I. THE ECONOMIC ENVIRONMENT

1. The first Trade Policy Review of India in 1993 noted that the reforms undertaken since June 1991 initiated a revolutionary turnaround in the economy. Since that Review, the reforms have continued, albeit at a slower pace. The economy, after an initial decline in growth in response to the devaluation of 1991 and contractionary fiscal and monetary policies, has performed very well. Important reforms have been undertaken in investment, the exchange-rate and, trade regimes, the financial sector and the tax system. Trade liberalization has constituted an integral part of the reform programme, allowing a more rational choice of options for Indian consumers and contributing to growth. However, in other areas, such as fiscal policy, adjustment has not been as forthcoming as expected at the time of the last Review. Moreover, limited progress has been achieved in the areas of agriculture and labour. This Chapter reviews the economic environment and recent economic performance, highlighting the linkages with external trade.

(1) Recent Economic Performance

(i) Macroeconomic developments

2. Following the structural and stabilization programme initiated in July 1991, the Indian economy initially experienced a sharp decline in growth. Since then, however, helped by good monsoons and strong supply-response to the reforms, the economy has shown annual growth rates rising to about 7 per cent in the past three years (Table I.1). The industrial recovery has, except for 1996/97, been particularly strong, with estimated annual average rates of above 10 per cent for manufacturing value added in 1994/95, 1995/96 and 1996/97 (Table I.2).[1] Industrial growth has been led by demand for investment.

3. India's increased integration with the world economy, as measured by the ratios of exports, imports and foreign investment to GDP (Chart I.1), has been an important factor in explaining the growth resurgence. Merchandise exports performed well between 1993/94 and 1995/96, growing on average by 20 per cent in current U.S. dollar value, albeit with a slow-down to 4 per cent in 1996/97, particularly in traditional sectors which were affected, among other factors, by weaker world demand and infrastructure bottlenecks (growth in construction, for example, has lagged that in manufacturing). Over the same period, imports have also grown strongly reflecting both increased access to the Indian market and India's need for modern capital goods. Throughout this period, the current account remained in moderate deficit (annual average of -1.1 per cent of GDP).

4. The liberalization of the foreign investment regime, initiated in 1991, has been a significant part of the reform programme. As a result, foreign direct investment (of about US$2.7 billion or 0.7 per cent of GDP) increased to a level in 1996/97 in line with net inflows of portfolio investment, shifting the financing of the balance of payments from debt-creating items to foreign inflows. These buoyant capital inflows permitted a healthy growth of international reserves, to the equivalent of 6.6 months of merchandise imports by end-March 1997 (Tables I.1 and I.3).

[1] India's fiscal year is from 1 April to 31 March.

Table I.1
Economic performance of India, 1991-97

	GDP share (1993/94)	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97
		Percentage change					
GDP by expenditure component							
Real GDP at factor prices[a]		0.9	4.3	6.0	7.2[c] 7.6[c]	7.1[d]	6.5[d]
Real GDP at market prices[a]		0.4	5.4	4.8	4.4[c]	7.3[d]	…
Private consumption	65.3	1.8	4.0	4.7	1.8[c]	6.0[d]	…
Government consumption	10.8	-0.6	3.3	6.4	13.3[c]	5.1[d]	…
Gross fixed capital formation	21.0	-4.0	7.0	5.6	7.6[c]	18.3[d]	…
Construction	7.4	2.3	2.9	-1.5	16.5[c]	4.6[d]	…
Machinery & equipment	13.6	-7.7	9.6	9.8	1.0[c]	25.2[d]	…
Change in stocks[b]	0.0	-1.7	1.2	-2.0	…	0.2[d]	…
Net exp., goods and non-factor serv.[b]	0.1	1.3	-0.8	0.8		…	…
Saving and investment (per cent of GDP)							
Gross domestic saving		22.8	22.1	23.1	24.9[c]	25.6[d]	25.8[d]
Public sector		1.9	1.5	0.6	1.8[c]	1.9[d]	1.8[d]
Gross domestic investment		23.4	24.0	23.6	26.0[c]	27.4[d]	27.5[d]
Public sector		9.2	8.9	8.6	8.8[c]	8.2[d]	8.6[d]
Prices (percentage change)							
Inflation[e]		13.6	7.0	10.8	10.4	5.0	7.3[d]
Government budget (per cent of GDP)							
Central Government balance		-5.9	-5.7	-7.4	-6.1	-5.5	-5.0[d]
Revenue and grants		11.7	11.3	9.8	10.7	10.7	11.3[d]
Import duties		3.6	3.3	2.7	2.8	3.2	3.5[d]
Current expenditure		13.9	13.6	13.9	13.3	13.4	13.4[d]
Interest payments		4.3	4.1	4.3	4.3	4.5	4.6[d]
States' balance		-3.1	-3.0	-2.5	-2.9	-3.1	-2.9[d]
Central public enterprises' balance		-2.8	-2.9	-3.1	-2.6	-2.1[d]	-2.5[d]
Overall public sector balance[f]		-9.3	-9.5	-10.7	-9.0	-9.0[d]	-8.5[d]
Money and interest rates (per cent, end-of-period)							
Money supply (M3, percentage change)		19.3	15.7	18.4	22.3	13.7	15.6
Discount rate		13.0	12.0	10.0	13.0	13.0	…
Interest rate on 91-day treasury bills		…	10.8	7.3	11.8	13.0	8.0
Interest rate on 10-year government bonds		12.5	12.8	12.5	12.7	13.9	13.7
External sector (per cent of GDP)							
Current account		-0.5	-1.4	-0.4	-1.1	-1.7	-1.1[d]
Merchandise trade		-1.1	-1.8	-0.9	-2.3	2.7	-3.1[d]
Non-factor services		0.5	0.5	0.2	-0.2	0.0	0.5[d]
Net investment income		-1.5	-1.4	-1.3	-1.1	-1.4	-1.4[d]
Net transfers		1.7	1.3	1.5	2.1	2.4	2.9[d]
Capital account		1.6	1.2	3.8	3.1	1.3	3.1[d]
Overall balance (US$ million)		-2,790	-560	8,677	6,102	-1,209	6,882[d]
Overall balance (% of GDP)		-1.1	-0.2	3.4	2.0	-0.4	2.0
Interl. res. (months of merchandise imports)		3.2	3.3	7.2	7.4	4.9	6.6[d]

… Not available.

a 1980/81 prices.
b Per cent contribution to GDP growth.
c Provisional data.
d Estimated data.
e Wholesale price (end-of-period).
f The overall balance is less than the sum of its components due to intra-sector transfers. It includes the operations of the Central Government, the State Governments, the Union Territories and the central public enterprises. The divestment receipts are treated as a revenue item.

Note: Year beginning 1 April, unless otherwise indicated.

Source: Government of India (1997c), Economic Survey 1996/97; and International Monetary Fund (1996b), India - Recent Economic Developments, Staff Country Report No. 96/131.

