REPORT ON THE CONSULTATION WITH INDIA

1. The WTO and the GATT 1947 Committees on Balance-of-payments Restrictions consulted jointly with India on 6 and 8 December 1995. The consultation was held under the Chairmanship of Mr. P. Witt (Germany), in accordance with the Committees' terms of reference, pursuant to Article XVIII:B, paragraph 12 (a) of GATT 1994 and the Understanding on the Balance-of-Payments Provisions of GATT 1994. The International Monetary Fund was invited to participate in the consultation in accordance with Article XV:2 of GATT 1994.

2. The Committees had the following documents before them:

- WT/BOP/9 Basic document supplied by India
- BOP/328
- WT/BOP/W/11 Background paper by the Secretariat
- BOP/W/166

Opening statement by the Representative of India

3. The opening statement of the representative of India is attached as Annex I.

Statement by the Representative of the International Monetary Fund

4. The statement made by the representative of the International Monetary Fund is attached as Annex II.

(i) Balance-of-payments position and prospects; alternative measures to restore equilibrium

5. Members commended India for the in-depth economic reforms carried out since 1991 which entailed, in recent years, outstanding macroeconomic turnaround, curbing of inflation, strengthening of the external accounts and improvement of the investment climate. The continuation of these reforms was essential to the stability of the Indian economy and to further improvement of the external position over the medium to long term. Supporting the Indian Government’s perseverance in relying on market conditions and deregulation, Members encouraged India to continue the on-going trade liberalization which, together with the implementation of its Uruguay Round commitments would bolster India’s integration to global trading system.
6. Many Members remarked that while India's external position appeared to be stable, the overall balance of payments remained structurally weak. In the first half of the present fiscal year, beginning April 1995, the current account deficit had widened as a result of rapid growth of imports and decline of exports. Strong domestic demand and the impact of trade liberalization, including the reduction and rationalization of tariffs and cuts in the number of products subject to import licensing, had continued to encourage import growth. The impressive macroeconomic performance of recent years, together with the improved fiscal policy and institutional reforms achieved, had a positive impact on the capital account; foreign capital inflows of which portfolio investment constituted a high proportion was the main source of the positive balance in this account in 1994/95 Fiscal Year. In addition, several members noted that such flows had proven to be volatile and reversible as a result of adverse developments in financial flows to emerging markets in the past year.

7. Noting that a widening trade deficit during 1995/96 had a negative impact on the stability of India's reserves, these Members shared the view expressed by the Indian delegation that an assessment solely of the level of reserves in terms of months of imports of goods and services was inadequate in view of uncertainties created by financial liberalization and the new conditions in capital markets; reserves should also be assessed in the light of their composition. They thus considered that India was justified in adopting a cautious pace in trade liberalization. Structural reforms should be completed in a manner that was socially and politically sustainable in an economy of the size of India, with a large population and wide income disparities. They supported the Indian position that the import growth had to be kept within prudent limits in view of the uncertain effects of domestic liberalization and external financial fluctuations on the balance of payments. India should be allowed to pursue its liberalization and structural reform policies at a pace suited to the country's conditions. The timing and sequence of the phase-out of quantitative restrictions, and the coverage of the negative import list should be left to the judgement of the Indian authorities. They therefore considered that India must continue using GATT Article XVIII:B in completing its agenda of economic reforms. Premature elimination of the remaining restrictive measures might reverse India's fragile balance-of-payments situation and disrupt the momentum of trade liberalization.

8. Many other Members observed that India's current account deficit had decreased from 3.4 per cent to 0.5 per cent of GDP in the past four years as a result of the remarkable recovery of exports since 1992. In the present fiscal year, rapid economic expansion had triggered growth of imports of capital and intermediate goods, outpacing the robust export performance and resulting in a wider trade deficit, forecasted to increase to 1.5 per cent of GDP in 1995/96. The growth of imports of capital and intermediate goods should, in turn, generate expansion of India's export capacity. They noted that India had attracted significant inflows of foreign capital as a result of financial reform and high interest rates; thus, the current account deficit was offset by large inflows of foreign direct and portfolio investment, leading to a substantial increase of India's foreign exchange reserves to around 6 months of imports of goods and services, compared to one month in 1991. The recent fall in capital inflows, rather than the widening of the current account deficit, contributed to the projected deterioration in the overall balance of payments for 1995/96. The stability of the overall balance of payments in the past two years showed that India's current level of reserves was comfortable and sustainable.

