentage point decline in U.S. growth would reduce India's growth by about 0.1–0.2 percent in the short run). On the domestic side, financial soundness indicators (while backward looking) are favorable, and with asset holdings still modest, wealth effects from asset-price fluctuations

[5] Oil bonds equivalent to 0.3 percent of GDP were issued to state petroleum companies in 2005/06; a further 0.4 percent of GDP is planned for 2006/07, along with 0.4 percent of GDP in Food Corporation of India (FCI) subsidy bonds.

are small. The fiscal debt and deficit are on a downward trajectory, helped by a favorable interest/growth differential.[6]

IV. Key Policy Challenges

15. **India faces four main policy challenges**:

- *Achieving fiscal sustainability while financing development,* by reducing high debt and creating fiscal room to fund priority-spending needs.

- *Managing price and financial stability*, by limiting the risk of overheating in demand and further strengthening financial regulation.

- *Fostering a broader and deeper financial sector* to expand the channels for saving, investment and risk management.

- *Promoting more job-intensive, inclusive growth*, through further structural reforms to create an environment in which growth more fully benefits the least advantaged.

16. **The authorities are cognizant that much work needs to be done if they are to realize their objective of raising growth to the 9–10 percent range**. Discussions mainly surrounded the implementation of the specific reforms that the authorities are considering in each of these four key areas, and in particular their desirable modalities and pace. The mission considered that the present conjuncture of strong growth provided a good opportunity to accelerate the government's reform agenda.

A. How Can India Best Achieve Fiscal Sustainability While Financing Development?

Background and Staff Views

17. **The authorities' medium-term fiscal strategy has two main pillars: the Fiscal Responsibility and Budget Management Act (FRBMA) and the Twelfth Finance Commission (TFC)**. The FRMBA targets a central government revenue (current) deficit of zero and an overall deficit of 3 percent of GDP by 2008/09. The TFC offers states debt relief and other incentives to adopt and implement fiscal responsibility laws (FRLs).[7] With this framework, the government aims to eliminate the general government revenue deficit and reduce the general government overall deficit to 6 percent of GDP by 2008/09, which would

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[6] The decline would be more gradual if the differential returned to its historical average; see Appendix I.

[7] All but five states enacted FRLs and nine states subsequently received TFC debt relief. Box 3 in IMF Country Report No. 06/55 describes the TFC.

place India's debt ratio firmly on a downward trajectory (Appendix I). However, within this framework, room also needs to be made for priority social spending; the Approach Paper for India's 11th Plan estimates that such spending needs to rise by 2½ percent of GDP by 2011. Meeting FRBM and TFC targets would speed up the medium-term decline in the debt/GDP ratio, and would be a good step toward longer-term debt reduction. Medium-term consolidation would also facilitate faster progress in financial sector reform and capital account liberalization.

18. **Consolidation under the FRBMA has resumed**. The 2006/07 central and state government budgets imply a 1 percent of GDP cut in the general government deficit, with adjustment at the center in line with FRBMA rules.[8] This would bring the cumulative decline in the general government deficit since the 2003/04 enactment of the FRBMA to 2¾ percent of GDP, with a fall in debt/GDP of around 5 percentage points of GDP.

19. **However, according to staff estimates, reaching the government's medium term targets will require further efforts at both the central and state levels**.

- *Achieving the center's FRBMA target of current balance in FY2008/09 will require additional measures*. While revenue buoyancy and planned expenditure restraint will help to narrow the deficit, measures equivalent to 0.8 percentage points of GDP will be needed (beyond the current-policies baseline) (see Appendix I).

- *In aggregate, states are well placed to meet medium-term adjustment targets, but the task will be more difficult for some states.* Already in 2006/07, the consolidated state budget deficit targets (overall and current) are broadly in line with the TFC's 2008/09 targets and achievable. But 13 of the 28 states failed to reduce their deficits from previous-year levels in 2005/06, as the TFC requires. Of these, 11 states, accounting for about a quarter of the aggregate states' deficit, had deficits that were more than 1 percentage point of state GDP above the 3 percent medium-term TFC target.

20. **The favorable near-term outlook provides an ideal opportunity to accelerate fiscal reform and make progress toward medium-term consolidation**.

- *Central government revenues are poised to overperform in 2006/07.* Stronger-than-expected GDP growth is boosting revenues, and expenditure remains contained. Accordingly, staff projects that the budget could overperform by 0.2 percent of GDP in 2006/07 if the tax windfall is saved. This stance would also help to contain any demand pressures.

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[8] Except where specified, cited figures correspond to the authorities' definitions of the deficit, which exclude off-budget issuance of subsidy bonds that have partly offset budgetary adjustment.

- *Looking to the medium term, comprehensive revenue and spending reforms could achieve FRBMA targets while creating resources for priory spending*. Broadening the tax base, by removing corporate income tax (CIT) and excise duty exemptions, could boost revenues by up to 1½ percent of GDP.[9] Eliminating non-essential subsidies, and better targeting food, oil, and fertilizer subsidies, could save up to 2¼ percent of GDP.[10] A more flexible, market-based pricing mechanism for petroleum products would also limit fiscal risks if oil prices rebounded (as well as improve incentives to conserve consumption and expand productive capacity). Subsidy reforms should be promptly acted on, and would complement ongoing efforts to improve spending efficiency, which include output-based budgeting and improved service delivery.

- *Tighter borrowing ceilings could reinforce states' adjustment efforts*. States' annual borrowing ceilings could be brought in line with adjustments targeted under their FRLs. This would require reducing states' dependence on National Small Savings Funds (NSSF) in favor of market borrowings subject to a borrowing cap.[11] Such a strategy would, however, require comprehensive NSSF reform (as recommended by the Reddy and Mohan Committees), including linking deposit rates to market rates and scaling back tax exemptions.

- *Care is needed to limit the risks of the forthcoming review of civil service pay.* The Sixth Pay Commission (SPC) will update the center's pay structure with a view to implementation in 2008/09. (States generally follow Pay Commission recommendations.) The previous pay review contributed to the deterioration in state finances in the late 1990s.[12]

Authorities' Plans and Views

21. **The authorities reiterated their strong commitment to the FRBMA**. They saw scope to overperform on the 2006/07 budget but acknowledged that reaching the 2008/09 current deficit target would be a challenge. However, with resolute actions on both revenue and spending they were confident that they would meet FRMBA targets. Their strategy for medium-term adjustment focused on strengthening tax administration, working toward a

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[9] These steps were recommended by the 2004 *Kelkar Report on Tax Reform*. Savings estimates are based on 2004/05 tax expenditure estimates published in the budget.

[10] See *The Central Government Subsidies Report* (2004).

[11] The government-run NSSF is administered via 154,000 post offices and over 8,000 public sector bank branches. For retail savers it offers a risk-free, tax-exempt, above-market interest rate. NSSF deposits are a captive source of finance for states, which are required to borrow 100 percent of net collections in their state.

[12] The Fifth Pay Commission resulted in a 0.9 percent of GDP increase in state employee compensation and a 0.5 percent of GDP increase in central wage and pension payments.

national Goods and Service Tax (GST), improving expenditure management, and reforming subsidies.

- *On tax administration*, recent and ongoing steps included introducing a large taxpayer unit, increasing use of electronic filing, and better-targeted audits. Favorable growth would keep direct tax and overall tax revenue buoyancy at current levels. Progress toward introducing a GST hinged on negotiations with states on revenue-sharing arrangements surrounding the phase out of the interstate tax.

- *On expenditure management,* the government planned to focus on priority rural and social programs. The growth in spending on these programs was expected to taper off now that they have been launched. For example, the National Rural Employment Guarantee program was introduced this year on a pilot basis in the poorest regions, before being expanded to all districts over the next two years. Going forward, strengthening implementation capacity and service delivery was seen as key, as a fast pace of spending may not result in intended outcomes. More generally, resources for social and infrastructure priorities remain subject to the FRBMA framework.

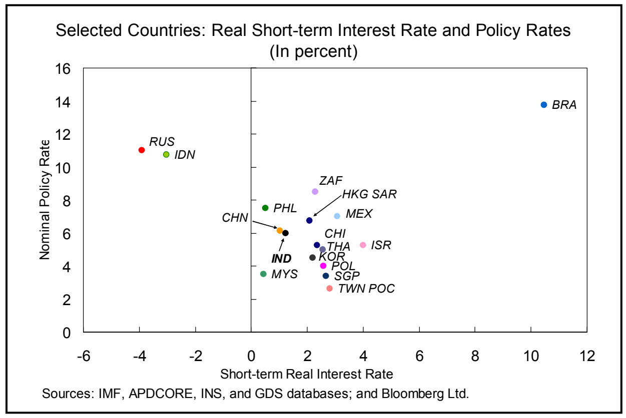
- *Subsidy reform is an important element of the expenditure strategy*. Efforts are underway to improve cost efficiency and reduce the interest burden of the FCI. However, the authorities reiterated the constraints to more fundamental reform, especially for oil subsidies.

22. **The authorities shared the concern that some states may fall short of the TFC's adjustment targets**. States with high initial deficits would require sizeable adjustments. However, they were hopeful that market discipline would increase as more states access markets, and that demonstration effects would prompt laggard states to reform. The authorities noted that lowering the share of NSSF borrowing taken by states would have broader implications, and had established a working group to study reform options.

23. **With the SPC recommendations still two years away from formulation, staff's concerns were seen as premature**. In any case, the lessons from the Fifth Pay Commission were well known. Moreover, with compensation already indexed to inflation, large hikes would not likely be needed.

B. How Can India Best Manage Price and Financial Stability?

Background and Staff Views



24. **While inflation remained contained, price pressures could emerge**. Monetary aggregates are expanding at rates well above RBI indicative projections, while real interest rates remain low from a historical and cross-country perspective.[13] In addition, while tightening in risk weights and provisioning standards has eased the credit expansion, growth in the new mortgage, retail, and commercial real estate lending segments remains strong.

25. **The RBI's stance of continued gradual removal of monetary accommodation, going forward, would provide insurance against a possible inflation overshoot**. This strategy would anchor inflation expectations and moderate the credit expansion by raising the cost of funds.

26. **The mission agreed that risks to financial stability were best managed by targeted prudential measures, better risk management, and enhanced supervision** (Box 3).

- *Scope exists to further tighten selected prudential norms in specific sectors*. Going forward, the key is to ensure that banks recognize early any pending deterioration in credit quality. The adoption of Basel II will help in this regard, as will stress tests. However, there is also scope to shorten the timeline for classifying sub-standard and doubtful loans, bringing classification and provisioning norms further toward best international practice.

- *Securitization can be better developed as an important avenue for banks to manage balance sheet risks*. Streamlining capital requirements for mortgage-backed securitization products, and stamp duties on securitized products, and removing legal impediments to the secondary market trading of such securities would promote market development.

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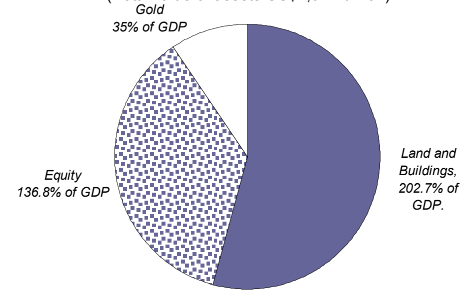
[13] The RBI's monetary policy framework follows a broad-based multiple-indicator approach, with indicative projections for inflation, as well as for growth in broad money, credit, and economic activity.

Box 3. India: How Should Policy Respond to the Asset Price Boom?

Asset values in India have been growing rapidly. Holdings of real estate, equity and gold are now sizable relative to GDP, with prices in each asset class having risen sharply. Since 2000, housing prices in India's main cities have more than doubled, as have gold prices, and between January 2003 and October 2006, the SENSEX has increased at a compound annual rate of about 40 percent. As rapidly rising asset prices can have implications for inflation and financial system stability, the question arises how macroeconomic (in particular monetary) policy should respond.



For monetary policy to be effective in addressing the risks associated with asset price volatility, it is necessary that

- Policymakers accurately identify asset price misalignments and bubbles.
- Fluctuations in asset prices are sizeable and macroeconomically significant.
- There are identifiable relationships between (a) asset prices and inflation, (b) asset prices and aggregate demand, and (c) changes in monetary policy and changes in asset prices.

These preconditions are not met in India. In particular, rapid structural change makes the identification of reliable macro-financial relationships and asset price misalignment difficult. On an informal level, recent price movements appear to be driven by fundamentals—housing prices seem to reflect rising per capita incomes, growing population, increased affordability, and easier access to credit, while stock market valuations appear to be supported by future growth. But overall, there is little firm data to conduct concrete analysis.[1/] That said, the wealth and financial accelerator channels through which asset prices impact economic activity are likely to be small reflecting households' limited direct and indirect holdings (via pension and insurance funds) of financial assets. Staff finds that a 10 percent increase in the stock market index is only associated with an increase in real private consumption of one tenth of one percent. In light of this, the RBI's approach of tightening prudential norms and raising risk weights in the areas of high credit growth, and the intensification of supervisory efforts, is appropriate.

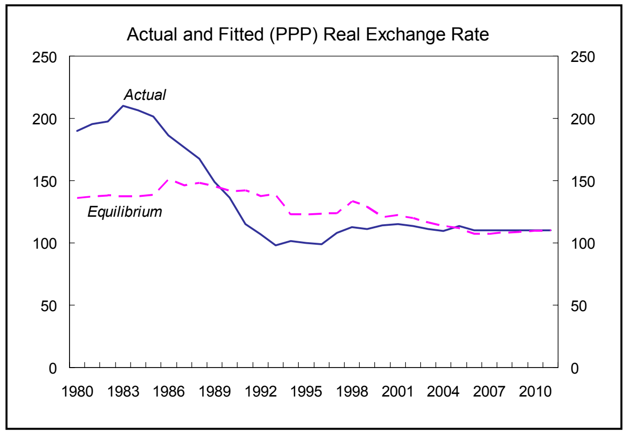
India: Household Financial Assets

	1993/94	2003/04	2005/06
	(In percent of GDP)		
Total financial assets	12.6	14.0	16.7
Currency	1.5	1.5	1.5
Deposits	5.4	5.8	7.9
Shares and debentures	1.7	0.1	0.8
Government securities/small savings	0.8	2.8	2.5
Insurance funds	1.1	1.9	2.2
Provident and pension funds	2.1	1.9	1.9

Sources: Central Statistical Organisation; and Reserve Bank of India.

1/ For related analysis see *Asia-Pacific Regional Economic Outlook,* September 2006.

27. **The mission saw the present market-determined exchange rate policy as serving India well**. The RBI's approach to exchange rate management allows two-way flexibility. In addition, the exchange rate appears to be broadly in line with fundamentals, although such empirical analysis is imprecise and should be treated with caution.[14] More generally, competitiveness does not seem to be a problem. Evidence of wage pressures seems to be confined to a few sectors and to skilled labor. India's share of world exports has been gradually trending upward over time, although it remains modest (see Figure 2). Looking ahead, continued two-way flexibility in the exchange rate will allow appropriate adjustment of the exchange rate to rising trade flows and facilitate greater capital account openness (as contemplated by the Tarapore Committee on Fuller Capital Account Liberalization (Box 4)). By the same token, targeting the level of the real effective exchange rate (as suggested by the Tarapore Committee) would not be warranted.



28. **Continued fiscal reform and steps to deepen financial markets would complement plans for further capital account liberalization**. The Tarapore report outlines a road map that envisages further gradual lifting of capital controls, with accompanying steps to strengthen the fiscal position and financial sector, broadly in line with generally accepted views about the appropriate phasing of capital account liberalization. Such liberalization has the potential to bring important benefits by further integrating India with international capital markets. A gradual approach, with complementary fiscal consolidation and strengthening of the financial sector (including a reduced public-sector role in financial intermediation, as envisaged by the report), would best manage the risks and reap the benefits of this approach.

Authorities' Plans and Views

29. **The RBI saw the balance of risks at this juncture as broadly favorable**. Inflation expectations were well anchored. Long-term bond yields had eased substantially from peaks,

[14] India's REER is close to the prediction of a staff model that relates the real effective rupee to productivity growth relative to trading partners, net foreign assets, and terms of trade (as shown in the figure). See also the analysis in Box 5 of the 2005 staff report (IMF Country Report No. 06/55), which reached a similar conclusion. Recent studies of the equilibrium level of the rupee yield widely varying results, ranging from an undervaluation of 30 percent to an overvaluation of about 5–10 percent at end-2004 (see IMF Country Report No. 06/56 for further details).

Box 4. India: Key Liberalization Steps Envisaged in the 2006 Tarapore Report

Like the Committee's 1997 report, the 2006 report envisages a gradual and partial liberalization of capital controls, over five years. Controls would be gradually eased on foreign holdings of Indian government and corporate bonds, and foreign investment in India's stock market, as well as foreign bond issuance in rupees, external commercial borrowing by Indian corporations and banks, and Indian investment abroad. Controls on resident individuals would remain in place, but caps on residents' outflows would be gradually raised.

The reports identify a comprehensive menu of reforms to minimize the potential risks associated with freer capital movements. The most important include:

- *Fiscal consolidation*: The central government should target a current budget surplus of 1 percent of GDP by 2010/11 to allow the gross borrowing requirement to fall.
- *A "fairly valued" exchange rate:* The RBI would target an exchange rate band of +/-5 percent around the neutral (not defined) level of the real effective exchange rate.
- *Strong domestic banking system*: RBI would (i) formulate prudential policies to encourage consolidation, and facilitate the emergence of four to five strong domestic banks that can compete better against foreign banks; (ii) encourage institutions to set up new private banks; and (iii) allow industrial houses to take stakes in Indian banks. The Government's (or RBI's) share in public banks would fall to 33 percent from 51 percent, and bank governance would be improved.
- *Well developed financial markets*. Steps to broaden the investor bases in money, government securities, corporate bond, and derivatives markets, including reducing statutory liquidity requirements and raising banks' mark-to-market asset portfolios.

	Inflows	Outflows
Non-Residents	*Debt* • Foreign Institutional Investor (FII) limits in government bonds increased to a maximum of 10 percent of annual total general government gross issuance; • FII investments limits in corporate bonds increased to a maximum of 25 percent of new issuance; and • Foreign institutions and corporates allowed to raise rupee-denominated bonds subject to a ceiling. *Equity* • All individuals and corporates allowed to invest in the Indian stock market through SEBI-registered entities.	
Residents	*Debt* • The ceiling for external commercial borrowing (ECB) raised and end use restrictions removed; and • Limits for overseas borrowing by banks linked to a broader definition of capital and raised.	*Corporate Investment* • Limits for corporate investments abroad doubled to four times their net worth. *Individuals* • Overall ceilings on mutual funds' investments raised to $5 billion • Caps on residents' outflows gradually raised to $200,000 per capita per year.

and officials saw little evidence of generalized wage pressures. The RBI was closely monitoring demand conditions and asset prices, but noted that inflation pressures were hard to gauge in an environment of ongoing structural change and financial deepening.