Table I.2
Major features of the Indian economy, 1990-97

	India	Low-income-economies[a]	Low- and middle- income-economies[a]
Population growth rate (per cent)[b]	1.8	1.7	1.6
Life expectancy at birth, 1995 (years)	62	63	65
Adult illiteracy, 1995 (per cent)	48	34	30
Infant mortality rate, 1995 (per cent)[c]	68	69	60
GNP per capita, 1995 (US$)	340	430	1,090

	GDP share (1995/96)	1990/91	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97
		Annual percentage change in value added						
Agriculture[f]	26.9	3.8	-2.3	6.1	3.6	4.6[d]	-0.1[e]	3.7[j]
Industry[f]	31.1	7.2	-1.3	4.2	6.8	9.4[d]	11.6[e]	8.7[j]
Mining and quarring	1.9	10.8	3.6	1.1	2.0	8.2[d]	7.0[e]	1.7[j]
Manufacturing	22.3	6.1	-3.7	4.1	8.5	10.2[d]	13.6[e]	10.6[j]
Electricity, gas and water	2.6	6.4	9.6	8.4	7.0	8.7[d]	9.0[e]	4.2[j]
Construction	4.3	11.6	2.2	3.4	1.3	6.8[d]	5.3[e]	4.6[j]
Services[f]	42.0	5.2	4.9	5.5	7.2	7.5[d]	8.8[e]	7.4[j]
Trade, hotels and restaurants	14.4	5.4	0.9	6.8	8.3	10.8[d]	14.6[e]	9.4[j]
Transport and communication	5.7	4.7	5.6	5.5	5.1	8.3[d]	10.0[e]	…
Finance	11.3	6.4	10.5	4.6	10.5	7.1[d]	4.0[e]	6.3[j]
Community services	10.7	4.3	4.0	5.0	3.9	3.8[d]	6.2[e]	4.9[j]
	1980/81	**US$ billion**						
Merchandise exports[g]	8.5	18.1	17.9	18.5	22.2	26.3	31.8[e]	24.2[h]
Merchandise imports[g]	15.9	24.1	19.4	21.9	23.3	28.6	36.7[e]	27.4[h]
		Twelve-month rates of growth end-of-period (per cent)						
Exports (GNFS)[i]	14.0	8.6	1.1	1.3	18.4	18.0	20.1	8.4
Merchandise exports	9.3	9.0	-1.1	3.3	20.2	18.4	20.9	4.0
Imports (GNFS)[i]	33.9	12.7	-21.0	7.9	11.0	25.3	29.9	7.7

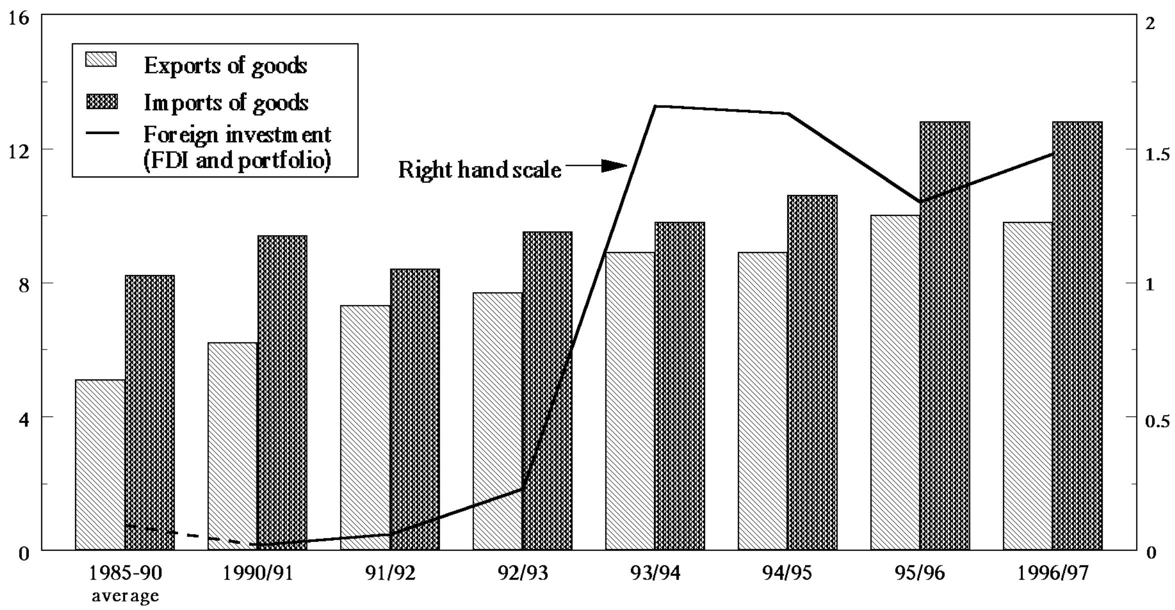
… Not available.

a Definition according to the World Bank; India is defined as a low-income economy. Weighted average data.
b 1990-1995.
c Per 1,000 live births.
d Provisional data.
e Estimated data.
f Real value added (at factor cost, 1980/81 prices).
g Customs clearance basis data; merchandise imports are c.i.f.
h Jan. to Sep. 1997.
i Goods and non-factor services; balance of payments data; merchandise imports are c.i.f., include interest on trade finance, and exclude personal imports of gold and silver.
j Data provided by Indian authorities.

Note: Year beginning 1 April, unless otherwise indicated.

Source: Government of India (1997c), Economic Survey 1996/97; International Monetary Fund (1996b), India - Recent Economic Developments, Staff Country Report No. 96/131; World Bank (1996), World Development Report 1996; and World Bank (1997b), World Development Report 1997.

Chart I.1
Openness and integration, 1985/86 - 1996/97[a]
(Per cent of GDP)



a Year beginnng 1 April.

Source: International Monetary Fund (various issues).

5. The most important issue in recent economic management has been to improve public savings and reduce the fiscal deficit. Between 1993/94 and 1996/97, the Central Government reduced its deficit from 7.4 to an estimated 5.0 per cent of GDP. The deficit of the State Governments is estimated to have improved slightly, but was partly off-set by a higher than expected deficit of the oil pool account (Oil Coordination Committee deficit of 0.8 per cent of GDP)[2], resulting in a consolidated fiscal deficit for the whole public sector of 8.5 per cent of GDP, down from 10.7 per cent in 1993/94.[3] Monetary policy has been disciplined, and inflation, though fluctuating has been held to an average of some 9 per cent a year in the period 1991/92 to 1996/97 (Table I.1).

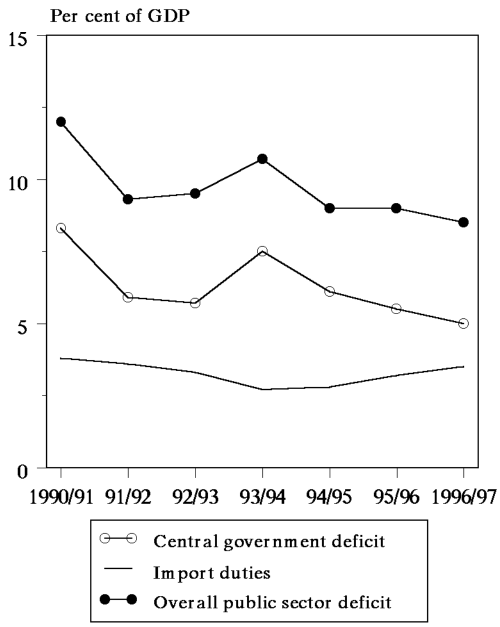
6. Financing of the fiscal deficits has, to a large extent, been through domestic borrowing from the banking system at (until recently) below-market interest rates, as well as through external commercial borrowing. These high fiscal deficits have led to an increased public debt, in tandem with increased real interest rates, and a degree of crowding out of private investment.