9. Members noted that fiscal imbalances at the Central Government and States' level continued to put pressure on monetary policy and that inflation had not been fully checked. They considered that more prudent macroeconomic policies were the basis of a sound balance of payments.

10. Many other Members stated that, currently, the public sector deficit was the major source of instability in the Indian economy. The deterioration of the Central Government's budget in recent years had fuelled inflationary pressures across the economy, leading to higher interest rates which had
crowded out private investment. Trade and financial liberalization had been fundamental to the remarkable growth of the economy and were essential to the stability of the balance of payments. Progress in financial reforms would also help to maintain momentum in foreign direct investment flows and international confidence in India's economy, while additional comprehensive structural reforms would remove the bottlenecks that limited the Indian economy's growth potential.

11. In reply to a Member, the representative of the IMF stated that India's balance-of-payments prospects looked sound in the medium-term. Nevertheless, curbing of the fiscal deficit and an appropriate pace of adjustment were crucial to prudent macroeconomic management. While the Indian economy could face some uncertainty in the coming six months, a period of two years gave time in which India could elaborate a time-table for relaxing import controls.

12. Many Members considered that the medium-term prospects for India's balance-of-payments situation appeared sound and the reserve position could be kept at comfortable levels, provided adequate macroeconomic policies were continued. India currently faced no threat of a serious decline in its reserves in terms of Article XVIII:B, nor a critical balance-of-payments position in terms of the Understanding; therefore there were no balance-of-payments grounds for continuing import restrictions. They emphasized that Article XVIII:B provisions were designed to allow Members to use temporary measures in case of specific balance-of-payments problems. India's current balance-of-payments situation was sustainable and no longer warranted the continued justification of the measures under Article XVIII:B.

13. In response, the representative of India stated that there had been growing pressure on the overall balance-of-payments in recent months, arising from both the current and capital accounts. The situation had become more fragile since the simplified consultations in November 1994, notwithstanding the relative growth of India's international reserves in terms of months of imports. Import growth, 32 per cent in dollar terms, in the first half of the 1995/96 fiscal year had been higher than export growth of 25 per cent. There had been a significant widening of the current account deficit over the past year to US$5 billion; foreign currency reserves had dropped by almost US$4 billion in the first eight months of the current fiscal year. The increase in the capital account balance during 1993/94, which had reflected a surge in foreign capital inflows, had been reversed with a decline in portfolio investment. Debt service had reached US$12.5 billion in the present year, creating additional pressure on the capital account.

14. India had undergone a massive liberalization of its trade and payments régimes and had reformed its internal market. He believed that, because of its size and complexity, India's need for reserves should be greater than the standard of three to four months of imports. The medium-term sustainability of the balance of payments was linked to prudent conduct of trade policy and adoption of an appropriate pace in dismantling existing quantitative restrictions. The trade balance being its key element, the current account could be manageable to the extent that the present import régime was maintained.

15. The representative of India stated that, since the last full consultations in 1992, there had been greater reliance on alternative instruments. The exchange system had been unified in March 1993 and full convertibility had been achieved in August 1994. There was still room for improvement in the overall fiscal position because of possible slippage on the expenditure side or in revenue performance. Rather than halting the steady trend of trade liberalization by new import restrictions, India had used the instruments of exchange rate adjustment and tightening of monetary policy to manage balance-of-payments pressures in the past year.

16. The representative of India indicated that the 1995/96 Export and Import Policy included further simplification of import and export procedures and pruning of products subject to import restrictions.
India could continue on the path of trade liberalization consistently and steadily provided it proceeded cautiously and pragmatically. Demand for imported consumer goods had grown steadily in the present fiscal year and if current import restrictions were removed, could soar to levels that would make the external account unsustainable. India would thus have to continue matching the expansion of imports with export growth before further relaxing import controls; the level of imports and the trade balance should be carefully monitored, to avoid the creation of serious distortions and imbalance in India's ability to handle its external obligations.