30. **The RBI remained vigilant, particularly in light of sustained rapid growth in monetary and credit aggregates and elevated asset prices**. However, a calibrated response was needed to avoid an adverse impact on the investment needed to sustain current growth rates. Given low inflation, lack of conclusive evidence of overheating, and lagged effects of earlier rate increases that had yet to feed through the system, the RBI preferred to closely monitor evolving macroeconomic developments. After the staff mission, at its end-October mid-year review of monetary policy, the RBI raised the rate at which it injects liquidity by 25 bps to 7¼ percent but left unchanged the rate at which it absorbs liquidity at 6 percent.

31. **The authorities saw the strong credit growth as a sign of financial deepening and robust economic activity, but were nonetheless alert for risks**.[15]

- *Financial soundness indicators are strong (Table 9)*: Low gross and net nonperforming loans reflected a pickup in loan recoveries on the back of an improved legal foreclosure framework, strong asset price growth, and turnaround in industrial profitability.

- *Loan origination standards are conservative*: The RBI was mindful that low retail and mortgage NPLs—less than 2½ percent—reflected a nascent market. However, conservative mortgage loan-to-value ratios (60–70 percent), the practice of making the loan size dependent on repayment capacity, and the separation of banks' loan origination and appraisal functions would help limit risks going forward. The credit information bureau was now fully operational, providing banks with information on retail borrowers. While the commercial real estate boom warranted continued attention, such lending still comprised only around 5.8 percent of total loans (including indirect exposure).

- *The RBI has recently issued guidelines for banks to conduct stress tests of their market, credit and other exposures*. Such tests, conducted regularly by systemically important banks and with implementation reviewed by the RBI, are expected to play an important role in alerting banks and the RBI to potential vulnerabilities.

[15] The 2005 *India—Selected Issues* (IMF Country Report No. 06/56) examined the issue of credit growth and concluded that credit risks were manageable.

- *The RBI is enhancing prudential standards*. Risk weights and provisioning in high-growth sectors were tightened. Stress tests and Basel II would encourage further risk management improvements. However, Basel II implementation would be challenging, in part due to information technology demands and the need to develop human skills. Accordingly, in October 2006 the timeline for its introduction was extended to March 2008 for banks with foreign operations, and to March 2009 for domestic banks. (The RBI estimates that banks will need to raise an additional 1 percent in capital for Basel II implementation, but it does not view this as a major hurdle for banks, especially as it has introduced new options for raising capital.)

- *Banks are managing funding risks*. To fund rapid credit growth, banks have reduced holdings of government securities. Deposit growth has picked up, aided by new tax incentives on term deposits and higher interest rates, helping reduce the incremental credit-deposit rate to under 80 percent. The RBI has alerted banks to the risks associated with wholesale commercial deposits, which were a growing source of funding but could be less stable than retail deposits.

- *The authorities are also undertaking a self-conducted assessment of financial stability and development.* The self-assessment would provide the opportunity to review systemic risks in the banking system, and the authorities plan to publish its results.

32. **The policy of a market-determined exchange rate remains unchanged**. The RBI reiterated its policy of no target or pre-announced path for the exchange rate. They noted that two-way variability in the exchange rate was encouraging corporations to hedge their open foreign exchange exposures. On the recent Tarapore Committee recommendations on the REER, the authorities noted that a previous report by that Committee had made the same recommendation, but it was not adopted.

33. **The Tarapore committee recommendations on capital account liberalization could also be a means to promote financial market development**. The RBI has established a committee to streamline foreign exchange regulations. In October 2006, the RBI announced additional steps to gradually liberalize capital flows, including increases in the limits on outflows by individual residents and overseas investments by mutual funds, and enhancements in currency hedging available for external trade. The authorities stressed that the liberalization process would proceed gradually in light of the fiscal deficit, as well as the need to further develop financial markets–which was seen as key.

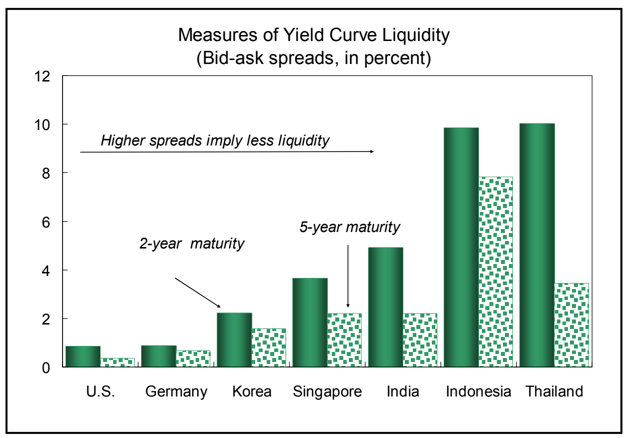
C. What Are the Priorities for Fostering A Broader and Deeper Financial Sector?

Background and Staff Views

34. **Developing India's financial markets would promote more efficient intermediation and risk management, with benefits for growth**. In addition to enhancing capital allocation, broader and more liquid financial markets will help to finance infrastructure development, as well as provide a broader set of tools to manage risks and facilitate capital account liberalization.

35. **The challenge going forward will be to develop the basic pillars for vibrant financial markets**. Existing benchmarks such as the money market and government securities markets need to be developed and made more liquid. The embryonic corporate bond and derivative markets need to grow to play a meaningful role in financing India's development. Finally, broadening the investor base, including through ongoing efforts to develop pension and insurance markets, will be crucial.

- *Improving benchmarks:* A deeper term money market could aid the development of financial markets by establishing reliable short-term pricing benchmarks. At present, the market is concentrated at the overnight maturity, reflecting the limited treasury operations of public banks, and term money markets are dominated by instruments such as CDs and CP. In addition, increased liquidity in the government securities (G-Sec) yield curve would establish more reliable pricing benchmarks for other long-term instruments. The G-Sec market is relatively illiquid on account of fragmentation of benchmark issues; limited short selling and when-issued trading; low foreign investor participation; and statutory restrictions that result in buy-and-hold behavior.



- *Developing corporate bond and derivatives markets*:[16] The corporate bond market is hampered by cumbersome issuance procedures, statutory guidelines that restrict banks' and institutional investors' holdings, and limits on foreign investor participation. The market is dominated by financial institutions and state-owned enterprises, who generally issue bonds with maturities of less than five years.

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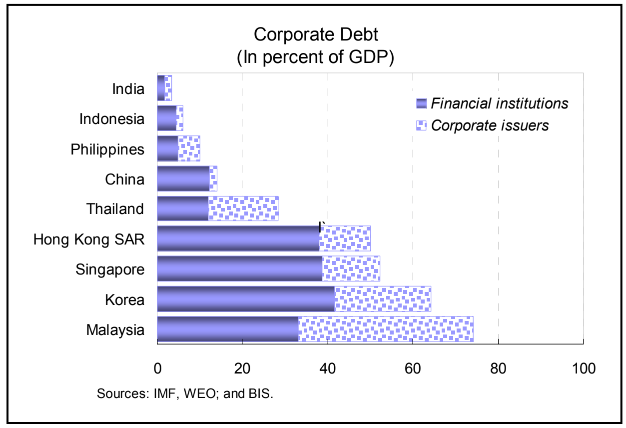
[16] See World Bank, 2006, *Developing India's Corporate Bond Market.*

Meanwhile, the OTC derivatives market is concentrated in relatively small number of institutions (India's top 15 banks account for about 82 percent of the banking system's off-balance sheet derivative exposure, of which two-thirds are held by foreign banks). The concentration of trading in a relatively small number of banks partly reflects the limited risk-management skills and market knowledge outside participating dealers.



- *Broadening the institutional investor base*: Insurance and pension reforms will broaden the institutional investor base and increase available long-term funding. The deregulation and opening of the insurance sector to private companies in 2000 has spurred rapid growth of the mutual fund and insurance industries. Forthcoming insurance reforms, including the increase in the FDI limit and the gradual lifting of pricing restrictions starting in 2007, should help ensure continued strong growth of the sector. The Pension Bill under consideration would open the sector to private participation and could transform the corporate bond and equity markets (Box 5).

Authorities' Plans and Views

"… if we can push through financial sector reforms, the growth rate will not be at 8 percent but close to 9.4 percent."

Finance Minister Chidambaram, October 2006

36. **The authorities agreed on the importance of vibrant financial markets**.

- In the money markets, the RBI is focused on developing collateralized segments, with a view to limiting credit risk and ensuring stability. In 2005, the creation of an anonymous order matching trading screen promoted the development of an active collateralized market. More recently, the RBI has created a screen-based system for transactions in the call and term money markets. The authorities are also considering the recommendations of a 2005 Report by the Technical Group on Money Markets, which recommended broadening the range of assets that could be utilized as collateral in repo transactions, including for example state government securities. Mainly in order to limit credit risk in the unsecured call money market, in 2005 participation was restricted to primary dealers.

Box 5. India: Financial Market Implications of Pension Reform

Decentralization of pension fund management, as envisaged in India, can spur major capital market development. In Latin America and Eastern Europe, reforms allocating the management of pension fund assets to specialized, privately-managed institutions generated fast growth in pension-led asset demand (1−1½ percent of GDP a year on average). In several cases, they also fostered new financial instruments such as mortgage backed securities (MBS) and other forms of securitization, venture capital, and inflation-protected bonds.

International experience suggests that pension reforms are most likely to contribute to the development of capital markets in the context of certain supporting conditions, such as:

- *Build-up of a critical mass*. The reform may need to generate sufficient asset demand before it can kick-start financial market development. Empirical tests validate the link between pension sector growth and financial depth in Chile, where after two decades the pension sector has reached a size comparable to that of the United Kingdom; however they fail to detect such a link for countries with a shorter history of reforms.[1/]

- *Design of capital market laws and regulations.* Laws and regulations should be flexible enough allow new instruments to appear, which can be suitable investments for pension funds. Some consider that this may require shifting from a positive to a negative system of regulation, in which all activities that are not expressly forbidden would be allowed. It may also require the buildup of market infrastructure.

- *Regulatory guidelines that enable optimum portfolio diversification.* For instance, Colombian pension funds hold 30 percent of their assets in corporate bonds, whereas Mexican pension funds hold less than 12 percent due to restrictive investment regulations. Similarly, Chilean pension funds hold 50–60 percent of outstanding private debt securities (corporate bonds and MBS) compared to one third for Mexican funds. Allowing investments abroad, commensurate with fund managers' expertise, also supports risk diversification. In underdeveloped markets, it also prevents imbalances between pension-led demand and the domestic supply of securities from heightening volatility in the short term.

The pension reform in India may not build critical mass initially, as its mandatory pillar is restricted to new government entrants. Along with pension reforms, concurrent improvements in the corporate governance of exempt nongovernment provident funds (employee pension funds), by making their boards more accountable for performance, could further strengthen the demand for new investment products and asset diversification, and help achieve the critical mass earlier.

1/ See Walker, Eduardo, and Fernando Lefort, 2002, "Pension Reform and Capital Markets: Are There Any (Hard) Links?," Social Protection Discussion Paper Series No. 0201 (Washington: World Bank).

- *Initiatives are afoot to develop a more liquid G-Sec yield curve.* In October 2006 the RBI expanded the scope of "when-issued" trading beyond reissues to selected new issues, extended permitted short sales from intraday to five days, and allowed the delivery of borrowed securities for repo transactions. The RBI is gradually consolidating reissues along the yield curve, while mindful of the fiscal implications of debt operations. The Government Securities Act (2006) legalizes stripping. The RBI has also proposed to broaden the investor base by gradually raising the limit on foreign participation in the G-Sec market to \$3.2 billion by March 31, 2007, from its current level of \$2 billion.

- *The authorities recognize the need for a dynamic corporate bond market.* The authorities are considering the report of the 2005 High Level Expert Committee on Corporate Bonds and Securitization, which recommended (i) permitting investment by institutional investors in rated corporate bonds; (ii) raising the limit on foreign institutional investment in corporate bonds; (iii) harmonizing state level stamp duties and tax deduction at source by investor type; and, (iv) setting up a system of market makers, developing a trade reporting system and clearing and settlement system to spur secondary market trading.

- *The RBI is developing a prudential regulatory and supervisory framework for OTC derivatives.* The 2006 Amendment to the RBI Act clarifies the legal status of OTC derivatives, and establishes the RBI as the regulator of the OTC derivatives market. The RBI has also tightened prudential norms. Banks are now required to hold minimum defined regulatory capital to cover their off-balance sheet exposures and banks are required to adhere to minimum transparency and disclosure requirements (capital adequacy norms for OTC derivatives have been in line with Basel I for some time). The 2006 guidelines for the valuation and accounting of derivatives introduce fair value accounting norms akin to international accounting standards (IAS39).

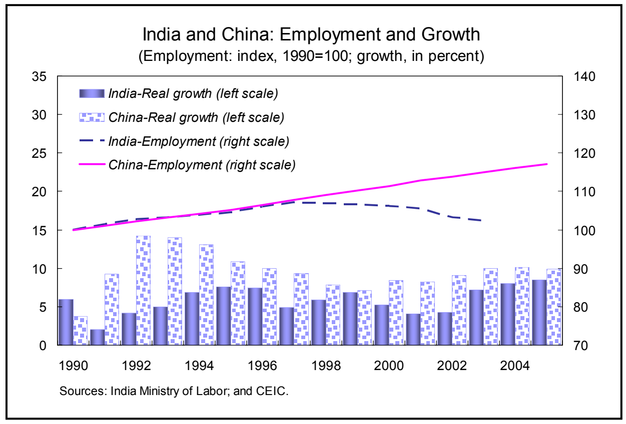
- *Pension and insurance reforms remain a key element of the authorities' agenda.* The pension bill that would allow the creation of a regulator is under consideration by Parliament. In the meantime, new civil servants in the central government and 17 states are in the process of shifting to the new pension system.

D. How Can Reforms Promote More Job-Intensive, Inclusive Growth?

"*There is a new dynamism in India…however, if we have to realize our full potential there is much work to be done.*"

Prime Minister Singh, October 2006

37. **Job creation has disappointed**. The employment elasticity of growth is low, and employment in the organized sector has remained roughly unchanged at about 27 million over the past decade and a half. Some 60 percent of the labor force continues to work in agriculture, a major reason why over 800 million Indians live on less than $2 a day. The challenge going forward will be to create jobs on the scale needed to successfully absorb excess agricultural labor and the 140 million new entrants to the labor force over the next decade. At the same time, skill gaps suggest that India's education system must adapt to the evolving needs of the growing industry and service sectors. The government is well aware of these challenges and are focusing on what they see as more immediate bottlenecks to growth—such as inadequate infrastructure—while continuing to encourage job-led growth through special economic zones (SEZs) and trade liberalization.



38. **The government is turning to the private sector to help meet its enormous infrastructure needs**. According to the World Bank, inadequate infrastructure costs India about 1 percent per annum in foregone growth and infrastructure investment needs to rise by 4 percentage points of GDP over the medium term if India is to sustain current growth rates.[17] With budgetary resources limited, the government's strategy is to involve the private sector through public-private partnerships. While continuing to provide limited gap funding to projects with below-market returns, the government has established the India Infrastructure Finance Company (IIFC) to provide finance and refinance facilities for long-term commercial infrastructure projects. It has also developed Model Concession Agreements in the key infrastructure sectors to clarify the surrounding policy framework. The IIFC has already raised some $400 million on the domestic market and provided financing to 5 mega-power projects. Additional efforts would bolster the PPP framework: strong and independent sector regulators would reduce regulatory uncertainties for investors, while developing domestic bond markets would facilitate infrastructure finance (any contingent liabilities to the government should be recorded in the budget).

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[17] World Bank, *Development Policy Review*, 2006.

39. **The role of SEZs in India's development strategy is the subject of debate**. International experience suggests that associated revenue losses could be high, particularly, as in India, when tax incentives are not well targeted (Box 6). Blanket tax incentives also work against efforts to streamline administration and broaden the tax base. Moreover, the small size of many approved SEZs suggests that they may provide only limited infrastructure. The mission suggested that consideration could be given to replacing tax holidays with more targeted incentives, as well as to raising the size threshold. The authorities recognize the revenue risks, and were already taking steps to limit diversion of already-planned investment into the zones. Approvals are limited to those projects that bring in new capital goods or service new contracts, and income from sales to the domestic market would not be exempt.

40. **The government has expressed its strong commitment to multilateral trade liberalization as a key element of its development strategy**. The government is concerned about the delay in the Doha round, and intends to play an active role in restarting the negotiations. They stressed the need for developed countries to reduce farm support, particularly in light of India's vulnerable and underdeveloped agricultural sector. In the meantime, the authorities have been cutting trade tariffs—the simple average tariff is now around 15.2 percent, compared with over 30 percent earlier in this decade. The mission encouraged the government to accelerate the timeline for reducing tariffs to ASEAN levels (currently about 8¾ percent on a simple average basis) ahead of 2009. The mission and the authorities agreed that regional trade agreements were no substitute for multilateral liberalization, and that arrangements with liberal and simple rules of origin, with liberalization on an MFN basis, would likely yield the largest payoff for India and its trading partners. The government also planned to extend duty- and quota-free access to at least 50 least developed countries (consistent with the decision reached at the Hong Kong Ministerial conference).

E. Other Issues

41. **An improved statistical system would better support India's emerging global role**. Progress is being made: quarterly demand-side GDP will be released starting in 2007; the lag in dissemination of annual expenditure-based estimates will be reduced to three months; and steps are underway to compile a new producer price index and improve preliminary export estimates through expanded electronic reporting by customs facilities. The authorities are also implementing 2004 IMF Fiscal Affairs Department technical assistance recommendations in state finance statistics, and the RBI is participating in the IMF Statistics Department's initiative to compile financial soundness indicators. Going forward,

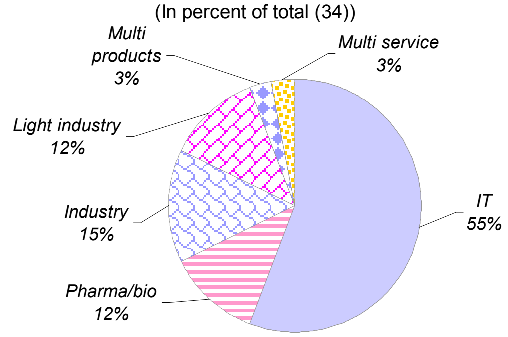
Box 6. India: Special Economic Zones (SEZs)

Interest in SEZs intensified with the passage of the SEZ Act 2005. India's SEZ policy aims to increase economic activity, promote exports and investment, create employment, and develop infrastructure. To achieve these goals, various incentives are given to business units in the zone as well as zone developers. Over 300 applications have been filed, and approvals have been notified for 34 zones (as of October 2006).

Some questions have been raised regarding the fiscal costs of the zones' tax incentives. International experiences with tax incentives, which exist in virtually all SEZs worldwide, are mixed. One strand of the literature using U.S. data suggests that targeted tax incentives can boost R&D or FDI. However, a number of case studies and surveys suggest that business climate and macroeconomic policies are more important. Moreover, revenue losses can arise from investment diversion—where investment would have been undertaken without the tax incentive. Such losses can be significant when, as in India, tax relief is provided through corporate income tax holidays.