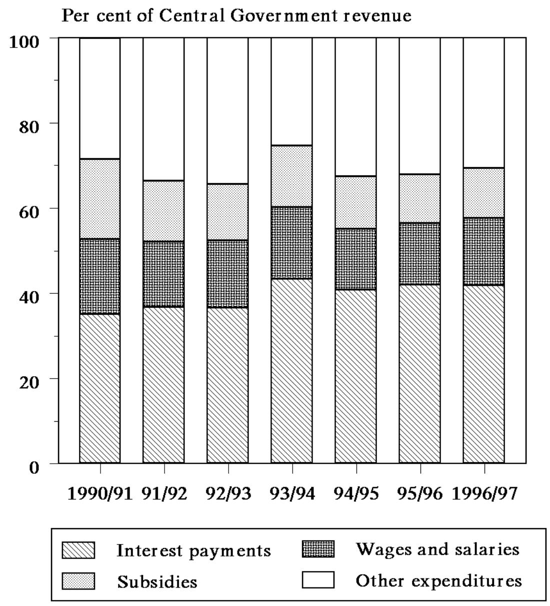
[2]The higher international prices for oil were not fully passed on to the consumers.

[3]The consolidated public sector comprises the operation of the Central Government, the State Governments, the Union Territories, and the central public enterprises. It should be noted that the authorities treat divestment receipts as a revenue item as opposed to a financing item.

7. There is a probable linkage between continued tariff reform programme and fiscal adjustment. Import duties as a share of central government total revenue are estimated at 32.0 per cent in 1996/97, or 3.5 per cent of GDP (Chart I.2). Hence, although policy is clearly to reduce tariffs further, the prospects in the short-run of doing so may be hampered by the high reliance of the Central Government on customs as a source of revenue.

Chart I.2
Fiscal adjustment and tariff duties, 1990/91 - 1996/97





Source: International Monetary Fund.

8. The prospects for fiscal adjustment through expenditure cuts may be more likely in the medium than short term as expenditure is dominated by wages, subsidies and interest payments which will take time to adjust (Chart I.2). Hence, in the short term, adjustment may need to come mainly from revenue measures. A comprehensive reform of the tax system and improving the finances of the States and public enterprises to generate alternate sources of revenue would be necessary for further lowering of tariffs, combined with priority to speedy reduction of tariff exemptions and to the phasing out of import restrictions, which would yield substantial revenues. Finally, meaningful adjustment would almost certainly require addressing the fiscal positions of the State Governments (Box I.1).

Box I.1: State-Centre fiscal relationship in India

India's persistent high overall public sector deficit of between 8 and 9 per cent of GDP is a challenge to macroeconomic stability and may impede the implementation of some needed structural reforms. While the negative macroeconomic effects of high fiscal deficits are well known, including inflation (if deficits are financed through printing money), draw-down of reserves (financing through external borrowing) and/or increased real interest rates and the associated crowding out of private investment (financing through domestic borrowing), then may also in the case of India, lead to delays in financial reforms (since the liberalization may induce higher interest rates and therefore higher debt servicing for the Government) and in the lowering of tariffs.

The fiscal adjustment that has taken place since 1990/91 has been made almost exclusively by the Central Government. Following a substantial cut in the Central Government's deficit in the first year of the reform programme (of more than 2 percentage points of GDP), the deficit has varied, but in 1996/97 was forecast at 5 per cent of GDP (Table I.1). The 1997/98 budget envisages a reduction of the fiscal deficit to 4.5 per cent of GDP, derived primarily from increased divestment receipts. At State level, there has been no improvement; the fiscal deficit has been close to 3 per cent of GDP through the period.

Expenditure reforms have lagged behind tax reform at State level. While some structural improvements have been made in the States' tax structure, revenue has not increased either as a share of GDP or in relation to developmental expenditure. On the expenditure side, "unproductive" expenditure has been allowed to account for a large part of available resources. The major issues are: a large and increasing wage and interest bill; low cost recovery; non-viable enterprises in the areas of, *inter alia*, electricity distribution and transportation; and squeezed expenditure on growth-inducing and socially productive investments. With respect to the latter, it should be noted that the States are constitutionally responsible for most expenditure on infrastructure and social programmes.

Fiscal consolidation also requires an overhaul of the system of intergovernmental transfers. Presently, the States derive a large part of their revenues from transfers made by the Centre through different modes of transfer (41 per cent of revenue in 1996/97). First, the Constitution provides for a transfer of 77.5 per cent of personal income tax revenue and 47.5 per cent of excise duty collected by the Centre. The 1997/98 budget proposes to form a single pool of taxes to be shared between the Centre and the States, with 29 per cent of the pool being transferred to the latter, enhancing the incentives for increased income tax collection at the Centre. The Bill seeking amendments to the Constitution has not yet been passed. Second, the States also receive tied transfers (associated with externally aided projects or central plan schemes and centrally sponsored development projects), and untied transfers. Finally, concessional loans to finance deficits are provided (States are constitutionally blocked from borrowing abroad).

The transfer system does not encourage the States to address problems related to fiscal discipline, such as unsustainable indebtness and, as noted above, weak tax collection effort. Increased revenue efforts are not awarded since the transfer of grants to a specific State is based on, *inter alia*, the "gap" between the State's revenues and expenditure. Periodic Central Government loan forgiveness and refinancing, without conditionality, have created the expectation of future debt relief. Moreover, the Centre funds the operating and the capital cost of new state programmes for the first five years (typically 30 per cent grant and 70 per cent loan), encouraging States, on the margin, to undertake new projects of low priority and/or for which they may not be able to finance operation and maintenance costs once the Centre has withdrawn its funding.

Source: Chopra et al. (1995), India - Economic Reform and Growth; World Bank (1995b), Economic Developments in India - Achievements and Challenges; and World Bank (1996b), India - Country Economic Memorandum, Five Years of Stabilization and Reform: The Challenges Ahead.

9. Monetary policy has been central to macroeconomic stabilization in recent years. The Reserve Bank of India (RBI), the central bank, has relied on broad monetary targets, but in tandem with the opening up of the economy it has paid greater attention to exchange and interest rate developments. The exchange rate is based on a freely determined market rate; the real effective exchange rate has shown some tendency to appreciate, reflecting the appreciation of the U.S. dollar against other major currencies and a widening of the partner country inflation differential, reversing its decline in the previous years (Annex I.1).

(ii) Structural reforms

10. The 1993 Review noted that important structural reforms had taken place since 1990/91. The reform process has deepened since then, although at a somewhat uneven pace across sectors. The key reforms since the last Review are presented in Box I.2.

11. The record in the financial sector is mixed. Most interest rates have been deregulated and barriers against entry of private banks have been relaxed. However, the banking sector is still dominated by public banks (almost 76 per cent of deposits in 1996/97), which are subject to strict rules regarding their lending (40 per cent of total lending to "priority sectors" and 12 per cent for exports[4]). In addition, a large share of bank deposits must be invested in government securities although some reform has taken place recently. Insurance companies, which are all publicly owned, are obliged to invest up to three quarters of their portfolio in government-designated securities.[5]

12. Delays in establishing an appropriate transparent framework with respect to bidding procedures and uncertainties in cost recovery and risk sharing, has slowed the expansion of private sector participation in infrastructure sectors. In particular power, roads and ports are becoming severe bottlenecks to trade and growth. Another area where progress has lagged expectations until recently is public enterprise reform. A Disinvestment Commission was established in 1996 to hasten the process of government disinvestment in public sector enterprises. Nine well-performing enterprises have been granted greater autonomy (Chapter III(4)(iii)(d)).