(ii) System, methods and effects of import restrictions

17. Many Members expressed concerns about the consistency of the system and methods of India's restrictive measures with the balance-of-payments provisions of GATT 1994. They noted that India had provided no justification why price-based measures were not adequate to alleviate balance-of-payments difficulties in terms of paragraph 3 of the Understanding. Furthermore, restrictive measures should be applied across the board, to control the general level of imports in terms of paragraph 4 of the Understanding. They had concerns as regards the sectoral scope of the measures in place, particularly the selective application of restrictions to consumer products. Taking note of the statement of the representative of the IMF that the transition to a tariff-based import régime with no quantitative restrictions could reasonably be accomplished within a period of two years they requested India to provide a time-schedule for the progressive relaxation and removal of remaining restrictions maintained for balance-of-payments reasons as required by paragraph 1 of the Understanding. They also requested India to provide a consolidated notification of the restrictions maintained at the HS 8-digit level, as provided in paragraph 9 of the Understanding. To allow a proper assessment of the scope of the restrictions, it would be essential to separate the specific items in the Negative List subject to balance-of-payments restrictions from those restricted for other purposes.

18. With regard to the effect of the measures, many Members stated that India's trade restriction justified for balance-of-payments reasons virtually banned the imports of around two thousand HS lines of consumer good items. The protection of the relevant domestic industries from international competition could damage the interests of both the Indian consumers and the trading partners. Given India's sound balance-of-payments position, increase of imports as a result of lifting restrictions on consumer goods should cause no problems.

19. One Member noted that India's balance-of-payments restrictions should be seen in a perspective of thirty years. As part of its progressive trade liberalization, such restrictions were being applied to a number of consumer goods.

20. Several Members maintained that the administration of licensing was complex and lacked predictability and transparency. Import licences amounted to virtual bans; licences were subject to the discretion of the authorities. Referring to the requirement in paragraph 4 of the Understanding "to use discretionary licensing only when unavoidable " and to provide appropriate justification "as to the criteria used to determine allowable import quantities and values", these Members asked India to provide a notification explaining the administration of specific restrictions and the criteria for granting import licences.

21. The representative of India stated that India had not chosen the products subject to import restrictions arbitrarily. Imports of capital goods were being progressively liberalized in order to stimulate the growth in the economy. Given India's balance-of-payments problems, abrupt liberalization of consumer goods could run counter to the trade interests of India's trading partners. Various macroeconomic elements would not at present allow India to announce a time-table for the phasing
out of quantitative restrictions. He also stated that the entire Import and Export Policy had been recently aligned in terms of HS lines. Price-based measures to control the level of imports of consumer goods would be inappropriate at the present stage because of the strong demand for imports. The quantitative restrictions maintained on balance-of-payments grounds over thirty years had been justified in the Committee under Article XVIII:B.

22. The representative of India further stated that the balance of payments appeared comfortable at present on account of certain restrictions being maintained. Liberalization would have strong multiplier effect on imports given the strong import demand. The Government had the responsibility to ensure that available foreign exchange resources were allocated for the priority needs of the country. More than 50 per cent of India’s imports were of key products, including petroleum and petroleum products, non-ferrous metals and fertilizers, essential to agricultural or industrial production. India had made substantial strides towards liberalization of its import régime in the past four years. However, the viability of the external account could not be made dependent on special facilities from external sources. India would have the ability to earn the required foreign exchange for imports of consumer goods to the extent of its sound management of its trade and current accounts. At the current level of export earnings, India could not afford to open up imports of consumer goods. The authorities would consider the elimination of the current restrictions as soon as, in their judgement, the overall economic, political and social situation was viable.

23. The Committees commended India for the wide-scale economic reforms and comprehensive stabilization programme over the past four years, which had resulted in robust economic recovery. The reforms, which included a considerable measure of trade and financial liberalization, exchange rate unification and a move to current account convertibility, had contributed to a large increase in the share of trade in India’s GDP.

24. The Committees noted that, since 1992, rapid export growth and capital inflows had been the source of the turnaround in India’s external sector and the steady increase in the level of foreign exchange reserves. However, they took note that, in recent months, there had been a deterioration in the trade balance, investment inflows had slowed and the foreign exchange reserves had declined. In addition, the fiscal deficit and the level of indebtedness remained high.

25. The Committees recalled India’s stated aim to move, by 1996-97, to a trade régime under which quantitative restrictions are retained only for environmental, social, health and safety reasons, provided sustained improvement was shown in its balance of payments. They also took note of the statement by the IMF that, with continued prudent macro-economic management, the transition to a tariff-based import régime with no quantitative restrictions could reasonably be accomplished within a period of two years. The Committees noted that, since the last full consultation, there had been considerable liberalization of India’s import régime, including a gradual increase in the number of consumer items which were freely importable; yet almost one-third of tariff lines at 8 digit level under the HS Classification remained subject to quantitative restrictions.