International experience suggests that targeted tax incentives are more cost efficient. In the United States, R&D or investment credits are used to promote innovation and investment, while employment credits have been effective in reducing unemployment in economically distressed regions. Similarly, experience in developing countries (including Mexico, Turkey, Pakistan, and Central European countries) also shows that blanket CIT incentives are less effective than targeted incentives in promoting investment. In addition, tax incentives might not reduce the overall tax burden for foreign investors. In particular, tax authorities often grant credits for taxes that firms pay abroad; hence, without a special clause in the tax treaty, savings from tax incentives in the host country may be offset by increased tax liability to the home country.

Industry Distribution for New SEZs with Notification
(In percent of total (34))



Source: Ministry of Commerce and Industry.

In India, the industry and size characteristics of SEZs raise questions about the extent to which the policy will create new investment and infrastructure. Among the 34 SEZs, more than half are in the IT sector, which has robust expansion prospects. These companies may simply relocate planned investments to SEZs. Moreover, unlike China where SEZs were used to experiment with market reforms at the start of its liberalization process, India already has a long track record in reform. Moreover, the small size of most SEZs—most are under 100 hectares—suggests that the accompanying infrastructure enhancements may be limited.

priority could be given to improving the timeliness and coverage of data on employment, wages, productivity, and outward FDI, as well as the timeliness of state finance statistics.[18]

42. **India has accepted the obligations of Article VIII**. However, restrictions remain in place with respect to the mutual debt agreement of 1993 with Russia and bilateral payment agreements with two Eastern European countries (see Appendix II).

V. Staff Appraisal

43. **India's remarkable growth performance has surpassed all expectations**. For the first time in history, growth of over 8 percent is in its fourth year. The expansion has broadened to industry and investment. Inflation remains subdued, the result of productivity and competitiveness gains, as well as macro management. The economy has shown remarkable resilience, weathering high oil prices, slowing U.S. growth and severe emerging market turbulence. Record corporate profits are funding ambitious expansions abroad.

44. **The immediate challenge is managing the near-term risk of inflationary pressures**. The increases in rates implemented over the past year and the RBI's continued vigilance are welcome. The central bank's stance of continued gradual removal of monetary accommodation is appropriate and going forward would provide insurance against a possible inflation overshoot. Overperformance on the 2006/07 budget, by channeling the anticipated revenue windfall to deficit reduction, would support this stance while contributing toward medium-term fiscal consolidation.

45. **The current exchange rate arrangement remains appropriate**. Competitiveness appears adequate. As the capital account opens further, the current policy will continue to promote flexibility, preserve monetary policy independence, and give the private sector incentives to manage currency exposures.

46. **Looking to the medium term, the new economic dynamism presents an opportunity to move India to a higher growth path by accelerating key reforms**. The government's vision is to reduce poverty and create employment by accelerating growth to the 9–10 percent range. It has rightly made fiscal consolidation, financial sector development, and addressing structural bottlenecks cornerstones of its reform platform. Staff fully support these priorities, which if implemented will reduce the debt burden, create space for priority social spending, generate private resources for investment, and create a more favorable environment for job creation.

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[18] An IMF technical assistance mission is visiting India during November-December 2006 to advise on reforms to the budget classification system and chart of accounts.

47. **Government finances are in their best position in over a decade, but further progress is needed to reduce public debt and make room for social and infrastructure spending**. Ongoing tax administration improvements have substantially boosted central government revenues. The state-level deficit has fallen on the back of TFC reforms and introduction of VAT. Implementation of the FRBMA and consolidation of state finances under the TFC will permit a steady decline in the public debt ratio.

48. **Further revenue and expenditure measures are needed to meet the center's 2008/09 revenue deficit target**. This could entail:

- *Further broadening the tax base*. Eliminating corporate income tax incentives and paring excise exemptions would bolster revenue and make up for possible erosion of revenues from tax incentives granted under SEZs. The phase out of the interstate trade tax would also pave the way for a national GST.

- *Reforming expenditure as well as improving its efficiency*. The potential for broad-based subsidy reform to reduce costs and improve poverty-reducing outcomes is well known. Subsidy reforms have been the subject of several government committees, including the most recent recommendations for an automatic market-based mechanism for petroleum goods, as well as better-targeted on-budget kerosene subsidies. The government should act promptly on these recommendations.

- *Tightening controls on state borrowing*. A number of states face sizable adjustments to meet 2008/09 TFC targets. Lowering annual borrowing targets in line with FRL targets, and reforming the NSSF, would harden state budget constraints.

49. **The rapid deepening of India's banking sector is welcome, but supervisory vigilance is warranted**. Financial soundness indicators are favorable. Going forward, however, asset quality could come under pressure, particularly if rapid credit growth is sustained. Comprehensive stress tests, and the authorities' self-assessment, will help expose any vulnerabilities, and staff look forward to publication of the results of both exercises. Implementation of Basel II will also give banks incentives to enhance risk management. To complement these steps, consideration could also be given to shortening the timeline for recognizing doubtful NPLs.

50. **Deeper and broader financial markets will foster growth and facilitate greater capital account openness**. Recent initiatives to develop money and government securities markets, expand foreign participation in debt markets, and strengthen supervision of OTC derivatives activities are welcome. Further expanding short selling, when-issued trading, and consolidation of benchmark issues would be useful, as would steps to streamline issuance requirements for corporate bonds and facilitate trading of securitized assets. Raising the limit on FDI in insurance and opening the pension sector to private participation (as anticipated in

the pension bill) would broaden India's investor base and improve channels for funding longer-term investment.

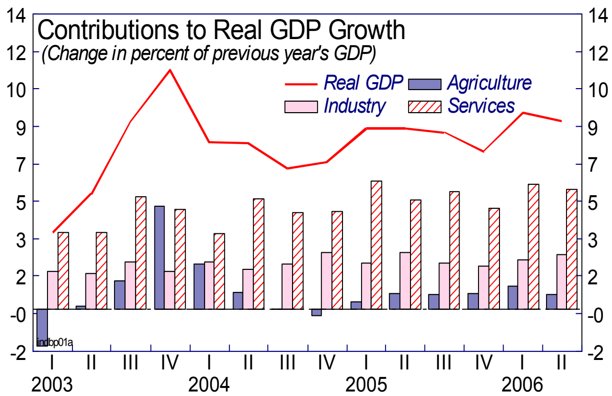
51. **Greater progress is needed in addressing structural obstacles to job-intensive, inclusive growth**. The problem of inadequate infrastructure is well known. Building strong and independent regulators would bolster investor interest in infrastructure, underpinning the authorities' PPP initiative. In addition, changes to SEZs policies would help them to play a more effective role in India's development strategy. International experience suggests that revenue losses from tax incentives could prove costly. The authorities should consider modifying the SEZ framework to increase minimum size and to target tax incentives, avoiding blanket income tax exemptions that narrow the tax base and complicate administration.

52. **India can play a proactive role in restarting multilateral trade talks**. The staff welcomes the unilateral extension of duty free, quota free access to LDCs. In implementing regional and bilateral trade arrangements, agreements with liberal and simple rules of origin, and liberalization on an MFN basis, will likely yield the largest payoff for India and its trading partners. India has already made considerable progress in reducing its simple average nonagricultural tariff, and the present rapid growth provides an opportunity to move more quickly towards ASEAN levels, reducing tariffs on an MFN basis.

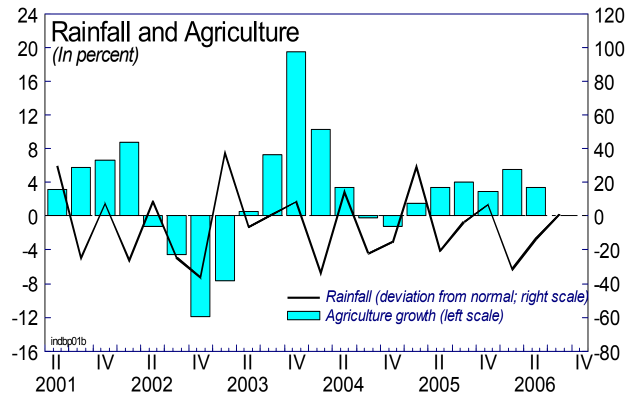
53. Staff recommends that the next Article IV consultation occur on the 12-month cycle.

Figure 1. India: Growth

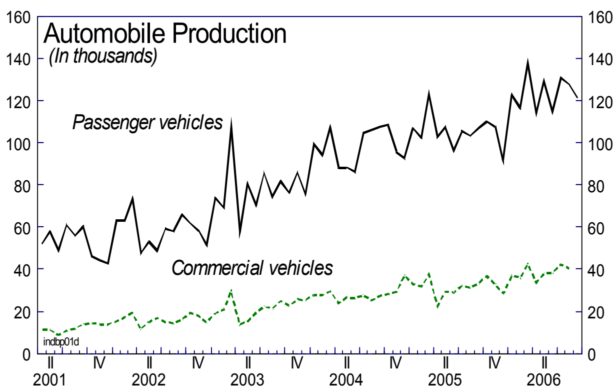
Growth has been robust…



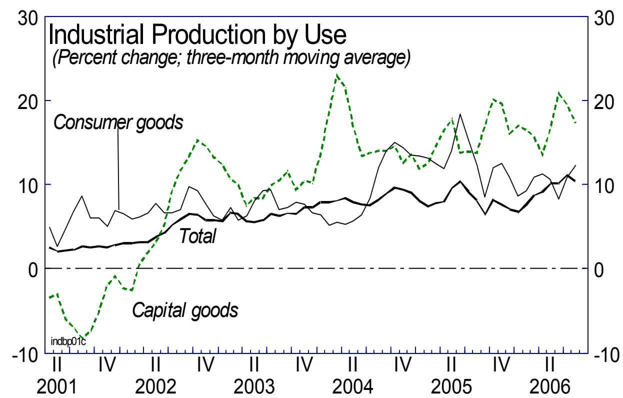
…helped by a normal monsoon,…



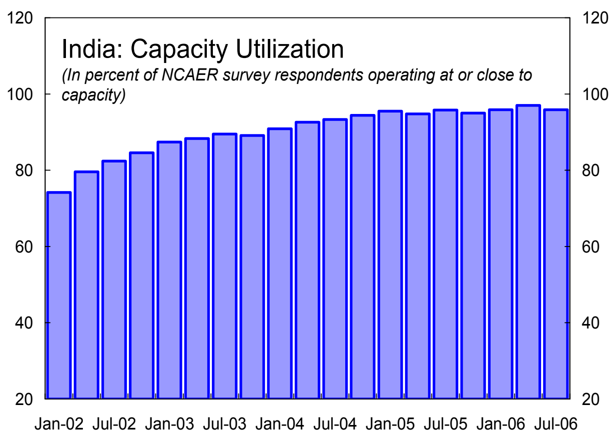
…buoyant household spending,…



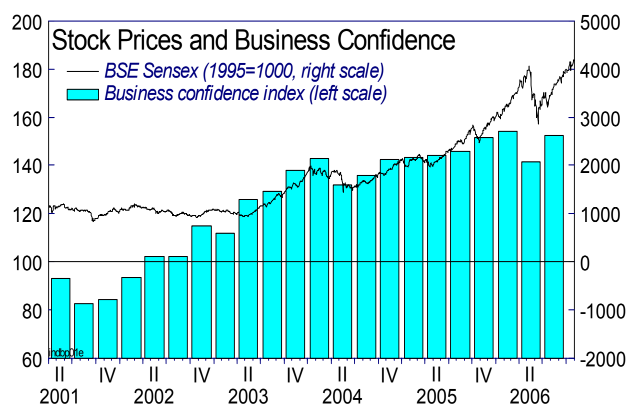
…strong industrial production,…



…higher capacity utilization,…



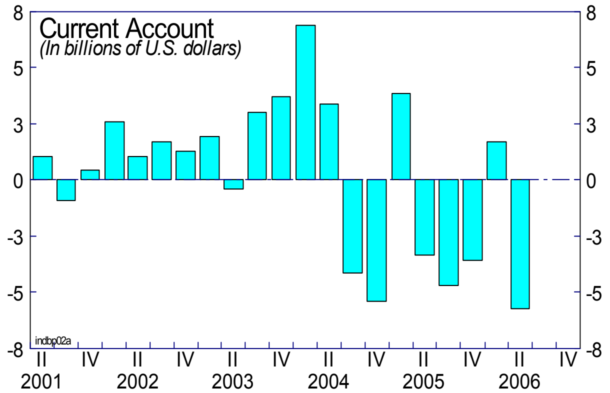
…and resilient financial markets.



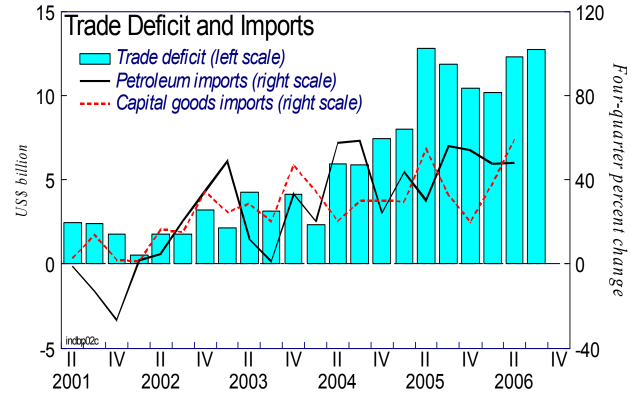
Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; NCAER; and IMF staff projections.

Figure 2. India: External Sector

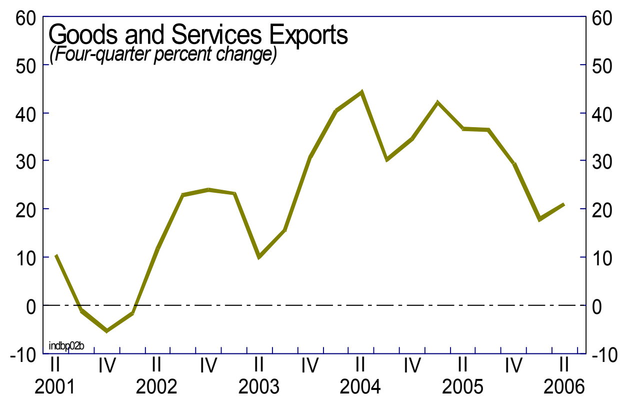
The current account moved into deficit…



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

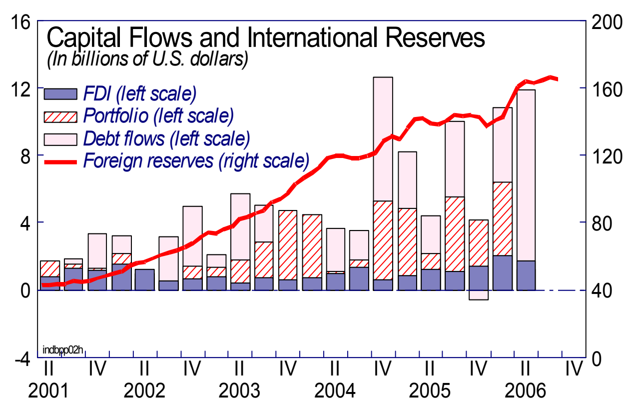


Export growth eased but remains strong..

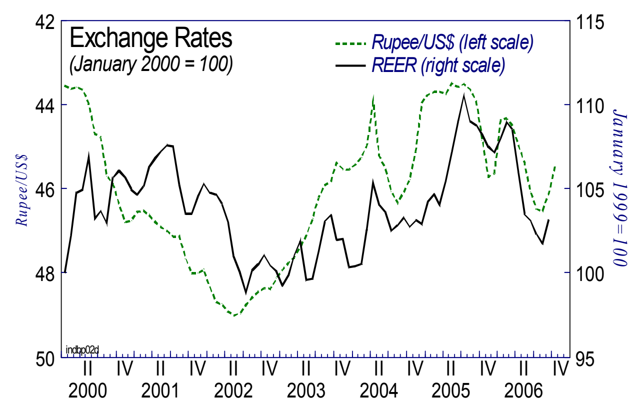


…and India's market share trends up.

Reserves continue to rise…



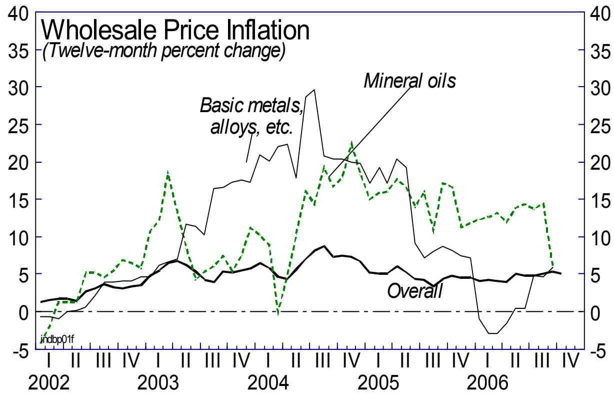
…and the real effective exchange rate has depreciated.



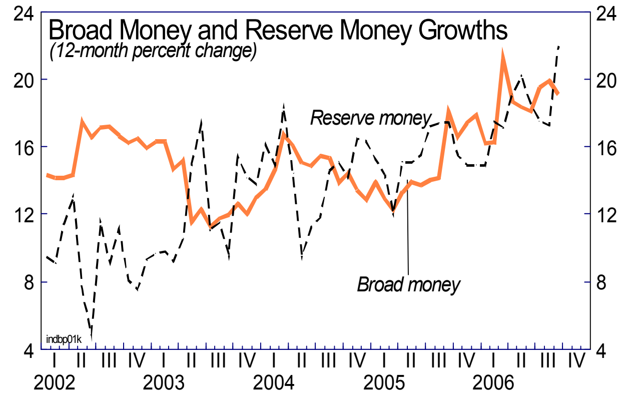
Sources: Data provided by the Indian authorities; CMIE Pvt. Ltd.; and, CEIC Data Company Ltd.
1/ Customs data, based on U.S. dollar values.