13. Finally, reforms in the agricultural and labour markets, which are crucial for achieving long-lasting and positive effects of trade liberalization, have not yet taken place, although discussions are continuing in tripartite bodies for amending the Industrial Disputes Act. According to the World Bank[6], the Indian labour market in the industrial sector is characterized, especially in relation to East Asian countries, by exceptional inflexibility. Although the incidence of industrial unrest, as shown in days list through strikes and lockouts, has declined by nearly 60 per cent since 1991. India's legal framework on termination of employment or closing of an industrial establishment remain complex and makes it difficult effectively to restrictive firms. Any amendment to industrial relations laws requires extensive tripartite consultation. These labour market rigidities are likely to become more costly, as India integrates further in the world economy, by hampering the desired restructuring of the domestic industry, and may limit India's ability to reach the Government's ambitious targeted level of foreign direct investment.

[4]Foreign commercial banks are subject to a 20 per cent allocation to "priority sectors", reflecting the exclusion of the agricultural sector (sub-target lending of 18 per cent).

[5]Seventy-five per cent for the life insurance sector and 45 per cent for the general insurance sector.

[6]World Bank (1996b) and selected data on international comparison is presented in Brahmbhatt et. al. (1996).

Box I.2: Key structural reforms since the 1993 Trade Policy Review

- **Trade reform**. The trade liberalization initiated in June 1991 has continued. Several stages of reform have lifted all licensing restrictions on imports on capital goods, liberalized partially imports of consumer goods, and reduced maximum tariffs from over 300 per cent to 45 per cent (including a surcharge of 5 per cent) and the simple average tariff to 35 per cent in 1997/98. A number of goods, including consumer durables, have been transferred to the list of products eligible for import under the special import licence (SIL) scheme while the list of freely imported products has gradually expanded (Chapter III(2)(vii)(c)).

- **Exchange market**. In March 1993 the exchange rates were unified, and transactions on the trade account were freed from foreign exchange control. Following a substantial liberalization of exchange restrictions on current account transactions, India accepted in August 1994 the obligations of Article VIII, Sections 2, 3, and 4 of the IMF. Automatic approval is given for the use of foreign currency hedging instruments.

- **Foreign investment**. The approval process for foreign direct investment has been streamlined and the Foreign Investment Promotion Council has been created with the objective to foster such investment. The number of sectors eligible for automatic approval for foreign equity participation has increased (3 industries for automatic approval up to 50 per cent, 48 industries for 51 per cent and 9 industries for 74 per cent as per January 1997). The limit on holdings by individual foreign institutional investors (FIIs) in a company has been raised from 5 per cent to 10 per cent of the company's shares, while the aggregate limit has been increased from 24 per cent to 30 per cent. FIIs have also since recently been allowed to invest in non-listed companies.

- **Financial market**. Competition has been increased by admitting new private banks. Ceilings on interest rates on bank deposits of over one year maturity were liberalized in April 1996, while loans by regional banks were liberalized in August 1996. Most interest rates are now deregulated (except those on deposit of less than one year, small commercial bank loans, and export loans). Automatic Reserve Bank of India (RBI) financing of the deficit through issue of ad hoc treasury bills has been replaced with a new system of temporary ways and means advances. The cash reserve requirement on bank deposits has been eliminated. Primary dealer system has been established for government securities. Screen-based trading systems have been introduced on most stock exchanges. A central share depository system is being set up. An Insurance Regulation Authority has been established.

- **Domestic tax reform**. Several measures have been taken to further broaden the tax base, and improve tax administration. The MODVAT system has been extended to the textiles sector, so that the system now covers all manufactured products. The services sector has been included in the tax base. Administration of direct tax has been strengthened by increased deduction at source and progressive computerization. The corporate tax has progressively been reduced to 35 per cent (48 per cent for foreign companies) in 1997/98. Further, a minimum corporation tax to be applied to corporate book profits (base-broadening measure) has been introduced, while eliminating the corporate tax surcharge (introduced at 15 per cent). Regarding personal income tax, the maximum tax has been reduced from 40 per cent, which has been the rate since 1991/92, to 30 per cent in 1997/98, narrowing the gap between corporate and income tax rates.

- **Infrastructure & private sector participation**. In the telecommunications sector, the Government has made significant progress in involving the private sector in some of the value-added services (cellular mobile, and paging). While the basic services sub-sector is supported by a very liberal policy, progress has been slow in awarding licences to private operators. In March 1997, the Telecom Regulatory Authority was established. Involvement of the private sector is also proceeding in other infrastructure areas (such as power generation, roads, airports, and ports), although progress has been lingering and few private investments have been brought to closure.

14. For external trade liberalization in agriculture to reach its full potential, it is necessary to introduce concurrent liberalization of internal agricultural markets for inputs and outputs.

(2) Major Features of the Indian Economy

15. India, with a population of 929 million (mid-1995), has one of the largest pools of trained technical labour in the world.[7] It has acquired expertise in advanced technology areas such as nuclear energy, satellites, software, deep-sea oil drilling, and oceanography. The opposing side of the story is that the majority of the population (about 70 per cent) owes its livelihood to agriculture, which with fishery, forestry and logging contributes over one quarter of GDP. Since two thirds of the cultivated land is still non-irrigated, most agriculture continues to depend on the annual monsoon. The poverty reduction potential from agriculture, a sector which is heavily regulated, seems far from exhausted.

16. Agriculture in India accounts for a large, but declining share of economic activity. Its share in GDP in 1995/96 was 27 per cent - including fishery, forestry and logging - compared to 33 per cent a decade ago (Table I.2). However, most of this shift away from a predominant agricultural base took place in the pre-adjustment period. India is the second largest world producer of paddy, accounting for 21 per cent of world production over the period 1991/92 to 1993/94, as well as sugar cane, where India accounted for 22 per cent of world production in the same period.[8]

17. As noted, the agricultural sector has not been a significant beneficiary of the overall reform programme initiated in 1991. The sector has, however benefited indirectly from a number of non-agricultural reforms. The exchange rate movements since 1990/91, as well as the reduction of protection of the manufacturing sector, may have helped to reduce the bias against agriculture and may spur export growth.[9] The outstanding reform agenda is, however, extensive and includes: (i) switching public expenditure from non-targeted subsidies to growth-enhancing and targeted safety net programmes; and (ii) increased deregulation of domestic markets.

18. The industrial sector, including manufacturing; mining and quarrying; electricity, gas and water; and construction, has performed well over the past decade. Its share of GDP has increased from 25 per cent in 1985/86 to 31 per cent in 1995/96 (Table I.2). The manufacturing sector, which accounted for more than two thirds of industrial value added in 1995/96, in particular, performed well with growth in sectoral value added rising to 13.6 per cent in 1995/96, spurred by the liberalization reforms. The industrial production indexes for transport equipment; machine tools; electric machinery; and beverages and tobacco, respectively, indicate increases of some 20 per cent in 1995/96 (Table AI.1).

19. The services sector accounts for a growing share of GDP, rising from about 38 per cent in 1985/86 to 42 per cent in 1995/96 and providing for about 25 per cent of total employment in 1995/96.[10] Over the adjustment period since 1990/91, the increase in the share of the sector largely balanced the decline in the agricultural sector. The sector is dominated by wholesale and retail trade, accounting for about 30 per cent of the sector's gross value of output (Table AI.2). The financial institutions sub-sector has increased substantially, from a share of 7 per cent in 1980/81 to around 16 per cent in 1995/96.

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[7]Brahmbhatt et al. (1996) compares the numbers of scientists, engineers and technicians in India with those in other countries (Table 2.5).

[8]Government of India (1996b).

[9]World Bank (1996b).