26. The Committees noted the view expressed by India that, in the context of a deteriorating balance-of-payments situation, it would be neither prudent nor feasible to consider the general lifting of quantitative restrictions on imports at this stage. Many Members supported India’s continued use of import restrictions under Article XVIII:B for balance-of-payments reasons in view of the uncertainty and fragility they perceived in India’s balance-of-payments position, and they felt that liberalization and structural reform policies should continue at a pace and sequence suited to Indian conditions. Many other Members stated that India’s balance-of-payments position was comfortable, that India did not currently face the threat of a serious decline in foreign exchange reserves as set out in Article XVIII, paragraph 9, and that therefore India was not justified in its continued recourse to import restrictions.
for balance-of-payments reasons. Many Members stated that the continued use of quantitative restrictions was inconsistent with paragraphs 1, 2, 3, 4 and 9 of the Understanding and asked India to present a firm time-table for the phasing out of the restrictions, and further information required, before the resumption of the consultations. Others, in the light of the ongoing liberalization, did not share these views.

27. In the light of all the above considerations, the Committees welcomed India's readiness to resume the consultations in October 1996, and to notify to the WTO all remaining restrictions maintained for balance-of-payments purposes soon after the announcement of the 1996/97 Export-Import Policy.
Mr. Chairman, distinguished Members of the Committee, distinguished representative of the IMF, and friends from the Secretariat.

I am happy to be here for this important meeting of the Committee on Balance of Payments Restrictions to make this Opening Statement on behalf of the Government of India. The basic document provided by India for the 1995 consultations under Article XVIII:B of GATT 1994 is before the Committee. The country note prepared by the IMF and the background paper of the Secretariat give details of the general trend of economic and trade developments from the time we held our simplified consultations last November. The IMF and the Secretariat deserve to be complimented for their detailed and professional documents. These documents clearly bring out the various liberalization measures undertaken by India since July 1991 in general, and since the time of the last consultations in particular. These documents also bear ample testimony to the Government of India's demonstrated commitment to economic liberalization.

Four years ago, the Indian economy was in the midst of serious crisis with stagnant production, high inflation, declining exports and a severe balance of payments problem. To deal with this difficult situation and to lay the basis for sustained growth of output and employment, Government initiated wide ranging economic reforms in industrial, fiscal, financial, trade, exchange rate and foreign investment policies. The Government's programme of stabilization and reform was both comprehensive in scope and carefully sequenced. As details of the reform measure are well known, I will not take this Committee's time in describing them.

The results of the reform programme over the past four years has been very heartening. Overall economic growth of real GDP has increased from less than 1 per cent in 1991-92 to over 6 per cent in 1994-95 and expected to record a similar order of growth in the current year. Industrial production, which was virtually stagnant in 1991-92, increased by 6 per cent in 1993-94 and a further 8.2 per cent in 1994-95 and is growing at over 11 per cent in the first four months of 1995-96. Food grains production had declined in 1991-92, whereas in 1994-95, production attained a new record of 192 million tonnes. The annual rate of inflation which had touched nearly 17 per cent in 1991, is now down to around 8 per cent.

The turnaround in the external sector has been equally heartening. Exports, which had declined in dollar terms in 1991-92, grew by 20 per cent in 1993-94 and a further 18 per cent in 1994-95. However, during 1994-95, imports also increased by 21.5 per cent leading to a doubling of the trade deficit relative to the previous year. During the first seven months of the current fiscal year (April-October 1995) while exports have grown by 24.5 per cent, imports have risen by nearly 31 per cent, leading to sharp increase in the trade deficit. Since the start of the reforms, the share of foreign trade in GDP has risen from 14 per cent to 19 per cent in 1994-95 and is expected to rise to 21 per cent in the current year. This testifies to the substantial increase in the openness of our economy. The current account deficit on the balance of payments shrank from over 3 per cent of GDP in 1990-91 to barely 0.1 per cent of GDP in 1993-94, before rising again to 0.7 per cent of GDP in 1994-95. The current account deficit is expected to be in the order of 1.5 per cent of the GDP during 1995-96.