Figure 3. India: Money and Inflation

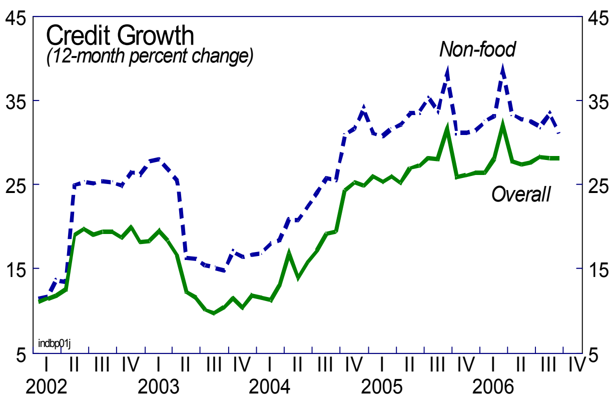
Headline inflation remains moderate…



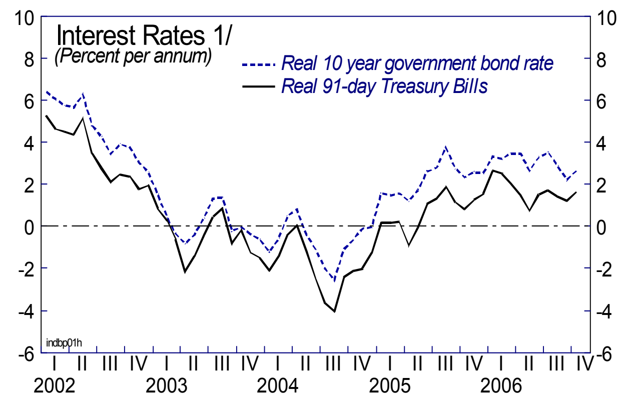
… but money supply growth is strong…



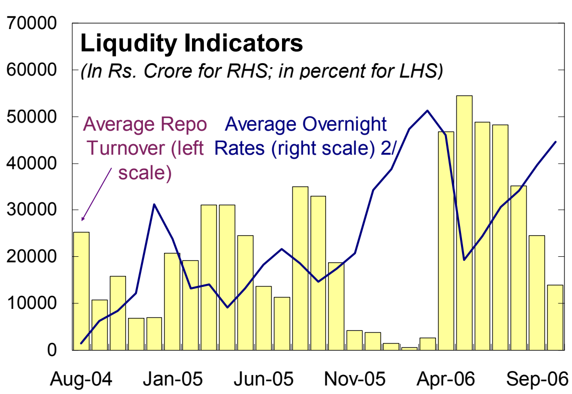
…as is credit growth…



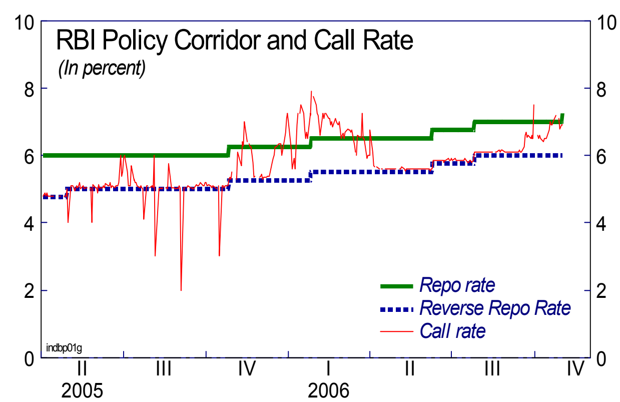
…amid low interest rates...



…and accommodative liquidity conditions…



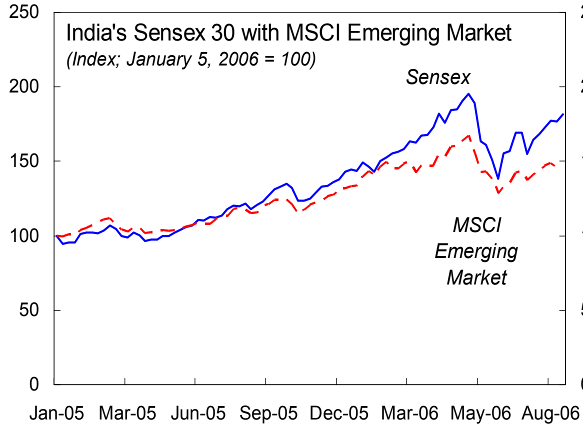
…prompting the RBI to raise rates.



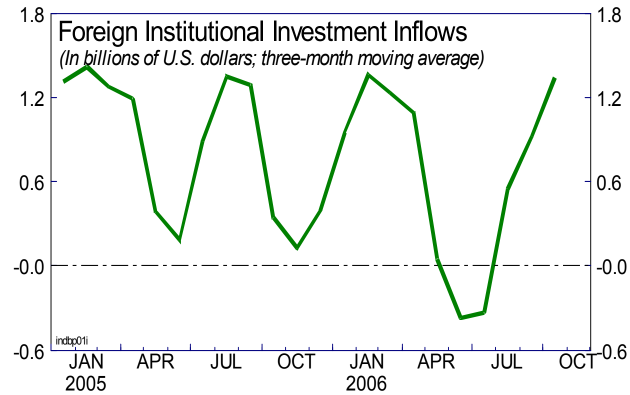
Sources: Data provided by the Indian authorities; CEIC Data Company Ltd; and IMF staff projections.
1/ Deflated by the WPI.
2/ Average of call, CBLO, and repo market.

Figure 4. India: Asset Market

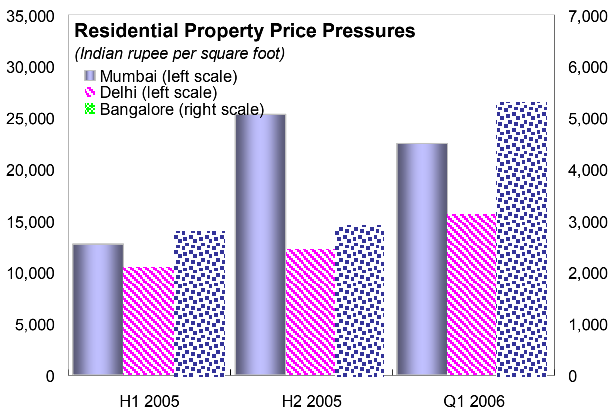
The market recovered from spring turbulence...



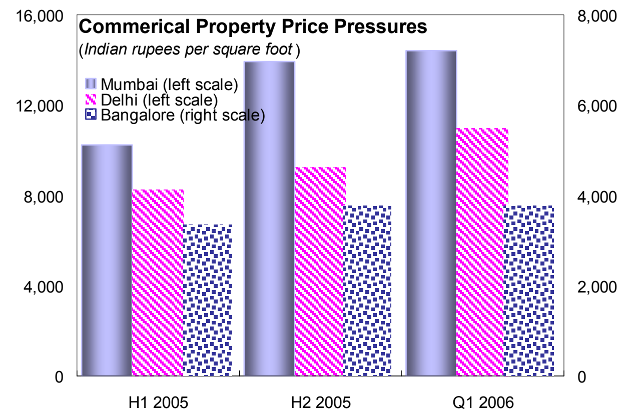
... as have inflows.



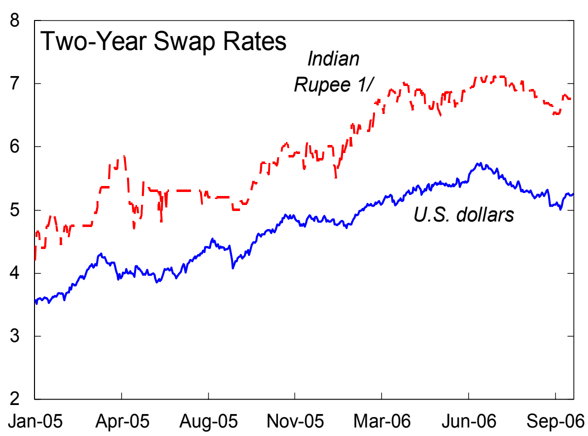
Real estate prices are buoyant in residential...



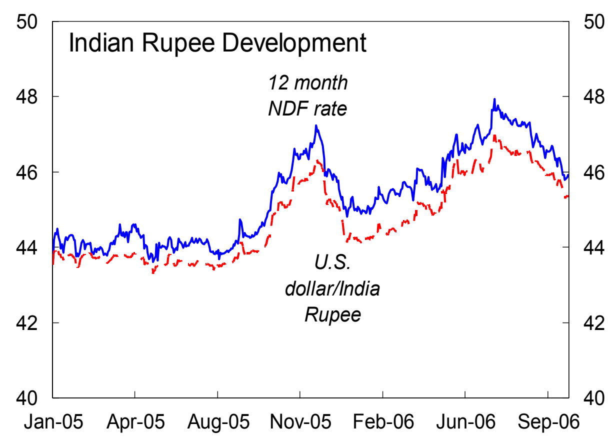
... and commercial markets.



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



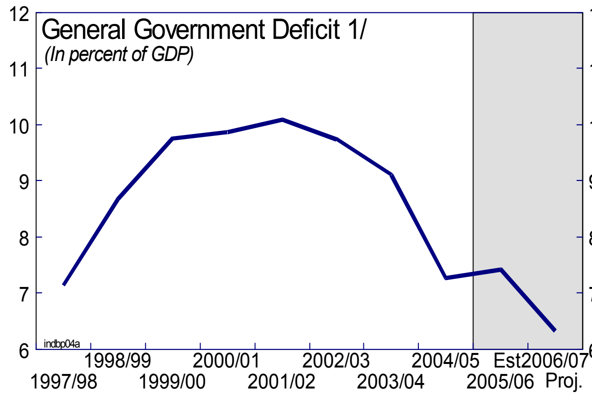
... as reflected in a forward discount.



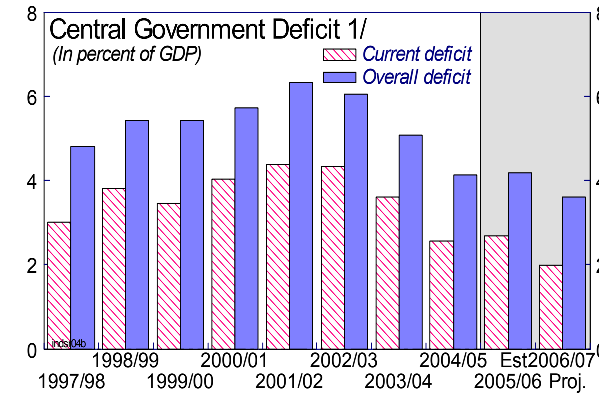
Sources: Data provided by the Indian authorities; Bloomberg, Datastream International Ltd; and, Colliers International.
1/ Nondeliverable forwards.

Figure 5. India: Fiscal Trends

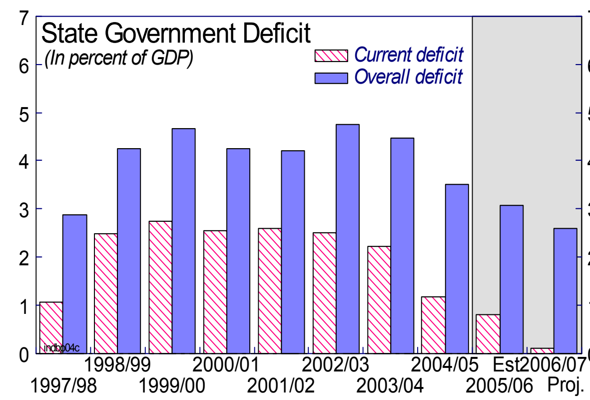
The public sector deficit has fallen...



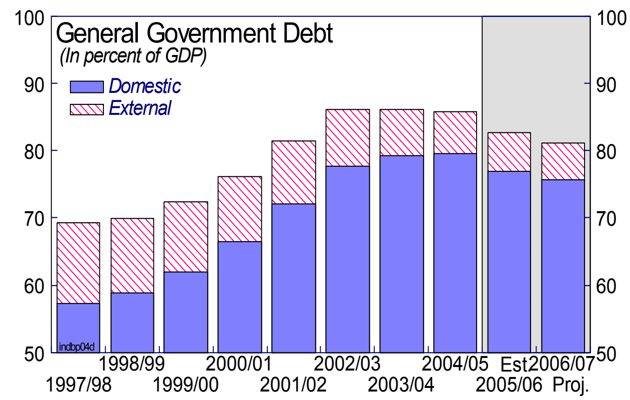
… reflecting the resumption of adjustment at the center…



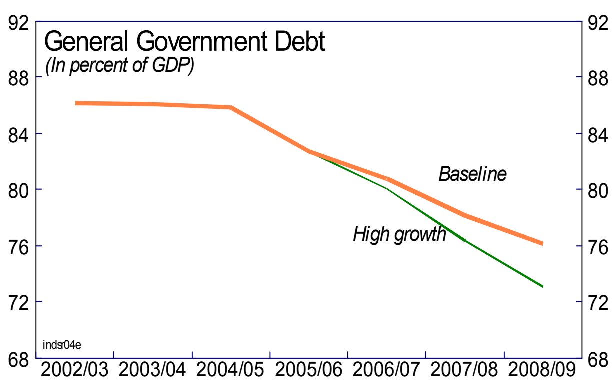
…and consolidation at the state level.



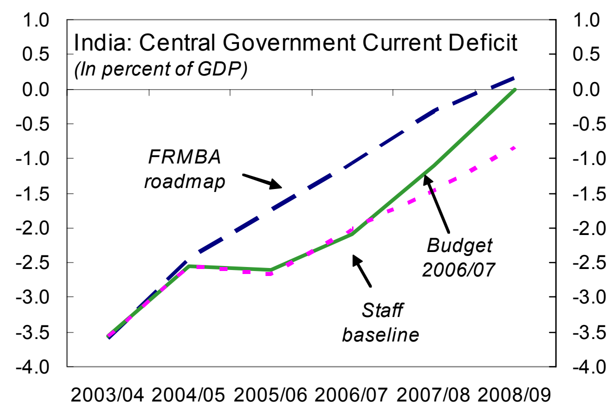
The debt ratio has fallen but remains high,...



... the fiscal responsibility act should engineer a reduction in debt to GDP...



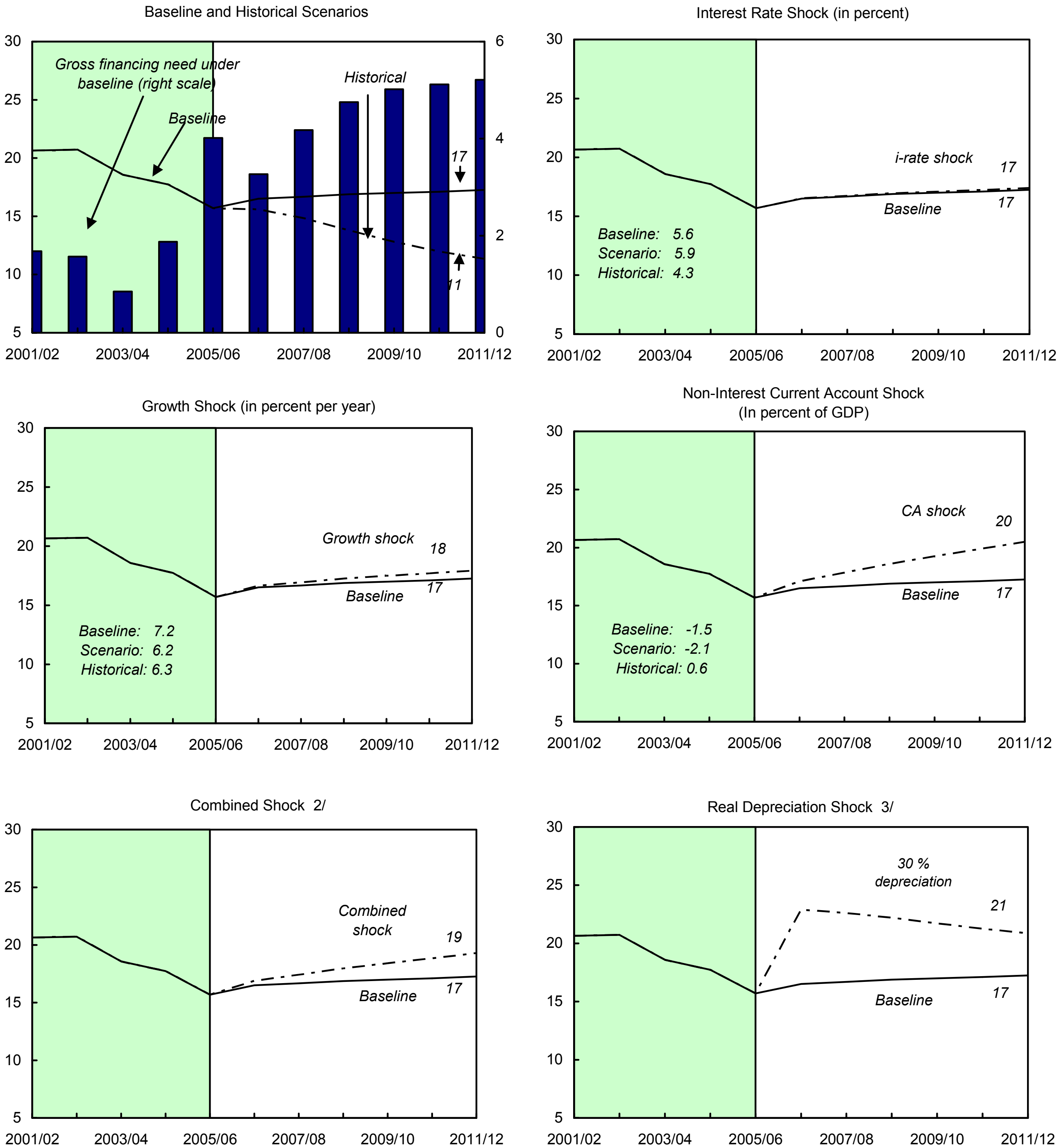
... but will require stepped-up reforms.



Sources: Data provided by the Indian authorities; and staff projections.
1/ Excluding privatization receipts and off-budget bond issuance to state-owned oil companies and Food Corporation of India.

Figure 6. India: External Debt Sustainability: Bound Tests 1/

(External debt, in percent of GDP)



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

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

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

3/ One-time real depreciation of 30 percent occurs in 2007.