[10]The services sector is defined to include: wholesale and retail trade; restaurants and hotels; transport and storage; communication; financial institutions; insurance; real estate; and community, social and personal services.

20. Transport services - including roads and ports - appear to be becoming severe constraints to growth. Substantial under-investment, poor maintenance and low operating efficiency, in combination with delays in establishing an appropriate transparent framework with respect to bidding procedures, and uncertainties in cost recovery and risk sharing, have contributed to these constraints. Efforts are being made to increase investment by private sector participation, through creating more transparent guidelines and standardizing bid documents; the authorities report an "encouraging" private sector response. In the area of financial services a process of liberalization has been initiated in the banking sector, while the insurance sector is still monopolized by the Government.

(3) Trade and Foreign Investment Performance

(i) Composition of merchandise trade

21. The rapid change in the composition of India's merchandise exports, which took place in the 1980s slowed after 1991. The share of agriculture, which fell from 33 to 19 per cent between 1980/81 and 1991/92, remained between 17 and 19 per cent thereafter rising to 20 per cent in 1995/96. The share of mining, by contrast, fell from 8 to 5 per cent in the period. Exports of manufactures, which had risen from 59 to 72 per cent between 1980/81 and 1991/92, averaged some 74 per cent subsequently. Exports of chemicals; diamonds; clothing; textile yarn and thread; office equipment; and software have all shown consistently good performance. In 1995/96, the major export products were, in descending order, pearls (15 per cent of merchandise exports), diamonds etc., (15 per cent), clothing (14 per cent), textiles (13 per cent), and chemicals (8 per cent) (Chart I.3 and Table AI.3).

22. On the import side, the share of manufactures in merchandise imports grew from 39 per cent in 1980/81 to 50 per cent in 1991/92 and 54 per cent in 1995/96. The share of machinery and transport equipment has grown from 14 to 21 per cent since 1991/92. Petroleum and its products remain major import item (21 per cent of merchandise imports in 1995/96), but have varied with world market prices (Table AI.4).

(ii) Geographic pattern of merchandise trade

23. The major structural change in merchandise exports that has taken place in recent years is the collapse of markets in eastern Europe, especially the former Soviet Union (Chart I.4 and Table AI.5). Merchandise exports to eastern Europe, including the former Soviet Union, plunged from 18 per cent in 1990/91 to 4 per cent in 1995/96. However, India has successfully diversified its exports to the United States and the East Asian countries over the same period. East Asia increased its share in merchandise exports from 20 per cent in 1990/91 to 25 per cent in 1995/96 (equivalent to a 122 per cent increase in current U.S. dollars) and the United States from 15 per cent in 1990/91 to 17 per cent in 1995/96 (equivalent to a 108 per cent increase in current U.S. dollars). India's single largest merchandise export market in 1995/96 was the European Union (27 per cent of total merchandise exports), followed by the United States (17 per cent) and Japan (7 per cent).

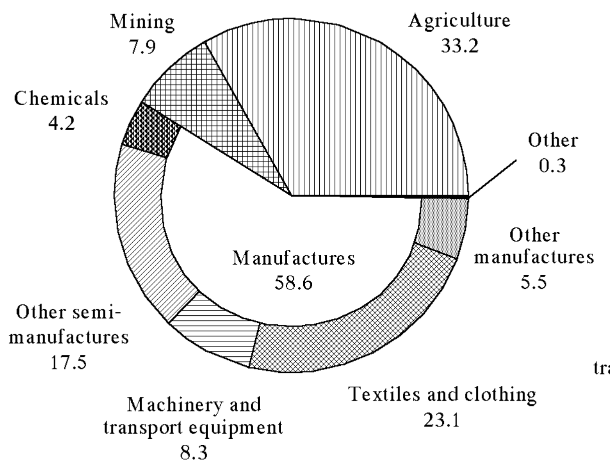
24. India's largest merchandise import sources in 1995/96 were the European Union (28 per cent of total merchandise imports) and the United States (11 per cent) (Chart I.4 and Table AI.6). The share of East Asia has increased from 17 per cent in 1990/91 to 21 per cent in 1995/96, with a 2.3 percentage point increase in imports from China, equivalent to some US$650 million growth over the period. As with exports, the imports from eastern European markets, including the former Soviet Union, have fallen since 1990/91, albeit from a much lower level compared to exports (from 5 per cent of total imports in 1990/91 to 4 per cent in 1995/96). The share of merchandise imports from Middle Eastern countries (13 per cent in 1995/96) has varied with the world market price of oil.

Chart I.3
Product composition of merchandise trade, 1980/81 and 1995/96

(Per cent)