During 1995-96, apart from doubling of the visible trade deficit, on the capital account, debt service payments are expected to rise further in 1995-96 to over US$12 billion. At the same time, the strong surge in foreign portfolio investments, witnessed during much of 1993 and 1994, has slackened during 1995 in the wake of the crisis witnessed in some other emerging markets. Because of these
and other factors, there has been a significant draw down of foreign currency reserves from a level of 20.8 billion dollars at the beginning of this financial year to about 17.2 billion dollars at the end of November 1995. In the period since August, pressures on the balance of payments have also been reflected in a significant, nominal depreciation of the Rupee in relation to the US dollar following a period of more than 2 years of stability.

Notwithstanding some renewed pressure on the balance of payments, the Government has refrained from any tightening of the import régime. Instead, the authorities have relied on the market-determined exchange rate and monetary restraint to manage the balance of payments.

In this context of widening trade and current account deficits, deceleration in flows of portfolio investment, rising debt service, falling reserves and heightened volatility of capital flows and foreign exchange markets, it would, in our view, be neither prudent nor feasible to consider the general lifting of quantitative restrictions on imports at this stage.

As sustainable improvement is recorded in the balance of payments, Government’s endeavour will be to move towards a trade régime under which quantitative restrictions are retained only for environmental, social, health and safety reasons. The sequencing of the necessary policy changes should, in our view, be left to the judgement of the Government of the country concerned. For a country like India with a large population base and wide-disparities in income, growth and development which characterize our economy, premature and abrupt changes in the import policy in the area of consumer goods can have a disruptive impact on the balance of payments situation. Furthermore, the availability of adequate and efficient infrastructure in terms of ports, airports, highways etc. is also an important pre-requisite for supporting growing volumes of international trade. Hence the need for careful calibration of trade policy changes can not be overlooked.

In the sphere of trade policy, Government’s objective is to put in place a régime under which the domestic production base can be strengthened and expanded both to cater to domestic demand and to global export opportunities. It has been recognized that if Indian producers of goods and services whether in the primary, secondary or tertiary sectors are not allowed easy access to the best production inputs and technology, they will not be able to optimally upgrade their production capacity and compete effectively in the international market. At the same time, Government also recognizes the usefulness of gradually expanding access to imported consumer goods so as to improve the availability of essential items of mass consumption and to create a more competitive environment which will provide greater choice and better value for money to Indian consumers. The limitations of an inward-oriented and import substituting trade régime are now fairly well acknowledged. Such a trade régime not only hampers the efficiency of resource use and consequential growth but is also unsuccessful in ensuring a viable balance of payments. An important objective of Government’s policy therefore is to move the trade policy régime towards openness and to reap the full benefits of the expansion of international trade.

For fulfilling the above objectives, the Government has implemented a series of trade policy changes since June 1991 with a view to the constructive integration of the Indian economy with the rest of the world. We have now been able to put in place a market determined unified exchange rate régime and convertibility of the rupee first on the trade account in April 1993 and on the current account in April 1994. The most significant aspect of these policy changes is that they have been implemented in a gradual and sequential manner to ensure that there is no disruptive impact on the economy and the changeover is smooth. It was possible to achieve this because the Government was able to choose the sequence and timing of the changes based on its perceptions of the economy’s needs as well as its ability to build a democratic consensus.
Together with the above-mentioned macro level trade policy reforms, Government’s objective has also been to: (a) impart stability, predictability and transparency in the trade régime, (b) reduce or eliminate discretionary controls, (c) prune the negative list of imports and move steadily towards a régime of replacing licensing controls by fiscal controls and (d) gradual reduction in both the level and dispersion of tariffs.

In pursuance of these objectives, Government had announced a 5 year import-export policy for the period 1992-97 so that a stable régime of policies is available to the industry and trade to enable them to plan their economic activities in a longer perspective.

For imparting transparency, a number of changes have been introduced in the policy. The most significant step has been the recent listing, in October 1995, of the import policy treatment of various items on tariff line basis in accordance with the HSN Classification. Linking of the import control classification with the HSN Custom Tariff Classification will reduce ambiguities and provide a transparent framework to exporters and importers. Steps have also been taken to introduce automaticity in the issue of licences, progressive removal of actual user conditions and increasing the tradability of licences. These measures will help in further easing tax restrictions and in imparting greater import competition. During the year 1994-95, there has been significant increase in the number of items which are freely importable. In addition, a large number of consumer items covering 1,487 tariff lines whose import is otherwise restricted, are now allowed to be imported under freely tradable Special Import Licences.

