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REPORT ON THE 1987 CONSULTATION WITH INDIA

Addendum

ANNEX

Statement by the representative of
the International Monetary Fund

India

In the early 1980s, India embarked on a long-term development program designed to promote higher growth while maintaining domestic financial stability and balance of payments viability. The underlying strategy called for a rapid expansion of output supplies together with the control of aggregate demand, the promotion of domestic savings to finance a high rate of investment, and a reallocation of resources to the export sector. Key policy measures to achieve these objectives were the relaxation of industrial regulations and import restrictions, tax and financial sector reforms, and the active use of pricing policy to improve the efficiency of production as well as the financial position of public enterprises. Demand management policies were directed toward generating high rates of domestic savings and restoring price stability. These measures were embodied in an economic adjustment program supported by the use of Fund resources under an extended arrangement (1981-84).

Major macroeconomic targets were generally achieved under the adjustment program. Notwithstanding adverse weather during part of the period, economic growth was sustained above a historical trend, with a step-up in public investment and an easing of infrastructural bottlenecks. Substantial adjustments of key administered prices contributed

to strengthening public sector resource mobilization, especially in the early years of the program period. Inflation subsided in response to cautious demand management as well as a moderation in international prices. The balance of payments improved, partly owing to a substantial progress in import substitution in the agricultural and energy sectors. However, export performance remained disappointing, as a shift of resources to the export sector was discouraged by inadequate profitability.

Reforms were carried further in 1985/86 (fiscal year beginning in April) in support of the Seventh Plan (1985/86-1989/90), which envisages rapid economic growth supported by a strong expansion of exports. These goals required strengthened efforts to promote exports and improve economic efficiency through more liberal industrial and trade regimes, tax reform, and improvements to the financial system.

In the area of industrial regulation, steps were taken to reduce the scope of industrial licensing and restrictive trade practice legislation, to simplify procedures for capacity expansion, to encourage foreign investment and collaboration, and to alleviate excessive protection of small scale industries. Further measures to liberalize imports were also taken; license requirements were relaxed, access to imports of capital goods was increased, and procedures for importation were simplified.

Tax reforms during 1985/86 and 1986/87 were designed to foster private sector growth, improve revenue buoyancy, and alleviate the cascading effect of indirect taxes which had considerably weakened the competitiveness and profitability of the export sector. In the 1985/86 budget, corporate and personal income taxes were reduced, the exemption limit was raised, and selected import duties were cut. In late 1985, the Government announced a long-term program for fiscal reform, which included the staged introduction of a modified value-added tax; the first stages were implemented in the 1986/87 and 1987/88 budgets. In conjunction with the fiscal reforms, steps to liberalize the financial sector are also planned; these are aimed at facilitating control of monetary growth, improving credit allocation, and promoting financial intermediation. As a first step to this end, interest rates on government securities were raised to help reduce rigidities in the interest rate structure. Also, during this period, exchange rate policy was used more actively; the real effective value of the rupee depreciated by some 24 percent between mid-1985 and mid-1987.

While the full impact of the recent liberalization measures is expected to show up only over the medium term, economic developments during 1985/86-1986/87 were generally encouraging. Despite adverse weather, real GDP growth averaged more than 5 percent, reflecting

increased resilience of agricultural production, an upturn in private investment, and buoyant industrial production; the latter was based to a large extent on the expansion in new industries (electronics and computers), which had benefited from the industrial and trade liberalization and the depreciation of the rupee. Inflation moderated as a result of an improved supply position. The tax reforms, which significantly reduced tax evasion, contributed to a sharp increase in government revenue. Nevertheless, higher budgetary expenditure and an erosion in the surplus of public enterprises resulted in a widening of the public sector deficit. Increased domestic financing of the deficit led to a relatively rapid expansion in liquidity.

The external current account deficit widened to \$5 billion (2.6 percent of GDP) in 1985/86, owing to a sharp increase in imports in the wake of liberalization measures, while exports stagnated. In 1986/87, however, the deficit narrowed to \$4 billion (1.9 percent of GDP); imports benefited from the drop in oil prices, and, despite the effect of intensified protection abroad on key manufacturing exports such as textiles and metal products, exports strengthened in response to improved profitability. With an increase in external assistance, higher inflows of nonresident deposits, and large valuation gains on non-U.S. dollar reserves the overall balance of payments position registered large surpluses (measured in U.S. dollars) in both 1985/86 and 1986/87. Gross official reserves, including India's reserve

position in the IMF, remained at a comfortable level with respect to levels in the past and with respect to imports. External debt at the end of 1986/87 was estimated at \$41 billion (19 percent of GDP); debt service payments rose to 22 percent of gross current receipts, partly reflecting increased repayments to the Fund.

In 1987/88, the worst drought in recent history has caused widespread damage to the summer crop and has seriously strained energy supplies. Information on the extent of the damage remains sketchy, but current estimates are for real GDP growth of no more than 3 percent with an increase in inflationary pressures. While foodgrain stocks are adequate to prevent famine, substantially higher than planned imports of edible oils will be needed and exports of some agricultural products will be adversely affected. The current account deficit is therefore expected to widen, and despite continuing large capital inflows, the overall position will probably weaken. On the fiscal side, the 1987/88 Central Government budget envisaged a narrowing of the deficit; in an effort to prevent a deviation from the target, the Government recently announced cuts in plan expenditures to offset outlays for drought relief; in addition, temporary surcharges were placed on personal and corporate income taxes, auxiliary customs duties and the wealth tax. Economic performance in 1988/89 is likely to continue to be affected by the recent drought owing to lags in the response of prices and the need to rebuild foodgrain stocks.

The Fund notes that the Indian economy has performed well during the 1980s and considerable progress has been made toward the long-term objectives of promoting higher growth without jeopardizing the external payments position. Significant structural reforms, particularly in the areas of industrial regulation and trade policy and more recently the substantial depreciation of the rupee, have played a critical role in this process. The initial response to these changes has been encouraging, with increased private investment and, more recently, stronger exports. Still there remains substantial scope for reducing the restrictiveness and complexity of the exchange and trade system. Continued liberalization, in tandem with industrial deregulation, is necessary to improve efficiency, channel more resources to the export sector and meet the relatively ambitious targets of the Seventh Plan. Such changes need to be supported by a judicious use of financial policies to address their balance of payments impact. In recent months, India has experienced a severe drought which will have widespread, adverse effects on the economy. This setback will make it difficult to undertake structural and financial reforms. The Fund welcomes the authorities' commitment to the objectives of the Seventh Plan and hopes that they can sustain progress in making needed changes in trade, industrial, and financial policies. Beyond their efforts, ready access to foreign markets will be essential to the development of India's exports and, therefore, its growth prospects.