Table 1. India: Millennium Development Goals, 1990–2004 1/

	1990	1995	1998	2001	2004
Eradicate extreme poverty and hunger 2/					
Income share held by lowest 20%	...	...	...	9.0	...
Malnutrition prevalence, weight for age (% of children under 5)	64.0	...	47.0	...	...
Poverty gap at $1 a day (PPP) (%)	...	...	...	8.0	...
Poverty headcount ratio at $1 a day (PPP) (% of population)	...	...	...	35.0	...
Poverty headcount ratio at national poverty line (% of population)	...	36.0	...	29.0	...
Prevalence of undernourishment (% of population)	...	...	21.0	...	20.0
Achieve universal primary education 3/					
Literacy rate, youth total (% of people ages 15-24)	64.0	...	...	...	76.0
Persistence to grade 5, total (% of cohort)	...	...	62.0	61.0	...
Primary completion rate, total (% of relevant age group)	...	77.1	72.6	75.8	88.5
School enrollment, primary (% net)	...	...	...	83.0	87.0
Promote gender equality 4/					
Proportion of seats held by women in national parliament (%)	5.0	...	7.0	9.0	9.0
Ratio of girls to boys in primary and secondary education (%)	69.8	...	77.2	78.0	87.7
Ratio of young literate females to males (% ages 15-24)	73.9	...	...	...	80.5
Share of women employed in the nonagricultural sector (% of total nonagricultural employment)	13.0	14.0	16.0	17.0	18.0
Reduce child mortality 5/					
Immunization, measles (% of children ages 12-23 months)	56.0	72.0	51.0	56.0	56.0
Mortality rate, infant (per 1,000 live births)	80.0	74.0	72.0	66.0	62.0
Mortality rate, under-5 (per 1,000)	123.0	104.0	...	94.0	85.0
Improved maternal health 6/					
Births attended by skilled health staff (% of total)	...	...	42.3	42.5	...
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	540.0	...
Combat HIV/AIDS, malaria, and other diseases 7/					
Children orphaned by HIV/AIDS	...	...	...	...	...
Contraceptive prevalence (% of women ages 15-49)	...	...	52.0	47.0	...
Incidence of tuberculosis (per 100,000 people)	167.8	...	...	...	167.8
Prevalence of HIV, female (% ages 15-24)	...	...	...	1.0	...
Prevalence of HIV, total (% of population ages 15-49)	...	...	...	1.0	1.0
Tuberculosis cases detected under DOTS (%)	...	0.3	1.7	23.8	57.1
Ensure environmental sustainability 8/					
CO2 emissions (metric tons per capita)	0.8	1.0	1.1	1.1	...
Forest area (% of land area)	22.0	...	...	23.0	23.0
GDP per unit of energy use (constant 2000 PPP $ per kg of oil equivalent)	4.0	4.0	5.0	5.0	5.0
Improved sanitation facilities (% of population with access)	12.0	...	...	30.0	...
Improved water source (% of population with access)	68.0	...	...	86.0	...
Nationally protected areas (% of total land area)	...	...	...	...	5.2
Develop a global partnership for development 9/					
Aid per capita (current US$)	1.7	1.9	1.6	1.7	0.6
Debt service (PPG and IMF only, % of exports of G&S, excl. workers' remittances)	29.0	32.0	23.0	13.0	20.0
Fixed line and mobile phone subscribers (per 1,000 people)	6.0	12.9	23.2	43.6	84.5
Internet users (per 1,000 people)	0.0	0.3	1.4	6.8	32.4
Personal computers (per 1,000 people)	0.3	1.3	2.7	5.8	12.1
Total debt service (% of exports of goods, services and income)	32.0	30.0	21.0	12.0	19.0
Unemployment, youth female (% of female labor force ages 15-24)	...	8.0	...	10.2	...
Unemployment, youth male (% of male labor force ages 15-24)	...	8.4	...	10.1	...
Unemployment, youth total (% of total labor force ages 15-24)	...	8.3	...	10.1	...
General indicators					
Fertility rate, total (births per woman)	3.8	3.4	3.3	2.9	2.9
GNI per capita, Atlas method (current US$)	390.0	380.0	420.0	460.0	620.0
GNI, Atlas method (current US$) (billions)	330.6	349.6	412.9	479.3	673.2
Gross capital formation (% of GDP)	24.1	26.5	21.4	22.4	24.1
Life expectancy at birth, total (years)	59.1	61.4	62.2	63.4	63.5
Literacy rate, adult total (% of people ages 15 and above)	49.3	...	...	...	61.0
Population, total (millions)	849.5	932.2	982.2	1,032.5	1,079.7
Trade (% of GDP)	15.7	23.2	24.1	27.7	41.6

Source: *World Development Indicators* database, April 2006.

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

Table 2. India: Selected Economic Indicators, 1996/97–2006/07 1/

Nominal GDP (2005/06): US$798 billion
Population (2005/06): 1.11 billion
GDP per capita (2005/06): US$716
Quota: SDR 4,158.2 million

	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06 Prov.	2006/07 2/ Proj.
Growth (y/y percent change)											
Real GDP (at factor cost)	7.8	4.9	6.6	5.4	4.4	5.8	3.8	8.5	7.5	8.4	8.2
Industrial production	...	6.6	4.1	6.6	5.0	2.7	5.8	7.0	8.4	8.2	...
Prices (y/y percent change, period average for annual data)											
Wholesale prices (1993/94 weights)	4.6	4.4	5.9	3.3	7.2	3.6	3.4	5.4	6.4	4.4	5.1
Consumer prices - industrial workers (2001 weights)	9.4	6.8	13.1	3.4	3.8	4.3	4.0	3.9	3.8	4.4	6.0
Saving and investment (percent of GDP)											
Gross saving 3/	21.9	22.7	21.8	25.0	23.6	23.7	26.6	29.6	29.7	30.4	31.3
Gross investment	24.5	24.6	22.6	26.0	24.2	23.0	25.3	27.2	30.1	31.7	32.9
Fiscal position (percent of GDP) 4/											
Central government deficit 5/	4.1	4.8	5.4	5.4	5.7	6.3	6.0	5.1	4.1	4.2	3.6
General government deficit	7.0	7.1	8.7	9.8	9.9	10.1	9.7	9.1	7.3	7.4	6.3
General government debt	67.7	69.2	69.9	72.4	76.2	81.4	86.2	86.1	85.9	82.7	80.8
Money and credit (y/y percent change, end-period)											
Broad money	16.0	18.0	19.4	15.0	16.4	14.1	14.7	16.7	12.3	21.2	...
Credit to commercial sector	9.2	15.1	14.5	18.3	15.8	11.8	18.3	13.0	26.0	32.1	...
Financial indicators (percent, end-period)											
91-day treasury bill yield	8.0	7.3	8.7	9.2	8.7	6.1	5.9	4.2	5.3	6.1	...
10-year government bond yield	13.7	12.1	12.0	10.7	10.4	7.4	6.1	5.1	6.7	7.5	...
Stock market (y/y percent change, end-period)	-0.2	15.8	-3.9	33.7	-27.9	-3.7	-12.1	83.4	16.1	73.7	...
External trade 6/											
Merchandise exports (US$ billions)	34.1	35.7	34.3	37.5	45.5	44.7	53.8	66.3	85.2	104.8	128.6
y/y percent change	5.6	4.5	-3.9	9.5	21.1	-1.6	20.3	23.3	28.5	23.0	22.7
Merchandise imports (US$ billions)	48.9	51.2	47.5	55.4	57.9	56.3	64.5	80.0	118.9	156.3	192.2
y/y percent change	12.1	4.6	-7.1	16.5	4.6	-2.8	14.5	24.1	48.6	31.5	22.9
Net oil imports (US$ billions)	9.6	7.8	6.3	12.6	13.8	11.9	15.1	17.0	22.9	32.4	40.1
Balance of payments (US$ billions)											
Current account balance	-4.6	-5.5	-4.0	-4.7	-2.7	3.4	6.3	14.1	-2.5	-10.6	-14.1
(in percent of GDP)	-1.2	-1.3	-1.0	-1.0	-0.6	0.7	1.3	2.3	-0.4	-1.3	-1.6
Foreign direct investment, net	2.7	3.5	2.4	2.1	3.3	4.7	3.2	2.4	3.7	5.7	9.3
Portfolio investment, net (equity and debt)	3.3	1.8	-0.1	3.0	2.6	2.0	0.9	11.4	9.3	12.5	5.8
Overall balance	6.8	4.5	4.2	6.4	5.9	11.8	17.0	31.4	26.2	15.1	21.3
External indicators											
Gross reserves (US$ billions end-period)	26.4	29.4	33.5	38.0	42.3	54.1	76.1	113.0	141.5	151.6	172.9
(In months of imports) 7/	5.4	6.1	5.9	6.4	7.3	8.0	9.4	9.2	8.7	7.6	7.4
External debt (percent of GDP, end-period) 8/	24.6	24.3	23.6	22.1	22.4	21.1	20.4	17.8	17.3	15.8	16.5
Of which : short-term debt 9/	...	2.8	2.7	2.7	2.5	3.0	3.8	1.8	3.1	1.9	2.3
Ratio of gross reserves to short-term debt (end-period)	2.0	2.5	2.9	3.1	3.7	3.8	4.0	10.7	6.6	10.2	8.5
Gross reserves to broad money (percent; end-period)	13.6	14.1	14.1	14.7	15.0	17.6	21.0	24.6	27.5	24.8	...
Debt service ratio 10/	23.0	19.5	18.8	17.1	16.2	13.6	16.0	15.9	6.0	9.7	5.3
Real effective exchange rate 11/											
(y/y percent change, period average for annual data)	...	5.7	-4.7	0.3	4.7	0.4	-4.7	1.0	2.2	4.4	...
Exchange rate (rupee/US$, end-period)	35.9	39.5	42.4	43.6	46.6	48.8	47.5	43.4	43.8	44.6	...
Memorandum items (in percent of GDP):											
Food Corporation of India (FCI) bonds 12/	...	...	...	...	...	...	...	...	...	...	0.4
Oil bonds 12/	...	...	...	...	...	...	...	...	...	0.3	0.4

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

1/ Data are for April-March fiscal years.
2/ Current staff projections.
3/ Differs from official data due to revisions in the current account.
4/ Privatization investment proceeds treated as below-the-line financing; FCI and oil bonds excluded from central government total expenditure.
5/ For central government.
6/ Annual data are on balance of payments basis.
7/ Imports of goods and services projected over the following twelve months.
8/ For projection, data is reported relative to staff's estimated annual GDP.
9/ Residual maturity basis, except contracted maturity basis for medium and long-term non-resident Indian accounts.
10/ In percent of current account receipts excluding grants.
11/ IMF INS calculation.
12/ Issued by the central government to FCI and the state-owned oil refining/distribution companies as compensation for losses incurred from the provision of universal government price subsidies.

Table 3. India: Balance of Payments, 2001/02–2006/07 1/

(In billions of U.S. dollars)

	2001/02	2002/03	2003/04	2004/05	2005/06 Prov.	2006/07 Proj.
Current account balance	3.4	6.3	14.1	-2.5	-10.6	-14.1
Merchandise trade balance	-11.6	-10.7	-13.7	-33.7	-51.6	-63.6
Merchandise exports	44.7	53.8	66.3	85.2	104.8	128.6
Merchandise imports	56.3	64.5	80.0	118.9	156.3	192.2
Oil	14.0	17.6	20.6	29.9	43.8	52.7
Non-oil	42.3	46.3	59.4	89.0	112.5	139.5
Of which: customs based 2/	36.7	42.5	57.7	76.8	96.4	...
Non-factor services balance	3.3	3.6	10.1	15.4	22.3	31.0
Receipts	17.1	20.8	26.9	43.2	60.6	78.5
Of which: software services	7.6	9.6	12.8	17.7	23.6	...
Payments	13.8	17.1	16.7	27.8	38.3	47.4
Income, net	-4.2	-3.4	-4.5	-5.0	-5.6	-7.1
Transfers, net	15.9	16.8	22.2	20.8	24.3	25.5
Capital account balance	8.6	10.8	16.7	28.0	24.7	35.4
Direct investment, net	4.7	3.2	2.4	3.7	5.7	9.3
Portfolio investment, net	2.0	0.9	11.4	9.3	12.5	5.8
Government borrowing, net	1.1	-3.1	-2.9	1.9	1.4	2.9
Commercial borrowing, net	-1.6	-1.7	-2.9	5.2	1.6	11.2
Short-term credit, net	-0.8	1.0	1.4	3.8	1.7	2.9
NRI deposits, net	2.8	3.0	3.6	-1.0	2.8	1.8
Rupee debt	-0.5	-0.5	-0.4	-0.4	-0.6	-0.5
Other capital, net 3/	0.9	8.0	4.1	5.5	-0.5	2.0
Errors and omissions	-0.2	-0.2	0.6	0.6	1.0	0.0
Overall balance	11.8	17.0	31.4	26.2	15.1	21.3
Valuation change	0.1	4.4	5.4	2.4	-4.9	0.0
Increase in gross reserves (-)	-11.8	-21.9	-36.9	-28.6	-10.1	-21.3
Memorandum items:						
Foreign exchange reserves	54.7	76.1	113.0	141.5	151.6	172.9
In months of next year's imports (goods and services)	8.0	9.4	9.2	8.7	7.6	7.4
Current account balance (percent of GDP)	0.7	1.3	2.3	-0.4	-1.3	-1.6
Merchandise trade balance (percent of GDP)	-2.4	-2.1	-2.3	-4.9	-6.5	-7.2
Overall balance (percent of GDP)	2.5	3.4	5.2	3.8	1.9	2.4

Sources: CEIC; and staff estimates and projections.

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

2/ Non-customs imports include defense related items.

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

Table 4. India: Reserve Money and Monetary Survey, 2001/02–2005/06 1/

	2001/02	2002/03	2003/04	2004/05	2005/06
Reserve money	(In billions of rupees; end-period)				
Reserve money	3,380	3,691	4,365	4,891	5,731
Net domestic assets of RBI	740	108	-479	-1,237	-999
Claims on government (net)	1,522	1,207	449	-180	81
Center	1,414	1,130	369	-233	52
States	108	77	80	53	30
Claims on commercial sector	59	30	21	14	14
Claims on banks	107	72	54	53	58
Other items (net)	-949	-1,201	-1,003	-1,123	-1,152
Net foreign assets of RBI	2,640	3,582	4,844	6,128	6,730
	(Contribution to reserve money growth)				
Reserve money	11.4	9.2	18.3	12.1	17.2
Net domestic assets of RBI	-10.6	-18.7	-15.9	-17.4	4.9
Claims on government (net)	-0.6	-9.3	-20.5	-14.4	5.3
Net foreign assets of RBI	22.0	27.9	34.2	29.4	12.3
Monetary survey	(In billions of rupees; end-period)				
Broad money (M3)	14,984	17,180	20,057	22,514	27,295
Currency with public	2,408	2,716	3,150	3,559	4,131
Deposits	12,547	14,431	16,856	18,891	23,095
Non-bank deposits at RBI	28	32	51	65	69
Net domestic assets	11,873	13,242	14,791	16,022	20,033
Domestic credit	13,492	15,755	17,591	20,370	24,601
Net credit to government	5,896	6,765	7,429	7,568	7,691
Of which: RBI	1,522	1,207	449	-180	81
Credit to commercial sector 2/ 3/	7,596	8,990	10,162	12,802	16,910
Of which: commercial bank lending	5,897	7,292	8,408	11,004	15,071
Nonfood	5,357	6,797	8,048	10,593	14,664
Other items (net)	-1,618	-2,513	-2,800	-4,348	-4,567
Net foreign assets	3,110	3,937	5,266	6,493	7,262
	(Twelve-month percent change)				
Broad money (M3)	14.1	14.7	16.7	12.3	21.2
Net domestic assets	11.7	11.5	11.7	8.3	25.0
Domestic credit	13.3	16.8	11.7	15.8	20.8
Net credit to government	15.2	14.7	9.8	1.9	1.6
Credit to commercial sector 2/ 3/	11.8	18.3	13.0	26.0	32.1
Of which: commercial bank lending	15.3	23.7	15.3	30.9	37.0
Nonfood	13.6	26.9	18.4	31.6	38.4
Net foreign assets	24.5	26.6	33.7	23.3	11.9
	(Contribution to broad money growth)				
Net domestic assets	9.4	9.1	9.0	6.1	17.8
Net credit to government	5.9	5.8	3.9	0.7	0.5
Of which: RBI	-0.1	-2.1	-4.4	-3.1	1.2
Credit to commercial sector 2/ 3/	6.1	9.3	6.8	13.2	18.2
Net foreign assets	4.7	5.5	7.7	6.1	3.4

Sources: Reserve Bank of India; and staff estimates.

1/ Data are for April - March fiscal years.

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

3/ Figures include the impact of conversion of a non-banking entity into a banking entity with effect from October 11, 2004.

Table 5. India: Central Government Operations, 2002/03–2006/07

	2002/03	2003/04	2004/05 Actual 1/	2005/06 Budget 2/	2005/06 Rev. Est. 1/	2005/06 Staff 1/ proj.	2006/07 Budget 2/	2006/07 Staff proj.
			(In billions of rupees)					
Total revenue and grants	2,453	2,818	3,204	3,680	3,643	3,597	4,196	4,246
Net tax revenue 3/	1,601	1,886	2,264	2,751	2,757	2,715	3,287	3,342
Gross tax revenue	2,163	2,543	3,050	3,700	3,701	3,659	4,422	4,495
Of which: corporate tax	462	636	827	1,106	1,036	994	1,330	1,361
income tax	369	414	493	662	662	652	774	777
excise taxes	823	908	991	1,215	1,120	1,112	1,190	1,173
customs duties	449	486	576	532	642	651	771	802
other taxes	61	100	163	185	241	249	357	383
Less: States' share	561	658	786	950	944	944	1,134	1,153
Nontax revenue	832	911	910	898	856	852	882	878
Grants	19	22	31	32	30	30	26	26
Total expenditure and net lending	3,934	4,223	4,501	5,192	5,129	5,076	5,683	5,683
Current expenditure 3/	3,531	3,802	3,988	4,634	4,562	4,543	5,043	5,043
Of which: interest payments	1,178	1,241	1,269	1,339	1,300	1,318	1,398	1,398
wages and salaries	314	322	352	372	379	379	398	398
subsidies	435	443	437	474	469	469	462	462
Capital expenditure and net lending 4/	403	421	513	558	567	533	640	640
Overall balance 5/	-1,482	-1,405	-1,296	-1,511	-1,485	-1,479	-1,487	-1,436
Overall balance (authorities' definition) 6/	-1,450	-1,235	-1,252	-1,511	-1,462	-1,463	-1,487	-1,436
Overall balance (augmented) 7/	...	...	...	...	...	-1,578	-1,790	-1,740
Financing	1,482	1,405	1,296	1,511	1,485	1,479	1,487	1,436
External (net)	-119	-135	148	97	75	75	83	83
Domestic (net)	1,601	1,540	1,149	1,415	1,410	1,403	1,404	1,353
			(In percent of GDP)					
Total revenue and grants	10.0	10.2	10.3	10.6	10.3	10.2	10.6	10.6
Net tax revenue 3/	6.5	6.8	7.3	7.9	7.8	7.7	8.3	8.3
Gross tax revenue	8.8	9.2	9.8	10.6	10.5	10.4	11.2	11.2
Corporate tax	1.9	2.3	2.6	3.2	2.9	2.8	3.4	3.4
Income tax	1.5	1.5	1.6	1.9	1.9	1.8	2.0	1.9
Excise taxes	3.4	3.3	3.2	3.5	3.2	3.1	3.0	2.9
Customs duties	1.8	1.8	1.8	1.5	1.8	1.8	1.9	2.0
Other taxes	0.2	0.4	0.5	0.5	0.7	0.7	0.9	1.0
Less: States' share	2.3	2.4	2.5	2.7	2.7	2.7	2.9	2.9
Nontax revenue	3.4	3.3	2.9	2.6	2.4	2.4	2.2	2.2
Grants	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Total expenditure and net lending	16.1	15.3	14.4	14.9	14.5	14.4	14.4	14.1
Current expenditure 3/	14.4	13.8	12.8	13.3	12.9	12.9	12.8	12.5
Of which: interest payments	4.8	4.5	4.1	3.8	3.7	3.7	3.5	3.5
wages and salaries	1.3	1.2	1.1	1.1	1.1	1.1	1.0	1.0
subsidies	1.8	1.6	1.4	1.4	1.3	1.3	1.2	1.1
Capital expenditure and net lending 4/	1.6	1.5	1.6	1.6	1.6	1.5	1.6	1.6
Overall balance 5/	-6.0	-5.1	-4.2	-4.3	-4.2	-4.2	-3.8	-3.6
Overall balance (authorities' definition) 6/	-5.9	-4.5	-4.0	-4.3	-4.1	-4.1	-3.8	-3.6
Overall balance (augmented) 7/	...	...	...	...	...	-4.5	-4.5	-4.3
Financing	6.0	5.1	4.2	4.3	4.2	4.2	3.8	3.6
External (net)	-0.5	-0.5	0.5	0.3	0.2	0.2	0.2	0.2
Domestic (net)	6.5	5.6	3.7	4.1	4.0	4.0	3.5	3.4
Of which: market borrowing	4.0	3.2	1.6	3.0	2.9	4.1	2.9	2.7
small savings (net of states' share)	0.6	0.2	0.1	0.2	0.2	0.2	0.2	0.2
divestment receipts	0.1	0.6	0.1	0.1	0.1	0.1	0.1	0.1
Memorandum items:								
Military expenditure	2.3	2.2	2.4	2.4	2.3	2.3	2.3	2.2
Primary balance	-1.2	-0.6	-0.1	-0.5	-0.5	-0.5	-0.2	-0.1
Current balance	-4.4	-3.6	-2.5	-2.7	-2.6	-2.7	-2.1	-2.0
Current balance (augmented) 7/	...	...	...	...	...	-3.0	-2.5	-2.7
Central government debt 8/	63.6	62.9	63.9	64.1	62.2	62.5	62.5	62.2
Food Corporation of India (FCI) bonds 9/	...	...	...	...	...	...	0.4	0.4
Oil bonds 9/	...	...	...	...	0.3	0.3	0.4	0.4
Nominal GDP (in Rs. billion)	24,497	27,602	31,214	34,816	35,272	35,315	39,552	40,240

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

1/ Ratios utilize the CSO's estimates of nominal GDP.
2/ Ratios utilize implicit GDP in the gross fiscal deficit to GDP ratio given in Union Budget.
3/ Including the surcharge on Union duties transferred to the National Calamity Contingency Fund, but excluding FCI and oil bond issuances.
4/ Authorities' treatment of state debt swap scheme (DSS) in 2002-05 shows the prepayment by States of on-lent funds to the center as net lending. The Center's prepayment of its debt to the National Small Savings Fund (NSSF) is treated as a capital expenditure.
5/ Treats divestment receipts as a below the line financing item.
6/ Authorities' definition treats divestment as a receipt item until 2005/06 included.
7/ Staff's definition treats divestment receipts as a below the line financing item and treats bond issuance by the central government to oil companies and FCI as current expenditure, in accordance with GFSM 2001.
8/ External debt measured at historical exchange rates.
9/ Issued by the central government to FCI and the state-owned oil refining/distribution companies as compensation for losses incurred from the provision of universal government price subsidies.