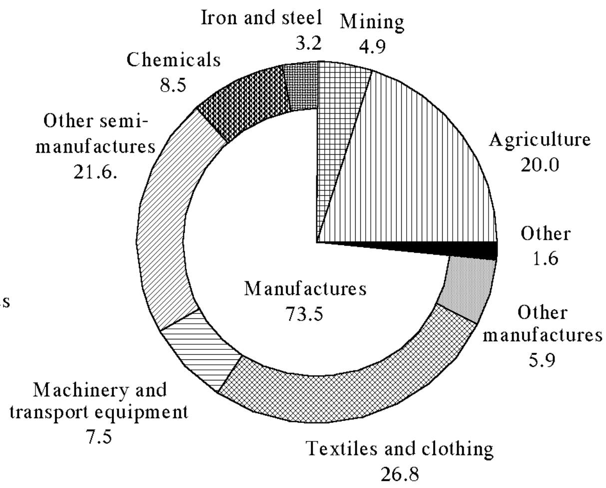
Exports

1980/81



Total exports: US$ 7.5 billion

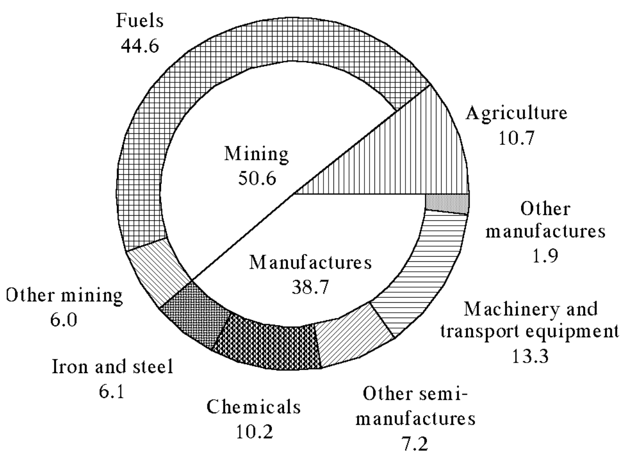
1995/96



Total exports: US$ 31.7 billion

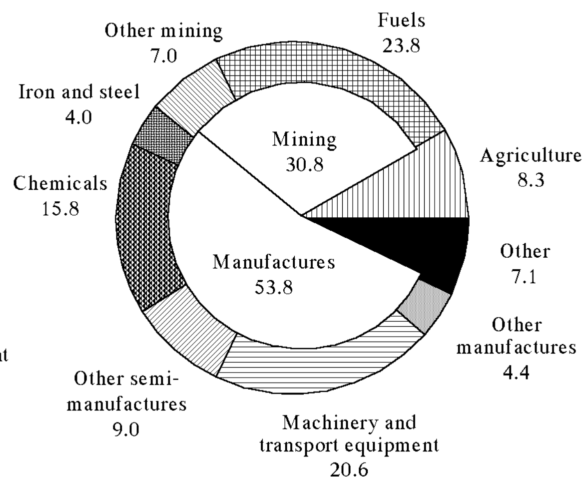
Imports

1980/81



Total imports: US$ 13.8 billion

1995/96



Total imports: US$ 36.1 billion

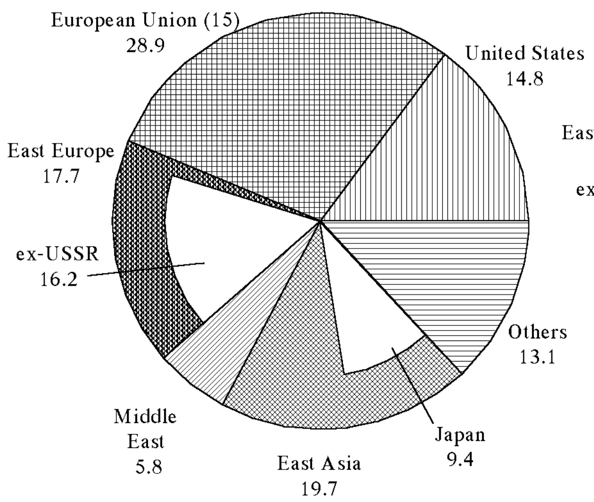
Source: UNSD, Comtrade Database (SITC Rev.1).

Chart I.4
Direction of merchandise trade, 1990/91 and 1995/96

(Per cent)

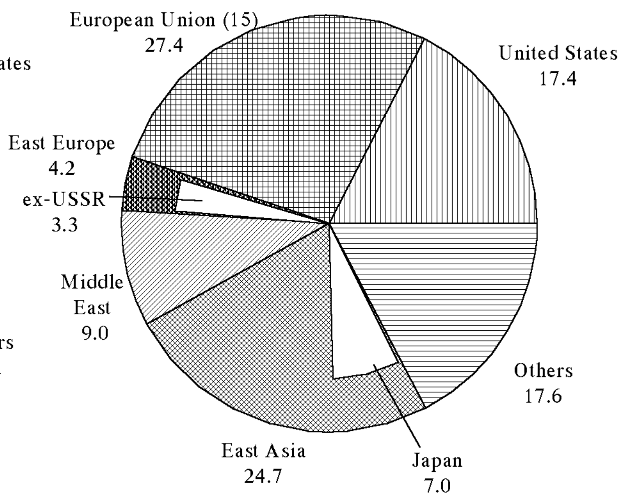
Exports

1990/91



Total exports: US$ 17.9 billion

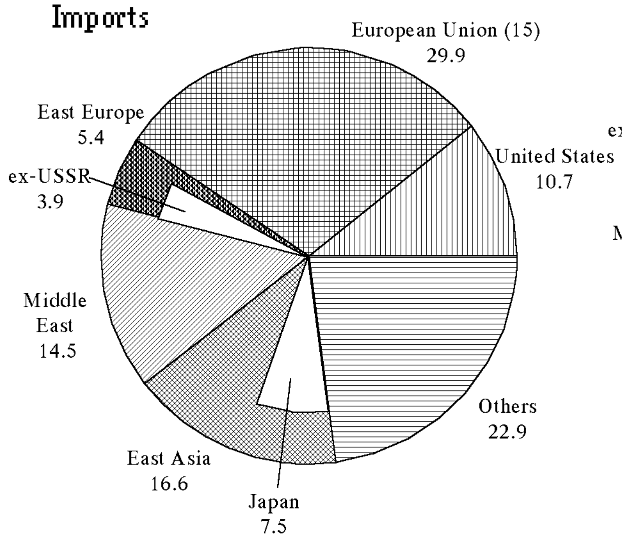
1995/96



Total exports: US$ 31.7 billion

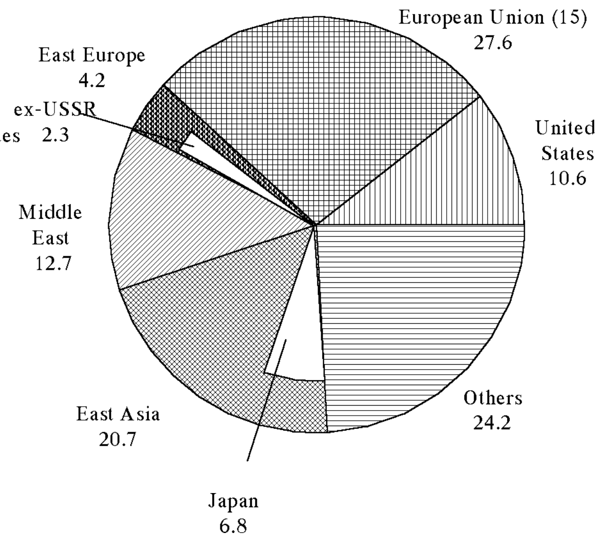
Imports

1990/91



Total imports: US$ 23.8 billion

1995/96



Total imports: US$ 36.0 billion

Source: UNSD, Comtrade database (SITC Rev.1).

(iii) Trade in services

25. India's trade in services has increased but a complete analysis is not possible because of shortage of data. Balance-of-payments data indicate that receipts of non-factor services increased from US$4.6 billion (equivalent to 1.5 per cent of GDP) in 1990/91 to US$9.2 billion (2.6 per cent of GDP) in 1996/97. Tourism accounted for about 40 per cent of total receipts in 1995/96. During the 1990s, India has been a net exporter of non-factor services (annual average of 0.3 per cent of GDP between 1990/91 and 1996/97). Interest payments, amounting to some US$4.8 billion (equivalent to 1.4 per cent of GDP) in 1996/97, heavily dominate payments of factor services; in 1996/97 the net factor income recorded a deficit of about US$5 billion.

26. Data on trade in services by individual trading partners are not available.

(iv) Foreign direct investment and portfolio investment[11]

27. The financing of the balance of payments has moved away from debt creating features to foreign direct investment and portfolio investment. The surge in foreign inflows since 1990/91 has been extraordinary. Net foreign direct investment has increased from an insignificant amount in 1990/91 to about US$2.7 billion (or 0.7 per cent of GDP) in 1996/97, while portfolio investment has increased from zero to US$2.8 billion over the same period (Table I.3).

28. The level of foreign direct investment by source has fluctuated in recent years. However, over the period 1992/93 to 1995/96, the United States, United Kingdom, and Japan were the major sources for foreign direct investment, respectively, accounting for 18, 10 and 7 per cent of total inflows, excluding non-resident Indians. Foreign investment in the financial sector has increased in recent years and emerged as the dominant sector in 1995/96 (19 per cent of total foreign direct investment). Over the same period, engineering has decreased its share to 18 per cent in 1995/96. Electronics and electrical equipment; chemicals and allied products; and services have also attracted substantial foreign direct investment (Table I.3).

29. Investments undertaken by foreign institutional investors (FIIs) have emerged as the main component of portfolio investment (67 per cent in 1996/97). The other major component of portfolio investment is Euro-issues/Global Depository Receipts(GDRs). The bulk of issues occurred in early 1994 as the stock market recovered, while 1995/96 showed a slump in inflows on account of GDRs of the Indian corporates in Euromarkets.[12]

30. The liberalization measures in particular, but also reasonably well developed stock markets and the potential for growth in a large domestic market with inexpensive labour, have contributed to the increased inflows in recent years. However, in light of the difficulties being encountered by privately financed infrastructure projects, it may be unrealistic to expect this growth pattern to continue.

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[11]This section describes the recent trend in foreign direct investment and portfolio. The actual procedures of the foreign investment regime are presented in Chapter II.