Out of 11,587 tariff lines at the 8 digit level under the HS Classification, 6,463 lines are in the freely importable list while 1,487 lines are in the freely tradeable Special Import Licence list. Today virtually all items of capital goods, raw materials, intermediaries, components, consumable, spare parts, accessories, instruments and other goods are freely importable. As already mentioned, the import of consumer items has also been eased in a gradual manner and it is Government intention to steadily carry this process forward.

Along with the easing of quantitative restrictions, simultaneous measures for reducing tariffs have also been taken. Members of the Committee may be aware that prior to the Uruguay Round, only 3 per cent of India’s tariff lines were GATT bound. This figure in the post-Uruguay Round period has gone up to 62 per cent. The peak rate of tariff has been progressively reduced from 400 to 50 per cent. The average incidence of import duties has been brought down from 60.26 per cent in 1987-88 to 27 per cent in 1994-95.

Before concluding, Mr. Chairman, I would like to recall that this Committee has in the past encouraged India to continue with its policy of economic reforms. The Committee had also expressed its hope that with the completion of the Uruguay Round, India’s exports in general would gain greater market access, particularly for products in which we enjoy a comparative advantage. In this context, it needs to be reiterated that continued and improved market access in the markets of our major trading partners will be an important factor in our on-going effort at economic liberalization in general and trade liberalization in particular.

Finally, Mr. Chairman, we do hope that the Committee will appreciate the substantial trade liberalization measures already implemented by India since the last full consultations in March 1992. We also hope that the Committee will signal its support and understanding for India’s desire to proceed on the trade liberalization course in an autonomous and sustainable manner, keeping in view the many complexities involved in managing a continental size developing economy like ours.
ANNEX II

Statement by the IMF Representative

India has made substantial progress over the past four years towards reforming its economy, and the benefits are being seen in the form of a robust economic expansion, the containment of inflation, and a strengthened external position. Moreover, major strides have been made toward transforming the Indian economy from an inward-looking, heavily regulated economy to an increasingly dynamic, outward-oriented one. Nonetheless, the public sector deficit remains too high and much remains to be accomplished in the area of structural reform if India is to reach its full growth potential.

The economic recovery is now firmly established, with real GDP expected to increase 5 1/2-6 percent in 1995/96 (the fiscal year runs April 1 through March 31). The strength of the economic expansion stems from strong export and investment growth driven by a robust supply response to the Government’s reform program, in particular the sweeping away of the investment and import licensing regimes. Agricultural production has benefitted from a string of good monsoons, and food stocks have risen to record levels.

While inflation was reduced to around 7 percent in 1993/94, inflationary pressures re-emerged in 1994/95 as a result of a loosening of monetary conditions related to the build-up in international reserves. Monetary policy has been tightened considerably over the past year, however, and this has been followed by a reduction of inflation to about 9 percent. For a period in early 1995/96, this progress was threatened by a surge in central bank lending to the Government to well in excess of the agreed limit on such financing. However, more recently this lending has been reined in as interest rates on government securities have been raised, allowing an increase in the Government’s market borrowing. A tight grip will need to be retained on monetary policy in order to avoid a resurgence of inflationary pressures.

India’s fiscal situation remains a major concern. While the initial stabilization response to the 1990/91 crisis involved measures to curtail expenditures, progress toward deficit reduction in recent years has been slow. Although the deficit of the central government was lowered to 6.7 percent of GDP in 1994/95, the states’ deficit has been rising, and the overall consolidated deficit remained around 10 1/2 percent of GDP in 1994/95. Part of the explanation for the slow progress is that some reforms—such as cutting import tariffs and moving toward market-related interest rates—have had fiscal costs. Nonetheless, the high deficit puts a heavy burden on monetary policy in curbing inflation, raises interest rates, and crowds out private investment.

For 1995/96, the authorities are aiming to bring down the central government’s fiscal deficit further to 5 1/2 percent of GDP, relying mainly on buoyant revenue growth and controlling budgetary transfers to the states. So far, tax revenues have risen faster than budgeted, so that the overall fiscal performance has been broadly on track despite some expenditure overruns. However, new social spending initiatives and a public sector wage increase that have already been announced, other pre-election spending pressures, and a shortfall in divestment proceeds will make it difficult to stick to the deficit target. Firm management will be required to ensure budgetary objectives are achieved.