Table 6. India: General Government Operations, 2002/03–2006/07 1/

	2002/03	2003/04	2004/05	2005/06			2006/07	
			Prov. 2/	Budget	Rev. est.	Staff proj. 3/	Budget	Staff proj.
				(In billions of rupees)				
Total revenue and grants	4,498	5,171	6,097	7,058	7,169	7,114	8,255	8,393
Tax revenue 4/	3,584	4,143	4,941	5,853	5,949	5,895	6,947	7,147
Nontax revenue 5/	895	1,006	1,126	1,173	1,190	1,189	1,282	1,220
Grants	19	22	31	32	30	30	26	26
Total expenditure and net lending 6/	6,884	7,684	8,375	9,768	9,824	9,733	10,826	10,936
General government balance	-2,386	-2,513	-2,277	-2,710	-2,655	-2,620	-2,571	-2,542
RBI: gross fiscal deficit 7/	-2,350	-2,329	-2,347	-2,709	-2,632	…	…	…
Financing	2,386	2,513	2,277	2,710	2,655	2,620	2,571	2,542
External (net)	-119	-135	148	97	75	75	83	83
Domestic (net)	2,506	2,648	2,130	2,614	2,580	2,545	2,488	2,459
Disinvestment receipts	32	170	44	0	0	0	0	0
				(In percent of GDP)				
Total revenue and grants	18.4	18.7	19.5	20.3	20.3	20.1	20.9	20.9
Of which : tax revenue 4/	14.6	15.0	15.8	16.8	16.9	16.7	17.6	17.8
nontax revenue 5/	3.7	3.6	3.6	3.4	3.4	3.4	3.2	3.0
Total expenditure and net lending 6/	28.1	27.8	26.8	28.1	27.9	27.6	27.4	27.2
General government balance	-9.7	-9.1	-7.3	-7.8	-7.5	-7.4	-6.5	-6.3
(including disinvestment receipts)	-9.6	-8.5	-7.2	-7.8	-7.5	-7.4	-6.5	-6.3
(augmented with FCI and oil bonds)	...	...	...	...	...	-7.7	-7.3	-7.1
Domestic financing (net)	10.2	9.6	6.8	7.5	7.3	7.2	6.3	6.1
Memorandum items:								
Consolidated general government								
Current balance 7/	-6.7	-5.8	-3.9	-3.4	-3.1	-3.5	...	-2.1
(augmented with FCI and oil bonds)	...	...	...	...	...	-3.8	...	-2.8
Primary balance	-3.3	-2.7	-1.2	-1.8	-1.7	-1.6	-0.8	-0.7
Non-defense capital expenditure	2.9	3.2	2.7	3.1	0.7	0.6	0.7	0.7
Net interest payments	6.5	6.4	6.1	6.0	5.8	5.8	5.7	5.6
General government balance	-9.7	-9.1	-7.3	-7.8	-7.5	-7.4	-6.5	-6.3
Central government	-6.0	-5.1	-4.2	-4.3	-4.2	-4.2	-3.8	-3.6
State and union territory governments	-4.2	-4.5	-3.5	-3.2	-3.2	-3.1	-2.7	-2.6
Consolidation items 8/	0.5	0.4	0.4	-0.3	-0.1	-0.1	-0.1	-0.1
FCI and oil bonds	...	...	...	...		0.3	0.8	0.8
General government debt	86.2	86.1	85.9	83.9	76.0	82.7	82.2	80.8

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

1/ The consolidated general government comprises the central government (CG) and state governments.
2/ Based on RBI's estimate of provisional outturn for state finances.
3/ Based on central government provisional unaudited outturn and staff's projection of state finances.
4/ Tax revenue = Tax revenue of central government (CG), including NCCF and states' share, plus state tax revenue.
5/ Nontax revenue = Nontax revenue of CG, less interest payments by states on CG loans, plus nontax revenue of states.
6/ Expenditure and net lending = Total expenditure and net lending of CG (authorities' definition excluding FCI and oil bonds), less net loans and grants to states and union territories, plus total expenditure of states (excluding interest payments on CG loans).
7/ From the *RBI Handbook of Statistics* and the *RBI Annual Report 2006* ; the authorities treat disinvestment proceeds above-the-line as capital receipts. From 2005/06, disinvestment receipts of the central government are transferred to the National Investment Fund (off-budget).
8/ Above-the-line items in the CGA, which cancel out in the consolidation (e.g., loans to states).

Table 7. India: Macroeconomic Framework, 2001/02–2009/10 1/

	2001/02	2002/03	2003/04	2004/05	Prov. 2005/06	Projections 2006/07	2007/08	2008/09	2009/10
Growth (percent change)									
Real GDP (at factor cost)	5.8	3.8	8.5	7.5	8.4	8.2	7.7	7.5	7.5
Real GDP (at factor cost, on calendar year basis)	4.5	4.5	7.3	7.3	8.2	8.6	8.2	7.9	7.8
Prices (percent change, period average)									
Wholesale prices (1993/94 weights)	3.6	3.4	5.4	6.4	4.4	5.1	4.3	3.9	3.9
Consumer prices	4.3	4.0	3.9	3.8	4.4	6.0	4.1	3.9	3.9
GDP deflator	2.8	3.6	4.1	4.2	4.1	5.3	4.1	3.5	3.6
Interest rate on general government domestic debt (percent)	9.4	9.1	8.8	8.4	8.0	7.9	8.6	8.6	8.7
Saving and investment (percent of GDP)									
Gross saving 2/	23.7	26.6	29.6	29.7	30.4	31.3	31.6	32.2	32.5
Gross investment 3/	23.0	25.3	27.2	30.1	31.7	32.9	33.7	34.6	35.0
Fiscal position (percent of GDP) 4/									
Central government deficit	6.3	6.0	5.1	4.1	4.2	3.6	3.3	3.0	2.7
General government deficit	10.1	9.7	9.1	7.3	7.4	6.3	6.2	5.9	5.5
General government debt	81.4	86.2	86.1	85.9	82.7	80.8	78.1	76.1	73.8
External trade (percent change, BOP basis)									
Merchandise exports (in U.S. dollar terms)	-1.6	20.3	23.3	28.5	23.0	22.7	15.2	13.2	13.2
Merchandise imports (in U.S. dollar terms)	-2.8	14.5	24.1	48.6	31.5	22.9	14.3	13.5	12.1
Balance of payments (in billions of U.S. dollars)									
Current account balance	3.4	6.3	14.1	-2.5	-10.6	-14.1	-20.3	-25.9	-28.3
(in percent of GDP)	0.7	1.3	2.3	-0.4	-1.3	-1.6	-2.1	-2.4	-2.4
(in percent of GDP, calendar year basis)	0.3	1.4	1.5	0.1	-1.0	-1.5	-2.0	-2.4	-2.4
Foreign direct investment, net	4.7	3.2	2.4	3.7	5.7	9.3	12.1	13.7	15.5
Portfolio investment, net (equity and debt)	2.0	0.9	11.4	9.3	12.5	5.8	10.3	11.2	12.3
Overall balance	11.8	17.0	31.4	26.2	15.1	21.3	16.5	14.3	15.2
External indicators									
Gross reserves (US$ bn. end-period)	54.7	76.1	113.0	141.5	151.6	172.9	189.4	203.7	218.9
(in months of imports) 5/	8.0	9.4	9.2	8.7	7.6	7.4	7.0	6.6	6.2
External debt (percent of GDP, end-period)	21.1	20.4	17.8	17.3	15.8	16.5	16.7	16.9	17.0
Of which: short-term debt 6/	3.0	3.8	1.8	3.1	1.9	2.3	2.6	3.0	3.3
Ratio of gross reserves to short-term debt (end-period)	3.8	4.0	10.7	6.6	10.2	8.5	7.5	6.5	5.7
Debt service (percent of current acct. receipts)	13.6	16.0	15.9	6.0	9.7	5.3	6.0	5.8	5.9
Memorandum items (in percent of GDP):									
Food Corporation of India (FCI) bonds 7/	...	...	...	...	...	0.4	0.0	0.0	0.0
Oil bonds 7/	...	...	...	...	0.3	0.4	0.0	0.0	0.0

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

1/ Data are for April-March fiscal years.
2/ Differs from official data due to revisions in the current account.
3/ Statistical discrepancy adjusted.
4/ Onlending of small savings collections to state governments excluded from central government expenditures and net lending; divestment proceeds treated as below-line financing; FCI and oil bonds excluded from central government total expenditure.
5/ Imports of goods and services projected over the following twelve months.
6/ Residual maturity basis, except contracted maturity basis for medium and long-term non-resident Indian accounts.
7/ Issued by the central government to FCI and the state-owned oil refining/distribution companies as compensation for losses incurred from the provision of universal government price subsidies.

Table 8. India: Indicators of External Vulnerability, 2001/02–2006/07 1/

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2/
Financial indicators							
General govenment debt (percent of GDP)	81.4	86.2	86.1	85.9	82.7	80.8	(Projection)
Broad money (percent change, 12-month basis)	14.1	14.7	16.7	12.3	21.2	18.6	As on 10/27/06
Private sector credit (percent change, 12-month basis)	11.8	18.3	13.0	26.0	32.1	25.7	As on 10/27/06
91 day T-bill yield (percent; end period)	6.1	5.9	4.2	5.3	6.1	6.6	(Oct.-06)
91 day T-bill yield (real, percent; end period) 3/	2.6	2.3	-1.1	-1.1	1.6	1.5	(Oct.-06)
External indicators							
Exports (percent change, 12-month basis in US$) 4/ 5/	-1.6	20.3	23.3	28.5	23.0	21.9	(Sept.-06)
Export volume (percent change, 12-month basis) 5/	1.7	15.2	10.7	11.7	15.5	16.5	(Projection)
Imports (percent change, 12-month basis in US$) 4/ 5/	-2.8	14.5	24.1	48.6	31.5	24.8	(Sept.-06)
Import volume (percent change, 12-month basis) 5/	1.7	8.6	8.8	28.0	20.0	13.5	(Projection)
Terms of trade (percent change, 12 month basis) 5/	1.1	-1.1	-2.4	-4.4	-6.6	0.0	(Projection)
Current account balance (percent of GDP)	0.7	1.3	2.3	-0.4	-1.3	-1.6	(Projection)
Capital and financial account balance (percent of GDP)	1.8	2.1	2.8	4.0	3.1	4.0	(Projection)
Of which : net portfolio investment (debt and equity)	0.4	0.2	1.9	1.3	1.6	0.7	(Projection)
Other investment (loans, trade credits, etc.)	1.0	0.5	2.1	1.2	2.4	1.6	(Projection)
Net foreign direct investment	1.0	0.6	0.4	0.5	0.7	1.1	(Projection)
Foreign currency reserves (billions of US$)	54.7	76.1	113.0	141.5	151.6	167.1	(3-Nov-06)
RBI forward liabilities (billions of US$)	-0.4	2.4	1.4	0.0	0.0	0.0	(July-06)
Official reserves in months of imports (of goods and services)	8.0	9.4	9.2	8.7	7.6	7.4	(Projection)
Ratio of foreign currency reserves to broad money (percent)	17.6	21.0	24.6	27.5	24.8	25.5	(Oct.-06)
Total short-term external debt to reserves (percent)	26.1	25.2	9.3	15.1	9.8	11.7	(Projection)
Total external debt (percent of GDP)	21.1	20.4	17.8	17.3	15.8	16.5	(Projection)
Of which: public sector debt	11.7	10.5	8.3	7.5	6.7	6.4	(Projection)
Total external debt to exports of goods and services (percent)	159.8	140.8	119.9	95.9	75.7	70.7	(Projection)
External interest payments to exports of goods and services (percent)	7.1	5.2	4.5	2.6	2.8	3.0	(Projection)
External amortization payments to exports of goods and services (percent)	11.0	15.7	15.8	3.4	6.8	3.0	(Projection)
Exchange rate (per US$, period average)	47.7	48.4	45.9	44.9	44.3	45.9	(to Oct-06)
REER (change in percent; end period) 6/	-2.1	-2.9	1.4	1.4	4.2	-5.1	(Sept.-06)
Financial market indicators							
Stock market index (end period)	3,469	3,049	5,591	6,493	11,280	13,283	(Oct.-06)
Foreign currency debt rating							
Moody's Investor Services	Ba2	Ba1	Baa3	Baa3	Baa3	Baa3	
Standard and Poor's	BB	BB	BB	BB+	BB+	BB+	
Fitch Ratings	BB	BB	BB	BB+	BB+	BBB-	

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

1/ April-March fiscal year.
2/ Latest date available or staff estimate, if noted.
3/ Nominal yield is less than actual WPI inflation.
4/ Data for 2006/07 are on a customs basis, whereas data for previous years are on a BOP basis.
5/ Merchandise trade only; volumes are derived from partner country trade price deflators from the WEO database.
6/ IMF INS calculation.

Table 9. India: Indicators of Financial System Soundness, 2001/02–2005/06

	2001/02	2002/03	2003/04	2004/05	2005/06
Measures of financial strength and performance 1/					
Risk-weighted capital adequacy ratio (CAR)	12.0	12.7	12.9	12.8	12.4
Public sector banks	11.8	12.6	13.2	12.9	12.2
Domestic private banks	12.5	12.8	13.7	12.5	12.2
Foreign banks	12.9	15.2	15.0	14.0	13.0
Number of institutions not meeting 9 percent CAR 2/	3	2	2	2	3
Public sector banks	2	0	0	0	0
Domestic private banks	1	2	2	2	3
Foreign banks	0	0	0	0	0
Net nonperforming loans (percent of outstanding net loans) 3/ 4/	5.5	4.4	2.9	2.0	1.3
Public sector banks	5.8	4.5	3.0	2.1	1.4
Domestic private banks	5.7	5.0	2.8	2.2	1.3
Foreign banks	1.9	1.8	1.5	0.9	0.7
Gross nonperforming loans (percent of outstanding loans) 4/	10.4	8.8	7.2	5.2	3.5
Public sector banks	11.1	9.4	7.8	5.5	3.9
Domestic private banks	9.6	8.1	5.8	4.4	3.2
Foreign banks	5.4	5.3	4.6	2.9	2.1
Number of institutions with net NPLs above 10 percent of advances	22	13	9	4	3
Public sector banks	3	2	0	0	0
Domestic private banks	4	2	2	1	0
Foreign banks	10	6	5	4	3
Net profit (+)/loss (-) of commercial banks 5/	0.8	1.0	1.1	0.9	0.9
Domestic private banks	0.7	1.0	1.1	0.9	0.8
Foreign banks	0.7	1.0	1.0	0.8	1.5
Balance sheet structure of commercial banks					
Investment/deposit ratio	39.7	42.7	45.0	43.5	34.0
Credit/deposit ratio	53.4	56.9	55.9	64.7	71.5
Lending to sensitive sectors (in percent of total loans and advances)					
Real Estate Market	1.4	1.7	1.8	12.7	17.2 6/
Capital market	0.5	0.3	0.4	1.4	1.5 7/
Commodities	1.4	1.2	1.1	0.2	0.3

Sources: Indian authorities; and staff estimates.

1/ Classification differs from that in other countries; for example, sub-standard assets are loans that have remained nonperforming between 90 days and 15 months (versus less than 90 days in the United States and South Africa).
2/ The three banks with capital shortfalls in 2005/06 are small, collectively accounting for less than 1 percent of total resident deposits.
3/ Gross nonperforming loans less provisions.
4/ Starting in 2001/02, figure includes ICICI, formerly a large development finance institution, which merged with ICICI Bank Ltd. in 2002.
5/ In percent of total assets.
6/ For 2004/05 and 2005/06, the exposure to real estate sector is inclusive of both direct and indirect lending.
7/ For 2004/05 and 2005/06, the exposure to capital market is inclusive of both investments and advances.