[12]Since September 1992, registered foreign institutional investors (FIIs) have been allowed to purchase equity and debt securities directly on local markets. A single FII may hold up to 10 per cent of a company's issued share capital, while all FIIs together may hold up to 30 per cent of a company's capital. Since February 1992, Indian firms in good standing have been allowed to raise funds through equity and convertible bond issues in Euromarkets (Chapter II).

Table I.3
Foreign investment by source and activity, 1990-97

	1990/91	1992/93	1993/94	1994/95	1995/96	1996/97[a]
Foreign direct investment, net (US$ million)	150	341	566	1,314	2,133	2,696
Portfolio, net (US$ million)	8	92	3,649	3,824	2,748	2,805
of which Foreign institutional investors	0	1	1,665	1,503	2,009	1,926
Euro-equities[b]	0	86	1,602	2,082	683	918
Other[c]	8	5	382	239	50	20
Total (US$ million)	68	433	4,235	5,138	4,881	5,560
Total as per cent of GDP	0.0	0.2	1.6	1.7	1.5	1.6
Foreign direct investment by country (per cent of total)[d]	**1992/93-1995/96[e]**	**1992/93**	**1993/94**	**1994/95**	**1995/96**	**1996/97**
United States	17.5	7.7	26.8	23.3	13.6	27.8
Germany	6.5	7.6	9.5	4.0	7.0	4.3
Hong Kong	4.6	1.4	1.6	2.4	6.9	1.4
United Kingdom	9.6	2.4	17.4	16.5	4.9	4.2
France	3.3	3.3	2.8	1.6	4.4	4.6
Japan	7.3	9.2	10.0	10.9	4.3	4.1
Singapore	3.3	1.0	2.7	2.8	4.1	0.8
Netherlands	5.4	7.5	12.6	5.1	3.5	2.9
Switzerland	3.9	12.6	6.1	3.0	2.3	0.4
Others	38.4	47.2	10.5	30.4	48.9	49.5
Foreign direct investment by activity (per cent of total)[d]						
Finance	14.3	1.3	11.4	11.2	19.0	…
Engineering	16.6	24.9	8.9	15.1	17.8	…
Electronics & electrical equipments	9.4	11.7	15.5	6.5	9.1	…
Chemicals & allied products	11.9	16.8	10.2	16.2	8.9	…
Services	7.4	0.9	5.5	10.7	7.1	…
Food & dairy products	7.3	10.0	11.8	7.0	6.0	…
Pharmaceuticals	4.0	1.1	13.4	1.2	3.9	…
Computers	2.7	2.9	2.1	1.2	3.7	…
Domestic appliances	4.2	5.7	0.6	12.4	0.0	…
Others	22.3	24.7	20.6	18.6	24.5	…

… Not available.

a Estimated data.
b Represents the amount repatriated to India by the corporates from their Global Depositary Receipts (GDRs).
c Including off-shore and others.
d Excluding direct investment by non-resident Indians routed through the Reserve Bank of India.
e Average for the period indicated.

Note: Year beginning 1 April.

Source: WTO Secretariat, based on data supplied by the Government of India; Government of India (1997c), Economic Survey 1996/97; and Reserve Bank of India (1996), Annual Report 1995/96.

31. Worth noting is the increased discrepancy in actual and approved foreign direct investment. From August 1991 to January 1995, about 22 per cent of approved proposals were transformed into actual flows, while during the 1970s and the 1980s the ratio was significantly higher. As noted by OECD (1996), one explanation may be that although many sectors are formally open to foreign investment, sector policies at the State level and the regulatory framework are not yet in a position to support the increased approvals of foreign direct investment. The authorities suggest that an alternative reason may be that, in certain sectors with long gestation periods, inflows may take time to materialize, given that approvals do not entail an obligation by investors.

(v) Intra-industry trade and "tariff-jumping" foreign direct investment

32. Intra-industry trade (IIT) refers to trade (imports and exports) of goods in the same industrial category. The degree of India's IIT with the rest of the world has increased substantially over the past decade (by almost 100 per cent since 1980/81), although it stagnated in the 1990s (Table I.4). As noted in the last review, this is due to the increased importance of manufactured products relative to agriculture in India's trade composition. Manufactured products, which tend to be more differentiated, generally have higher levels of IIT. Moreover, intra-industry trade at the industry level in general has grown. The IIT values for 34 industries are presented in Tables AI.7, AI.8 and AI.9.

Table I.4
Intra-industry trade by India 1980/81, 1990/91, and 1995/96[a]

	1980/81	1990/91	1995/96
With the world	13.8	28.0	27.8
With the United States	4.8	14.0	18.9
With the European Union	11.8	21.2	24.5

a Intra-industry trade measures the extent to which trade occurs within, as against across industries. If all traded goods in a sector are either only exported or only imported, the intra-industry trade ratio would be zero. If, for all commodities in a sector, exports equal imports, the intra-industry trade ratio is 100 per cent.

Note: Year beginning 1 April.

Source: Calculations by WTO Secretariat using 4-digit SITC Rev.1 data.

33. India's IIT with its main sources of foreign direct investment, namely the United States and the European Union, are lower than with the rest of the world, although the levels have increased markedly in both cases. This is particularly true for the United States, with an IIT value of only 68 per cent of the IIT with the rest of the world in 1994/95. These results suggest that in India foreign direct investment has acted as a substitute for trade, rather than a complement. The relatively liberalized foreign direct investment climate in combination with a widespread application of prohibitive licensing requirements on imports are likely to be contributing factors. The hypothesis is supported by Brahmbhatt et al. (1996), who conclude that India's relative high trade protection is likely to have reduced the potential benefits of foreign direct investment by directing investment into globally uncompetitive import-substituting markets, as well as reducing competitive pressures on foreign companies to transfer their technology to Indian companies.[13] Trade liberalization could be expected to reverse this tendency and increase India's level of intra-industry trade.

[13]Brahmbhatt et al. (1996) notes that trade restrictions may attract certain "tariff-jumping" foreign direct investments and "that within the set of inward oriented economies the scale economies offered by a large domestic market may well attract a higher rate of domestic market oriented foreign direct investment .... This would be particularly relevant for India which combines what are still among the highest level of protection and the second largest GDP among developing countries".

(4) Outlook

34. An ambitious reform agenda was set out by the Government in its Common Minimum Program (CMP), unveiled in June 1996. Several steps have been taken in this direction, most recently in the 1997/98 Budget. The CMP emphasizes:

- fiscal adjustment through revenue enhancing and expenditure reducing reforms;
- increased fiscal devolution of financial powers to the States;
- attracting an annual foreign direct investment inflow of US$10 billion through further easing and greater transparency of the regulations on foreign investment;
- increased investment in infrastructure with heavy reliance on private sector participation;
- greater focus on social sectors with the objective of achieving full literacy by the year 2005; and
- agricultural reforms with focus on increasing rural credit and investment while in tandem reviewing all controls and regulations.

35. The reform agenda, which was translated into medium-term macroeconomic projections in the Ninth Five Year Plan (1997/98 through 2001/02), implies strong adjustment (Table I.5). The plan aims at an annual real GDP growth of 7 per cent, with a speedy recovery in investment rate (increase from 27.5 per cent of GDP in 1996/97 to 28.2 per cent), increased productivity (reflected by an ICOR assumption of 4.1[14] and an ambitious annual target of foreign direct investment inflow of US$10 billion (compared with US$2.7 billion in 1996/97). The projections hinge in particular on a recovery in gross domestic savings (26.2 per cent of GDP from 25.8 per cent of GDP), both private and public, supported by strong fiscal adjustment (central government deficit of 4.5 per cent of GDP compared with 5.0 per cent of GDP in 1996/97).