Looking beyond the present year, sustained fiscal consolidation requires fundamental reforms of government. This will need to involve determined efforts at all levels, in particularly the states. An overhaul of public expenditure management would help to improve efficiency and cut costs, while meeting more effectively critical needs in areas such as health, education and infrastructure. Inevitably, a substantial part of the adjustment will need to be accomplished through higher revenues. To this
end, efforts must continue to broaden the tax base, overhaul the system of sales taxes, and improve tax administration.

India's external position has recovered from the crisis of 1990/91. Foreign exchange reserves were around $19 billion at end-September 1995, around six and a half months of imports. Factors behind the buildup in reserves were a surge in private capital inflows following the liberalization of restrictions on inward foreign investment and the resumption of rapid export growth. While the scale of portfolio inflows has subsided since late 1994, consistent with a general reappraisal of emerging markets by investors in the wake of the Mexico crisis, it is encouraging that foreign direct investment has continued to increase.

On the trade front, export performance has been quite strong across the board for the last three years, spurred by the sustained real exchange rate depreciation since 1991. Since 1994/95, imports have also begun to grow rapidly, and the current account deficit is expected to widen to around 1 1/2 percent of GDP this year compared with 1/2 percent in 1994/95. The fast growth of imports is in large part due to heavy imports of capital goods and intermediate inputs spurred by the industrial recovery as well as a progressive reduction in import duty rates. Specifically, the average (import-weighted) tariff rate was lowered from 87 percent in 1990/91 to 27 percent in 1994/95, while the maximum tariff rate has been brought down from 400 percent to 50 percent.

For about two years since the unification of the exchange rate in March 1993, the rupee's value remained stable vis-à-vis the U.S. dollar, as upward pressure on the exchange rate was neutralized by central bank reserve accumulation. During 1995, by contrast, with the slowing of capital inflows and a widening of the current account deficit, there have been downward pressures on the value of the rupee. The rupee has declined by about 11 percent against the U.S. dollar since July, implying a depreciation of about 4 percent in real effective terms.

India has made substantial progress toward the elimination of exchange restrictions on current international transactions in recent years, notably liberalizing the treatment of most invisibles transactions. In August 1994, India accepted the obligations under the Fund's Article VIII. Nevertheless, a number of restrictions still remain in place, in particular related to the treatment of nonresident deposits, income transfers by non-resident Indians, the Indo-Russian debt agreement, bilateral payments agreements, and the transfer abroad of dividends by foreign investors in the consumer goods industries.

With continued prudent macroeconomic management, India's medium-term balance of payments prospects look sound. Both imports and exports should continue to grow rapidly as India becomes increasingly integrated into the global economy. In view of the heavy investment needs, the current account deficit is expected to widen further to the range of 2-3 percent of GDP, but such a path should be sustainable in view of the improved prospects for private capital inflows, including direct investment. The debt-service ratio would be lowered from 27 percent in 1994/95 to under 20 percent by the end of the decade, while international reserves would be maintained at comfortable levels.

Notwithstanding the recent achievements, realizing India's longer term growth potential still requires a second round of structural reforms to remove persistent obstacles that constrain the growth response. Main areas for attention include reform of the public enterprises, establishing an effective framework for private involvement in infrastructural development, agricultural reform, and liberalization of land and labor laws.

On the external front, the process of trade liberalization needs to be completed. Tariff levels are still high and need to be brought down further. Even more important, the quantitative restrictions on imports of consumer goods need to be eliminated, and replaced by tariffs at moderate levels.
Excessive protection has hindered the development of this important sector of the economy. Some phasing of this process may be appropriate in view of recent exchange market pressures, the potential volatility of private capital inflows, and the need to provide adequate time for adjustment of certain domestic industries. Nevertheless, the transition to a tariff-based import regime with no quantitative restrictions could reasonably be accomplished within a period of two years.

There should also be scope for continued capital account liberalization. Here the progress will need to be in tandem with success in strengthening India’s domestic financial markets and continuing progress toward a low-inflation macroeconomic environment. Finally, the remaining exchange restrictions on current international transactions should be eliminated as soon as possible.

In conclusion, while India’s recent economic development has been encouraging, the reform and adjustment efforts need to be sustained. Achieving the sustained high rate of growth necessary for more rapid progress in poverty alleviation will require continued fiscal consolidation and further bold reform initiatives. These will be the major economic challenges for India in the post-election period.