Table 10. India: External Debt Sustainability Framework, 2001/02–2011/12

(In percent of GDP, unless otherwise indicated)

	Actual				Projections						
	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	Debt-stabilizing non-interest current account 6/
Baseline: external debt	20.4	17.8	17.3	15.8	16.5	16.7	16.9	17.0	17.1	17.3	-3.2
Change in external debt	-0.2	-2.6	-0.5	-1.5	0.8	0.2	0.2	0.1	0.1	0.2	
Identified external debt-creating flows (4+8+9)	-3.2	-7.7	-3.9	-3.1	-1.3	-1.4	-1.0	-1.1	-1.2	-1.3	
Current account deficit, excluding interest payments	-2.0	-3.1	-0.3	0.7	0.9	1.3	1.6	1.5	1.5	1.6	
Deficit in balance of goods and services	1.4	0.6	2.6	3.7	3.7	4.0	4.1	3.9	3.7	3.3	
Exports	14.7	15.5	18.5	20.7	23.4	25.0	26.6	28.1	29.7	-2.0	
Imports	16.1	16.1	21.1	24.4	27.0	29.0	30.7	32.0	33.3	34.5	
Net nondebt creating capital inflows (negative)	-0.8	-2.3	-1.9	-2.3	-1.7	-2.3	-2.4	-2.4	-2.4	-2.5	
Automatic debt dynamics 1/	-0.4	-2.3	-1.7	-1.5	-0.4	-0.3	-0.3	-0.2	-0.2	-0.4	
Contribution from nominal interest rate	0.7	0.7	0.7	0.6	0.7	0.8	0.9	0.9	0.9	0.8	
Contribution from real GDP growth	-0.7	-1.4	-1.3	-1.3	-1.2	-1.2	-1.1	-1.2	-1.2	-1.2	
Contribution from price and exchange rate changes 2/	-0.5	-1.6	-1.0	-0.9	...	...	...	...	...	...	
Residual, including change in gross foreign assets (2-3) 3/	3.0	5.1	3.4	1.6	2.1	1.5	1.3	1.2	1.3	1.4	
External debt-to-exports ratio (in percent)	138.5	114.8	93.6	76.2	70.7	66.7	63.6	60.4	57.6	-868.8	
Gross external financing need (in billions of U.S. dollars) 4/	7.9	5.1	13.0	32.0	29.0	40.6	50.4	58.2	65.1	72.5	
In percent of GDP	1.6	0.8	1.9	4.0	3.3	4.2	4.8	5.0	5.1	5.2	
Scenario with key variables at their historical averages 5/					15.6	14.8	13.8	12.8	12.0	11.3	-1.9
Key macroeconomic assumptions underlying baseline											
Real GDP growth at market prices (in percent)	3.6	8.3	8.5	8.4	8.2	7.7	7.5	7.5	7.5	7.5	
GDP deflator in US dollars (change in percent)	2.1	9.7	6.5	5.6	2.7	1.9	1.6	1.7	2.0	1.8	
Nominal external interest rate (in percent)	3.8	4.2	4.2	4.1	5.2	5.6	5.7	5.9	6.0	5.0	
Growth of exports goods and services (U.S. dollar terms, in percent)	20.5	25.0	37.9	28.8	25.2	17.4	16.0	15.9	15.6	14.9	
Growth of imports goods and services (U.S. dollar terms, in percent)	16.4	18.6	51.7	32.7	23.1	17.8	15.5	14.1	14.0	13.2	
Current account balance, excluding interest payments	2.0	3.1	0.3	-0.7	-0.9	-1.3	-1.6	-1.5	-1.5	-1.6	
Net non-debt creating capital inflows	0.8	2.3	1.9	2.3	1.7	2.3	2.4	2.4	2.4	2.5	

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

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

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

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

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

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

APPENDIX I: INDIA—MEDIUM-TERM DEBT SUSTAINABILITY ANALYSIS

A. The Baseline Scenario

Staff assumptions. The macroeconomic assumptions underlying the staff baseline scenario are as described in Table 7 and assume some increase in real interest rates and continued fiscal restraint. These policies, combined with progress in structural areas, deliver continued firm growth and contained inflation. In addition, the government is assumed not to issue further bonds to the state-owned petroleum companies, the Food Corporation of India, or other state-owned entities over the medium term.

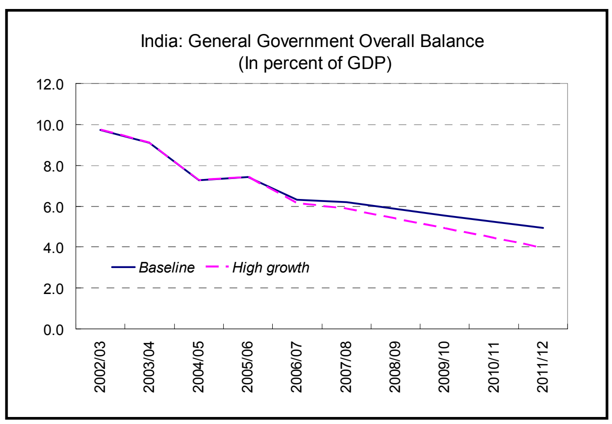
Debt path. Under the baseline scenario (a general government deficit of 6¼ percent of GDP in 2006/07 declining to 5 percent of GDP by 2011/12), gross public debt would fall from 80¾ percent of GDP to 69 percent of GDP over the same period.

FRBML targets. Under the baseline scenario, while the general government overall borrowing requirement is brought under 6 percent of GDP by 2008/09, achievement of the current balance target by the central government is delayed by three years to March 2012.

B. Sensitivity Analysis

Relative to the baseline scenario:

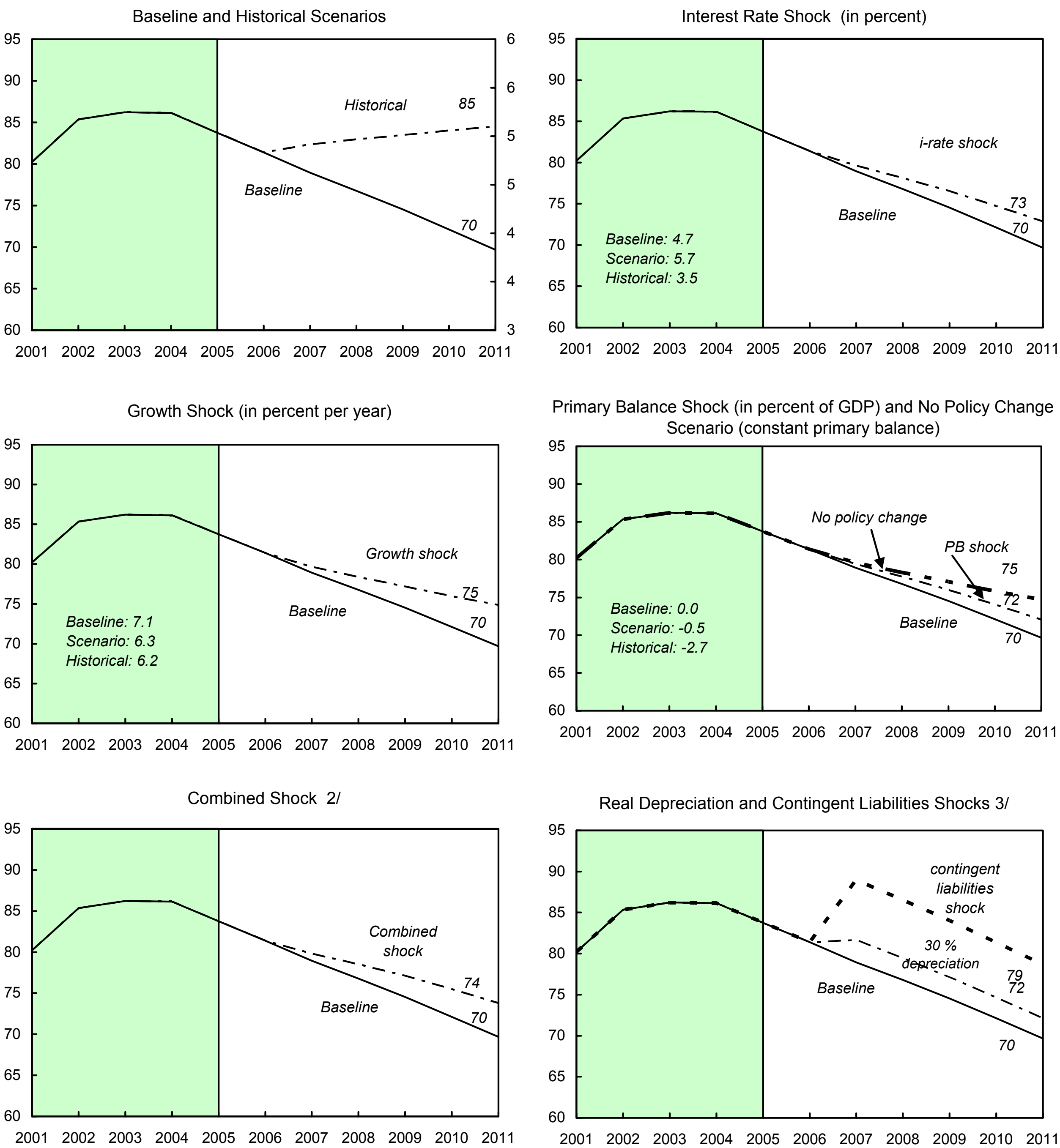
Interest rate and other shocks. A gradual decline in the debt-to-GDP ratio would still occur under various shocks, including in a scenario where the growth-interest-differential returns to its historical average (Figure I.1 and Table I.1). Only in the case of a return to historical averages for the primary balance, real GDP growth, and real interest rates would the debt ratio rise over the medium term.



Growth and pace of adjustment. A more ambitious adjustment path in the context of sustained GDP growth higher by 1½ percentage point ("*high growth*" scenario) compared to the baseline would lower the general government deficit to under 4 percent of GDP and public debt to 62 percent of GDP by March 2012 (Figure 5). Higher growth, combined with stronger tax measures (including elimination of sectoral and area-based corporate incentives and paring of excise exemptions) and progress in subsidy reform would also allow the government to meet both FRBML targets by 2008/09.

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

(Public debt, in percent of GDP)



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

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

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

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

Table I.1. India: Public Sector Debt Sustainability Framework, 2001–2011

(In percent of GDP, unless otherwise indicated; calendar year basis)

	Actual							Projections						
	2001	2002	2003	2004	2005	10-Year Historical Average	10-Year Standard Deviation	2006	2007	2008	2009	2010	2011	Debt-stabilizing primary balance 9/
Baseline: public sector debt 1/	80.2	85.3	86.2	86.1	83.8			81.4	78.9	76.8	74.5	72.1	69.7	-1.8
Of which: foreign-currency denominated	9.4	8.7	7.3	6.4	5.9			5.6	5.3	5.1	4.9	4.7	4.6	
Change in public sector debt	5.2	5.1	0.9	-0.1	-2.4			-2.4	-2.4	-2.2	-2.2	-2.4	-2.5	
Identified debt-creating flows (4+7+12)	5.2	4.4	-1.0	-2.6	-1.9			-2.7	-2.7	-2.4	-2.4	-2.6	-2.6	
Primary deficit	3.8	3.3	2.3	1.3	1.4			0.8	0.1	-0.1	-0.3	-0.4	-0.7	
Revenue and grants	17.7	18.4	19.2	19.6	20.1			20.8	21.6	22.4	23.2	24.1	25.0	
Primary (noninterest) expenditure	21.4	21.7	21.5	20.9	21.6			21.6	21.7	22.2	22.9	23.6	24.3	
Automatic debt dynamics 2/	1.2	1.0	-2.9	-4.0	-3.8			-4.6	-3.1	-2.2	-2.0	-2.1	-1.9	
Contribution from interest rate/growth differential 3/	0.8	1.0	-2.5	-3.7	-4.0			-4.6	-3.1	-2.2	-2.0	-2.1	-1.9	
Of which: contribution from real interest rate	3.7	4.2	3.0	2.5	2.4			1.7	2.5	3.1	3.1	2.9	3.0	
Of which: contribution from real GDP growth	-2.8	-3.2	-5.5	-6.1	-6.5			-6.3	-5.6	-5.3	-5.1	-5.0	-4.9	
Contribution from exchange rate depreciation 4/	0.3	0.0	-0.4	-0.3	0.2			...	...	...	...	...	...	
Other identified debt-creating flows	0.3	0.1	-0.4	0.1	0.5			1.2	0.2	-0.1	-0.1	-0.1	-0.1	
Privatization receipts (negative)	-0.1	-0.1	-0.5	-0.2	-0.1			-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	
Recognition of implicit or contingent liabilities	0.4	0.2	0.1	0.3	0.5			1.3	0.3	0.0	0.0	0.0	0.0	
Other (specify, e.g., bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2–3) 5/	0.0	0.8	1.8	2.5	-0.4			0.3	0.3	0.2	0.2	0.2	0.1	
Public sector debt-to-revenue ratio 1/	453.5	464.9	449.6	438.8	415.8			390.9	365.1	343.0	321.1	299.8	278.5	
Gross financing need 6/	…	…	…	…	…			…	…	…	…	…	…	
In billions of U.S. dollars	…	…	…	…	…			…	…	…	…	…	…	
Scenario with key variables at their historical averages 7/								81.4	82.4	83.0	83.5	84.0	84.5	-2.2
Scenario with no policy change (constant primary balance) in 2006–2011								81.4	79.6	78.3	77.1	75.8	74.7	-1.9
Scenario with real GDP growth and real interest rate at their historical averages								81.4	80.2	79.0	77.6	75.9	74.1	
Key Macroeconomic and Fiscal Assumptions Underlying Baseline														
Real GDP growth (in percent)	4.1	4.3	7.2	8.0	8.5	6.2	1.6	8.6	7.7	7.5	7.5	7.5	7.5	
Average nominal interest rate on public debt (in percent) 8/	8.8	8.6	8.4	8.0	7.7	8.4	0.4	7.7	8.2	8.4	8.4	8.4	8.6	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	5.4	5.8	4.2	3.6	3.5	3.5	1.9	2.7	3.8	4.7	4.8	4.6	4.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-3.0	0.3	5.3	4.6	-3.3	-2.3	4.7	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	3.4	2.8	4.2	4.4	4.2	4.9	1.8	5.0	4.4	3.7	3.6	3.8	3.7	
Growth of real primary spending (deflated by GDP deflator, in percent)	3.8	5.3	6.5	5.2	11.6	7.1	3.0	8.7	8.5	9.9	10.8	10.7	10.8	
Primary deficit	3.8	3.3	2.3	1.3	1.4	2.7	1.0	0.8	0.1	-0.1	-0.3	-0.4	-0.7	

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

APPENDIX II: INDIA—FUND RELATIONS

(As of October 31, 2006)

I. **Membership Status**: Joined 12/27/45; Article VIII.

II. **General Resources Account**:

	SDR Million	% Quota
Quota	4,158.20	100.00
Fund holdings of currency	3,719.11	89.44
Reserve position in Fund	439.11	10.56

III. **SDR Department**:

	SDR Million	% Allocation
Net cumulative allocation	681.17	100.00
Holdings	4.93	0.72

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	10/31/1991	06/30/1993	1,656.00	1,656.00
Stand-By	01/18/1991	04/17/1991	551.92	551.92
EFF	11/09/1981	05/01/1984	5,000.00	3,900.00

VI. **Projected Obligations to Fund** (SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2006	2007	2008	2009	2010
Charges/interest	6.61	27.36	27.43	27.36	27.36
Total	6.61	27.36	27.43	27.36	27.36

VII. **Exchange Rate Arrangement**:

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

VIII. **Article IV Consultation**:

The previous Article IV consultation discussions were held in October 2005. The staff report (IMF Country Report No. 06/55) was discussed by the Executive Board on February 6, 2006.

IX. **FSAP Participation and ROSCs**:

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

X. **Technical Assistance**:

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

XI. **Outreach and Other Activities**:

Department	**Purpose**	**Date of Delivery**
OAP/APD/NCAER	Conference: A Tale of Two Giants: India's and China's Experience with Reform and Growth	11/03
FAD	Conference: International Experiences with Fiscal Reform	1/04
APD/FAD	Seminar: Decentralization: International Experiences with Subnational Debt Controls	1/04
APD	Training: Applying Debt Sustainability Templates to Indian States	3/04
APD	Training: Revenue Forecasting	5/05
APD	Seminar: Going Global: India's Emerging Role in the World Economy at Centro di Studi Internazionali sull'Economia e lo Sviluppo	6/06
APD	Book: *India Goes Global: Its Expanding Role in the World Economy"*	8/06
APD	Workshop: State-Level Inequality and Economic Performance at the Institute for Financial Management and Research	10/06

XI. **Resident Representative**:

A resident representative's office was opened in November 1991. Mr. Joshua Felman replaced Mr. Michael Wattleworth as Senior Resident Representative in August 2006.

APPENDIX III: INDIA—RELATIONS WITH THE WORLD BANK GROUP

After a year of significantly high lending by the World Bank to India during Bank FY05, reaching $2.89 billion, the Bank's support to India in FY06 declined to $1.32 billion. This shortfall from plan was due to delays in project approval as a result of institutional/fiduciary issues, which have recently been resolved. World Bank support to India in Bank FY07 is expected to increase and again reach its targeted level consistent with the Country Assistance Strategy (CAS), having already delivered over $700 million as of end-August 2006. IFC also recorded a strong commitment in FY05 of $412.5 million. The World Bank Group's program of support combines policy dialogue with diversified IBRD/IDA lending, IFC investments and analytical and advisory activities in the sectors that are important to reducing poverty and sustaining growth.

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

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

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

India: World Bank Group Financial Operations

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

	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Commitments 2/	699	2,450	2,830	2,092	1,328	2,705	1,886
IBRD	190	1,495	1,904	951	698	1,463	1,241
IDA	509	955	926	1,141	630	1,242	645
Disbursements	1,468	1,761	1,997	1,533	1,816	1,835	2,135
IBRD	644	706	803	647	892	818	938
IDA	824	1,054	1,195	886	924	1,017	1,197
Repayments	1,228	1,361	1,147	3,491	2,403	784	842
IBRD	899	994	724	3,031	1,871	201	221
IDA	330	367	424	460	532	582	621
Debt outstanding and disbursed	26,746	25,968	26,466	26,243	27,019	28,527	28,925
IBRD	7,816	7,080	7,010	5,082	4,238	4,865	5,557
IDA	18,930	18,888	19,456	21,161	22,781	23,662	23,368

Source: World Bank.

1/ On a fiscal year basis beginning April 1.

2/ Based on loan approval date.

APPENDIX IV: INDIA—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

Asian Development Bank (AsDB) operations in India began in 1986. Cumulative public sector loan commitments totaled $14.6 billion as of July 31, 2006 for 80 loans. With an additional $0.4 billion in private sector loans (the latter without government guarantee), total loan commitments amounted to $15.0 billion. These funds have been provided from the Bank's ordinary capital resources (OCR). Also, AsDB has approved equity investments amounting to $0.2 billion. AsDB's lending and equity activities are summarized below.

India: Asian Development Bank Financial Operations 1/

(In millions of U.S. dollars, as of July 31, 2006)

Calendar Year	OCR Loan Commitments	Private Equity	Disbursements
1986–90	2,318	15.9	339
1991–95	3,459	59.5	2,131
1996	600	...	592
1997	563	15.5	645
1998	250	--	620
1999	625	--	605
2000	1,150	--	487
2001	1,500	--	270
2002	1,163.6	25	577
2003	1,430	0.65	658
2004	1,200	29.7	381.4
2005	367.31	20.6	641
2006	--	72.6	295
Total	14,625.9	239.45	8,241.4

Source: Asian Development Bank.

1/ In addition to these public sector loans, AsDB also provided $750 million for rural roads in 2005 under its multitranche financing facility.

