As requested, this note provides the IMF staff’s assessment of India’s macroeconomic conditions, prospects, and related policies for the Bihar Development Policy Loan/Credit being considered by the Executive Board of the World Bank. The thrust of our assessment remains the same as in the 2006 staff report.

**Growth remains strong, supported by domestic demand.** GDP growth has been stronger than expected, but is expected to moderate to 8¾ percent in 2007/08, from a high of 9½ percent last fiscal year. Headline inflation (WPI), at around 3 percent, is below the RBI’s near-term projections, although CPI inflation is higher. The rupee has appreciated by 10 percent in real effective terms y/y through September, but export growth remains strong at about 19 percent y/y. The external current account deficit is expected to widen to about 2 percent of GDP in 2007/08 (close to the projection in the 2006 staff report), against the backdrop of the strengthened rupee and slowing global growth. The deficit is comfortably financed by private inflows. Reserves exceed $260 billion (over 10 times short-term external debt), and external debt remains low (about 17 percent of GDP, as of end-2006/07). India’s financial markets have largely recovered from corrections during the summer’s credit-market turbulence, with the Sensex stock price index ranging near record highs. India’s strong economic performance is the consequence of steady reforms over the past 16 years, although more remains to be done to sustain that performance going forward.

**The immediate macroeconomic policy challenge is managing the effects of rapid capital inflows.** India’s bright economic prospects have driven inflows, which in turn have given rise to rupee appreciation and excess liquidity. In response, the authorities have intervened in the foreign exchange market, undertaken sterilization operations, and tightened controls on inflows while loosening those on outflows. The Reserve Bank of India has also withdrawn monetary accommodation, most recently by increasing reserve requirements. With WPI inflation remaining low, monetary policy could remain on hold for now, but in light of rapid monetary growth, vigilance for inflationary pressures is warranted.

**High government debt needs to be brought down, and fiscal space made for social and infrastructure spending.** General government debt remains very high—nearly 80 percent of GDP—limiting the room for priority spending. In 2007/08, staff expects a further decline in the on-budget general government deficit, to 5.7 percent of GDP (compared with a projection of 6¼ percent in the staff report), on the back of buoyant revenues and improved state-level finances. However, off-budget subsidies for food, fuel and fertilizer, projected to amount to about 1.0 percent of GDP this fiscal year, will slow consolidation, with upside risks to fuel subsidies if oil prices range higher (retail fuel prices are administered). For the medium term, comprehensive revenue and expenditure reforms are needed, including the streamlining of tax exemptions and better targeting of subsidies.

**In addition, greater progress in structural reforms is needed to tackle supply constraints, create jobs and further reduce poverty, and prepare the financial sector for a more open...**
**capital account.** Investments in health, education and infrastructure are essential. Trade tariffs could be further reduced to enhance competition and reduce the cost of imported inputs, building on the trend in recent years. In addition, steps to develop corporate bond and derivatives markets would facilitate investment (including infrastructure) and enable better risk management as the capital account opens further.

**Overall, prospects for India’s growth and macroeconomic stability remain good, and a higher growth path could be achieved by accelerating key reforms.** The staff report on the 2006 Article IV consultation with India was published on February 15, 2007.