36. The reform programme, with very ambitious targets, such as sustained annual growth rates averaging 7 per cent, require some hard political decisions. In particular, on the structural front, infrastructure has become a constraint to trade and growth. The needs are enormous and the disciplined fiscal stance implies that public finance would not be largely available. Thus further liberalization of the foreign direct investment regime would be necessary, especially in areas such as financial services (including insurance), power and transport. Moreover, to achieve the Central Government's fiscal deficit target of 4.5 per cent of GDP, a comprehensive reform of the tax system and improvement of the finances of the State and public enterprises (including moving forward on the divestment programme) would be required while, over the medium term, the fiscal relationship between the Centre and States would need to be addressed.

[14]The ICOR is calculated by dividing a country's investment rate by its real GDP growth rate. Muhleisen (1997) estimates India's ICOR at 4.65 for the period 1991-95.

Table I.5
Government's macroeconomic projections 2001/02

	1996/97[a]	1997/98 - 2001/2002[b]
Output and prices (per cent)		
Real GDP growth rate, factor cost	6.5	7.0
Inflation (wholesale price, end-of-period)	7.3	7.0
Investment and saving (per cent of GDP)		
Gross domestic saving	25.8	26.2
Gross domestic investment	27.5	28.2
Gross private investment	8.6	18.5
Government budget (per cent of GDP)		
Central Government balance	-5.0	-4.5
Overall public sector balance	-8.5	-7.9
Money and credit sector (percentage change)		
Broad money (M^3)	15.6	15.0
Domestic credit	9.9	12.5
External sector		
Current account/GDP (per cent)	-1.1	-2.4
Overall balance of payments (US$ billion)	6.9	9.3
International reserves (months of merchandise imports)	6.6	5.5

a Estimated data.
b Annual average.

Note: Year beginning 1 April.

Source: Government of India.

Annex I.1: Exchange rate arrangements

(1) Foreign exchange system

37. The Government of India is responsible for exchange rate policy under the Reserve Bank of India Act, 1934. The Reserve Bank of India (RBI) implements the policy in consultation with the Government. The exchange rate of the rupee is determined by supply and demand in the interbank market; however, to level excessive and erratic movements as well as to offset seasonal fluctuations in the exchange rate, the RBI may intervene with the U.S. dollar as the chosen currency. The RBI allows the exchange rate to move within target bands. The bands, which are not made public, are adjusted from time to time reflecting inflation differentials with trading partners.

38. The exchange rate system for the rupee, has undergone three major changes since the mid-1970's. In March 1992 the fixed official rate, which was set by the RBI on the basis of a weighted basket of currencies of India's major trading partners, was abolished in favour of the Liberalized Exchange Rate Management System (LERMS). This was an explicit dual exchange rate system consisting of a "free" market rate and an official rate set by the RBI in U.S. dollars. Import transactions undertaken through the official rate included crude and diesel oil, kerosene, certain fertilizers, fertilizer raw materials, life-saving drugs, and imports by government departments, while all other imports were undertaken at the free market rate. Forty per cent of current account receipts, from exports and invisibles, were required to be converted to rupees at the official rate. All capital account transactions, except IMF transactions, were undertaken at the free-market rate.

39. The exchange rates were unified in March 1993. At that time the rupee's value was set close to the previous free market rate of about Rs 31 per U.S. dollar. The real effective exchange rate has recently shown some tendency to appreciate, reflecting the appreciation of the U.S. dollar against major currencies and a widening of the partner country inflation differential.

(2) Foreign exchange controls

40. Foreign exchange controls are administered by the RBI, in consultation with the Ministry of Finance, in accordance with the Foreign Exchange Regulation Act, 1973, as amended periodically.

Current account transactions

41. When exchange rates were unified in March 1993, transactions on the trade account were freed from foreign exchange control. In March 1994, India took additional measures to liberalize on the current account. Limits on invisible transactions such as foreign travel, payments for services, and donations, were indicative, and foreign exchange was made available without limit for all bona fide current transactions. The limit on repatriation of interest on one of the three types of non-residents deposits (NRNR) was removed. Development of an interbank foreign exchange market was allowed, including forward trading to provide exporters and importers with the possibility to hedge foreign currency exposures.

42. Following the liberalization of these current account transactions, India accepted in August 1994 the obligations of Article VIII, Sections 2, 3 and 4 of the IMF Articles of Agreement. Although some additional steps toward full current account convertibility have been taken since then, exchange restrictions are maintained in the following areas: (i) the Indo-Russian debt agreement (which was signed prior to the acceptance of Article VIII obligations); (ii) existing balances under bilateral agreements relating to trade transactions also signed with some eastern European countries prior to

the acceptance of Article VIII obligations, and (iii) repatriation of dividend income on foreign investment relating to trade transactions in 22 industries in the consumer goods sector.

Capital account transactions

43. Several measures have been taken to liberalize the capital account. As discussed in detail in Chapter II, the RBI grants, on an automatic approval basis, foreign direct investment (FDI) up to 51 per cent equity in 48 priority sectors, and up to 74 per cent in nine additional sectors. Moreover, non-resident Indians (NRIs) or overseas corporate bodies predominantly owned by NRIs can invest up to 100 per cent of equity in these industries. Foreign institutional investors (FIIs) are allowed to invest in listed securities in primary and secondary markets, and more recently in non-listed companies. Indian companies with a good standing are allowed to raise funds through equity issues (Global Depository Receipts, GDRs) and foreign currency convertible bonds (FCCBs) issued in Euromarkets. Finally, short-term credits with a maturity of up to one year are allowed for trade, while financing for up to three years maturity may be approved by the RBI on a case-by-case basis.

44. The capital account remains somewhat restricted with limitations applying to FDI, commercial borrowing, and capital outflows by residents. The key remaining restrictions on capital account transactions are as follows:[15]

- FDI in excess of 51 per cent equity in industries not on the automatic approval list (or 74 per cent equity in the case of nine other industries) requires clearance from the Foreign Investment Promotion Board (FIPB) on a case-by-case basis;
- dividend remittance on income from FDI in 22 consumer-goods industries is required to be balanced by export proceeds over a period of seven years from the commencement of production;
- outward FDI by residents is restricted;
- FIIs are not permitted to invest in treasury bills or longer term government dated securities;
- FIIs are not permitted access to the forward foreign exchange market;
- individual investments undertaken by an FII is limited to 10 per cent while the aggregate limit by all FIIs in any company may not exceed 30 per cent;
- residents are not permitted to undertake portfolio investments abroad from domestic income;
- no more than 25 per cent of GDRs can be used for general corporate restructuring;
- issue of money market instruments abroad is not permitted;
- non-residents are not permitted to issue securities in the local market; and
- approval from the Ministry of Finance is required for all external commercial borrowing, subject to an indicative annual ceiling (US$7.9 billion in 1996/97), with priority given to infrastructure and export-oriented sectors. No such ceiling has, however, been indicated for 1997/98.

45. In June 1997, the Committee on Capital Account Convertibility, set up by the RBI, presented a report on the road map, including the economic conditions that need to be fulfilled at each milestone, for achieving full capital account convertibility. The proposed three-year timetable emphasizes the need to carefully sequence the liberalization measures with fiscal and financial reforms.

[15] IMF (1996b).