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

APPENDIX V: INDIA—STATISTICAL ISSUES

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

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

- **National accounts**: The Central Statistical Organization (CSO) rebased the annual national accounts statistics and began publishing quarterly data in 1999. The CSO has recently reduced the dissemination lag for quarterly releases from three to two months and released a new series of national accounts, with base year 1999–2000 in January 2006. However, quarterly data are only available from 1996Q2 and relate only to production-based concepts. Information on major expenditure categories is available with considerable delay (at least ten months after the end of the fiscal year). Estimates of value added in constant prices for public administration and defense may be biased upwards, as they are based on the government's wage bill (with arrears counted in the year that they are paid) deflated by the Consumer Price Index (CPI) for industrial workers. The CSO plans to disseminate quarterly expenditure-based aggregates starting in 2007 and aims to reduce the dissemination lag for the annual expenditure-based estimates to three months.

- **Industrial production index (IPI)**: In May 2000, the CSO took the welcome step of releasing a revised time series for IPI, using the new WPI (base year 1993/94) series as a deflator. The government has also contracted a private company, CMIE, to increase the number of respondents and products in the sample, as recommended by the data ROSC.

- **Price statistics**: The CSO has published revised CPI with a 2000 base year. Presently, there are four CPIs, each based on the consumption basket of a narrow category of consumers (namely industrial workers, urban and nonmanual employees, agricultural laborers, and rural laborers). The CPIs are published with a lag of about one month.

The WPI is published weekly with a lag of two weeks and is subject to large revisions, especially in periods of rising inflation. A new WPI series was published in 2000 with updated weights, new categories, and a revised base year (1993/94). However, the representativeness of the index may be undermined by the collection of prices from a relatively small sample of products.

- **External sector statistics**: While the concepts and definitions used to compile balance of payments statistics are broadly in line with the fifth edition of the *Balance of Payments Manual (BPM5)*, the Reserve Bank of India's (RBI) presentation does not follow the *BPM5*. Furthermore, trade data have quality, valuation, timing, and coverage problems, and data on trade prices and volumes are not regularly available on a timely basis (a committee will examine the base year of trade indices). Starting January 2001, external debt statistics are available on a quarterly basis with a one quarter lag. Estimates of short-term external debt are presented in the debt statistics on an original maturity basis. The short-term maturity attribution on a residual maturity basis is only available annually (and excludes residual maturity of medium- and long-term nonresident Indian accounts). The international investment position (IIP) statistics cover the sectors prescribed in the *BPM5* and these data are disseminated within six months of the reference period in respect of annual data. India began disseminating the Data Template on International Reserves and Foreign Currency Liquidity as prescribed under the SDDS in December 2001. The more up-to-date information on certain variables, such as total foreign reserves, foreign currency assets, gold, and SDRs, are available on a weekly basis and are disseminated as part of a weekly statistical supplement on the RBI website. A STA mission that visited the country during August-September 2005 identified the major priorities for improvement in external statistics to be: (a) obtaining legislative authority to cover liberalized transactions; (b) adopting market valuation of direct investment, portfolio investment, and reserve assets; and (c) additional detail on service transactions.

- **Monetary and financial statistics**: The RBI website and the *RBI Bulletin* publish a wide array of monetary and financial statistics, including interest rates, exchange rates, foreign reserves, the monetary survey, and results of government securities auctions. The frequency and quality of data dissemination have improved substantially in recent years. However, some crucial data, such as the RBI's forward liabilities and intervention data, are still published with lags of two to three months.

- The ROSC data module mission of May 2002 found that the concepts and definitions used by the RBI to compile monetary statistics were in broad conformity with the guidelines provided in the *Monetary and Financial Statistics Manual (MFSM)*. Nevertheless, the following concepts and principles deviate from the *MFSM*. First, the resident sector data do not provide sufficient information on the sectoral distribution of domestic credit. Specifically, under their present sectorization scheme, the authorities subdivide the resident nonbank sector data by (i) central government, (ii) state government, and (iii) the commercial sector (including other financial corporations, public and other nonfinancial corporations, and other resident sectors). Second, commercial banks add accrued interest to credit and deposit positions on a quarterly basis only. The staff has recommended that the authorities adopt the full range of sectors prescribed in the *MFSM* and include accrued interest on a monthly basis instead of reflecting it only on a quarterly basis.

- India has submitted to STA test data (for the period December 2001-June 2006) on Standardized Report Forms (SRFs) that have been developed to implement the methodology in the *Monetary and Financial Statistics Manual.* STA is working with the authorities in resolving outstanding data issues. In October 2006, India initiated electronic reporting of monetary data, which is a major improvement from the previous paper-based reporting.

- **Fiscal statistics**: The Ministry of Finance posts selected central government monthly fiscal data and quarterly debt data on its website. However, no monthly data on fiscal performance at the state level are available, and annual data are available only with an eight- to ten-month lag. Consolidated information is unavailable on local government operations. In addition, data on the functional and economic classification of expenditures are available with considerable lag. There is also scope to improve the analytical usefulness of the presentation of the fiscal accounts. For example, classification of government expenditure between developmental/nondevelopmental and plan/nonplan obscures the economic nature and impact of fiscal actions. Reporting to the Fund for publication in the *Government Finance Statistics Yearbook (GFSY)* has been current (with data reported to 2004 in the 2005 GFSY), but only cash data is reported, and the coverage is generally limited to the central government. Some limited general government data has been reported for 2002.

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

- The revision of statistical and data reporting methods in order to keep pace with the shift to a more market-oriented economy following the elimination of industrial licensing.

- The need for the CSO to initiate procedures through which its interaction with other agencies in the decentralized statistical system is made more proactive as well as effective. The planned establishment of the National Statistical Commission is a first step.

India: Table of Common Indicators Required for Surveillance

As of November 10, 2006

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]	Memo Items[7]:	
						Data Quality – Methodological soundness[7]	Data Quality – Accuracy and reliability[8]
Exchange rates	11/16/06	11/16/06	D	D	D		
International reserve assets and reserve liabilities of the monetary authorities[1]	11/3/06	11/10/06	W	W	W		
Reserve/base money	10/27/06	11/10/06	W	W	W	O, O, LO, LO	O, O, O, O, O
Broad money	10/27/06	11/10/06	BW	BW	BW		
Central bank balance sheet	8/06	8/06	A	A	A		
Consolidated balance sheet of the banking system	8/06	8/06	A	A	A		
Interest rates[2]	11/10/06	11/10/06	D	D	D		
Consumer price index	10/28/06	10/10/06	M	M	M	O, LNO, O, O	LNO, LO, O, O, O
Revenue, expenditure, balance and composition of financing[3] – general government[4]	8/06	8/06	A	A	A	LNO, LO, O, O	O, O, O, O, LO
Revenue, expenditure, balance and composition of financing[3]– central government	8/06	8/06	M	M	M		
Stocks of central government and central government-guaranteed debt[5]	03/06	03/06	A	A	A		
External current account balance	6/06	6/06	Q	Q	Q	LO, O, LO, O	LO, O, O, O, LO
Exports and imports of goods and services	6/06	6/06	Q	Q	Q		
GDP/GNP	5/06	5/06	Q	Q	Q	LO, LNO, LO, LO	LNO, LNO, O, O, LO
Gross external debt	12/05	3/06	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), Weekly (W), Biweekly (BW), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC (published on April 2, 2004, and based on the findings of the mission that took place during May 13–30, 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative
December 20, 2006

1. This statement contains information that has become available since the staff report was circulated to the Executive Board on November 29, 2006. This information does not alter the thrust of the staff appraisal.

2. **Recent data suggest stronger-than-expected near-term growth**. Real GDP growth accelerated to 9.2 percent y/y in the June-September quarter, well above market and staff projections, reflecting strong services and a marked pickup in manufacturing. Industrial production growth eased to 6.2 percent y/y in October, but this largely reflected the temporary seasonal impact of holidays. Strong momentum has also contributed to a widening trade deficit. WPI inflation edged up to 5.3 percent in November, mainly reflecting rising food and manufacturing prices. On the basis of recent data, staff has revised upward GDP growth to 8.9 percent for FY2006/07 and to 8.2 percent for FY2007/08, with upward revisions to the projected current account deficit (2 percent of GDP) and inflation (5.2 percent) in FY2006/07.

3. **Fiscal revenues have been stronger than anticipated**. The central government's net tax revenue grew 33.8 percent y/y during April-October, reflecting strong corporate tax receipts. State VAT collection rose over 30 percent y/y during April-September.

4. **On December 8, the RBI announced increases in the Cash Reserve Ratio (CRR)**. The CRR will be raised by 25 basis points to 5.25 percent on December 23, and another 25 basis points on January 6, to remove some Rs. 135 billion (2.2 percent of reserve money) in excess liquidity from the market. Nonetheless, monetary conditions remain accommodative; in November, M3 grew 19.3 percent y/y, reserve money grew 17.5 percent y/y, non-food credit expanded 30.1 percent y/y, and real short-term interest rates remain at low levels compared with the past.

5. **The equity market has recently experienced volatility.** Between December 8 and 12, the BSE Sensex fell 5.8 percent, but subsequently stabilized. Between end-November and December 13 the rupee gained 0.1 percent against the dollar amid dollar weakening, while foreign exchange reserves now stand at $175 billion (December 8).

6. **The government has cut domestic petrol and diesel prices by 4¼ percent and 3 percent respectively**; LPG and kerosene prices are unchanged. The impact on inflation is likely to be limited (perhaps reducing WPI inflation by 0.1 percent). According to staff estimates, petrol is now 3½ percent above, and diesel 4½ percent below, cost-recovery levels on an import parity basis.

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IMF Executive Board Concludes 2006 Article IV Consultation with India

On December 20, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with India.[1]

Background

India's economy has continued to grow above trend, with average growth of 8 percent in the last three years. Growth is broad based, with robust consumption, investment, and exports. With manufacturing expanding at over 10 percent y/y, industry has joined services as an engine of growth. A normal monsoon is supporting agriculture. Staff projects growth of about 9 percent this year, further moderating toward trend in 2007/08. WPI inflation is contained within the RBI's indicative projection range of 5−5½ percent, partly reflecting gradual hikes in policy rates since late 2005, limited pass-through of higher world oil prices to domestic LPG and kerosene, and cuts in import duties. However, high food prices are contributing to CPI inflation (industrial workers) exceeding 6 percent. Staff projects WPI inflation to remain in the 5−5½ percent range in the near term.

The investment recovery and consumption boom continue to widen the external current account deficit. In 2005/06, buoyant imports have offset rising goods and services exports, pushing up the trade deficit to 6½ percent of GDP and the current account deficit to 1¼ percent of GDP. While

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

exports are growing apace, robust domestic demand is expected to contribute to a further widening in both deficits this year.

Strong capital inflows comfortably financed the current account deficit. In 2005/06, inflows remained dominated by portfolio flows and external commercial borrowings, particularly convertible bonds. While gross FDI inflows have begun to rise, they have been partly offset by a pickup in outward investment by Indian corporates. So far this fiscal year, capital inflows have remained strong and reserve coverage has remained stable at around 7½ months of imports of goods and services. While more reliance on debt and portfolio inflows has increased exposures to changes in international investor sentiment, India's large reserves and low external debt limit this risk.

The exchange rate has exhibited two-way flexibility and in real effective terms is broadly around its 2004/05 level. In the first half of 2006, the rupee depreciated against the U.S. dollar, against a backdrop of tightening global liquidity and a widening current account deficit. The RBI limited its intervention in foreign exchange markets to easing exchange rate volatility and smoothing domestic liquidity pressures that arose from the redemption of external bonds. Since then the rupee has regained ground against the dollar and the RBI continued to intervene only occasionally, both buying and selling dollars.

Financial markets continue to soar. Net foreign investor inflows rebounded after the May/June 2006 stock market correction and stock prices recovered smartly, reaching new historical highs. PE ratios are now high relative to other countries and India's recent past. Meanwhile, real estate prices continue to grow at a rapid clip on the back of a credit boom. To curb speculative pressures, the RBI has tightened prudential standards further, including by raising general provisioning requirements and boosting risk-weights on high-growth areas, including real estate, to above Basel norms. Indicators of financial soundness (backward looking) suggest that banks' balance sheets and income remain healthy.

Following three years of reduced deficits, fiscal consolidation "paused" in 2005/06. The general government deficit was broadly unchanged at around 7½ percent of GDP, with a modestly rising central government deficit broadly offset by a falling states deficit. All but five states enacted fiscal responsibility laws (FRLs) and nine states subsequently received debt relief under the new facility introduced last year by the Twelfth Finance Commission. General government debt remains high—over 80 percent of GDP—reflecting both budget deficits and off-budget subsidies for oil and food. Consolidation has resumed in 2006/07. The state and central government budget deficit targets of 2.7 percent of GDP and 3.8 percent of GDP, respectively, are consistent with the minimum reductions required under their fiscal responsibility legislations. Staff projects the general government deficit to overperform budget estimates by 0.2 percent of GDP on the back of strong revenue growth.

Executive Board Assessment

Executive Directors commended the authorities on India's continued outstanding economic performance—reflected *inter alia* in strong growth, enhanced resilience to shocks, and increasing integration with the global economy. The favorable conjuncture and outlook provide a good opportunity to accelerate key reforms to support the government's vision of reducing poverty and creating employment by boosting growth. Directors endorsed the government's reform priorities of fiscal consolidation, financial sector development, and removal of structural bottlenecks as the appropriate means to achieve these objectives.

While recognizing the difficulty in gauging inflation pressures during a period of financial deepening and other structural reforms, Directors agreed that vigilance is needed to guard against any potential risks of overheating. They supported the central bank's stance of continued gradual removal of monetary accommodation. Overperformance on the 2006/07 budget could support this policy stance by channeling the anticipated revenue windfall to deficit reduction. Directors concurred that India's policy of a market determined exchange rate is appropriately promoting flexibility, preserving monetary policy independence, and giving the private sector incentives to manage currency exposures as the capital account opens further. They supported the authorities' gradual approach to capital account liberalization, in step with fiscal consolidation and financial deepening.

Directors commended the improvement in government finances, but called for further progress in reducing public debt to make room for social and infrastructure spending. To achieve the target of bringing the central government's revenue deficit to balance by 2008/09, they recommended steps to broaden the tax base by eliminating corporate income tax incentives, paring exemptions, and reforming interstate taxation to pave the way for a national goods and services tax. On expenditure reform, Directors encouraged the authorities to implement the recommendations of government committees on subsidies, including the introduction of an automatic market-based mechanism for petroleum goods and better targeting of kerosene subsidies. Consideration should also be given to hardening state budget constraints, given that a number of states still face sizable adjustments.

Directors welcomed the strengthening of financial sector supervision, with prudential norms generally in line with international best practices. They advised continued vigilance to guard against pressures on asset quality in the face of rapid credit growth. Useful steps to expose potential vulnerabilities will be comprehensive stress tests and the authorities' self assessment of financial stability and development, while the future implementation of Basel II will give banks incentives to enhance risk management.

Directors saw the ongoing deepening and broadening of India's financial markets as key to fostering growth and facilitating greater capital account openness. Recent initiatives to develop money and government securities markets and strengthen regulation of derivatives activities are welcome. Directors encouraged the authorities to press ahead with measures that will further deepen markets, including the expansion of short selling, the consolidation of benchmark issues, and the streamlining of issuance requirements for corporate bonds. To broaden India's investor base and improve channels for funding longer-term investment, the limit on FDI in insurance should be raised and private participation in the pension system permitted.

Directors urged greater progress in addressing structural obstacles to job-intensive, inclusive growth. To help meet India's infrastructure needs, steps should be taken to strengthen implementation capacity and develop strong and independent regulators, as these would bolster investor interest and underpin the authorities' public private partnership initiative. Directors encouraged the consideration of steps to maximize the contribution of Special Economic Zones to India's growth strategy while limiting potential revenue losses. More broadly, efforts should continue to improve the business climate and reform education, as well as to alleviate rural poverty through promoting agricultural growth.

Directors welcomed the government's commitment to multilateral trade liberalization and supported India's intention to play an active role in restarting multilateral trade talks. They welcomed the unilateral extension of duty free, quota free access to the least-developed countries and the continued reduction in trade tariffs. Rapid economic growth provides an opportunity to move tariffs more quickly towards ASEAN levels.

India: Selected Economic Indicators 1/

	2002/03	2003/04	2004/05	2005/06	2006/07 Proj.	
			(In percent)			
Domestic economy						
Change in real GDP at factor cost	3.8	8.5	7.5	8.4	8.9	
Change in industrial production	5.8	7.0	8.4	8.2	...	
Change in wholesale prices (period average)	3.6	5.4	6.5	4.4	5.2	
Change in consumer prices (period average)	4.0	3.9	3.8	4.4	6.6	
			(In billions of U.S. dollars)			
External economy						
Merchandise exports	53.8	66.3	85.2	104.8	127.6	
Merchandise imports	64.5	80.0	118.9	156.3	196.8	
Current account balance	6.3	14.1	-2.5	-10.6	-17.9	
(In percent of GDP)	1.3	2.3	-0.4	-1.3	-2.0	
Direct investment, net 2/	3.2	2.4	3.7	5.7	9.3	
Portfolio investment, net	0.9	11.4	9.3	12.5	14.7	
Capital account balance	10.8	16.7	28.0	24.7	48.6	
Gross official reserves 3/	76.1	113.0	141.5	151.6	175.4	7/
(In months of imports) 4/	9.4	9.2	8.7	7.5	7.9	7/
External debt (in percent of GDP) 3/	20.7	18.6	17.7	15.7	16.7	
Short-term debt (in percent of GDP) 3/ 5/	3.8	1.8	3.1	1.9	2.2	
Debt service ratio (in percent of current receipts)	16.1	16.0	6.0	9.7	5.2	
Change in real effective exchange rate (in percent) 3/	-4.7	1.0	2.2	4.4	-1.4	8/
Financial variables						
Central government balance (in percent of GDP) 6/	-6.0	-5.1	-4.1	-4.2	-3.6	
General government balance (in percent of GDP) 6/	-9.7	-9.1	-7.3	-7.4	-6.2	
Change in broad money (in percent) 3/	14.7	16.7	12.3	21.2	19.3	9/
Interest rate (91-day Treasury bill rate) 3/	5.9	4.2	5.3	6.1	7.1	10/

Sources: Reserve Bank of India; Ministry of Finance; CEIC Data Company Ltd; IMF, *International Financial Statistics*; and IMF staff estimates.

1/ Data are for April-March fiscal years as available at the time of the Executive Board meeting, unless otherwise indicated.
2/ Net foreign direct investment in India less net foreign investment abroad.
3/ End of period.
4/ Imports of goods and services projected over the following twelve months.
5 Residual maturity basis, except contracted maturity basis for medium- and long-term nonresident Indian accounts.
6/ Excluding divestment receipts from revenues and onlending of small saving collections from expenditures and net lending.
7/ As of December 8, 2006.
8/ IMF calculations as of November 30, 2006.
9/ As of November 24, 2006.
10/ As of December 22, 2006.